

Concurrent Session

Consumer Bankruptcy Cases Year in Review: A Look at Supreme Court and Appellate Decisions

Richardo I. Kilpatrick, Moderator | Kilpatrick & Associates, PC
Auburn Hills, Mich.

Hon. Jeffery P. Hopkins | U.S. Bankruptcy Court (S.D. Ohio); Cincinnati

Claire Ann Resop | von Briesen & Roper, SC; Madison, Wis.

Prof. G. Ray Warner | St. John's University School of Law
Of Counsel, Greenberg Traurig, LLP
Jamaica, N.Y.

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Panelists:

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Hamilton v. Lanning (*In re Lanning*), 130 S. Ct. 2464 (U.S. 2010)

In *Hamilton v. Lanning* (*In re Lanning*), the United States Supreme Court conducted another foray into the meaning of the 2005 Amendments to the Bankruptcy Code (BAPCPA). The dispute in *Lanning* involves the meaning of the phrase “projected disposable income” and its effect on how much money a Chapter 13 debtor is required to devote to a Chapter 13 plan.

In *Lanning*, the appellee debtor filed a Chapter 13 bankruptcy case. In the sixth months before the date that the case was filed, the debtor received a one-time buyout from a former employer. This payment resulted in average monthly income in the sixth months prior to filing that was greatly in excess of the debtor’s actual monthly income resulting from her current employment. In her proposed Chapter 13 plan, however, the debtor proposed a monthly payment to the Chapter 13 Trustee that was based on her actual monthly income at the time that the case was filed rather than on the average monthly income for the sixth months prior to the filing date. The Chapter 13 Trustee objected to confirmation of this proposed plan asserting that the monthly plan payment should be based on the debtor’s average income in the six months prior to the date that the case was filed.

Under 11 U.S.C. § 1325(b)(1), a Chapter 13 debtor is required to devote all of his or her “projected disposable income” to plan payments if the plan does not propose to pay all creditors in full. The debtor argued that her actual monthly income at the time of filing conformed with the Bankruptcy Code’s requirement that she pay her “projected disposable income” to the Trustee since that is based on the monthly income that she expects to earn during the term of the plan. The Chapter 13 Trustee, on the other hand, asserted that, although the Code does not define “*projected* disposable income”, it defines the phrase “disposable income” as “current monthly income received by the debtor . . . less amounts reasonably necessary to be expended. . . .” 11 U.S.C. § 1325(b)(2). “Currently monthly income”, in turn, is defined as the average monthly income received by the debtor in the six months prior to the date that the case was filed. 11 U.S.C. § 101(10A). The Trustee, therefore, argued that “*projected* disposable income” means “disposable income”, as defined by Section 1325(b)(2) extended out through the life of the Chapter 13 plan.

The bankruptcy court accepted the debtor’s position and both the Tenth Circuit Bankruptcy Appellate Panel and Court of Appeals affirmed the bankruptcy court.

Judge Alito, writing for the eight-justice majority, held that the debtor's position (the "forward-looking" approach) was the stronger one. In reaching this conclusion, the Court first examined the meaning of the term "projected" in light of its common meaning and use in other Federal Statutes and case law. The Court found that "projected" takes into account anticipated events and is not simply the mechanical extension of past results. (Op. at 6) Pre-BAPCPA case law also buttressed the majority's ruling. Prior to the enactment of the 2005 Amendments, courts generally adopted a flexible standard that took into account present income to determine the debtor's "projected disposable income". (Op. at 8-10) The Court reasoned that since Congress did not present a "clear indication" that it wished to alter past bankruptcy practice when failed to alter the phrase "projected disposable income" in the 2005 Amendments, the pre- BAPCPA practice of basing "projected disposable income" on a debtor's present, not past, income should continue in force. (Op. at 10).

The *Lanning* Court dismissed the Trustee's "mechanical approach" as inconsistent with other provisions of the Bankruptcy Code. (Op. at 11-12) Furthermore, the Court found the "mechanical approach" to be in opposition to the goals of the Bankruptcy Code because it would preclude individuals, such as the debtor, from filing Chapter 13 cases by creating an artificially high payment. (Op. at 14) Finally, the Court discards the Trustee's suggestions that a debtor could avoid this implication of the "mechanical approach" by delaying the filing of a case or employing other strategies to bring the average income in the six-month "look-back" period in line with a debtor's present income. (Op. at 15-18)

The lone dissenter, Justice Scalia, argues that the majority essentially re-writes the Bankruptcy Code by "deleting words Congress enacted, or adding others it did not". (Dis. Op. at 4)

The *Lanning* decision impacts the Bankruptcy Code beyond the definition of "projected disposable income" in Chapter 13 cases. Following the lead of many bankruptcy and appellate courts, the Supreme Court has indicated that the often imprecise language of the 2005 Amendments should be interpreted beyond its literal meaning. In other words, the *Lanning* Court extends an implicit invitation to lower courts to apply their common sense and look to the purposes of the Bankruptcy Code when a "mechanical" approach would yield an inequitable result.

Darrohn v. Hildebrand (*In re Darrohn*), 615 F.3d 470 (6th Cir. Tenn. 2010)

In this case, the Sixth Circuit reversed and remanded the bankruptcy court's calculation of the debtor's projected disposable income in light of the Supreme Court's holding in *Hamilton v. Lanning*.

In *Darrohn*, the Debtors' proposed payment plan was based "disposable income" as calculated on their schedules but that did not account for their changed circumstances. The "current monthly income" number in the plan was based on the six-month look-back

period, which included a 90-day period of unemployment for David Darrohn. The Debtor had had since found a new job so the previous six month produced an artificially low projected disposable income number. The Debtors also deducted mortgage payments on property they intended to surrender.

