

**Bankruptcy Circuit Update**  
*Featuring cases from January 2016*

**Second Circuit**

***Garfield v. Ocwen Loan Servicing, LLC,***  
**--- F. 3d ---, 2016 WL 26631 (January 4, 2016)**

The Second Circuit reversed the judgment of the district court dismissing claims brought by debtor Donna Garfield (“Garfield”) under the Fair Debt Collection Practices Act (“FDCPA”) regarding the collection of a debt discharged in bankruptcy and remanded the case with instructions to reinstate the FDCPA claims.

Garfield had obtained a mortgage from the predecessor-in-interest of Ocwen Loan Servicing, LLC (“Ocwen”), Litton Loan Servicing L.P. and became personally obligated on a mortgage loan. Garfield failed to make payments on the mortgage loan and filed for Chapter 13. During the bankruptcy proceedings, Ocwen acquired Garfield’s mortgage loan. Pursuant to her bankruptcy plan, Garfield paid the arrears on her mortgage loan in monthly installments during the bankruptcy proceeding and later obtained a discharge of her entire personal obligation for the mortgage loan. However, Garfield also agreed to continue paying Ocwen on a monthly basis to prevent foreclosure of the mortgaged property. Garfield only made one such payment following the discharge of her bankruptcy, and Ocwen later demanded that Garfield pay an amount equal to both her conceded arrears for post-bankruptcy monthly payments and the mortgage loan arrears that had been discharged.

Garfield then filed her FDCPA complaint in district court, alleging that Ocwen’s attempt to collect the arrears on her discharged mortgage loan violated several provisions of the FDCPA. Garfield also claimed that Ocwen violated the FDCPA in the manner it attempted to collect the post-bankruptcy monthly mortgage payments, alleging in part that Ocwen violated subsection 1692e(11), which requires a so-called “mini-Miranda warning,” during conversations with a debtor. The district court dismissed Garfield’s complaint and held that the Bankruptcy Code provides the exclusive remedy for Garfield’s claim that Ocwen attempted to collect an allegedly discharged debt. The district court also held that, even if the Bankruptcy Code does not broadly preclude all FDCPA claims for conduct that violates the discharge injunction, Garfield’s particular FDCPA claims conflicted with the Code’s remedies and were therefore precluded.

The Second Circuit began its analysis by discussing the applicability of implied statutory repeal, which can occur when a later enacted statute creates an irreconcilable conflict with an earlier statute. In such circumstances, the question before a court is whether the later statute, by implication, has repealed part of, or the entirety of, the earlier statute. After noting that repeal by implication is generally disfavored, the Second Circuit further stated that in cases where the later statute is the Bankruptcy Code, a distinction must be made between claims brought under the earlier statute during the pendency of a bankruptcy proceeding, and those brought after a discharge. Though there is a circuit split on this issue, the Second Circuit had previously held that the FDCPA does not authorize suits during the pendency of bankruptcy proceedings. After

reviewing the precedent from the various circuits, the Second Circuit held that the Bankruptcy Code does not broadly repeal the FDCPA for purposes of FDCPA claims based on conduct that would constitute alleged violations of the discharge injunction. The Court found no irreconcilable conflict between the post-discharge remedies of the Bankruptcy Code and the FDCPA and also found no reason to assume that Congress did not expect these two statutory schemes to coexist in the post-discharge context.

After holding that the Bankruptcy Code does not impliedly repeal all FDCPA provisions to remedy conduct that violates the discharge injunction, the Second Circuit then considered whether it might instead impliedly repeal specific provisions invoked to remedy such conduct. The Court first turned to Ocwen's argument that Garfield's claim regarding Ocwen's failure to provide a so-called "mini-Miranda" warning in its initial communication irreconcilably conflicts with the Bankruptcy Code's post-discharge remedies. The Second Circuit held that Ocwen's communication, even without a mini-Miranda warning, was an attempt to collect a discharged debt in violation of both the Bankruptcy Code and the FDCPA; there was thus no conflict between the two statutes to be resolved in this instance. The Court then briefly considered several claims under specific provisions of the FDCPA, and similarly held that none of Garfield's individual FDCPA claims conflicted with the discharge injunction under the Bankruptcy Code. The Second Circuit therefore reversed the judgment of the district court and remanded the case with instructions to reinstate Garfield's FDCPA claims against Ocwen.

