Selected Bankruptcy Cases of Note

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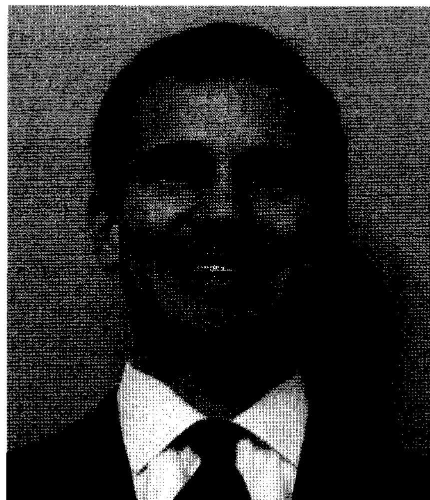

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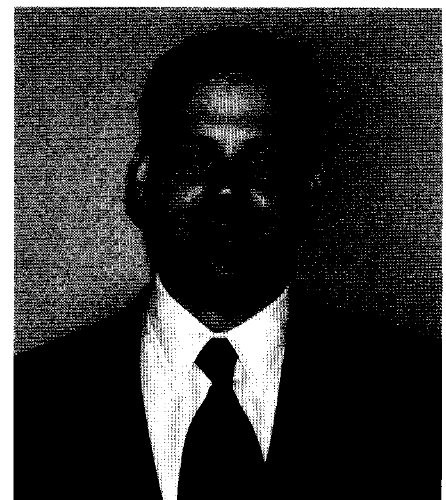

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I. Treatment of "Unsecured" Second Mortgages and Judicial Liens (for the Section 522(f) Buff)

A. The "Unsecured" Mortgage

The Second and Sixth Circuit U.S. Courts of Appeal have joined the majority of lower courts in finding that an unsecured mortgage can be crammed down in a Chapter 13 case, despite the language of 11 U.S.C. section 1322(b)(2). In *In re Lane*,[1] the Sixth Circuit concluded that the extent to which a "completely unsecured" second mortgage lien must be treated as "secured" for Chapter 13 plan purposes is determined by the ordinary valuation process of "cram-down" under 11 U.S.C. section 506.[2] There are certainly strong arguments to the contrary, particularly considering United States Supreme Court precedent on the issue,[3] so it will be interesting to see how this issue is handled by other circuits as more cases are presented for appellate review.

B. The "Short-Term" Unsecured Mortgage

11 U.S.C. section 1322(c)(2) creates another potential exception to the 11 U.S.C. section 1322(b)(2) prohibition on cramming down a mortgage on the debtor's principal residence. If the last payment due date on the original payment schedule for the mortgage is due before the date on which the final plan payment is due, the "plan may provide for the payment of the claim as modified pursuant to section 1325(a) (5) of this title." In *In re Witt*,[4] the Fourth Circuit U.S. Court of Appeals concluded that the phrase "payment of the claim as modified" is ambiguous because "it cannot be determined, merely from the statute's text, whether the words 'as modified' should apply to 'payment' or 'claim'." Upon further analysis, the Fourth Circuit concluded that section 1322(c)(2) does not permit cram-down of claims based on short-term mortgages, but rather is limited to modification of the payment schedule.

But in *American Gen. Finance Inc. v. Paschen (In re Paschen)*,[5] the Eleventh Circuit U.S. Court of Appeals read section 1322(c)(2) "literally" and concluded that short term mortgages could be crammed-down. The *Paschen* court's reasoning was based on an interpretation that the phrase "as modified" modifies, as a matter of grammar, the term "claim" rather than the full phrase "payment of the claim." Since "as modified" immediately follows "claim," the Eleventh Circuit saw no need to look further. The Witt decision suggests that other courts may find that view less than compelling.

C. The Section 522(f) Attack on the "Undersecured" Judicial Lien in the Joint Case

For section 522(f) buffs only, it is noteworthy that the Third Circuit U.S. Court of Appeals joined the First and Eleventh Circuits and the Ninth Circuit Bankruptcy Appellate Panel (BAP) in interpreting the formula for calculating how much an exemption is impaired when property is jointly owned but only one party files for bankruptcy. It rejected the "literal reading" approach of the Tenth Circuit BAP.[6]

II. Reaffirmations

In 2001, a First Circuit BAP concluded, in *Katahdin Federal Credit Union v. Jamo (In re Jamo)*,[7] that a creditor which had a security interest in the debtors' home violated the automatic stay when it conditioned reaffirmation of the debtor's mortgage on the debtor reaffirming other, unsecured debts and indicated it would foreclose the mortgage on the home if the debtor did not reaffirm. The BAP's rationale was that, while there is an implied exception to the automatic stay for collection action when a creditor is seeking to negotiate a reaffirmation agreement from a "willing" debtor, the creditor could not "coerce" the debtor. The crucial step in the BAP's analysis was its view that conditioning the reaffirmation of one debt upon the reaffirmation of other debts was coercive.

