Northeast Consumer Forum

The Supreme Court Takes On Consumer Bankruptcy (and the Unintended Consequences)

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2010 Educational Materials

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Lamie v. United States Trustee, 540 U.S. 526; 124 S. Ct. 1023 (2004)

Statement of Facts:

The Petitioner was an attorney who had filed an application with the U.S. Bankruptcy Court for the Western District of Virginia, seeking attorneys' fees under § 330(a)(1) for the time he had spent working on behalf of a debtor after his clients' case had been converted from Chapter 11 to Chapter 7. Although the Court had approved the debtor's application to employ the Petitioner during the Chapter 11 phase of the case, an application was not filed to employ the petitioner after the case was converted to Chapter 7. The Respondent United States Trustee objected to the Petitioner's request for post conversion attorneys' fees on the ground that the Petitioner was not employed pursuant to § 327 and therefore could not be compensated under § 330(a(1). The Bankruptcy Court agreed with the Respondent and denied the Petitioner's application for attorneys' fees and held that in a Chapter 7 case, § 330(a)(1) did not authorize payment of attorneys' fees unless the attorney had been appointed under § 327.

Procedural Posture:

Both the U.S. District Court for the Western District of Virginia and the Fourth Circuit Court of Appeals affirmed the Bankruptcy Court's denial of fees.

Holding:

The Supreme Court affirmed the Fourth Circuit's decision and held that, although § 330(a)(1) was awkward and even drafted with poor grammar, it was not ambiguous and did not authorize compensation awards to debtors' attorneys from bankruptcy estate funds, unless their employment was authorized by § 327. The Court stated that attorneys are not included on the list of payees under § 330(a)(1) except as professional persons employed by a trustee and approved

by the bankruptcy court. The Court held that it was irrelevant that attorney services were listed as compensable services under § 330(a)(1)(A).

The Court held that the Bankruptcy Reform Act of 1994 amended the Bankruptcy Code to replace the old § 330(a) provision which authorized a court to "award to a trustee, to an examiner, to a professional person employed under section 327 . . . or to the debtor's attorney . . . reasonable compensation for . . . services rendered by such trustee, examiner, professional person, or attorney," with § 330(a)(1)'s provision authorizing a court to "award to a trustee, an examiner, a professional person employed under section 327 . . . reasonable compensation for actual, necessary services rendered by the trustee, examiner, professional person, or attorney," basically deleting "or to the debtor's attorney." The Court held that because the plain meaning of § 330(a)(1) did not lead to an absurd result, the Court would not read into § 330(a)(1) language that was purportedly inadvertently omitted by Congress.

Take Away/Questions:

Unless a debtor's attorney is employed by the trustee, he or she will not be paid from the bankruptcy estate for time spent while the case is in Chapter 7. When can a debtor's attorney refuse to assist the Chapter 7 trustee if the trustee does not employ her? How does this decision impact debtor's counsel when a Chapter 11 trustee is appointed? Can a retainer obtained prior to the filing of a Chapter 11 case be structured to apply first to time spent after conversion to Chapter 7?

Lee M. Till, et ux. v. SCS Credit Corporation, 541 U.S. 465; 124 S. Ct. 1951 (2004)

Statement of Facts:

The Debtors, Lee and Amy Till, purchased a used truck from Instant Auto Finance for $6,395 plus $330.75 in fees and taxes on October 2, 1998. The Debtors made a $300 down

payment and financed the balance of the purchase price by entering into a retail installment contract with Instant Auto Finance. This contract was immediately assigned to SCS Credit Corporation (the "Creditor"). The Debtors initial indebtedness amounted to $8,285.24, broken down as follows: $6,425.75 balance on the truck purchase plus a finance charge of 21 percent per year for 136 weeks. The Creditor retained a purchase money security interest. *Till v. SCS Credit Corporation*, 541 U.S. 465, 469-470 (2004). On October 25, 1999, the Debtors were in default on their payments and filed a joint petition for relief under Chapter 13. At the time of the filing, the balance due on the truck was $4,894.89. The parties agreed that the value of the truck securing the claim was $4,000. *Till* at 470. The Debtors Chapter 13 plan proposed to pay the secured portion of the Creditor's claim through the plan and would pay interest at a rate of 9.5 percent per year. The Creditor objected to the proposed interest rate. *Till* at 471.