The trustee objected to the Debtors' proposed payment plan. The trustee argued that the plan should take into account the Debtors' changed circumstances as well as the fact that they intended to surrender the property. The bankruptcy court approved the plan notwithstanding the trustee's objections.

The trustee appealed the plan confirmation alleging that the bankruptcy court erred in using the Debtor's income calculated under form B22C, rather than the income listed in Schedule I, and it also erred in allowing the Debtors to deduct mortgage payments even though they intended to surrender the property. *Id.* at 473.

Section 1325(b) provides that the bankruptcy court may not confirm a plan unless the plan "provides that all of the debtor's 'projected disposable income' be submitted to unsecured creditors and that this amount be calculated by taking the debtor's 'disposable income' less 'amounts reasonably necessary' for maintenance and support." *Id.* at 474. In calculating a debtor's "disposable income," the bankruptcy code uses "current monthly income" which is the average monthly income the debtor receives in the six months prior to filing the bankruptcy petition.

In *Lanning*, the Supreme Court examined the term "projected disposable income" and concluded that "when a bankruptcy court calculates a debtor's projected disposable income, the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation." *Id.* at 475-6 *quoting Hamilton v. Lanning*, 130 S.Ct. 2464, 2478 (2010). According to the Court, "a mechanical application would clash with the terms of § 1325 and would lead to 'senseless results'." *Id.* at 476.

The Court of Appeals held that the issues in this case "both fall squarely within the Court's decision in *Lanning*," and the bankruptcy court erred in deciding both issues. *Id.* First, in determining the Debtors' projected disposable income, the bankruptcy court had the authority to consider the income from David Darrohn's new job because it was "known or virtually certain" at the time of confirmation. In using the Debtors' past income, rather than their actual projected income, the bankruptcy court's decision "clashed with the mandates of section 1325." *Id.*

The court also held that the bankruptcy court erred in failing to account for the Debtors' intent to surrender the properties securing the mortgages. The Debtors' should not have deducted the mortgage payments from their current monthly income in calculating their projected disposable income when they were no longer going to be responsible for these payments.

This case shows that in light of *Lanning*, bankruptcy courts have the authority to account for changes in a debtor's financial situation since filing their petition. Doing so allows the court to use a debtor's actual projected income, because rigid application of the estimates produced through the six-month look-back period have the potential to produce inaccurate and sometimes absurd results.

Whaley v. Tennyson (*In re Tennyson*), 2010 U.S. App. LEXIS 14638 (11th Circuit, 2010):

In *Whaley v. Tennyson* (*In re Tennyson*), the 11th Circuit Court of Appeals was required to interpret the meaning of the term "applicable commitment period" as used in 11 U.S.C. §1325. Specifically, whether §1325 requires a five year plan for an above median income debtor whose plan fails to pay unsecured creditors in full, when the debtor has a negative disposable income.

In *Tennyson*, the appellee debtor filed a chapter 13 bankruptcy case. The debtor's income was above the median family income for a household of his size in his home state of Georgia. When the expenses listed in 11 U.S.C. §707(B)(2)(a) & (b) were subtracted from his monthly income it resulted in a negative monthly disposable income. The debtor proposed a three year chapter 13 plan that failed to repay unsecured creditors in full. The chapter 13 trustee objected to the plan claiming 11 U.S.C 325(b)(4) requires a five year plan for above median debtors whose plan will not pay unsecured creditors claims in full.

11 U.S.C. §1325(b)(4) provides that, "For purposes of this subsection," the "applicable commitment period" shall be a minimum of 5 years for above median income debtors, unless their plan provides for payment in full of all allowed unsecured claims. The debtor argued §1325(b)(4) does not stand alone to create a strict minimum plan duration. Rather it is meant to be read together with the rest of §1325 because the language "For purposes of this subsection," limits the scope of the term "applicable commitment period" to its use in other parts of §1325. The only other use of the term "applicable commitment period" is found in §1325(b)(1)(B) which provides for the confirmation of a debtor's plan, over the objection of the Trustee or unsecured creditor, if the plan provides for payment of all of the debtors disposable income to unsecured creditors during the "applicable commitment period."

Under the debtor's interpretation of the statute, an above median debtor with a negative disposable income would always be providing "all" [\$0] of their disposable income to the plan. Regardless of the length of the plan, the unsecured creditors would receive nothing, and the "applicable commitment period" would be meaningless. The chapter 13 trustee, in the alternative, argued that the plain reading of §1325(b)(4) provided a "applicable commitment period" of five years for above median income debtors unless the plan provided for payment of unsecured claims in full.

The bankruptcy court accepted the debtor's interpretation of "applicable commitment period" and the district court affirmed.

The U.S. Court of Appeals for the Eleventh Circuit reversed the two lower courts rulings, finding that the plain reading of the term “applicable commitment period” found in §1325(b)(4) provides the minimum duration of a chapter 13 debtors plan. The only exception to the minimum duration set forth in §1324(b)(4) is when the debtors plan provides for full payment of unsecured claims.

The Court also found support for its holding in the recent U.S. Supreme Court decision, *Hamilton v. Lanning*, 130 S. Ct. 2464 (U.S. 2010). The *Lanning* Court found that projected disposable income may not be the result of a strict §1325(b)(1)(B) calculation and outlined other factors for courts to consider. As such, this Court reasoned, the “applicable commitment period” must have an independent significance, or it would be without a definite meaning as it too would be dependent on the multitude of factors outlined in *Lanning*.

The Court of Appeals went on cite legislative history to further reinforce their opinion. A report on the legislation from the House of Representatives stated, “The heart of [BAPCPA] consumer bankruptcy reforms...is intended to ensure that debtors repay creditors the maximum they can afford.” Specific references to restrictions on plan length were also found in the House Report and indicate that §1325(b)(4) was intended to establish a five year plan for debtors with income exceeding certain monetary thresholds. The Court found its’ interpretation of “applicable commitment period” consistent with Congress’ intent.

