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Second Circuit Finds 2017 Fee Increase for Chapter 11 Debtors Unconstitutional, Awards Debtors a Refund

On May 24, 2021, the Second Circuit held that a 2017 increase to the quarterly fees paid by chapter 11 debtors was unconstitutional and awarded Clinton Nurseries, Inc., Clinton Nurseries of Maryland, Inc. and Clinton Nurseries of Florida, Inc. (collectively, "Clinton Nurseries") a refund of the statutory fees it found unconstitutional.[1] The Second Circuit held that Congressionally mandated fee increases that applied only to debtors who filed bankruptcy in a judicial district subject to the United States Trustee Program (the "US Trustee" and the "UST Program") but not to debtors who filed bankruptcy in judicial districts outside of the UST Program, violated the uniformity clause of the U.S. constitution.[2] Congress has since corrected the statutory fee structure at issue. However, debtors like Clinton Nurseries, who filed bankruptcy in the Second Circuit and who paid UST Program fees during the relevant period at the unconstitutional rates, may have good grounds for obtaining a refund which may be substantial.

Background

US Trustees oversee bankruptcy administration in 88 out of 94 federal districts.[3] Bankruptcy administrators perform the same role as US Trustees in the remaining six districts (such districts, the "BA Districts" and the program, the "BA Program") .[4] Both the UST and BA Programs are funded by quarterly fees paid by debtors.[5] Until 1994, when the Ninth Circuit Court of Appeals held that doing so was unconstitutionally non-uniform, only debtors who filed bankruptcy in UST Program districts paid quarterly fees.[6] Debtors who filed in BA Program districts did not. Congress quickly passed legislation to provide for corresponding quarterly fees in BA Program districts, and the Judicial Conference thereafter directed that such fees be in the same amounts in both types of districts, thereby addressing the fee regime's constitutional infirmities.[7]

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1 *In re Clinton Nurseries, Inc.*, 998 F.3d 56 (2d. Cir. 2021).

2 U.S. Const. art. 1, § 8, cl. 4 (granting Congress the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States.")

3 *See Clinton Nurseries*, 998 F.3d 56 at 59.

4 *See id.* The Judicial Conference oversees the bankruptcy administrators in the remaining six districts, which are located in North Carolina and Alabama. *See id.*

5 *See id*.

6 *See id.* citing *St. Angelo* v. *Victoria Farms, Inc.*, 38 F.3d 1525, 1535 (9th Cir. 1994).

7 *See Clinton Nurseries*, 998 F.3d 56 at 60.

In 2017, Congress amended the fee statute (the "2017 Amendment") to tie the amount of quarterly fees a debtor pays to the size of its disbursements, in other words, to the amount that the debtor pays to third parties.[8] The fee increase was significant, with a debtor (including each debtor within a jointly administered filing of a corporate group of debtors) having to pay fees potentially reaching $250,000 per quarter. Before the 2018 effective date of the 2017 Amendment, the maximum quarterly fee a debtor had to pay was $30,000.

Debtors in UST Program districts became subject to the fee increase in January 2018, but the BA Program districts lagged and did not implement the fee increase until October 2018. Moreover, while UST Program districts enforced the fee increase on all debtors with ongoing cases, BA Program districts only applied the fee increase to bankruptcies filed after October 1, 2018. These differences resulted from the language of the 2017 Amendment, which provided that debtors in UST Program districts "shall" be charged the increased fees, while debtors in BA Program districts "may" be charged the increased fees. The Judicial Conference did ultimately adjust the fee increases in BA Program districts so that they harmonized with fees in UST Program districts, but between January 1, 2018 and September 30, 2018, debtors in UST Program districts paid significantly different statutory fees than debtors in BA Program districts.[9]

The Second Circuit Rules the 2017 Fee Increase Unconstitutional

Clinton Nurseries operated plant nurseries in Connecticut, Florida and Maryland. On December 18, 2017, Clinton filed for chapter 11 bankruptcy protection in the District of Connecticut, a UST Program district. Clinton Nurseries' disbursements consistently exceeded the statutory threshold for the maximum fees payable under the amended fee statute, and it was charged and paid the increased quarterly fees required under the 2017 Amendment.

In April 2019, Clinton Nurseries filed a motion with the Bankruptcy Court seeking relief from the increased quarterly fees, arguing that the 2017 Amendment violated the U.S. Constitution, which authorizes Congress "[t]o establish . . . *uniform* Laws on the subject of Bankruptcies throughout the United States"(the "Bankruptcy Clause").[10] The UST for the region objected. The Bankruptcy Court denied Clinton Nurseries' motion, finding that the statute was uniform on its face. The debtors filed a direct appeal to the Second Circuit.[11]

On appeal, the UST argued that the Bankruptcy Court's ruling should be affirmed because, first, the 2017 Amendment was not subject to the Bankruptcy Clause, and second, even assuming it was, the 2017 Amendment was uniform and even if not, the "geographically isolated problem" exception to the uniformity requirement applied.

After addressing a preliminary standing issue,[12] the Second Circuit quickly dispensed with the UST's first argument, noting that it was one that had "been repeatedly rejected by other courts."[13] The Second Circuit held that because the 2017 Amendment governs debtor-creditor relationships as well as available relief, the 2017 Amendment was a "bankruptcy law," was subject to the Bankruptcy Clause, and therefore, was only constitutional if "uniform."[14]

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8 *See id.* at 60-61.

9 *See Clinton Nurseries*, 998 F.3d 56 at 69.