The First Circuit U.S. Court of Appeals, however, reversed the BAP.[8] It agreed that in deciding whether there was an automatic stay violation, the court should consider whether the pre-reaffirmation discussions were "coercive," but concluded that merely linking reaffirmation of secured debt to reaffirmation of unsecured debt did not violate that standard. The First Circuit also concluded that describing a legal right to foreclose does not amount to coercion. The First Circuit noted that the debtors were not entitled to absolute protection: "Bankruptcy, as life itself, is a series of tradeoffs." It concluded that a debtor who files for Chapter 7 should anticipate that creditors will seek reaffirmation or enforcement; this alone is not coercive.

The court clearly left open the possibility that improper threats could cross the line and become coercive under some circumstances. Moreover, the general approach of the First Circuit leads to a case-by-case analysis of whether particular creditor conduct has crossed that line. On the other hand, this approach has always been a part of automatic stay violation litigation. And the First Circuit seemed to make clear that a statement of the creditor's legal rights, and the probable consequences, is not coercive. Overall, the First Circuit clearly has taken

1. 280 F.3d 663 (6th Cir. 2002).
2. A similar result occurred in Pond v. Farm Specialist Realty (*In re* Pond), 252 F.3d 122 (2d Cir. 2001). *Compare* the analysis in American Savings Bank v. Nobelman, 508 U.S. 324 (1993); *see also* Richard E. Coulson and Alvin C. Harrell, *Consumer Bankruptcy Developments*, 56 Bus. Law. 1265, 1266-69 (2001).
3. *See Nobelman*, 508 U.S. 324.
4. 113 F. 3d 508 (4th Cir. 1997).
5. 2002 U.S. App. LEXIS 13853 (11th Cir. July 10, 2002).
6. Miller v. Sul (*In re* Miller), 299 F.3d 183 (3d Cir. 2002). *Compare In re* Cozad, 208 B.R. 495 (10th Cir. BAP 1997) (plain language), with *In re* Lehman, 205 F.3d 1255 (11th Cir. 2000) (policy); *see also* Nelson v. Scala, 192 F.3d 32 (1st Cir. 1999) (policy); and *In re* Nielson, 197 B.R. 665 (9th Cir. BAP 1996).
7. Jamo v. Katahdin Federal Credit Union (*In re* Jamo), 262 B.R. 159 (1st Cir. B.A.P. 2001).
8. 283 F.3d 392 (1st Cir. 2002).

a step back from the super-protective stance toward the debtor that the bankruptcy court and BAP took in *Jamo*. As a result, it seems clear that secured and other creditors can act reasonably in presenting their position to debtors as part of reaffirmation negotiations, including linkage of secured and unsecured debts and an accurate description of the creditor's foreclosure rights.[9]

III. Other Circuit and BAP Cases of Interest

A. The Pitfalls of Litigation: When Is a Settlement a Bad Thing?

In *Archer v. Warner (In re Warner)*,[10] the Fourth Circuit U.S. Court of Appeals decided that a settlement of a fraud claim was a novation that converted the nondischargeable fraud claim into a dischargeable contract claim. One Judge dissented. The United States Supreme Court has accepted *certiorari*.[11]

There is a split in the Circuits on this point. In *Warner*, the Fourth Circuit joined the Ninth and Seventh circuits.[12] The District of Columbia Circuit and Eleventh Circuit have taken the opposite view, focusing on the nature of the underlying basis for the contract.[13] A Sixth Circuit BAP agreed with the latter approach.[14]

This issue can arise when settling, prebankruptcy, any nondischargeable debt. Careful drafting of the settlement agreement is important. The rationale of *Warner* is that by reason of the settlement agreement containing a general release, a novation occurred. The problem can therefore be avoided by drafting a settlement agreement that does not release the underlying claim, but merely liquidates it in a certain amount. Or, if in fact the parties intend the agreement to result in a novation and a change in the nondischargeable character of the obligation, they should say so and include a specific release in the agreement.