The *Tennyson* decision clarifies the plan length requirements for above median income debtors. The language in the statute is clear and unambiguous regarding the “applicable commitment period” in §1325(b)(4). An above median income debtor is required to have a 5 year plan unless he provides for payment in full of all unsecured claims in a shorter period.

Jason M. Ransom v. MBNA (In re Ransom), 577 F. 3d 1026 (9th Cir. 2009)

The 9th Circuit Court of Appeal in, *In re Ransom*, was asked to decide whether an above median income chapter 13 debtor was allowed to deduct from his projected disposable income a vehicle “ownership cost” for a vehicle he owned free and clear.

The chapter 13 debtor, in *Ransom*, had monthly income above the median income for a household of his size in his home state. The debtor claimed monthly expenses that included vehicle “ownership cost” in the amount of \$471.00. The debtor proposed a five year chapter 13 plan that provided a 25% distribution to general unsecured claims. An unsecured creditor, MBNA objected to confirmation of the debtor’s plan claiming it failed to devote all of his projected disposable income to fund the plan. MBNA argued that the debtor could only deduct a vehicle ownership cost if he was actually making a lease or loan payment, and in this case, the debtor owned the vehicle outright.

Under 11 U.S.C. §1325(b)(1)(A), (B) A court may not approve a chapter 13 plan over the objection of an unsecured creditor unless the plan provides for 1) payment in full of the unsecured claim, or 2) the plan devotes all of the debtor's projected disposable income to make payments to unsecured creditors over the life of the plan. "Disposable income" is defined as "current monthly income received by the debtor..less amounts reasonably necessary to be expended... for the maintenance and support of the debtor..." 11 U.S.C. §1325(b)(2)(A)(i). The amount is reasonably necessary to be expended for an above median income debtor are determined by reference to the "means test" in 11 U.S.C. §707(b)(2).

According to §707(b)(2) a debtor's monthly expenses "shall be the debtor's *applicable* monthly expense amounts specified under the National Standards and Local Standards, and the debtor's *actual* monthly expenses for categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides..." The IRS Local Standards allow for two categories of transportation expenses: 1) operating costs and public transportation costs, and 2) ownership costs.

The bankruptcy court denied confirmation of the debtor's plan and the bankruptcy appellate panel affirmed the bankruptcy court's decision.

The Court of Appeals affirmed both lower courts rulings finding that the statute does not allow a debtor to deduct an "ownership cost" that the debtor does not actually have. It acknowledged a split of authority on the issue with the 5th and 7th circuits permitting a deduction for vehicle "operating costs" even though the vehicle was unencumbered by a debt or lease. Those courts applied a "plain language approach" to the statute, focusing on §707(b)(2)(A)(ii)(I)'s use of the term "applicable" and finding that if referred to the expense amount as applied to the corresponding geographic area, and the number of vehicles owned by the debtor.

The 9th Circuit recognized that other courts have denied the deduction from disposable income using the "IRM approach" looking at the definition of the term "applicable" as used in the Internal Revenue Manual. These courts reason that because Congress incorporated the IRS National and Local Standards in §707(b)(2)(A)(ii)(I), it must have intended courts to look at how the IRS defines categories and calculates expenses. These courts have found the IRM requires a taxpayer to have a loan or lease payment to qualify for the ownership cost deduction.

In this case, the Court of Appeals employed a plain language approach, but reached the opposite conclusion of the 5th and 7th circuits. It found that the term "applicable," as used in §707(b)(2)(A)(ii)(I), indicates that the deduction of the monthly expense amount specified under the Local Standard for the expense becomes relevant to the debtor when he in fact has such an expense. The Court went on to support its conclusion by finding it consistent with a primary objective of the BACPA amendments, ensuring that debtors repay as much of their debt as reasonably possible.

The *Ransom* decision reinforces the spirit of the BACPA amendments by preventing the

chapter 13 debtor from sheltering part of his income from creditors. It suggests that a common sense approach should be used in reference to calculating a debtors' disposable income and rejects an allowance for expenses that the debtor doesn't actually pay.

United Student Aid Funds, Inc. v. Espinosa (*In re Espinosa*), 130 S. Ct. 1367 (2010)

The Supreme Court, in *In re Espinosa*, examines the effect of a creditor's failure to timely assert rights to which it is entitled under the Bankruptcy Code. The creditor in *Espinosa*, United Student Aid Funds, Inc. ("United"), was the holder of a claim based on a student loan and received actual notice of the debtor's proposed Chapter 13 plan which proposed a discharge of a portion of the student loan. Despite the fact that this proposed treatment of the student loan claim was contrary to provisions of the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure, United failed to file an objection to the proposed plan (but filed a proof of claim). In the absence of an objection, the plan was confirmed with language subjecting a portion of the student loan claim to discharge. The debtor subsequently received a discharge after the completion of the plan payments.

When United, after discharge and approximately ten years after the confirmation of the plan, attempted to collect the unpaid balance on the loan, the debtor filed a motion in the bankruptcy court to enforce the discharge. In response to this motion, United filed a motion for relief from the order confirming plan under Fed. R. Civ. P. 60(b)(4) alleging that the order was void. In the motion, United asserted that the order was void because the provisions in the debtor's plan discharging a portion of the student loans were contrary to the Bankruptcy Code; the bankruptcy court never made a finding that the full repayment of the loans would constitute an "undue hardship" as required under 11 U.S.C. § 523(a)(8) and 11 U.S.C. § 1328(a); and were contrary to the Bankruptcy Rules because such a finding of undue hardship was required to be made in the context of an Adversary Proceeding pursuant to Fed. R. Bankr. P. 7001(6). United also argued that the order confirming plan was void because it was denied due process as it was not served with a summons and complaint in derogation of Fed. R. Bankr. P. 7003, 7004 and 7008.