***Ortegón v. Giddens, as Trustee for the SIPA Liquidation of Lehman Brothers, Inc.,***  
**---Fed. Appx. ---, 2016 WL 125268 (January 12, 2016)**

The Second Circuit affirmed the district court's judgment affirming the bankruptcy court's order granting the motion for summary judgment on a breach of contract claim asserted by Mary Ortegón ("Ortegón") in favor of the trustee, James W. Giddens. Ortegón claimed that Lehman Brothers, Inc., ("LBI") breached its contract with her by failing to pay her a \$350,000 bonus, notwithstanding the undisputed facts that LBI terminated its contractual relationship with Ortegón before she began any work contemplated by the contract, and that LBI terminated this relationship prior to the official start date for performance contemplated by that contract.

Relying on principles of contract interpretation, the Second Circuit held that the courts below correctly rejected Ortegón's argument that she was entitled to the \$350,000 minimum bonus because the contract clearly stated that the bonus was part of Ortegón's compensation for her performance, and not a signing bonus to which Ortegón became entitled simply by agreeing to work for LBI. Ortegón conceded that she never "began work" at LBI because she never commenced any duties related to the position she had been offered. As such, because Ortegón did not become an employee of LBI and never commenced performance under the contract, the Second Circuit held that Ortegón never had any right to the bonus she sought, and LBI did not breach any contract when it refused to give it to her.

***Morse v. Rescap Borrower Claims Trust (In re Residential Capital, LLC),***  
**---F.3d ---, 2016 WL 277732 (January 22, 2016)**

The Second Circuit affirmed the judgment of the district court disallowing and expunging the claim of Gregory C. Morse (“Morse”), proceeding pro se, against debtor Rescap Borrower Claims Trust (“Rescap”) on the grounds that Morse’s proofs of claim failed to state a basis for liability against Rescap.

Deferring in large part to the reasoning of the bankruptcy court below, the Second Circuit held that Morse failed to state claims for fraud under both Texas common and statutory law, or for violations of the Racketeer Influenced and Corrupt Organizations Act, the Texas Mortgage Broker License Act, the Texas Mortgage Banker Registration and Residential Mortgage Loan Originator License Act, or the Texas Deceptive Trade Practices Act.

The Second Circuit then briefly considered Morse’s procedural claims that that the bankruptcy court’s (i) refusal to consider certain evidence, (ii) refusal to adjourn a hearing on Rescap’s objections to his proofs of claim, and (iii) ex parte communications with Rescap’s counsel deprived him of due process. The Second Circuit first held that Morse’s evidentiary claim was meritless, finding that the bankruptcy court did not err in refusing to consider certain evidence because Morse violated Fed. R. Bankr. P. 9014(b) by failing to serve these documents on Rescap in accordance with Fed. R. Civ. P. 5(b). The Second Circuit also held that the bankruptcy court acted within its discretion in denying Morse an adjournment of the hearing on Rescap’s objections because the bankruptcy court had afforded Morse an opportunity to appear via telephone, which he failed to do; additionally, Morse was not prejudiced by the challenged denial because, as a consequence of his non-appearance at the hearing, Rescap was also prevented from orally arguing its objections. The Second Circuit then addressed Morse’s final procedural complaint, which was based on an email exchange in which the bankruptcy court instructed Rescap’s counsel to request that Morse provide it with copies of his evidence, in an apparent effort to ensure that those documents could be properly considered. The Second Circuit found that the emails were purely administrative and did not indicate that the bankruptcy court engaged counsel in any substantive discussion of the case. Additionally, even if this limited scheduling communication would fall within the prohibition on ex parte communications regarding “matters affecting a particular case or proceeding,” the Second Circuit held that Morse had failed to show any prejudice resulting from this exchange. As such, the Second Circuit affirmed the judgment of the district court.