Procedural history:

The United States Bankruptcy Court for the Southern District of Indiana confirmed the Debtors Chapter 13 plan over the objection of the Creditor which included an interest rate of 9.5 percent, supposedly representing the then national prime rate of 8 percent plus a risk adjustment of 1.5 percent. *Till* at 472. On appeal, the United States District Court for the Southern District of Indiana reversed the bankruptcy court's decision stating that the interest rates in a cram-down ought to be set under a "coerced loan" approach, at the level which a creditor could have obtained if the creditor had foreclosed on the loan in question, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk. *Id*. On further appeal, the United States Court of Appeals for the Seventh Circuit, vacated the District Court's judgment, and expressed the view that the original contract rate of interest ought to serve as the "presumptive" cram-down

rate, which either a creditor or a debtor could challenge with evidence that a higher or lower rate ought to apply. *Till* at 473.

Holding:

The Court granted certiorari in order to determine how rates of interest should be determined in a cram-down in Chapter 13. The Court settled upon the "prime-plus" or formula approach which it stated took its cue from ordinary lending practices and best comported with the purposes of the Bankruptcy Code.[1] *Till* at 478. The "formula approach" begins "by looking to the national prime rate, reported daily in the press, which reflects the financial market's estimate of the amount a commercial bank should charge a creditworthy commercial borrower to compensate for the opportunity costs of the loan, the risk of inflation and the relatively slight risk of default." *Till* at 479. Recognizing that bankruptcy debtors pose an increased risk of nonpayment than solvent borrowers, the formula approach allows the court to adjust the prime rate accordingly. Factors that would contribute to the size of the risk adjustment include "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." *Id*. The Court believed that some of the evidence for making this determination would come directly from a debtor's petition and schedules. The Court found that any additional evidentiary burden for adjusting an interest rate upward stated should be "squarely on the creditors, who are likely to have readier access to any information absent from the debtor's filings." *Id*.

The Court concluded that many of the factors a bankruptcy court would examine in determining any adjustment would "fall squarely within the bankruptcy court's area of expertise." *Id*. The Court reasoned that the formula approach it proposed would minimize the

need for costly additional evidentiary proceedings. *Id*. Finally, the resulting "prime-plus" rate of interest depended only on the state of financial markets, the circumstances of the bankruptcy estate, and the characteristics of the loan, not on the creditor's circumstances or its prior interactions with the debtor.

Take Away/Questions:

In hindsight, did the Court meet its objective of keeping evidentiary hearing costs down? Was this the most straightforward approach for determining the rate of interest that could be taken?

Richard Gerald Rousey v. Jill R. Jacoway, 544 U.S. 320; 125 S. Ct. 1562 (2005)

Statement of Facts:

The Debtors, Richard and Betty Jo Rousey had been employed at Northrup Grummen Corp. Their employment was terminated and the company required the Debtors to take a lump-sum distribution from their employer-sponsored pension plans. The Debtors, subsequently, deposited each lump sum into two IRAs,[2] one in each of their names. Several years after establishing the IRAs, the Debtors filed a joint Chapter 7 bankruptcy petition and claimed an exemption for the IRAs under 11 U.S.C. § 522(d)(10)(E). The Chapter 7 trustee objected to the Debtors claim of exemption for the IRAs and moved for immediate turnover.

Procedural Posture:

(…continued)

[1] The Court rejected the coerced loan, presumptive contract rate and the cost of funds approaches.

[2] The Debtors accounts qualified as IRAs because they met the following requirements imposed by the Internal Revenue Code: (1) Each account was "a trust created or organized in United States for the exclusive benefit of an individual or his beneficiaries," 26 U.S.C. § 408(a); (2) the Internal Revenue Code limited the types of assets in which IRA-holders may invest their accounts, §§ 408(a)(3), (a)(5); (3) the Internal Revenue Code provided that the balance in the IRAs was nonforfeitable, § 408(a)(4); (4) the Internal Revenue Code capped yearly contributions to IRAs, § 408(o)(2); and (5) withdrawals made before the accountholder turns 59 ½ were, with limited exceptions, subject to a 10-percent tax penalty, § 72(t). *Rousey v. Jacoway*, 544 U.S. 320, 323 (2005).