B. Who Can Sue a Creditor to Assert Avoiding Powers

Can the debtor assert an avoiding power against a creditor? This has been an issue for some time, both in commercial and consumer cases. Recently, in a commercial case, the Third Circuit U.S. Court of Appeals concluded that only the case trustee or a debtor in possession (DIP) (in Chapter 11)[15] could sue to assert an avoidance action. The case is controversial, and will probably be reviewed *en banc* by the Third Circuit. In commercial cases, it may have less impact than at first it seems, since the creditors' committees can intervene and in effect pursue the case once the DIP or trustee brings it. However, in the typical consumer case, resources are a lot thinner and the issue may become more important.

Pursuit of estate-owned claims by third parties usually proceeds under an arrangement that has been more or less blessed by the bankruptcy court and/or the case trustee or DIP. Challenges to the standing of the third parties prosecuting these suits have had varied effect.

In re Cybergenics (Official Committee of Unsecured Creditors of Cybergenics Corp. v. Chinery)[16] establishes a new approach to these matters. The Third Circuit held that only the trustee or DIP can prosecute 11 U.S.C. section 544(b) avoidance claims, applying the "literal reading" analysis of 11 U.S.C. section 506(c), as used by the U.S. Supreme Court in *Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A.*,[17] to section 544(b). In *Hartford Underwriters*, the Court read the language "[t]he trustee may recover [under section 506(c)]" as restricting pursuit of section 506(c) claims solely to the trustee or DIP. Similarly, section 544(b) provides strong arm avoidance powers only to a specifically named party, the trustee. The Third Circuit took this to be determinative, and rejected creditors' committee pursuit of the claim.

The Supreme Court in note 5 of the *Hartford Underwriters* decision had specifically reserved whether its reading of section 506(c) limited the ability of creditors or creditors' committees to pursue avoidance actions. However, that did not deter the Third Circuit. The *Cybergenics* decision also rejected the arguments that 11 U.S.C. section 1109(b) or 1103(c)(5) would be broad enough to authorize suit by the creditors' committee.[18]

On the latter issue, the Second Circuit has held that an avoidance suit may be jointly prosecuted by a secured creditor and the case trustee under an agreement between the two that is blessed by the bankruptcy court, with the proceeds being shared. Creditors and creditors' committees can also prosecute avoidance suits under the standards for standing set out in *In re Commodore International Ltd.*[19] In *Commodore*, the creditors' committee's pursuit of actions against former officers and directors of the debtor was authorized by the Second Circuit based on the fact that the bankruptcy court had approved the arrangement.

C. Surcharge of Collateral Under Attack

In *Golden v. Chicago Title Ins. Co. (In re Choo)*,[20] a Chapter 11 trustee sought

9. *See also* Jon Ann Giblin and Alvin C. Harrell, *Consumer Bankruptcy Developments*, 57 Bus. Law. 1333, 1351-53 (2002). *Cf.* Jacqueline B. Stuart, *All or Nothing Reaffirmation: Can Secured and Unsecured Debts be Linked?*, 58 Bus. Law. [in press] (2003).

10. 283 F.3d 230, 2002 WL 369926 (4th Cir. 2002).

11. No. 01-1418, __ U.S. __, 122 S. Ct. 2618, 153 L. Ed.2d 802, 70 USLW 3616, 2002 WL 496658 (S. Ct. June 24, 2002).

12. Key Bar Invs., Inc. v. Fischer (*In re* Fischer), 116 F.3d 388 (9th Cir. 1997) (per curiam); *In re* West, 22 F.2d 775 (7th Cir. 1994).

13. United States v. Spicer, 57 F.3d 1152 (D.C. Cir.), *cert. denied*, 516 U.S. 1043 (1996); Greenberg v. Schools, 711 F.2d 152 (11th Cir. 1983) (per curiam).

14. Ed Schory & Sons, Inc. v. Francis (*In re* Francis), 226 B.R. 385 (6th Cir. BAP 1998).

15. *See* 11 U.S.C. §§ 1101(1), 1107.

16. 304 F. 3d 316 (3d Cir. 2002).

17. 530 U.S. 1, 120 S. Ct. 1942, 147 L.Ed.2d 1 (2000).

18. *Contra: In re* Debbie Reynolds Hotel & Casino Inc., 255 F.3d 1061 (9th Cir. 2001) (really a § 506(c) case); *In re* Housecraft Industries USA Inc., 310 F.3d 64 (2d Cir. 2002).

19. 262 F. 3d 96 (2d Cir. 2001).