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## **Third Circuit**

***In re Radnor Holdings Corporation,***  
**2015 WL 8479679 (3rd Cir. Dec. 10, 2015)**

The Third Circuit affirmed the decision of the United States District Court for the District of Delaware, approving the final fee application of the Debtors' attorneys. After filing for bankruptcy protection in 2006, the Debtors applied to the Court for an order authorizing the retention of Skadden, Arps, Slate Meagher & Flom ("Skadden") as its lead counsel. In the application, Skadden disclosed that it represented Tennenbaum Capital, an equity holder of the Debtors, in matters wholly unrelated to the bankruptcy cases. The Bankruptcy Court considered the application and found that Skadden's relationship with Tennenbaum Capital was not a disabling conflict of interest. Shortly thereafter, Tennenbaum Capital purchased all of the Debtors' assets. Six years later, Skadden filed its final fee application, to which the appellant objected on the basis that Skadden's prior Tennenbaum-related disclosures failed to comply with Bankruptcy Rule 2014. The Bankruptcy Court disagreed and approved the fee application, finding that Skadden had not misrepresented its relationship with Tennenbaum. The District Court and the Third Circuit affirmed.

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## **Fifth Circuit**

***In re Cavu/Rock Properties Project I, L.L.C.,***  
**--- F. Appx. ---, 2016 WL 43677 (5th Cir. Jan. 4, 2016) (per curiam).**

In this matter, the Fifth Circuit examined whether res judicata or judicial estoppel prevent significantly different valuations of the same property under §1129 and § 506 of Chapter 11 of the Bankruptcy Code.

Cavu/Rock engaged Gold Star to construct improvements on real estate located in Bakersfield, California. Before Gold Star completed the improvements, Cavu/Rock filed a Chapter 11 bankruptcy petition, and Gold Star subsequently asserted a mechanic's lien over the improvements. Cavu/Rock then brought an adversary proceeding challenging Gold Star's lien and claim. In the bankruptcy proceeding, as part of feasibility projections for its reorganization plan pursuant to 11 U.S.C. § 1129, Cavu/Rock had estimated the value of the Bakersfield property was between \$8 million and \$10 million. In the adversary proceeding, however, Cavu/Rock valued the same property between \$2.1 million and \$2.6 million under 11 U.S.C. § 506.

Affirming the lower court decision, the Fifth Circuit reasoned that because § 1129 and § 506 have different purposes, Cavu/Rock had not assumed inconsistent positions by presenting significantly different valuations of the Bakersfield property. Cavu/Rock's valuation under § 1129 was simply a set of projections to support the reorganization plan feasibility and could thus take into account funds to be realized by continued *future* development of the property and the *future* lot sales. At the same time, Cavu/Rock's valuation under § 506 was used to provide for the division of allowed claims and must therefore be based on realistic measures of *present* worth. Moreover, a bankruptcy court's acceptance of a § 1129 feasibility plan does not constitute a final judgment on the property's value under § 506. Thus, the Fifth Circuit held that the doctrines of judicial estoppel and res judicata did not bar Cavu/Rock from presenting two widely different valuations of the same property.

The court also affirmed the bankruptcy court's finding that Gold Star's mechanic's lien was premature and invalid because, at the time, California law required the lien to be filed only after all work had been performed, excused, or otherwise discharged under the contract. Finally, the court upheld the lower court's (1) denial of a motion to transfer venue, (2) determination of the amount of Gold Star's unsecured claim, and (3) order that each party bear its own costs.

***Hernandez v. Larry Miller Roofing, Inc.*,  
--- F. App'x. ---, 2016 WL 67217 (Jan. 5, 2016).**

The Fifth Circuit applied the specificity test to determine whether release language in a reorganization plan was sufficient to release a creditor's Fair Labor Standards Act ("FLSA") claim against an officer of the debtor in this matter.

Plaintiff Hernandez filed a claim for unpaid overtime wages in violation of the FLSA against debtor Larry Miller Roofing, Inc. ("LMRI") and its officer, Larry Miller (individually). The action was stayed when LMRI filed a Suggestion of Bankruptcy. Ultimately, the district court approved a reorganization plan for LMRI and, in accordance with the plan, Hernandez received payment of a portion of his FLSA claim. Thereafter, the district court reopened Hernandez's case against Miller individually but granted summary judgment in favor of Miller, reasoning that the release language of the reorganization plan released Hernandez's claim against both LMRI and Miller. Reasoning that LMRI and Miller were jointly and severally liable for any FLSA violation and assuming (without deciding) that a reorganization plan can release FLSA claims, the Fifth Circuit examined whether the plan language effectively released Hernandez's claim against Miller.