The United States Bankruptcy Court for the Western District of Arkansas sustained the Chapter 7 trustee's objection to the Debtors claimed exemption. The Debtors appealed the decision to the Bankruptcy Appellate Panel (BAP) which, in turn, agreed with the lower court finding that the Debtors could not exempt their IRAs under § 522(d)(10)(E). The BAP concluded that the IRAs were not similar plans or contracts to a stock bonus, pension, profit-sharing or an annuity plan, because the Debtors had unlimited access to the funds held in their IRAs. The BAP reasoned that the Debtors had complete control over the funds in the IRAs and this was only subject to a 10-percent tax penalty.

The Debtors appealed the decision to the Court of Appeals from the Eighth Circuit. The Eighth Circuit affirmed the BAP's decision. It reasoned that the Debtors right to payment was conditioned neither on age nor any other statutory factors. The Eighth Circuit concluded that the Debtors' IRAs were "readily accessible savings accounts of which the Debtors may easily avail themselves (albeit with some discouraging tax consequences) at any time for any purpose." *Rousey v. Jacoway*, 544 U.S. 320, 325 (2005).

Holding:

The question before the Court was whether debtors could exempt IRAs from the bankruptcy estate under 11 U.S.C. § 522(d)(10)(E). In *Patterson v. Shumate*, the Court indicated that IRAs like those at issue in the instant case satisfied the requirements laid out in § 522(d)(10)(E). *Rousey v. Jacoway*, 544 U.S. 320, 326 (2005), citing *Patterson v. Shumate*, 504 U,S, 753, 762-763 (1992)("Although a debtor's interest [in an IRA] could not be excluded under § 541(c)(2) . . ., that interest nevertheless could be exempted under § 522(d)(10)(E).") The Court reaffirmed the finding from *Patterson v. Shumate* and found that debtors could exempt the IRAs from the bankruptcy estate under § 522(d)(10)(E). The Court focused on two requirements

under § 522(d)(10)(E): (1) the right to receive payment must be from "a stock bonus, pension, profit sharing, annuity, or similar plan or contract;" and (2) the right to receive payment must be "on account of illness, disability, death, age, or length of service."

The Court's analysis first turned to the right to receive payment. The Court explained that it "interpreted the phrase 'on account of' to mean 'because of,' thereby requiring a casual connection between the term that the phrase 'on account of' modifies and the factor specified in the statute at issue." *Rousey* at 326. The Court concluded that "on account of" required that the right to receive payment be "because of" illness, disability, death, age, or length of service. It observed that the Debtors right to receive payment under the IRAs was restricted by a ten-percent tax penalty that applied to withdrawals that occurred prior to the accountholder turning 59 ½. The Court found this tax penalty to be substantial and a strong indication that Congress designed the statute to preclude early access to IRAs. The Court found the statutes governing the IRAs sufficiently persuasive that the right to payment from the IRAs was casually connected to their age. Because of this age limitation, the Court found that the Debtors right to the balance of their IRAs was a right to payment "on account of" age. *Rousey* at 328.

The Court then turned its focus to the requirement that the Debtors IRAs are "similar plan[s] or contract[s]" within the meaning of § 522(d)(10)(E). The Court found that to be "similar" means the IRAs must be like, though not identical to, the specific plans or contracts listed in the statute and must share characteristics common to the listed plans and contracts in the statute. *Rousey* at 329. The Court found that IRAs were similar to the plans and contracts listed in the statute as those plans provided a substitute for wages. The Court looked at three features of the IRAs. First, the minimum distribution requirements required distribution to begin at the latest in the calendar year after the year in which the accountholder turned 70 ½, thus when

accountholders were likely to be retired and lack wage income. *Rousey* at 331. Second, the Internal Revenue Code deferred taxation of money held in accounts qualifying as IRAs until the year in which it was distributed, thus treating it as income only in such years. *Id*. Finally, withdrawal before the age 59 ½, with a few exceptions, were subject to a tax penalty, further restricting preretirement access to the funds. *Rousey* at 332. The Court concluded that "all of these features show[ed] that IRA income substitutes for wages lost upon retirement," thereby distinguishing IRAs from typical savings accounts. *Id*.