20. 273 B.R. 608 (9th Cir. BAP 2002).

to surcharge the fees, expenses, attorneys' fees, and legal costs incurred in liquidating encumbered real property. The secured creditor opposed the trustee's surcharge motion, arguing that because the trustee's actions primarily benefitted other creditors, no surcharge on the second creditor's claim should be allowed. In response, the trustee claimed that a surcharge was proper because his actions saved the creditor from incurring the costs of foreclosure and sale. The bankruptcy court disallowed any surcharge.

On appeal, the Ninth Circuit BAP rejected the secured creditor's argument that a surcharge is improper where the expenses were not incurred primarily for the secured creditor's benefit. Instead, the BAP concluded that the correct inquiry is whether the expenditure in question was directed specifically toward the collateral, as opposed to property of the estate in general.

Next, the BAP examined the record to see if the trustee had adequately quantified a benefit to the collateral to justify the surcharge. In the bankruptcy court, the trustee alleged that his liquidation of the property benefited the secured creditor by saving the creditor the costs associated with the sale, sparing the creditor from the need to seek stay relief, the need to incur foreclosure costs, and the need to bear the costs of maintaining the property pending the sale.

However, the BAP concluded that in *Choo* the trustee's allegations failed to establish an entitlement to surcharge the creditor's[21] collateral. The BAP agreed with the bankruptcy court that the trustee's "hypothetical grouping" of unquantified benefits did not provide an evidentiary basis on which to surcharge the collateral at issue.[22] According to the BAP:

> In the present context, Chicago Title benefited, if at all, by avoiding costs of sale and disposition, rather than from improvement of the property. But as noted, the trustee did not even attempt to prove up what it would cost Chicago Title to restart the sheriff's sales and dispose of the properties, or the likelihood of it as executing creditor becoming the purchaser and thus having further disposal costs. These are factual issues put at issue by Chicago Title's opposition to the surcharge motion, and are susceptible to resolution by the court after discovery and presentation of expert testimony or other evidence or by stipulation.[23]

Therefore, the BAP affirmed the bankruptcy court's denial of the trustee's motion to surcharge the collateral.

IV. Other Selected Bankruptcy Cases of Note

A. Money Judgments May Not Be Available in Conjunction with Dischargeability Actions

In the case of *In re Hamilton*,[24] the Bankruptcy Court for the Western District of Oklahoma reviewed whether bankruptcy courts possess jurisdiction to award money judgments in connection with dischargeability actions. The court noted a split of authority within the bankruptcy courts of the Tenth Circuit, and that neither the Tenth Circuit U.S. Court of Appeals nor the Tenth Circuit BAP has decided the issue.

The *Hamilton* court noted that most courts, including the Sixth, Seventh, and Ninth Circuit U.S. Courts of Appeal, hold that bankruptcy courts have the authority to award money judgments in nondischargeability actions.[25] The *Hamilton* court concluded, however, that "[t]hese courts rely on nebulous theories of judicial economy and the bankruptcy courts' inherent power of equity and are not grounded on any statutory grant of authority."[26]

Rather than following the majority, the *Hamilton* court adopted the limited jurisdiction approach taken in *First Omni Bank, N.A. v. Thrall (In re Thrall)*.[27] This approach finds no express grant of authority to render money judgments in either the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure (Rules). Courts adopting this approach note that, in contrast, the former Bankruptcy Act specifically permitted bankruptcy courts to determine money judgments.

Ultimately, the *Hamilton* court adopted the limited jurisdiction approach, and concluded it had no subject matter jurisdiction to provide the creditor with a money judgment.[28] Because it lacked the requisite subject matter jurisdiction, *Hamilton* held that while the creditor's debt was non-dischargeable, the creditor had to liquidate its money judgment in either state or federal district court.[29]

B. Discharge of Student Loans Not Appropriate Without an Adversary Proceeding

In 2002, the Fourth Circuit U.S. Court of Appeals weighed in on the effect of placing language in a Chapter 13 plan discharging liability on a student loan, instead of filing an adversary proceeding or serving a motion on the creditor regarding the debtor's actions. Although the case involved a Chapter 13 plan, the Fourth Circuit's holding and reasoning are important even in commercial cases.

In *Banks v. Sallie Mae Servicing Corporation*,[30] the debtor placed language in his Chapter 13 plan regarding his student loans that stated:

21. *Choo*, 273 B.R. at 613.

22. *Id.* at 612.

23. *Id.* at 613.

24. 282 B.R. 22 (Bankr. W.D. Okla. 2002).

25. *Hamilton*, 282 B.R. at 23.