The Circuit Court reversed the district court after applying the specificity test developed in *Republic Supply Co. v. Shoaf*, 815 F.2d 1046, 1049 (5th Cir. 1987), *Applewood Chair Co. v. Three Rivers 150 Planning & Development District*, 203 F.3d 914, 919 (5th Cir. 2002), and *FOM P.R. S.E. v. Dr. Barnes Eyecenter, Inc.*, 255 F. App'x. 909, 912 (5th Cir. 2007). Because Miller was not identified by name in the release language (as in *FOM*), the release contained only boilerplate language (as in *Applewood*), and the plan did not make any mention of anything relating to a FLSA claim or employment law violation (as in *Shoaf*), the court concluded that the release language found in LMRI's reorganization plan lacked specificity to release Hernandez's

claim against Miller. The fact that Miller was an officer of LMRI was insufficient to change this conclusion. Accordingly, the court held that Hernandez could proceed in his claim against Miller.

The court also held that neither *res judicata* nor the fact that Hernandez had already received some compensation from LMRI on the underlying FLSA claim served to bar Hernandez from proceeding on his FLSA claim.

***In re Tusa-Expo Holdings, Inc.*,  
--- F.3d ---, 2016 WL 360795 (Jan. 28, 2016).**

In this case, the Fifth Circuit examined whether a creditor's first-priority security interest in the proceeds of a debtor's accounts receivable survived various transfers from the debtor's customers to a lockbox (i.e., deposit account) and then from the lockbox ultimately to the debtor's operating account.

Originally, debtor Tusa-Expo Holdings, Inc. ("Tusa") granted creditor Knoll, Inc. ("Knoll") a first-priority security interest in substantially all of Tusa's present and after-acquired assets, including its accounts receivable. Subsequently, Tusa granted Textron Financial, Inc. ("Textron") a first-priority security interest in all of Tusa's current and after-acquired assets, including Knoll's collateral, and Textron and Knoll entered a separate subordination agreement, under which Knoll retained a first-priority security interest in specified accounts receivable and a second-priority security interest in all of Tusa's current and after-acquired assets. Under the various agreements, Tusa's accounts receivable were required to be paid directly into a bank deposit account (the "lockbox") controlled by Textron. Textron would withdraw deposited funds on a daily basis from the lockbox and apply them to increase the available credit on Tusa's revolving loan. On request by Tusa, Textron would advance new revolving loan funds to Tusa's operating account; Tusa would then use these advanced funds to pay down the debt it owed to Knoll.

Trustee for Tusa brought an adversary action seeking to avoid transfers made to Knoll on the basis that they qualified as preferences under 11 U.S.C. § 574(b). At issue was whether the transfers met the requirements of § 574(b)(5), requiring a trustee to establish that the transfer enabled the creditor (Knoll) to receive more than it would have received upon liquidation under Chapter 7 before the trustee can avoid the transfer. Under the *El Paso Refinery* analysis (used to determine whether the requirements of § 574(b)(5) have been met), a creditor who recovers its own collateral will be deemed to have received no more than it would have under Chapter 7 liquidation (and thus, the transfer is not a preference). Here, it was crucial whether Knoll received payments from its own collateral or from Textron's collateral. The court had to determine whether Knoll's first-priority security interest in proceeds from Tusa's accounts receivable survived the following transfers:

- (1) From Tusa's customers into the lockbox (controlled by Textron),
- (2) Out of the lockbox by Textron to apply them to Tusa's available credit, and
- (3) By Textron to Tusa's operating account.

As to transfers from Tusa’s customers to the lockbox, the trustee argued that because the customer payments constituted a transfer of *money*, Knoll’s first-priority security interest was stripped by operation of UCC § 9.332(a), which provides that a transferee of money takes the money free of a security interest. The trustee contended that Textron was the transferee because Textron “owned and controlled” the lockbox. The Fifth Circuit disagreed, holding that because the language of the agreement between Tusa and Textron was clear that Tusa, not Textron, owned the lockbox, § 9.332(a) did not apply, and Knoll’s first-priority security interest in the proceeds survived deposit into the lockbox.