The unanimous Supreme Court affirmed the Ninth Circuit Court of Appeals' ruling that United failed to demonstrate that the order confirming plan was void so as to warrant relief from the order under Fed. R. Civ. P. 60(b)(4).¹ The Court determined that a void judgment or order "is one so affected by a fundamental infirmity that the infirmity may be raised even after the judgment becomes final." (Op. at 8) Such an infirmity, for purposes of Rule 60(b)(4), only includes "the rare instance where a judgment is premised either on a certain type of jurisdictional error or on a violation of due process that deprives a

¹ It should also be noted that the Court was presented with a challenge to the order confirming plan based on Rule 60(b)(4) only. The Court, therefore, does not explicitly foreclose other potential avenues for relief from an order confirming plan such as the other grounds for relief set forth in Rule 60(a) and 60(b) or in 11 U.S.C. § 1330 (providing a party in interest the ability to revoke an order confirming plan within 180 days of entry if the order was procured by fraud).

party of notice or the opportunity to be heard.” *Id.*

The Supreme Court found that United demonstrated neither a jurisdictional error nor a violation of due process. United failed to allege a jurisdictional error and the Court determined that such an argument would fail even if it had been presented. The Court also ruled that there was no violation of United’s due process rights because the failure to serve a summons and complaint pursuant to the Bankruptcy Rules was simply a violation of a right granted by a procedural rule, not a constitutional right. Rather, United was afforded its right to due process because it had actual notice of the contents of the debtor’s plan prior to confirmation.

The Supreme Court also failed to heed the United’s invitation to expand the definition of a void judgment or order under Rule 60(b)(4) to include circumstances in which a court acts wholly without statutory authority. United argued that because Section 523(a)(8) requires a court to make a determination of undue hardship before a student loan is subject to discharge and because Section 1325(a)(1) instructs a court to confirm a plan if a plan complies with the Bankruptcy Code, the bankruptcy court acted beyond its authority, thereby rendering the order confirming plan void. Although the bankruptcy court’s confirmation of the debtor’s proposed plan was a clear legal error, the Supreme Court determined that this defect does not void the order confirming plan. Instead, the legal error merely provides grounds for a timely appeal.

The Supreme Court’s decision, however, is not, on its face, wholly bereft of language favorable to creditors. As almost an epilogue (see footnote 14), the Court disagrees with the Ninth Circuit’s determination that a bankruptcy court *must* confirm a plan that has provisions contrary to the Bankruptcy Code, such as in the case at hand, absent a timely objection. Rather, the Court relies on Sections 1325(a) and 105(a) to obligate bankruptcy courts to conduct an “independent determination” of undue hardship under Section 523(a)(8) even if the effected creditor fails to object to confirmation or appear in an adversary proceeding.

Furthermore, the Court, to discourage debtors from including provisions in plan that are clearly in derogation of the Bankruptcy Code and Rules as a result of its ruling, endorsed the possibility of sanctions under Fed. R. Bankr. P. 9011 against debtors who file such pleadings. The Court also implicitly encourages Congress to enact other provisions to counteract “bad-faith” provisions in Chapter 13 plans.

Implications of *Espinosa*

In light of the Supreme Court’s decision in *Espinosa*, creditors in bankruptcy reorganization cases may be compelled to take a more active role in the confirmation process, including objecting to the confirmation of a debtor’s plan with provisions that are contrary to the protections provided under the Bankruptcy Code. The Court’s ruling is particularly relevant in jurisdictions in which case law had provided that the proof of claim superseded any contrary treatment in the plan. The decision in *Espinosa* is a clear indication that, henceforth, the treatment in a confirmed plan controls anything to the contrary in a proof of claim.

Milavetz, Gallop & Milavetz, P.A. v. United States, 130 S. Ct. 1324 (2010)

The *Milavetz* decision represents the Supreme Court's first foray into the 2005 Amendments to the Bankruptcy Code. In *Milavetz*, the Court contemplates the meaning of a "debt relief agency" in the Bankruptcy Code and whether such a person or entity may be subjected to certain limitations on advertisement and pre-petition advice to clients.

The plaintiffs, a law firm, two of its attorneys and two of its clients, filed a complaint in district court seeking declaratory relief from enforcement of certain provisions of the 2005 Amendments. The plaintiffs argued that an attorney is not a "debt relief agency" as defined by 11 U.S.C. 101(12A) and, even if attorneys were considered debt relief agencies, a number of the restrictions of and requirements for debt relief agencies set forth in 11 U.S.C. §§ 526, 527, and 528 are unconstitutional. Specifically, the plaintiffs asserted that the prohibition of a debt relief agency from advising a client to incur more debt "in contemplation of" the filing of a bankruptcy case in Section 526(a)(4) and the disclosure requirements in Section 528 are overbroad and, therefore, unconstitutional.

On appeal, the Supreme Court held that attorneys were considered debt relief agencies under the Bankruptcy Code and that the restrictions and requirements imposed on debt relief agencies should be read narrowly and, therefore, are constitutional.

The Court first examined the threshold question of whether attorneys are debt relief agencies. In affirming the Eighth Circuit Court of Appeals' finding that attorneys were debt relief agencies, the Court dismissed the plaintiffs' arguments, including one that Section 101(12A) makes no mention of attorneys, and relied on definitions supplied in the Bankruptcy Code and other provisions of the Code.