26. *Id.*

27. 196 B.R. 959 (Bankr.D.Colo. 1996).

28. 282 B.R. at 25.

29. 282 B.R. at 25-26.

30. 299 F.3d 296 (4th Cir. 2002).

> During the pendency of this case, no interest, penalties, late charges, or costs of collection, including attorneys fees, shall accrue....Upon his discharge, Debtor...shall be liable for only the unpaid balance of his prepetition debt.

The debtor obtained an order confirming the plan. The student loan agency agreed that it received notice of the debtor's plan as well as the confirmation order, and did not object to the plan or appeal the confirmation order.

After the debtor received his discharge, the student loan agency notified the debtor that it had applied his plan payments to interest and not principal. The debtor then reopened his bankruptcy case seeking a determination that his plan discharged all postpetition interest that accrued during the pendency of his case. The student loan agency argued that the debtor could not discharge postpetition interest without proving undue hardship in an adversary proceeding. Relying in part on *Anderson v. UNIPAC NEBHELP (In re Anderson)*,[31] the bankruptcy court ruled that the unappealed confirmation order was *res judicata*, and that postpetition interest had been tolled. The district court reversed, and the decision was appealed to the Fourth Circuit.

In its *Banks* decision, the Fourth Circuit first noted that the Bankruptcy Code and Rules require debtors to file adversary proceedings in order to discharge student loans and postpetition interest on student loans.[32] Further, the court noted that the Bankruptcy Rules require heightened notice requirements for adversary proceedings. In fact, the Fourth Circuit expressly rejected the Tenth Circuit's *Anderson* decision precisely because the Tenth Circuit did not address the due process requirements of an adversary proceeding. Moreover, an adversary proceeding requires the debtor to shoulder the burden of proof to establish an undue hardship.[33] The Fourth Circuit then held that the debtor's attempt to establish undue hardship in the plan was no more than "discharge by declaration."[34] Moreover, the Fourth Circuit broadly held that the due process requirements that accompany an adversary proceeding will bar debtors from discharging student loan debts by merely inserting language in a Chapter 13 plan.[35]

More recently, Judge Niles Jackson of the Bankruptcy Court for the Western District of Oklahoma published an interesting and somewhat similar opinion regarding what the court termed improper "gamesmanship" by debtors' counsel.[36] In *Lemons*, the debtors' counsel inserted language in a Chapter 13 plan that called for abatement of interest on student loan debt during the term of the Chapter 13 plan. Furthermore, the plan directed that all collection expenses and penalties associated with the student loan would be paid as unsecured debt and thus discharged.

At the *Lemons* confirmation hearing, the student loan creditors argued that both a student loan and the interest accruing postpetition on the student loan are nondischargeable in bankruptcy. The creditors further noted that the same debtor's counsel had unsuccessfully tried to insert similar language in a Chapter 13 plan submitted to Judge Jackson's predecessor, Judge John TeSelle, in a prior case, and that Judge TeSelle had specifically rejected that practice.

Judge Jackson used the *Lemons* case as an opportunity to discuss the Tenth Circuit's holding in *Anderson*, in light of subsequent case law such as the Fourth Circuit's *Banks* decision, discussed above. Judge Jackson noted that both the Bankruptcy Code and Rules require debtors to initiate adversary proceedings to discharge student loan debts upon a requisite showing of undue hardship. He also noted that the rights to be determined in adversary proceedings invoke heightened notice requirements under Bankruptcy Rule 7004.

Judge Jackson observed that the *Anderson* court did not address the issue of the heightened due process notice requirements for adversary proceedings. Therefore, in the absence of guidance from the Tenth Circuit on the matter, Judge Jackson adopted the reasoning and result of the Fourth Circuit's *Banks* decision, declaring that he would enforce compliance with the due process requirements as set forth in the Bankruptcy Code and Rules. Judge Jackson also used the *Lemons* opinion as an opportunity to caution the bankruptcy bar about his dim view of the "gamesmanship" by the debtor's counsel. Included within the ambit of such gamesmanship would be: (1) attempts to discharge otherwise nondischargeable debt through plan language; (2) assertion of exemptions as to property that is clearly not exempt under state law; (3) plan provisions characterizing, as unsecured, claims that are clearly secured; (4) plan provisions that unilaterally lower a contract rate of interest; (5) attempts to cram-down junior mortgages without proper notice; and (6) any other attempt to bypass clear and unambiguous language of the Bankruptcy Code and controlling case law.