For transfers from the lockbox to Textron to apply to Tusa’s available credit on the revolving loan, the trustee contended that Knoll’s first-priority security interest was stripped by operation of UCC § 9.332(b), which provides that a transferee of funds from a deposit account takes the funds free of a security interest in the deposit account. The court again disagreed, reasoning that § 9.332(b) protects Knoll from Textron’s first-priority security interest in the deposit account itself (i.e., the lockbox), but did not protect Textron from Knoll’s first-priority security interest in the funds contained in that account. Thus, when Textron transferred the lockbox funds from the lockbox to increase Tusa’s available loan, those funds remained subject to Knoll’s security interest. This result harmonized with the subordination agreement between Knoll and Textron.

Finally, for transfers by Textron into Tusa’s operating account, the trustee argued that the proceeds were commingled in Tusa’s operating account and therefore Knoll’s first-priority security interest did not survive transfer into the operating account. Knoll contended, however, that the language of UCC § 9.315(b)(2), specifying that “proceeds that are commingled . . . are identifiable proceeds . . . to the extent that the *secured party* identifies the proceeds by a method of tracing,” (emphasis added), was inconsistent with the requirement set forth in 11 U.S.C. § 547(g) that “the *trustee* has the burden of proving the avoidability of the transfer” (emphasis added) under § 547(b). The Fifth Circuit agreed with Knoll, holding that § 547(g) clearly placed the burden on the trustee to demonstrate that the funds in Tusa’s operating account were not proceeds of Tusa’s accounts receivable. In so holding, the court reasoned that the definition of the proceeds under the UCC is broad, and adopted the Ninth Circuit’s reasoning in *Batlan v. TransAmerica Commercial Finance Corp. (In re Smith’s Home Furnishings, Inc.)*, 265 F.3d 959, 967 (9th Cir. 2001), that it is part of the trustee’s burden under § 547(b) to trace the funds.

Because Knoll’s first-priority security interest in Tusa’s accounts receivable survived the various transfers, Knoll was deemed to have recovered its own collateral. Thus, Tusa’s trustee did not meet the requirement of § 547(b)(5)—showing that Knoll received more from the transfers that it would have under a Chapter 7 liquidation—and the transfers could not be avoided as preferences.

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### **Sixth Circuit**

***In re The Village at Knapp's Crossing, LLC, --- Fed. Appx. ----, 2016 WL 98160 (6th Cir. Jan. 8, 2016)***

The 6th Circuit affirms the decision of the 6th Circuit B.A.P. finding an appeal moot as a result of the sale of a debtor's primary asset. Following conversion of a debtor's case to chapter 7, and without a stay having been obtained pending appeal, a debtor's primary assets were sold. The particular order appealed by the debtor was the Bankruptcy Court's order converting the case from chapter 11 to chapter 7. Because the debtor's chapter 11 reorganization was dependent upon the development of these assets (three separate commercial lots), once sold, the 6th Circuit and 6th Circuit B.A.P. both agreed that it would be impossible to grant effectual relief. Accordingly, the appeal was found to be moot.

***Juett v. Casciano (In re Casciano), 2016 WL 105926 (6th Cir. B.A.P. Jan. 11, 2016)***

The 6th Circuit B.A.P. reverseed the Bankruptcy Court for the Western District of Michigan's ruling on the issue of whether a debtor's conduct was willful within the meaning of § 523(a)(6), and remands for further consideration of the element of malice. Between the hours of midnight and 2 A.M. on a January night in 2011, the Plaintiff-Appellant (Juett) and Defendant-Appellee's (Casciano) lives crossed at the Traverse City late-night establishment Bootleggers. If it isn't clear from the name, Bootleggers serves alcoholic beverages, several of which were consumed by the parties in this case. At one point, while Juett had taken leave to the restroom, his girlfriend and her friend were approached by Casciano and his friends. A verbal confrontation ensued when Juett returned. The verbal confrontation continued as the parties were asked to leave and turned physical. Although Juett and Casciano were found not to have engaged in the verbal sparring, when things turned physical, the uncontroverted evidence indicated Casciano struck Juett with a right to the left side of Juett's face, causing severe injury. Reversing the Bankruptcy Court, which had found that Casciano had no reason to believe he would cause the level of injury he had, the B.A.P. finds Casciano's conduct clearly "willful" under § 523(a)(6) because he intended harm. However, on remand, the Bankruptcy Court is instructed to consider whether Casciano acted in self-defense, which if found, may negate the issue of malice.