The Supreme Court, however, reversed the Court of Appeals' determination that Sections 526(a)(4) and 528 are unconstitutionally overbroad. The plaintiffs contended that Section 526(a)(4), as written, improperly encompasses any advice provided by an attorney to a debtor if the debtor might be considering bankruptcy. The Court, however, determined that the prohibition of advice to incur debt "in contemplation of" the filing of a bankruptcy case only pertained to "a specific type of misconduct designed to manipulate the protections of the bankruptcy system." (Op. at 13) To reach its conclusion, the Court read Section 526(a)(4) in conjunction with other sections of the Bankruptcy Code, such as Sections 523 and 707(b), which proscribed abusive conduct by creating infirmities for debtors who have engaged in such conduct. The purpose of Section 526(a)(4), therefore, is "to provide an additional safeguard against the practice of loading up on debt prior to filing" a bankruptcy case. (Op. at 14) The Court, therefore, adopted a narrow reading of Section 526(a)(4) and held that "a debt relief agency violates § 526(a)(4) only when the impetus of the advice to incur more debt is the expectation of filing for bankruptcy and obtaining the attendant relief." (Op. at 18)

The plaintiffs' challenge to disclosure requirements in Section 528 also was denied. Section 528, in part, mandates a debt relief agency to disclose, in advertisements, that it

is, in fact, a debt relief agency that assists individuals in filing bankruptcy cases. The plaintiffs alleged that the requirements of Section 528 are an improper regulation of commercial speech as applied to the plaintiff law firm. The Court, however, found that because Section 528 is geared to prevent misleading commercial speech, minimal scrutiny is required. Relying on *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, 471 U.S. 626 (1985), the Court determined that Section 528 was simply a disclosure requirement intended to protect consumers from the potentially misleading content in advertising.

Justice Scalia wrote a concurrence in which he agreed with the Court's conclusions and judgment, but disagreed with its reliance on legislative history. Justice Thomas also wrote a concurrence in which he questioned the validity of the relaxed scrutiny standard as set forth in *Zauderer, supra*.

Conn. Bar Ass'n v. United States, 2010 U.S. App. LEXIS 18894 (2d Cir. Conn. Sept. 7, 2010)

The Second Circuit applied and extended *Milavetz* in a free speech challenge to BAPCPA by the Connecticut Bar Association and bankruptcy attorneys.

The Code sections at issue in this case were: § 526(a)(4) which prohibits debt relief agencies from advising their clients "to incur more debt in contemplation of [bankruptcy] or to pay an attorney or bankruptcy petition preparer fee or charge for services performed as part of preparing for or representing a debtor" in a bankruptcy case; §527(a) and (b) require a debt relief agency to provide an assisted person with certain notices; § 528(a)(1)-(2) require a debt relief agency to execute a written contract with an assisted person; § 528(a)(3)-(4) and (b)(2) require certain language to be included in debt relief agency advertisements.

The Second Circuit applied *Milavetz* to the sections also at issue in *Connecticut Bar* and extended it to the new sections raised in the case. The Court ruled that the requirements in § 527(a) and (b) and § 528(a)(1)-(2) were compelled disclosures pertaining to commercial speech, and as such they were to subject rational basis review. The court found there was no violation of the Plaintiffs' First Amendment rights.

The Court also held that the contract requirements of § 528(a)(1)-(2) were subject to rational basis review. Using that standard, the court held that while the statute imposes strict liability on debt relief agencies whenever a client fails to sign a contract, that does not violate the Fifth Amendment Due Process Clause. The Court also concluded that §528(a)(3)-(4) and (b)(2) were "reasonably related" to the government's legitimate interest in combating the problem of inherently misleading commercial advertisements.

In re Bronsdon, 2010 WL 3655972 (1st Cir.BAP (Mass.))

Section 523(a)(8) of the Bankruptcy Code provides that student loans may be discharged in bankruptcy if the debtor shows “undue hardship.” This is a very difficult burden to meet. Most circuits follow the *Brunner* test which makes students loans extremely difficult to discharge in bankruptcy. It often requires a debtor to show mental illness or another incapacity as dire financial circumstances generally do not qualify.

While nine circuit courts of appeal have followed the Second Circuit’s *Brunner* test, a recent decision from the First Circuit Court of Appeals BAP rejected *Brunner* and opted to follow the Eight Circuit’s “Totality of the Circumstances” test instead.

The issue before the Court was whether Debtor Denise Bronsdon could discharge \$82,000 in student loans. Bronsdon, a 64-year old law school graduate, was unable to pass the bar exam after multiple attempts and lives solely on Social Security. Unable to obtain her own home on her small income, she lives in her father’s house. The Court noted that but for her father’s assistance, Ms. Bronsdon could find herself homeless. The court concluded there was no way someone at this age earnings this income on could pay back \$82,000 in student loans.

The *Brunner* test provides that student loans may only be discharged if the debtor shows: (1) inability, at his current level of income and expenses, to maintain a “minimal” standard of living; (2) the likelihood that this inability will persist for a significant portion of the repayment period; (3) and the existence of good faith efforts to repay the student loans. This is a very high standard to meet and typically an inability to pay is not enough

The Court rejected the lender’s request for the Court to adopt *Brunner* and to deny Ms. Bronsdon discharge of her student loans. (The Court also rejected the idea of an income contingent repayment plan because any debt forgiveness there would leave Ms. Bronsdon with nondischargeable tax debt). The Court explained that it would follow the “totality of circumstances” test, which allows a court to “consider all relevant evidence - the debtor’s income and expenses, the debtor’s health, age, education, number of dependents and other personal or family circumstances, the amount of the monthly payment required, the impact of the general discharge under chapter 7 and the debtor’s ability to find a higher-paying job, move or cut living expenses.” *Id.* at 5.

Applying this standard, the court found undue hardship and discharged the Debtor’s student loans. The Court agreed with the bankruptcy court’s reasoning, “in view of her age and work history, her prospects for a better financial future are dim. To subject her to a meaningless repayment plan when she clearly does not have the ability to repay these student loans now or in the foreseeable future is not required by 11 U.S.C. § 523(a)(8) and is inconsistent with this Court’s role as the adjudicator of undue hardship.” *Id.* at 11.