Take Away/Questions:

Practically speaking, this question is no longer an issue. Practioners must review any IRAs of their debtors to ensure that they qualify under the Internal Revenue Code. And if they do, the debtors may claim an exemption for an IRA under § 522(d)(10)(E).

Marrama v. Citizens Bank of Massachusetts et al, 549 U.S. 365, 127 S. Ct. 1105 (2007)

Statement of Facts:

Respondent in this case was Robert Marrama who had filed a Chapter 7 bankruptcy case. During the Section 341 meeting, the Trustee determined that Marrama had not properly disclosed his ownership interest in certain real estate (the "Undisclosed Real Estate"). The Trustee advised the Debtor and his attorney during the Section 341 meeting that it was the Trustee's intention to sell the Undisclosed Real Estate for the benefit of the bankruptcy estate. Shortly after the Section 341 meeting the Debtor filed a Notice of Conversion of his case to Chapter 13. The Trustee filed an Opposition to the Motion to Convert which asserted that the request was being made in bad faith solely for the purpose of stopping the Trustee from selling the Undisclosed Real Estate. The United States Bankruptcy Court for the District of Massachusetts sustained the Trustee's objection holding that the conversion was being sought in bad faith.

Procedural Posture:

The Bankruptcy Appellate Panel and the First Circuit Court of Appeals affirmed the decision of the Bankruptcy Court.

Holding:

The Supreme Court affirmed the lower courts decisions finding that Marrama had forfeited his right to convert his case to Chapter 13. Although the Court noted that the legislative history of Section 706(a) indicates that the debtor has an "absolute" right to convert a Chapter 7 case to Chapter 13, conversion could be denied because Section 706(d) provides that "a case may not be converted to a case under another Chapter of this title unless the debtor may be a debtor under such Chapter". The Supreme Court reasoned that Marrama did not qualify to be a Chapter 13 debtor because under Section 1307(c) a Chapter 13 case may be dismissed or converted to Chapter 7 "for cause". Since Bankruptcy Courts routinely find that bad faith conduct constitutes "cause" for a ruling that a Chapter 13 case should be dismissed, the existence of bad faith means the individual does not qualify as a Chapter 13 debtor. The Court also found that "the broad authority granted to Bankruptcy Judges to take any action that is necessary or appropriate to prevent an abuse of process described in Section 105(a) of the [Bankruptcy] Code, is surely adequate to authorize an immediate denial of a Motion to Convert filed under Section 706 in lieu of a conversion order that merely postpones the allowance of equivalent relief and may provide a debtor with an opportunity to take an action prejudicial to creditors" and even if Section 105(a) had not been enacted, the inherent power of every Federal Court to sanction abusive litigation practices might well provide an adequate justification for a prompt rather than a delayed ruling on a unmeritorious attempt to qualify as debtor under Chapter 13."

Take Away/Open Questions

What is the applicability of *Marrama* to conversions from Chapter 7 to Chapter 11? Did the Supreme Court's rulings in connection with "bad faith", Section 105 and the Court's "inherent powers" change the landscape for all parties in all bankruptcy cases?

Milavetz, Gallo & Milavetz, P.A., et al., v. United States, 130 S.Ct. 1324, 2010 U.S. LEXIS 2206, ** (2010).

Statement of Facts:

The law firm Milavetz, Gallo & Milavetz, P.A. filed a preenforcement suit in District Court seeking declaratory relief with respect to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) debt-relief-agency provisions. Specifically, Milavetz challenged whether attorneys were included in the defined class of bankruptcy professionals termed "debt relief agencies" under 11 U.S.C. § 101(12A) and whether those statues applicable to debt relief agencies governed the actions of attorneys as well. The specific statues at issue were (1) § 526(a)(4) which prohibits any professional defined as debt relief agencies from advising an assisted person from incurring more debt in contemplation of filing bankruptcy, and (2) §§ 528(a)(3), (a)(4), (b)(2)(A) and (b)(2)(B) which requires debt relief agencies to disclose in their advertisements that certain services they provided may involve bankruptcy relief and that the advertisements must identify these professionals as debt relief agencies. Milavetz asked the court to hold that the firm was not a debt relief agency and therefore not bound by these provisions and thus may freely advise clients to incur additional debt and need not identify itself as a debt relief agency in it advertisements.

