

CLIENT ALERT

Creditors' Rights and Bankruptcy Practice Group

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Supreme Court Rules that Chapter 13 Trustees Must Refund Undistributed Postpetition Earnings to the Debtor Following Conversion

Today, in the case of Harris v. Viegelahn, 575 U.S. ___ (2015), the Supreme Court held that, following a debtor's conversion of a Chapter 13 bankruptcy case to Chapter 7, a debtor is entitled to the return of any postpetition wages not yet distributed by the Chapter 13 Trustee.

The treatment of a debtor's postpetition wages in bankruptcy generally depends on whether the debtor is proceeding under Chapter 13 of the Bankruptcy Code (in which the debtor retains his/her assets subject to a court-approved plan for the repayment of debts) or Chapter 7 (in which the debtor's assets are immediately liquidated and the proceeds distributed to creditors by a chapter 7 Trustee). *Id.* at 1.

In a Chapter 13 proceeding, postpetition wages earned by the debtor are "[p]roperty of the estate" under 11 U. S. C. § 1306(a), and may be collected by the Chapter 13 trustee for distribution to prepetition creditors under 11 U.S.C. § 1322(a)(1). *Id.* In a Chapter 7 proceeding, the debtor's postpetition earnings are not estate property; instead, they belong to the debtor. *Id.* The Bankruptcy Code permits the debtor to convert a Chapter 13 proceeding to one under Chapter 7 "at any time," and upon such conversion, the service of the Chapter 13 trustee terminates. *Id.*

Charles E. Harris III filed a Chapter 13 bankruptcy petition in February 2010. *Id.* at 5. At the time of his bankruptcy filing, Harris was indebted to multiple creditors and had fallen \$3,700 behind on mortgage payments to Chase Manhattan ("Chase"). *Id.* Harris' confirmed Chapter 13 plan provided that he would immediately resume making monthly mortgage payments to Chase and \$530 per month would be withheld from his postpetition wages and remitted to the Chapter 13 trustee, who would distribute (i) \$352 per month to Chase to pay down Harris' outstanding mortgage debt, and (ii) \$75.34 per month to Harris' other secured lender. *Id.* Once Chase and the other secured creditor were paid in full, the Chapter 13 Trustee was to begin distributing funds to Harris' unsecured creditors. *Id.*

Harris quickly fell behind on his mortgage payments under his Chapter 13 plan, and in November 2010, Chase obtained relief from the automatic stay to foreclose on Harris' home. *Id.* at 4. Following the foreclosure, the Chapter 13 Trustee continued to receive \$530 per month from Harris' wages, but stopped making the payments earmarked for Chase. *Id.* As a result, funds formerly reserved for payment of Chase's claim accumulated in the Chapter 13 Trustee's possession. *Id.*

On November 22, 2011, Harris converted his Chapter 13 case to a Chapter 7 case. *Id.* Ten days later, on December 1, 2011, the Chapter 13 Trustee disposed of the accumulated funds by giving \$1,200 to Harris' counsel, paying herself a \$267.79 fee, and distributing the remaining money to the other secured creditor and six of Harris' unsecured creditors. *Id.* at 4-5.

Harris moved the Bankruptcy Court for an order directing refund of the accumulated wages that the Chapter 13 Trustee had given to his creditors asserting that the Chapter 13 Trustee lacked authority to disburse funds

to creditors once the case was converted to Chapter 7. *Id.* at 5. The Bankruptcy Court granted Harris' motion, and the U.S. District Court affirmed. *Id.* The Fifth Circuit reversed. *Id.*¹

Writing for a unanimous Court, Justice Ginsburg wrote:

By excluding postpetition wages from the converted Chapter 7 estate, [section] 348(f)(1)(A) removes those earnings from the pool of assets that may be liquidated and distributed to creditors. Allowing a terminated Chapter 13 trustee to disburse the very same earnings to the very same creditors is incompatible with that statutory design. We resist attributing to Congress, after explicitly exempting from Chapter 7's liquidation-and-distribution process a debtor's postpetition wages, a plan to place those wages in creditors' hands another way.

Id. at p. 7.

The Court explained that if it is determined that a debtor converts in bad faith—for example, by concealing assets in “unfair manipulation of the bankruptcy system,” section 348(f)(2) penalizes bad-faith debtors by making their postpetition wages available for liquidation and distribution to creditors. *Id.* However, *Harris* involved a voluntary, good faith conversion.

The Court explained that shielding a Chapter 7 debtor's postpetition earnings from creditors enables the “honest but unfortunate debtor” to make the “fresh start” the Bankruptcy Code aims to facilitate. *Id.* at 7. Rejecting the stated concern that debtors would receive a “windfall” if they could reclaim accumulated wages from a terminated Chapter 13 trustee, Justice Ginsberg explained that a “debtor's chance of having funds returned” is “dependent on the trustee's speed in distributing the payments” to creditors.

The Court explained that: “Creditors may gain protection against the risk of excess accumulations in the hands of Chapter 13 trustees by seeking to include in a Chapter 13 plan a schedule for regular disbursement of funds the trustee collects.” *Id.* at 11. Therefore, creditors of Chapter 13 debtors should take note of *Harris* and be sure that all Chapter 13 plans include a regular schedule of payments of postpetition earnings to avoid nonpayment based upon conversion.

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¹Some courts had previously relied upon the Ninth Circuit case of *Nash v. Kester (In re Nash)*, 765 F.2d 1410 (9th Cir. 1985) to hold that the debtor did not have a right to the return of postpetition earnings following conversion, although *Nash* was actually a *dismissal* case.