

Judge Alito on Bankruptcy

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The agility of the Supreme Court in deciding bankruptcy issues depends upon a number of issues, including the justices' understanding of the Code and its overall policies, whether the justices are "strict constructionists", whether they use legislative history, and whether they lean toward the sentiments of debtors or creditors. Judge Samuel Alito, nominated by President Bush to serve on the Court, has written or participated in writing a number of Third Circuit decisions that speak to these issues.

Does Judge Alito understand the bankruptcy system and its policies?

For the most part, yes. For example, in *Belcufine v. Aloe*, 112 F.3d 633 (3d Cir. 1997), employees of a chapter 11 debtor sued officers under a Pennsylvania statute that appeared on its face to make the officers personally liable for unpaid pre-petition vacation and retirement benefits. In turn, the officers held potential indemnification claims against the debtor company for these amounts. The lower court found that the automatic stay precluded the debtor from paying the claims and that as a result, the employees could not sue the officers. The district court and the Third Circuit affirmed, finding that the federal bankruptcy Code preempted Pennsylvania law on this issue.

Writing for the Third Circuit, Judge Alito held that the bankruptcy court had "related to" jurisdiction over the suit by the employees (which had been removed from state to federal court) despite the fact that the suit was not against the debtor, because the indemnification claims could have an effect on the bankruptcy estate. On the substantive issue, the state statute in question provided that officers were liable for benefits that were "due and payable." Judge Alito held that because the automatic stay precluded their payment at this time, these claims were not technically "due and payable."

He bolstered his statutory interpretation with the two policy arguments. First, the goal of the Pennsylvania statute is to give officers an incentive to pay benefits while the company still has funds, and to discourage officers from diverting funds. Since management no longer had the right to decide whether to pay or not pay these claims, they should not be personally liable for them. He also reasoned that given the frequency and duration of chapter 11 cases, upholding the state statute in this context could discourage firms from setting up in Pennsylvania. A dissenting opinion claimed that the state statute was clear on its face and required finding the officers personally liable.

Showing further familiarity with chapter 11, in *In re Channel Home Centers Inc*, 989 F.3d 682 (3d Cir. 1993), Judge Alito affirmed decisions of the bankruptcy and district courts, granting a large chapter 11 debtor's motion to extend the time to assume or reject a commercial real estate lease, even though section 365(a)(4) explicitly disallows all extensions after the one granted during the first 60 days of the case. The section states that extensions must be granted "within such additional time as the court,

for cause, within such 60-day period, fixes....” Judge Alito stated that even though section 365(d)(4) explicitly states that a court may not extend the deadline outside the initial 60 days:

even unambiguous statutory language need not be followed in those rare cases [in which] a literal application of the statute will produce a result demonstrably at odds with the intentions of its drafters.

Id. at 687 (*citations omitted*). Judge Alito analyzed legislative history in reaching this result as well as numerous decisions of other courts. Judge Hutchinson dissented, again based on what he saw as the clear language of the statute.

In re G-I Holdings Inc., 385 F.3d 313 (3d Cir. 2004), Judge Alito recognized that the appointment of a chapter 11 trustee is a last resort. He affirmed a decision denying a motion to appoint a chapter 11 trustee. Recognizing that whether to appoint a trustee is a factual issue, the judge found no abuse of discretion where the moving party alleged self-dealing but did not prove it. He also rejected a technical argument by the movant, a committee of asbestos claimants. The committee argued that prior case law states that there is a strong ‘presumption’ against appointing a trustee, but that the use of the word ‘presumption’ implied that it could be rebutted. They claimed they had done so and Judge Alito held that the language did not suggest a true ‘presumption’ in the legal sense.

Judge Alito also has decided several issues involving bankruptcy claims. In *Commonwealth of Pennsylvania v. Convoy*, 24 F.3d 568 (3d Cir. 1994), Judge Alito upheld a decision holding that response costs incurred by an environmental agency for clean-up costs are administrative expenses in a chapter 11 case. Since a debtor cannot abandon hazardous waste, these are necessary costs of administering the estate. In another case dealing with environmental clean-up costs, Judge Alito recognized clean-up costs as legitimate claims even when contingent. *AL Tech Steel Corp v. Allegheny Int’l Credit Corp.*, 104 F.3d 601 (3d Cir. 1997). In *In re Hechinger Investment Co. of Delaware*, 298 F.3d 219 (2002), Judge Alito affirmed the district court, which affirmed the bankruptcy court, in holding that “stay on” benefits owed to former employees were legitimate administrative claims only to the extent that they were attributable to post-petition services.