Procedural Posture:

The District Court agreed with Milavetz that "debt relief agencies" does not include attorneys and that §§525 and 528 are unconstitutional as applied to that class of professionals. The Eighth Circuit affirmed in part and reversed in part. It unanimously rejected the District Court's finding that attorneys are not debt relief agencies. The Eighth Circuit upheld the application of § 528's disclosure requirements to attorneys as the disclosures were intended to prevent consumer deception and are "reasonably related" to that interest. Finally, the Eight Circuit agreed with Milavetz that § 526(a)(4) is invalid holding that the language of the statute could not withstand either strict or intermediate scrutiny. It determined that § 526(a)(4) broadly prohibited a debt relief agency from advising an assisted person . . . to incur any additional debt when the assisted person contemplated bankruptcy even when that advice constitutes prudent prebankrupty planning not intended to abuse the bankruptcy laws. Both Milavetz and the United States appealed the judgment of the Eighth Circuit.

Holding:

The Court was asked to examine three questions: (1) whether the term "debt relief agency" included attorneys; (2) the scope and validity of § 526(a)(4); and (3) the validity of § 528's challenged disclosure requirements.

(1) Whether the term "debt relief agency" includes attorneys:

The Court held that attorneys who provide bankruptcy assistance to assisted persons are debt relief agencies within the meaning of BAPCPA. The Court examined the language of the statute and found that in the drafting of § 101(12A), Congress gave no indication that it intended to exclude attorneys and that the text and statutory context of § 101(12A) foreclosed a reading of debt relief agency that excluded attorneys. *Milavetz* at **13. The Court was not persuaded by

Milavetz's arguments that § 101(12A) does not expressly include attorneys or that the statute impermissibly trenches on an area of traditional state regulation. *Milavetz* at **16.

(2) The scope and validity of 11 U.S.C. § 526(a)(4)

The Court rejected the Eighth Circuit's conclusion that "§ 526(a)(4) broadly prohibits a debt relief agency from advising an assisted person . . . to incur any additional debt when the assisted person is contemplating bankruptcy." *Milavetz* at **19. The Court concluded that a narrower reading of § 526(a)(4) was more appropriate and that the statute was not impermissibly vague.

The Court determined that § 526(a)(4) prohibits a debt relief agency only from advising a debtor to incur more debt because the debtor is filing for bankruptcy, rather than for a valid purpose. The Court stated that the controlling question under the statute is "whether the impelling reason for 'advis[ing] an assisted person . . . to incur more debt' was the prospect of filing for bankruptcy." *Milavetz* at **26. The Court found that the statutory context supported the conclusion that § 526(a)(4) prohibited advice to "load up" on debt with the expectation of obtaining its discharge – i.e., conduct that was abusive per se. *Milavetz* at **27. In support of this determination, the Court looked to pre-BAPCPA statutes §§ 523(a)(2)(A) and (C), which prevent the discharge of debts obtained by false pretenses and making debts for purchases of luxury goods or services presumptively nondischargeable, as well as BAPCPA provisions like § 707(B)(2)(A)(i)-(iv) which lays out the means test. *Milavetz* at **27-28. Prohibited advice is not defined in terms of abusive prefiling conduct but rather the incurrence of additional debt when the impelling reason is the anticipation of bankruptcy.

The Court found professionals remain free to talk fully and candidly about the incurrence of debt in contemplation of filing a bankruptcy case. Section 526(a)(4) merely required that

professionals avoid instructing or encouraging assisted persons to take on more debt in that circumstance. In a footnote, the Court indicated that advising a potential debtor to refinance a mortgage or to purchase a more reliable car prior to filing because it will reduce a debtor's interest rates or improve a debtor's ability to repay is not prohibited under § 526(a)(4) as "the promise of enhanced financial prospects, rather than the anticipated filing is the impelling cause." *Milavetz* at **34.

The Court determined that it did not have to determine whether the statute could withstand further First Amendment scrutiny as Milavetz only challenged the constitutionality of the statute on vagueness grounds. *Milavetz* at **35.