C. Debtors No Longer Routinely Excused From Attending Their Meeting of Creditors

Under 11 U.S.C. section 343, the Bankruptcy Code requires debtors to appear at their section 341 meeting of creditors. Although the statute contains mandatory language, debtors periodically seek to be excused from attending the section 341 meeting. A recent bankruptcy court decision examined the circumstances under which debtors may be relieved from their obligation to attend the meeting of creditors.[37] In this case,

31. 179 F.3d 1253 (10th Cir. 1999).

32. *Banks*, 299 F.3d at 300.

33. *Id.* at 301.

34. *Id.*

35. *Id.* at 302.

36. *In re* Lemons, 285 B.R. 327 (Bankr. W.D. Okla. 2002).

37. *In re* Agan, 285 B.R. 324 (Bankr. W.D. Okla. 2002).

the debtor filed an unopposed motion to excuse her attendance from her meeting of creditors. In her motion, the debtor stated that she could not attend the meeting due to work restrictions by her employer. The court first noted the important functions served by the meeting of creditors. The court noted that the meeting allows the trustee and creditors the opportunity to inquire about financial information that could lead to discovery and liquidation of bankruptcy estate assets.

Additionally, the court noted that neither the Bankruptcy Code nor the Rules provide for a waiver of the required appearance. Although other portions of the Bankruptcy Code allow bankruptcy judges to exercise discretion based upon "cause" or a similar finding, section 343 does not allow a bankruptcy judge to exercise any discretion to excuse a debtor's attendance at the meeting of creditors. The court concluded that there is "...no apparent reason to doubt that if Congress had wanted to give bankruptcy judges the power to excuse debtors' attendance at the meeting for some good reason it would have said so."[38]

In concluding that the debtor is required to attend the section 341 meeting, the court stated that there is one departure from the mandatory requirement imposed by section 343. Individuals who file bankruptcy and are in the military service may have some relief. The Soldiers' and Sailors' Relief Act[39] may apply. But, according to Judge Bohanon in *Agan*, "[m]ilitary debtors are not excused from appearing at the meeting of creditors but, upon a proper showing, it may be stayed until they are able to appear."[40]

38. *Agan*, 285 B.R. at 326.

39. 50 App. U.S.C. § 521, as cited in *Agan*, 285 B.R. at 326. *See generally* Michael I. Raschid, *Congress Amends Soldiers'' and Sailors' Civil Relief Act of 1940 and Veterans' Reemployment Rights Law*, 45 Consumer Fin. L.Q. Rep. 331 (1991); Mary Beth Guard, *The Soldiers' and Sailors' Civil Relief Act of 1940: It's Not Just for Wartime*, 45 Consumer Fin. L.Q. Rep. 209 (1991).

40. Judge Bohanon also recognized that certain bankruptcy authorities suggest that, in appropriate cases, debtors might appear by telephone or video conference. And, in the case of disabled debtors the United States Trustee must find ways for them to appear without them being subjected to discrimination. As Judge Bohanon correctly stated, however, those matters were not before him.

Federal Reserve Adopts Regulations...

(Continued from page 280)

- Institutions may engage in transactions with exempted subsidiaries without regard to the affiliate transactions restrictions, but all such transactions are consolidated with those of the institution for purposes of the statutory limits and other requirements of Sections 23A and 23B.

- Federal and state savings associations also are subject to Sections 23A and 23B and Regulation W. However, due to ambiguity in the statutory language and a request from the OTS, Regulation W does not alter the current treatment of subsidiaries of savings associations under the affiliate transactions rules.

- Regulation W confirms existing court precedent which holds that the statutory collateral requirements can only be met where the institution takes a perfected security interest in the collateral under applicable state law.

- Regulation W contains comprehensive rules for valuing affiliate transactions for purposes of the quantitative limits of Section 23A, and for determining the timing of affiliate transactions.

- Regulation W codifies and clarifies the FRB's interpretive exemption which allows an institution to purchase loans originated by affiliates under strict conditions. The FRB has also requested comment on a proposal to limit the exemption based on the amount of the purchasing institution's capital.

- Regulation W is generally effective as of April 1, 2003 but contains a transition rule allowing until July 1, 2003 for compliance for certain transactions which were entered into prior to December 12, 2002 and are subjected to Section 23A or 23B solely as a result of Regulation W (or whose treatment under Section 23A or 23B would change solely as a result of Regulation W).

In view of the issuance of Regulation W, all institutions should evaluate their outstanding affiliate transactions to assure compliance, and amend their internal affiliate transaction policies to achieve consistency with the Regulation.

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