Finally, *In re Federal Mogul Global, Inc.*, 348 F.3d 390 (3d Cir. 2003), he showed knowledge of a bankruptcy judge’s broad discretion on professional compensation issues. In *Federal Mogul*, an equity security committee appointed in a possibly insolvent case moved for the appointment of a financial advisor and the bankruptcy court capped the fees at \$30,000 a month. The committee appealed, claiming that the court had no right to impose the fee cap. The district court affirmed. In a long opinion outlining the bankruptcy court’s authority to limit fees in various ways, Judge Alito held that the court had the right to cap the fees, but remanded the case for fact-finding on the issue of whether the debtor was insolvent, and also whether its financial advisors had information it could share with the committee.

Judge Alito's understanding of the bankruptcy system does have its limits, however. In *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 304 F.3d 316 (3d Cir. 2002), the Third Circuit found that a creditors' committee lacked standing to bring a fraudulent transfer actions after a liquidating chapter 11 debtor refused to do so. This decision was based upon Section 544(b)(1)'s explicit language that "the trustee may avoid..." a transfer, but the lack of specific statutory language recognizing a committee's right to do so. This opinion ran counter to most others on the subject and was hotly criticized by bankruptcy commentators. It also attracted the attention of many amici brief-writers and other parts of the bankruptcy community.

Shortly after issuing the opinion, the Third Circuit reversed itself, withdrawing its prior opinion and holding that indeed the committee could bring the action. *Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery*, 330 F.3d 548 (3d Cir. 2003). The new opinion recognized that these avoidance actions were valuable estate assets and that there was little reason not to allow another estate fiduciary to pursue them for the benefit of creditors. Judge Alito and a few others dissented from the corrected opinion on a strict construction grounds, not seeming to recognize that this could result in either no recovery for creditors for these assets or the precipitous appointment of a chapter 11 trustee where none was otherwise required.

Similarly, *In re Continental Airlines*, 75 F.3d 868 (3d Cir. 1996), he was the lone dissenter from an opinion in which the majority found a motion for adequate protect and to lift the stay had been made equitably moot by substantial consummation of the debtor's plan. He called the majority decision 'disturbing,' claiming the movants were given no right to an adjudication by an Article III court on various issues, though the motions did appear to be mooted by confirmation.

Is he a strict constructionist?

Yes and no. Both *Belcufine*, and *Channel Home*, discussed above, show a willingness to recognize the practice and realities of chapter 11 over the desire to follow a literal Code reading. *Channel Home* even suggests that he will ignore apparently clear statutory language in the Code where that is clearly at odds with chapter 11 goals. His dissent in *Cybergenics* (above) shows the opposite tendency, and is highly textualist.

Judge Alito showed strict constructionist sentiments in another case in which he reversed a decision of the district court allowing the debtors to hire their former accountants, who held claims against the debtors. *United State Trustee v. Price Waterhouse (In re Sharon Steel)*, 19 F.3d 138 (3d Cir. 1994). Judge Alito said the statute against hiring professionals who were not disinterested was clear on its face. Judge Alito said that "bankruptcy courts cannot use equitable principles to disregard unambiguous statutory language," and that if Congress wanted to allow debtors to hire professional who were not disinterested in some circumstances, it would need to say so.

Similarly, in *In re Hechinger Investment Co.*, 335 F.3d 243 (2003), Judge Alito reversed a decision of the district court, which upheld a bankruptcy court decision. He held that the section 1146(c) exemption from transfer tax for a sale made “under a confirmed plan of reorganization” did not apply to a pre-plan transfer. In finding that the word ‘under’ in this context requires an existing plan, the judge also noted that tax exemptions should be strictly construed in favor of the taxing authority. He rejected the dissent’s argument that construing section 1146(c) more broadly would best implement the policies of chapter 11. In deciding this case, he also held that sovereign immunity did not bar his jurisdiction over the case.

Does he use legislative history and if so, when?

In two of these decisions, he engages in extensive discussions of legislative history. First, in *In re Channel Home Centers Inc*, 989 F.3d 682 (3d Cir. 1993), he reviewed the legislative history of several portions of the Code in deciding whether the 60-day period to assume or reject a commercial real estate lease could be extended beyond the initial 60-day period. Finding none of this history helpful, he made his decision based upon common sense and on the practicalities of chapter 11 practice. In *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990), he did an extensive review of legislative history in concluding that no creditor could have his or her claim equitably subordinated without committing wrongdoing, an issue about which the statute was silent.

Does he favor states rights?

As discussed above in *Belcufine*, he did not favor a state statute over the Bankruptcy Code, though there was room to do so. In *In re Four Three OH, Inc.*, 256 F.2d 107 (3d Cir. 2001), however, he showed deference to a town board that refused to allow a Hindu Temple (which purchased property from a chapter 11 debtor) to move into a former nightclub. The Hindu temple purchased a chapter 11 debtor’s real estate, conditioned upon the purchaser obtaining a zoning variance to use it as a place of worship. A town planning board denied the variance, delayed the proceeding, and after an earlier appeal, granted the variance but imposed the additional condition that the Temple hire off-duty police to direct traffic on the property. The bankruptcy found the condition arbitrary and the district court and the Third Circuit affirmed. Judge Alito dissented, finding that the town board was not arbitrary in having traffic concerns (even though the temple had a smaller occupancy than the nightclub). Judge Alito also claimed that the question of whether the off-duty police condition was appropriate was not before the court, since the condition was imposed only after this appeal was filed with the district court.