Ameriquet Mortgage Company v. Nosek (In re Nosek), 609 F. 3d 6 (2010)

This case is timely considering the current mortgage crisis. In this case the bankruptcy court imposed sanctions of \$250,000 on a lender, which originated the mortgage loan,

for misrepresenting it was the “holder” of the mortgage, when it had assigned the mortgage and was only the servicing agent.

In 1997 Ameriquest provided a loan for \$90,000 to Debtor Jacalyn Nosek, it took back a mortgage in that amount on her home. Ameriquest subsequently assigned the mortgage to a securitization trust for which Norwest Bank, Minnesota, N.A., acted as trustee. *Id.* at 7. Under the terms of the assignment, Ameriquest would service the loan and continue to deal with Nosek in this capacity. In 2005 it assigned these duties to another entity in 2005. *Id.*

In 2000 Nosek fell behind on her payments and Norwest began a foreclosure action. To stave off the foreclosure, Nosek filed for bankruptcy. She ultimately filed multiple petitions, the third of which was filed in October 2002. Ameriquest filed a proof of claim in its own name and moved for relief from the automatic stay pursuant to 11 U.S.C. § 362(a), staying in its motion that it was “the holder of a first mortgage.” *Id.* The Court acknowledged that suits by servicers acting on behalf of holders are common. “Under its service agreement with Norwest, Ameriquest arguably had power to file proof of claim and seek relief in its own name; but Ameriquest did not then hold the mortgage and did not identify in its motion the source of its authority to act for Norwest.” *Id.*

In a subsequent adversary proceeding between Nosek and Ameriquest, Ameriquest filed an affidavit stating that it did not hold the mortgage and was acting as an agent for Norwest.

The bankruptcy court ordered Ameriquest to show cause why sanctions should not be imposed under Federal Rule of Bankruptcy Procedure 9011 for misrepresenting during the bankruptcy proceedings that Ameriquest was the holder of the mortgage. *Id.* at 8. The bankruptcy court imposed a total of \$650,000 Rule 9011 sanctions, \$250,000 was assessed against Ameriquest.

Ameriquest appealed the decision, arguing that while it could have done more to describe its representative capacity, a \$250,000 sanction was unreasonable. *Id.*

The Court of Appeals reduced the sanction amount as “not reasonable” under the facts of the case. *Id.* at 10. There was nothing to indicate that Ameriquest’s claim was “a deliberate falsehood or intended in any way to mislead the court or Nosek or achieve anything for Ameriquest.” *Id.* at 9. The decision seems to come down to a lack of prejudice as a result of misrepresentation. The sanction reduced to a relatively insignificant \$5000.

The Court acknowledged, “studies have shown that mortgage holders and servicers routinely file inaccurate claims, some of which may not be lawful.” *Id.* at 9. Porter, *Misbehavior and Mistake in Bankruptcy Mortgage Claims*, 87 Tex. L.Rev. 121, 123-24 (2008). Given the fact that “confusion and lack of knowledge, or perhaps sloppiness...is not unique in the residential mortgage industry.” Perhaps a larger sanction would have sent an important message to the industry.

In re Bartelini, 434 B.R. 285 (N.D.N.Y 2010)

A Trustee objected to confirmation of proposed Chapter 13 payment plans in three separate cases where the Debtors each received social security benefits. The Trustee disputed whether the debtors in each case had committed all of their projected disposable income during the applicable commitment period.

The Court held that Chapter 13 debtors cannot be compelled to include social security benefits when computing disposable income. The Court found that the provisions of BAPCPA that relate to social security income are clear and leave the court without discretion “regardless of how unfair the outcome may seem in a particular case.” *Id.* at 288. The Bankruptcy Code explicitly excludes social security income from the statutory definition of “current monthly income.” Therefore social security income “enjoys complete protection from the reach of unsecured creditors” in bankruptcy. *Id.* at 297.

Jerman v. Carlisle, 130 S.Ct. 1650 (2010)

Debtor brought an action against a debt collector alleging violations of the federal Fair Debt Collection Practices Act (FDCPA). The Supreme Court held that the bona fide error defense in FDCPA does not apply to a violation of the Act resulting from a debt collector’s incorrect interpretation of the legal requirements of the Act.

The FDCPA imposes civil liability on debt collectors for certain prohibited practice. The bona fide error defense protects debt collectors from liability when there is a qualifying factual error. “Section 813(c) of the Act, 15 U.S.C § 1692k(c), provides that a debt collector will not be liable in an action brought under the Act if he can show ‘the violation was not intentional and resulted from a bona fide error notwithstanding the maintenance of procedures reasonable adapted to avoid any such error’.” *Id.* at 1609.

In this case Carlisle, a law firm, filed a foreclosure action in state court on behalf of its client, Countrywide Home Loans, Inc. The complaint included a “Notice,” that was served on Karen L. Jerman, a homeowner, stating that the mortgage debt would be assumed to be valid unless she disputed it in writing. *Id.* at 1610. Her lawyer sent a letter disputing the debt and Carlisle verified this with Countrywide, which acknowledged that the debt had been paid in full. Upon receiving this information, Carlisle withdrew the lawsuit.

Jerman filed suit against Carlisle alleging that by requiring her to dispute the debt in writing, it violated FDCPA. The District Court held that Carlisle had violated the statute but that it was shielded from liability because the violation was not intentional, resulted from a bona fide error and occurred despite procedures designed to provide such errors. *Id.* The Sixth Circuit acknowledged that courts are divided regarding the scope of the bona fide error defense and that the majority view is that it is “available for clerical and factual errors only.” *Id.* The Sixth Circuit held that it extended to “mistakes of law” as well. *Id.*

The Supreme Court explained that it has long been recognized “that ignorance of the law will not excuse any person, either civilly or criminally.” *Id.* at 1611. Therefore, the bona fide error defense only applies to qualifying mistakes of fact, not a mistake of law.