(3) Validity of § 528's Challenged Disclosure Requirements

The Court determined that Milavetz's challenge to § 528 disclosure requirements was an "as-applied challenge." *Milavetz* at **35. The Court determined that the proper standard of scrutiny for provisions regulating only commercial speech was whether the disclosures that require a debt relief agency to identify itself as such and include certain information about its bankruptcy-assistance and related services are "reasonably related to the [Government's] interest in preventing deception of consumers." *Milavetz* at **42 citing *Zauderer v. Office of Disciplinary Counsel of the Supreme Court of Ohio*, 471 U.S. 626, 651 (1985). The Court found that "§ 528's required disclosures are intended to combat the problem of inherently misleading commercial advertisements – specifically, the promise of debt relief without any reference to the possibility of filing for bankruptcy which has inherent costs." *Milavetz* at **37-38. Additionally, the Court found that the required disclosures did not prevent a debt relief agency from conveying additional information, such as also being a law firm or an attorney. The Court was not persuaded by Milavetz's argument that the term "debt relief agency" was confusing or

misleading, nor did it accept Milavetz's argument that § 528 was not reasonably related to any governmental interest because it applies equally to attorneys who represent creditors. Milavetz argued that the required disclosures would counterfactual and misleading in instances where attorneys may represent both debtors and creditors. The Court found the language of the statute to be clear that it only applied to those professional who offer bankruptcy-related services to consumer debtors. *Milavetz* at **96-97.

Take Away/Questions:

While the Court explains that there are valid purposes for incurring debt prior to filing bankruptcy, and it includes as examples a debtor refinancing her home or purchasing a new car, what would not be a valid purpose? Will the courts now have to hold evidentiary hearings and determine if this pre-bankruptcy debt has a valid purpose or was it incurred in anticipation of a bankruptcy filing?

United Student Aid Funds, Inc. v. Espinosa, 559 U.S. ___ (2010).

Statement of Facts:

Prior to the filing of his Chapter 13 bankruptcy petition, the Respondent Debtor, Francisco Espinosa, obtained four federally guaranteed student loans in the total principal amount of $13,250.00 (the "Student Loans"). After filing his bankruptcy petition, the Respondent filed a Chapter 13 Plan (the "Plan") in which he listed the holders of his Student Loans as his only creditors. The Plan proposed to repay only the principal amount due on the Student Loans and specifically sated that the interest on the Student Loans would be discharged once he repaid all of the principal. In accordance with the Federal Rules of Bankruptcy Procedure, notice and a copy of the Plan was mailed to the Petitioner, United Student Aid Funds, Inc. ("United") The Petitioner, who had filed a proof of claim in the amount of $17,832.15,

which amount included both the principal and the accrued interest on the Student Loans, did not object to the Plan's proposed discharge of the Student Loan interest. The Bankruptcy Court entered an order confirming the Plan (the "Confirmation Order").

Four years after the entry of the Confirmation Order, the Respondent completed the payments toward the outstanding principal on the Student Loans as required by the Plan and the Bankruptcy Court entered a Discharge Order. Three years later, when the Department of Education attempted to collect the unpaid interest on the Student Loans, the Respondent moved to have the Discharge Order enforced (the "Enforcement Motion"). The Petitioner filed an Opposition to the Enforcement Motion and a cross-motion seeking to set aside the Confirmation Order as void pursuant to Fed. R. Civ. P. 60(b)(4). The Petitioner argued that (1) the provision of the Plan authorizing the discharge of the interest due on his Student Loans was inconsistent with the Bankruptcy Code, which requires that prior to allowing the discharge of any amount due on a student loan a court must make a finding of undue hardship in an adversary proceeding, and (2) that its due process rights had been violated because the Respondent failed to serve it with the summons and complaint that are the prerequisite to an adversary proceeding.