10 U.S. Const. art. I, § 8, cl. 4 (emphasis added).

11 On November 8, 2019, a district court in the District of Connecticut certified this matter for direct appeal under 28 U.S.C § 158(d)(2)(A), and on April 14, 2020, the Second Circuit granted Clinton Nurseries' petition for permission to appeal.

12 The Second Circuit held that a debtor has standing to seek reimbursement where three criteria are met: 1) the debtor must have filed for chapter 11 in a UST program district before October 1, 2018; 2) the debtor must have had disbursements over $1 million during any quarter between January 1 and October 1, 2018; and 3) the debtor must have paid more than a similarly situated debtor would have paid in a BA program district. The court concluded that Clinton Nurseries could seek a refund as it met all three criteria.

13 *Clinton Nurseries*, 998 F.3d at 64.

14 *See id*. quoting U.S. Const. art. I, § 8, cl. 4.

The Second Circuit then turned to the substance of the UST's constitutional argument. Notably, none of the parties disputed that during the time Clinton Nurseries paid the disputed quarterly fees, a clear geographic discrepancy in application of the 2017 Amendment's fee increase existed: "debtors like Clinton who filed for bankruptcy in UST Districts were charged the increase beginning January 1, 2018; debtors who filed for bankruptcy in BA Districts before October 1, 2018, were never charged the increase."[15]

The Second Circuit rejected the UST's textual argument that the 2017 Amendment was facially uniform because – notwithstanding differences in language between the statute promulgated for UST Program districts and BA Program districts – Congress mandated its equal implementation.[16] The court found that the statute in UST Program districts stated that the fees "shall" be imposed on debtors in UST Program districts whereas the analogous state in BA Program districts stated that such fees "may" be imposed. Thus, the plain terms of the statute *required* application of the increase in UST Program districts but merely *permitted* its application in BA Program districts. This, the Second Circuit held, rendered the statute non-uniform on its face.

The UST argued that the 2017 Amendment could nonetheless be salvaged because of the "geographically isolated problem" exception to the uniformity requirement.[17] As a general matter, to be constitutionally uniform, a law enacted pursuant to the Bankruptcy Clause must: (a) apply uniformly to a defined class of debtors; and (b) be geographically uniform.[18] Congress may, however, take into account differences that exist between different parts of the country, and fashion legislation to resolve geographically isolated problems.[19] Doing so does not necessarily render a law non-uniform.[20]

The Second Circuit, while recognizing this "geographically isolated problem" exception to the Constitution's uniformity requirement, observed that even so, the Supreme Court has held that "[t]o survive scrutiny under the Bankruptcy Clause, a law must at least apply uniformly to a defined *class* of debtors."[21] As a result, because the 2017 Amendment applied to a class of debtors whose disbursements exceed $1 million, the 2017 Amendment would need to treat all debtors with disbursements exceeding $1 million, in UST and BA program districts alike, uniformly. That is, the 2017 Amendment had to "apply uniformly to a defined class of debtors." As Clinton Nurseries demonstrated, the statute did not do so. Instead, the harms that the Bankruptcy Clause sought to redress were squarely implicated: "Two debtors, identical in all respects save the geographic locations in which they filed for bankruptcy, are charged dramatically different fees."[22]

In the end, the Second Circuit concluded that the 2017 Amended was non-uniform, both on its face and notwithstanding the "geographically isolated exception" to uniformity. It concluded that, to the extent that Clinton Nurseries paid the unconstitutional fee increase, it was entitled to a refund of the amount in excess of the fees it would have paid in a BA District during the same time period.

Conclusion

Congress has already amended the statutory language at issue to conform the fees payable by debtors in BA Program districts to those payable by debtors in UST Program districts. Thus, the *Clinton Nurseries* decision mainly affects debtors like Clinton Nurseries who (a) filed chapter 11 in the Second Circuit before October 1, 2018, (b) issued disbursements exceeding $1 million during any quarter between January 1 and October 1, 2018, and (c) paid more than a similarly situated debtor in a BA district

15 *See id*.

16 *See id*.

17 *See id*. citing *Blanchette* v. *Connecticut General Insurance Corp.*, 419 U.S. 102 (1974).

18 *Siegel* v. *Fitzgerald* (*In re Circuit City Stores, Inc.*),996 F.3d 156, 165 (4th Cir. 2021) citing *In re SCI Direct, LLC*, 17-61735, 2020 WL 5929612, at *10 (Bankr. N.D. Ohio Sept. 22, 2020) (citing *Ry. Labor Execs.' Ass'n* v. *Gibbons*), 455 U.S. 457, 473 (1982).

19 *See id.* (citations omitted).

20 *See id*.

21 *Clinton Nurseries*, 998 F.3d at 68 citing *Ry. Labor Execs.' Ass'n* v. *Gibbons*, 455 U.S. 457, 473, (1982) (emphasis added).

22 *See id*. at 69.

would have. More litigation on the constitutionality of the 2017 Amendment is expected. Indeed, the UST filed a consensual motion to extend the time in which it can seek rehearing of the *Clinton Nurseries* ruling before the Second Circuit. Other circuits may well share the Second Circuit's view, and given the existing circuit split,[23] the Supreme Court may well have to ultimately determine the constitutionality of the 2017 Amendment. At least for now, however, the *Clinton Nurseries* decision is binding precedent in the Second Circuit. Debtors who filed chapter 11 in the Second Circuit may be eligible for refunds on excess fees if they satisfy the criteria set forth above. For those debtors, the difference in fees paid could be substantial.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

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[23] The Fourth Circuit and the Fifth Circuit also reviewed the constitutionality of the 2017 Amendment. Both courts found the fee increase constitutional.