U.S.A. v. Carroll, 423 B. R. 294 (E.D. Mich, 2010)

The Court in *U.S.A. v. Krispen S. Carroll* had to decide whether to enjoin the chapter 13 trustee’s and the Eastern District Bankruptcy Judges from ordering the IRS to pay a debtor’s tax refund directly to the chapter 13 trustee during the debtor’s ongoing bankruptcy case. To resolve this matter the Court needed to determine whether the bankruptcy court had the power to grant such an order and whether it would be a violation of sovereign immunity.

The Bankruptcy Court in the Eastern District of Michigan developed a standardized model plan and confirmation order directing the IRS to issue any refund the debtor becomes entitled to during the pendency of his chapter 13 plan directly to the chapter 13 trustee. The IRS indicated that complying with the orders had become a substantial burden. As of April, 2008 the IRS was tracking 401 chapter 13 plans with the provision included and by April 2009 the number had increased to 4,966. The IRS moved the U.S. District Court for the Eastern District of Michigan to issue a writ of mandamus to prevent the enforcement of orders that included the order to the IRS and to prohibit the bankruptcy court from issuing orders with that language in the future.

The doctrine of “sovereign immunity” provides for complete immunity for the United States unless it consents to suit and that any waiver of that immunity must be explicit. In order for a writ of mandamus to be issued, the party seeking the writ must establish three elements. First, the party must have no other means to attain the relief desired. Second, the party must show that the right to issue the writ is clear and indisputable. Third, the court issuing the writ must find the writ appropriate under the circumstances.

The District Court ruled in favor of the IRS and issued an order preventing the chapter 13 trustee from enforcing confirmation orders with the IRS redirection provisions and prohibiting the bankruptcy court from entering future orders with such a provision.

The Court found that IRS satisfied its burden to have the writ issued. First, there was no other means for the IRS to attain the desired relief. The Court rejected the idea that the issue should be remanded to the bankruptcy court because the bankruptcy court made its position clear in a joint letter to the Attorney General, from 2009, indicating that the bankruptcy court judges had the jurisdiction and authority to issue such orders. Additionally, the IRS was not required to file an appeal in each case with the offending order as the relief sought did not relate to a particular case, but concerned the bankruptcy court’s procedure as it related to the model plan and confirmation order.

Second, the District Court found that because the IRS did not waive its sovereign immunity, the IRS did have a clear and indisputable right to have the writ issued. 11

U.S.C. §106 provides only a limited waiver of sovereign immunity insufficient to subject the IRS to the bankruptcy court's jurisdiction in this regard. The Court also rejected arguments for a waiver of sovereign immunity through the granting of *in rem* jurisdiction pursuant to 28 U.S.C. §1334(d). The Order at issue requires the IRS to direct yet to be determined tax refunds to the trustee, therefore there is no *res* [property] for the bankruptcy court's jurisdiction to attach. Finally, the Court also found the issuance of the writ to be appropriate under the circumstances because the bankruptcy court, by entering the orders, was acting beyond its jurisdiction.

Ultimately, based on the ruling in *U.S.A. v Krispen S. Carroll*, the bankruptcy court does not have the power to require the IRS to turn over tax refunds directly to the chapter 13 trustee. The redirection provision was one tool used by the chapter 13 trustee to assist in the successful completion of a debtors plan. The chapter 13 trustee will now need to attempt to recover tax refunds that are not turned over by debtors, or have debtors sign an authorization form allowing the trustee to receive the debtor's refund directly.

Schwab v. Reilly, 130 S. Ct. 2652 (U.S. 2010)

In this case the court held that when a Debtor claims property as exempt, the debtor retains an interest in the property but they do not retain a right to the asset itself.

Reilly filed a Chapter 7 petition when her catering business failed. On Schedule B, under assets, she listed cooking and other kitchen equipment from the catering business and estimated their value at \$10,718. *Id.* at 2658. On Schedule C, on which debtors list property they wish to claim as exempt, she listed two exempt interests. *Id.* at 2658. One was "business equipment": a "tool[s] of the trade" exemption for the statutory maximum "\$1,850 in value," 11 U. S. C. §522(d)(6); and \$8,868 under the statutory provisions allowing miscellaneous, or "wildcard," exemptions up to \$10,225 in value. *Id.* The total value of the claimed exemptions was \$10,718, equal to her estimate of the equipment's market value.

Property claimed as exempt will be excluded from the bankruptcy estate "[u]nless a party in interest" objects, §522(*l*), within a certain 30 day period, see Fed. Rule Bankr. Proc. 4003(b). Absent an objection, the property will be excluded from the estate even if the exemption's value exceeds the limits permitted in the Code. *Id.*

Despite the fact that an appraisal of the equipment indicated that it could be worth as much as \$17,200, the trustee, did not object to the claimed exemptions because the dollar value the Debtor assigned to each fell within the limits of §§522(d)(5) and (6). Instead, the trustee made a motion for permission to auction the equipment so that the Debtor could receive the amount she claimed as exempt and the trustee could distribute any value in excess of that to her creditors.

The debtor argued that the estate had forfeited its claim to any portion of that value because the trustee had failed to object to the exemption. *Id.* The bankruptcy court denied the trustee's motion. The District Court also denied the trustee relief. The Third

Circuit affirmed explaining that the by listing the equipment on Schedule C, the debtor indicated her intent to exempt the equipment's full value and the trustee's failure to object entitled the Debtor to exempt the full value of her equipment, even though that value exceeded the amounts that the Debtor declared and the Code permitted.