Though not strictly a states rights issues, he appears to be protective of the claims taxing authorities (*Burden v. United States*, 917 F.2d 115 (3d Cir. 1990); *In re Hechinger Investment Co.*, 335 F.3d 243 (2003)), as well programs supported by taxes, such as one

that pays for the education of doctors who agree to serve in underrepresented regions. *Mathews v. Pineo*, 19 F.3d 121(1994) (discussed below).

Does he favor debtors or creditors?

He has shown no favoritism toward either side of this issue. In business cases, he has decided in favor of reorganized debtors in *Belcufine*, *Channel Home Centers*, *Hechinger Investments*, and *AL Tech*, and favored the requests of various creditors, including the EPA, in *Continental Airlines*, and *In re Convey*. In *Four Three OH*, he came out in favor of a party outside the bankruptcy system, a municipality.

In individual bankruptcy cases, he has ruled in favor of creditors and debtors equally, refusing to allow a special form of student loan to be discharged and refusing to automatically subordinate tax penalties in the creditor-friendly cases, and recognizing an IRA exemption and allowing lender liability claims to go forward in the debtor-friendly cases.

Cases for the creditor

In *Mathews v. Pineo*, 19 F.3d 121(1994), the debtor received a medical school scholarship from an organization that places doctors in underrepresented areas. Under the agreement, doctors must fulfill a three-year residency in the state in question or pay triple what they borrowed. Ms. Matthews was to work in South Dakota but never did, and owed \$400,000 in student loans as a result. A separate federal statute allows discharge of this debt in bankruptcy only if not doing so would be unconscionable. The bankruptcy court was alarmed by the size of the debt and discharged part of it. The district court affirmed, but the Third Circuit reversed. Writing for the court, Judge Alito uses dictionary and common definitions to interpret the word “unconscionable,” deciding that requiring the debtor to close her practice in Pennsylvania, leave her home, separate from her husband, and uproot her children was not unconscionable. Judge Alito noted that ordinary taxpayers subsidize these medical school programs.

In *Burden v. United States*, 917 F.2d 115 (3d Cir. 1990), the bankruptcy court equitably subordinated tax penalties in a chapter 13 case without an analysis of the equities of the case. Penalties are automatically subordinated in a chapter 7 case under section 726(a)(4), but not in chapter 13. Courts use their equitable power to subordinate such claims in chapter 13 cases. The district court affirmed the ruling, but the Third Circuit reversed and remanded, holding that one could subordinate such claims but only if the equities of the case justified doing so, adding that it was not necessary for the government to engage in wrongdoing in order to subordinate the penalty claims. Judge Alito dissented in part, stating that the legislative history of section 510(c) shows that no claim can be equitably subordinated unless the claimant has engaged in inequitable conduct and that this applies equally to tax penalties. In his reasoning, he disagrees with the sentiment that penalties are not equal to debts resulting from an actual pecuniary loss.

Cases for the debtor

In *Kaplan v. First Options of Chicago, Inc.*, 143 F.3d 807 (3d Cir. 1998), Judge Alito allowed an individual to pursue lender liability claims that had been dismissed by the bankruptcy court, a decision affirmed by the district court. The debtor, Kaplan, worked as an options trader on the Philadelphia stock exchange. He traded through MKI a market maker on the exchange, who contracted with First Options for various forms of support. First Options guaranteed MKI's exchanges. MKI became behind on its obligations to First Options and MKI (and Kaplan) did a workout agreement in which Kaplan agreed to give First Options his tax returns. When Kaplan missed a meeting with First Options, and was way behind on his financial obligations to First Options, he liquidated and closed down MKI's accounts. After Kaplan filed for bankruptcy, First Options sought the tax returns pursuant to its proof of claim and the agreement and Kaplan filed counter-claims for lender liability. The bankruptcy court granted the tax return to First Options and dismissed the debtor's counterclaims. The district court affirmed. Judge Alito reversed, analyzing the law of consideration, finding a good faith obligation in every contract, and examining the parties' contract in detail. Based on this analysis, he concluded that the case against First Option should go to trial and remanded the case back. In so doing, he distinguished or disagreed with a body of Seventh Circuit case law on implied good faith in contracts.

In *Orr v. Yuhas (In re Yuhas)*, 104 F.3d 612 (3d Cir. 1997), a New Jersey debtor sought a declaration that his IRA was not part of his bankruptcy estate. All three courts, including the Third Circuit, agreed. Judge Alito interpreted Section 541(a)(1) and a New Jersey statute that explicitly stated that IRAs were "excluded from the estate in bankruptcy."