Procedural Posture:

The Bankruptcy Court granted the Enforcement Motion, denied Petitioner's cross-motion, and ordered the holders of the Student Loans to cease and desist collection efforts. United appealed to the District Court, which reversed, holding that United was denied due process because the Confirmation Order was issued without service of the summons and complaint. Respondent appealed that decision to the Ninth Circuit, which reversed the District Court's order and held that (1) by confirming the Plan without first finding undue hardship in an adversary proceeding, the Bankruptcy Court, at most, committed a legal error that United might

have successfully appealed, but that any such legal error was not a basis for setting aside the Confirmation Order as void, and (2) that although the Respondent's failure to commence an Adversary Proceeding and serve United with a summons and complaint before seeking a discharge of his student loans violated the Bankruptcy Rules, that it was not a basis upon which to declare the Bankruptcy Court's order void because the Petitioner had received actual notice of the Plan and failed to object.

Holding:

The Supreme Court held that Fed. R. Civ. P. 60(b)(4) applies only in 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 party of notice or the opportunity to be heard. Section 523(a)(8)'s statutory requirement that a bankruptcy court find undue hardship before discharging a student loan debt is a precondition to obtaining a discharge order, not a limitation on the bankruptcy court's jurisdiction, and additionally, the requirement that a bankruptcy court make said finding in an adversary proceeding is derived from the Bankruptcy Rules, which are procedural rules adopted by the court for the orderly transaction of its business and are not jurisdictional in nature.

The Court held that § 523(a)(8), which provides that student loan obligations guaranteed by governmental units are not dischargeable unless a court finds undue hardship, means only that the bankruptcy court must make an undue hardship finding even if the creditor does not request one. Section 523(a)(8) does not mean that a bankruptcy court's failure to make the finding renders its subsequent confirmation order void for purposes of Rule 60(b)(4).

Therefore, the Court held, though the Bankruptcy Court's failure to find undue hardship before confirming the Respondent's plan was legal error, the order remains enforceable and

binding on the Petitioner because it had notice of the error and failed to object or file a timely appeal.

Take Away/Questions:

Is this a student loan case or a Rule 60 case? Will debtor's attorneys try to "sneak through" these types of provisions in Plans in the future?

Schwab v. Reilly, No. 08-538 - (Argued November 3, 2009)

Issue:

Whether a Chapter 7 trustee is required by Federal Rule of Bankruptcy Procedure 4003(b) and the Supreme Court's decision in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), to object to a debtor's claimed exemption when the claimed monetary amount itself is proper under the specific allowed exemption, but the debtor inaccurately lists the value of the exempt property as being equal to the amount of the exemption.

Statement of Facts:

The Respondent debtor, Nadejda Reilly, was a cook who operated a small, one-person catering business before filing a Chapter 7 bankruptcy petition on April 21, 2005. The Respondent's assets included her business' kitchen equipment (the "Equipment"). On Schedule C of her bankruptcy petition, the Respondent claimed as exempt a monetary interest in the Equipment amounting to $1,850.00 under § 522(d)(6) (the "tools of the trade" exemption), and a monetary interest in the Equipment amounting to $8,868.00 under § 522(d)(5) (the "wild-card" exemption). In the column headed "Value of Claimed Exemption," Respondent asserted a total exemption of $10,718.00 for the Equipment, and in the column headed "Current Market Value of Property without Deducting Exemptions," Respondent stated the market value of the Equipment

was $10,718.00. The Respondent used her remaining "wild-card" exemption to exempt $2,306.00 worth of dry food goods.

The Petitioner served as the Chapter 7 trustee for Respondent's case. Prior to the Section 341 meeting the Petitioner had an auctioneer appraise the equipment. The auctioneer advised the Petitioner that the Equipment was worth at least $17,000.00. The Petitioner trustee acknowledged that the Respondent was entitled to exempt $10,718.00 of her interest in the Equipment and therefore he did not object to the exemption. At the § 341 meeting, Petitioner indicated that there might be value in the Equipment in excess of the exempted amount and that he would seek to auction the Equipment and provide Respondent with her exempted monetary interest from the proceeds of the sale. Respondent then moved to dismiss her bankruptcy case. Before the bankruptcy court acted on Respondent's motion to dismiss, Petitioner filed a motion seeking authority to auction the Equipment. Respondent argued that because the amount of the exemption she claimed in the equipment was equal to the estimate of the Equipment's market value, she had claimed the Equipment as exempt in full. She further argued that because no party in interest had objected to the list of exempt property within 30 days of the § 341 meeting, that the Equipment was fully exempt regardless of its actual value and Petitioner was thus barred from selling the Equipment at auction.