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## **Seventh Circuit**

### ***In re Sentinel Management Group, Inc.*, 809 F.3d 958 (7<sup>th</sup> Cir. Jan. 8, 2016)**

On January 8, 2016, the Seventh Circuit affirmed in part and reversed in part the decision of the bankruptcy court, holding (a) the bank's claim would not be considered secured where it accepted collateral to secure \$300 million in debt when the bank knew that the debtor had less than \$20 million of its own assets because that knowledge was sufficient to put the bank on inquiry notice and require an investigation into whether the debtor was engaging in fraud by pledging those assets, but (b) the bank's failure to act on that inquiry notice did not amount to conduct sufficiently egregious as to warrant equitable subrogation, to reduce the bank's overall claim priority. Specifically, the Court found that the facts demonstrating that the bank had suspicions that the debtor was pledging assets that did not belong to it – including the fact that the debtor itself had assets worth only 1/150<sup>th</sup> of the \$300 million in collateral it was putting up – was enough to “lead a reasonable, law-abiding person to inquire further – [to] make him in other words suspicious enough to conduct a diligent search for possible dirt.” (Slip Op. pp.4-7). As such, the bankruptcy trustee was entitled to strip the bank of its secured creditor status under 11 U.S.C. § 548(a)(1)(A).

The Court refused, however, to equitably subordinate the bank's claims. The Court noted that the “statute authorizing equitable subordination does not indicate what conduct justifies that Draconian remedy, but there is general agreement in the case law that the defendant's conduct must be not only ‘inequitable’ but also seriously so” (as noted by use of words like “egregious,” “tantamount to fraud” and “willful”), and also “must harm other creditors.” (*Id.* at 10). Here, there was harm to other creditors, but “[t]o suspect potential wrongdoing yet not bother to seek confirmation of one's suspicions is negligent, and negligence has not been thought an adequate basis for imposing equitable subordination.” (*Id.* at 11). That is, there was “the inquiry-notice argument for forbidding the bank to retain its secured creditor status when it should have investigated [the debtor's] fraudulent use of its customer accounts to secure the bank's loan to it” but that “is not proof of fraud.” (*Id.* at 11-12).

### ***In re Smith*, 2016 WL 231995 (7<sup>th</sup> Cir. Jan 20, 2016)**

On January 20, 2016, the Seventh Circuit affirmed the decision of the Bankruptcy Court, holding that *BFP v. Resolution Trust Corp.*, 511 U.S. 531 (1994), which held that a mortgage foreclosure sale that complies with state law is deemed a sale “for reasonably equivalent value” under 11 U.S.C. § 548 as a matter of law, does not extend to Illinois tax sales of real property based on “fundamental differences between the bidding methods used.” (Slip Op. 2). Specifically, in Illinois, “[b]ids are expressed not as a total price for the property but rather as decreasing interest percentages . . . [of] the penalty interest rates that the buyer may demand

from the delinquent taxpayer.” (*Id.* at 8). In the “vast majority of tax sales in Illinois, the penalty percentage paid by the winning bidder is zero percent,” and “if the delinquent tax payer and any mortgage lenders fail to redeem in the subsequent two years, the buyer takes the property free and clear.” (*Id.* at 9). Thus, “[t]he purchase price of the property, taking into account the risk of redemption, is usually nothing more than the sum of the delinquent taxes.” (*Id.*).

The Seventh Circuit held that, unlike the mortgage foreclosure sales contemplated by *BFP*, “Illinois’s tax sale method is not designed to produce bids that could fairly be called ‘reasonably equivalent value’” because “there is ‘no correlation between the sale price and the value of the property.’” (*Id.*). Moreover, if “an insolvent debtor’s asset worth between \$50,000 and \$110,000 can be transferred for about \$5,000 [the amount of the delinquent taxes], a tax sale under the Illinois interest rate method can provide a windfall to one creditor at the expense of others.” (*Id.* at 11). The opinion went on to distinguish case law from other Circuits where, unlike in Illinois, the tax sale procedures were designed to elicit the highest bids approaching the value of the underlying property. In the end, however, the debtors were granted only a single \$15,000 homestead exemption because Illinois law provides that homestead exemptions are only granted to actual owners of the property, and Mrs. Smith inherited the property in her name only, even though her husband and other relatives lived there.

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