The Supreme Court held that the trustee was not required to object to the Debtor's exemptions in order to preserve the estate's right to retain any value in the equipment beyond the value of the exempt interest. The Court explained that the Code defines exempt property as an "interest, not to exceed a certain dollar amount, in a particular asset, *not* as the asset itself." *Id.* at 2662. The value of the property claimed exempt should be judged on the dollar value the debtor assigns the interest, *not* on the value the debtor assigns the asset." To hold otherwise would "convert the Code's goal of giving debtors a fresh start into a free pass." *Id.* at 2667.

Gebhart v. Gaughan (*In re Gebhart*), ___ F.3d ___, 2010 WL 3547641 (9th Cir. Sept. 14, 2010) (companion case – Chappell v. Klein (*In re Chappell*))

In these companion cases, the court found that value attributable to appreciation in the debtor's residence is property of the estate even though the debtor's equity in the property was claimed as exempt.

In this case, when the Debtors filed for Chapter 7 the value of the equity in their homes was less than the amount they were eligible to claim under the state or federal homestead exemption. This meant there was no value in the property that could become part of their bankruptcy estate. As a result, the debtors expected that they would be able to retain ownership of their home, subject to a mortgage. The value of the homes subsequently increased so that the debtors had equity in excess of the homestead exemptions

The Trustee sought to sell the property in order to recover the excess equity for the benefit of creditors. The bankruptcy court ruled that the homestead had passed entirely out of the estate when the Chappells had claimed all of their equity in it as exempt and the Trustee failed to object. The Trustee appealed and the bankruptcy appellate panel (the "BAP") reversed the bankruptcy court's decision, holding that the postpetition appreciation in the homestead belonged to the estate. *Klein v. Chappell* (*In re Chappell*), 373 B.R. 73, 83 (9th Cir. BAP 2007).

The Ninth Circuit relying on *Schwab v. Reilly*, allowed the sale. 130 S. Ct. 2652 (2010). The Court held that when a Debtor exercises a homestead exemption, "what is removed from the estate is an 'interest' in the property equal to the value of the exemption claimed at filing." *Id.* at 12. This means that the value of the exemption is fixed at the date of filing, but the equity in a home is not. Because the exemption applies to the Debtor's interest and not the home itself, the home remained part of the bankruptcy estate. This allowed the trustee to distribute the post-petition increase in the home's value over and above the total of the exemption and the encumbrances on the property.

Application of the Absolute Priority Rule to Individual Chapter 11 Debtors

***In re Roedmeier*, 374 B.R. 264 (Bankr. D. Kan. 2007), and Its Progeny**

In *Roedmeier* an individual Debtor proposed a Chapter 11 reorganization plan which provided that the Debtor would continue to operate his dental practice. The debtor sought approval of his disclosure statement and confirmation of the plan under 11 U.S.C.S. § 1129, and an unsecured creditor objected to the disclosure statement.

One objection was based on an alleged failure to satisfy the “projected disposable income” requirement. In confirming the plan over the creditor’s objection, the court held that the strict § 707(b) “means test” expense allowances should not apply when calculating an individual Chapter 11 Debtor’s projected disposable income. The court explained that § 1129(a)(15)(B) “must be read to allow a judicial determination of the expenses that are reasonably necessary for support of the debtor and his or her dependents.” *Id.* at 272-3. This creates a much more flexible standard in individual Chapter 11 cases than in Chapter 13.

The more controversial part of the decision was when the Debtor asked the court to confirm the plan over the objections of the class of general unsecured creditors through cramdown under § 1129(b).

The "fair and equitable" prong of the § 1129(b) "cramdown" test is referred to as the "absolute priority" rule because it generally prohibits any junior class of interests from receiving or retaining any interest if any senior impaired class does not accept the plan. This requirement was modified in BAPCPA with respect to individual Chapter 11 cases. Now an individual chapter 11 debtor “may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14) of . . . section [1129].” 11 U.S.C. § 1129(b)(2)(B)(ii).

In *Roedmeier*, the Court confirmed the Debtor’s plan and held that the absolute priority rule does not apply to individual Chapter 11 Debtors. The Court explained that BAPCPA had made a number of changes to chapter 11 "so that it could function for individual debtors much like Chapter 13 does." *Id.* at 264. In chapter 13, there is no "absolute priority" rule.

There is a circuit split in the interpretation of the changes to Chapter 11 under BAPCPA. In the Eighth Circuit, a bankruptcy court in Nebraska issued a decision concluding that the absolute priority rule has been eliminated for individual Chapter 11 debtors. *See In re Tegeder*, 369 B.R. 477 (Bankr. D. Neb. 2007).

Conversely, two bankruptcy courts in the Eleventh Circuit recently issued decisions concluding that the absolute priority rule does apply to post-BAPCPA individual Chapter 11 debtors. *See In re Gelin*, 2010 Bankr. LEXIS 3217 (Bankr. M.D. Fla. Sept. 29, 2010); *In re Steedley*, 2010 Bankr. LEXIS 3113 (Bankr. S.D. Ga. Aug. 27, 2010).

There is a split within the Ninth Circuit cases. A bankruptcy court in the Northern District of California held that the absolute priority rule continues to apply in cases involving individual Chapter 11 debtors. *In re Gbadebo*, 431 B.R. 222, 228 (Bankr. N.D. Cal.

2010). A bankruptcy court in the district of Nevada, takes the opposite view. See *In re Shat*, 424 B.R. 854 (Bankr. D. Nev. 2010).

A bankruptcy court decision in the Fourth Circuit cited the *In re Gbadebo* decision explaining that its approach is more consistent with the language of the statute. The court in *In re Mullins* held that the “language of §1129(b)(2)(B)(ii) is not ambiguous and that it only excepts from the absolute priority rule the debtor's post-petition earnings and other property acquired after the commencement of the case. *In re Mullins*, 2010 435 B.R. 352 (Bankr. W.D. Va. 2010).