Procedural Posture:

The Bankruptcy Court denied Respondent's motion to dismiss, but sustained her objection to the sale of the Equipment. Petitioner appealed to the District Court, which affirmed. Petitioner then appealed to the Third Circuit, which also affirmed, invoking the Supreme Court's decision in *Taylor v. Freeland & Kronz*, 503 U.S. 638 (1992), which held that "when a debtor

improperly claimed as exempt the proceeds of a lawsuit, listing the value of the exemption as 'unknown,' the trustee's failure to object within the time period set out by the rules meant that the proceeds of the suit were fully exempt." The Third Circuit concluded that, by listing the same value for her claimed exemption in the Equipment and for the equipment itself, the Respondent had in fact claimed an exemption in the entire value of the Equipment, regardless of what that value might be, and that by failing to object within the 30 days, Petitioner was barred from selling it. Petitioner was granted a writ of certiorari.

Arguments:

I. *Petitioner*

Petitioner argues that the statute and the rule do not require a trustee to object to a debtor's valuation of the property in which she claims to have an exempt interest, nor do they require the trustee to object to a claim of exemption that is valid on its face in order to liquidate and distribute to creditors value in property beyond the amount that the debtor has specifically claimed as exempt.

The Petitioner makes two arguments in support of his request that the Court reverse the prior holdings. The first argument is that requiring a trustee to make a valuation decision and object to a claimed exemption that is not accurately valued would be neither sensible not workable in practice. Petitioner argues that Chapter 7 trustees handle hundreds of cases every year and lack the time and resources to investigate the value of every item of property in which a debtor claims an exemption, and thus determine if such an objection is necessary, all within the timeframe set out by Rule 4003. The second argument is that forcing Chapter 7 trustees to do so would create perverse incentives for dishonest debtors to undervalue their property, entirely

undermining the "fresh start" concept of the Code. Petitioner also argues that *Taylor* does not support the Third Circuit's holding because that case is readily distinguishable, standing for the unremarkable proposition that a trustee is required to file a timely objection in circumstances in which the debtor's claimed exemption is improper.

II. *Respondent*

The Respondent debtor argues that she fully complied with the applicable forms and their requirements when she listed the Equipment on both her Schedules B and C and stated its value as $10,718.00. Respondent argues that there was nothing more that the forms required of her, and there was nothing ambiguous about what she stated, which is that she intended to claim the equipment as exempt in its entirety. Respondent argues that if the Trustee wished to challenge her full exemption of the Equipment, he was obligated to file an objection. The Respondent also argues that *Taylor* is controlling.

Jan Hamilton v. Stephanie Kay Lanning, No. 08-998 - (Argued March 22, 2010)

Issue:

Whether, in calculating the debtor's "projected disposable income" during the plan period, the bankruptcy court may consider evidence suggesting that the debtor's income or expenses during that period are likely to be different from her income or expenses during the pre-filing period.

Statement of Facts:

The Debtor, Stephanie Kay Lanning, filed her bankruptcy petition on October 26, 2006. The Debtor's Statement of Financial Affairs reflected an income of $43,147 in 2004 and $56,516 in 2005. Both amounts put her above the median family income for a family of one in Kansas.

In the six month period prior to filing, the Debtor took a buyout from her then employer which caused her April 2006 gross income to total $11,990.03, and her May 2006 gross income to total $15,356.42 – over three times her previous regular monthly income. Because of the buyout, her "current monthly income," as defined by 11 U.S.C. § 101(10A), was skewed upwards to $64,214 per annum, or $5,343 a month.

At the time of her filing, the Debtor was no longer employed by that employer. Her Schedule I reflected a net monthly income of $1,922, which, when annualized, equaled $23,064, well below he median income for one in Kansas. Her Schedule J reflected expenses of $1,772.97. Upon comparison, the Debtor showed excess income of $149. Her Chapter 13 plan proposed to pay $144 per month for 36 months. According to the Debtor's Form B22C, the Debtor had monthly expenses in the amount of $4,228, and according to Line 58 of Form B22C, the Debtor had a "monthly disposable income" under § 1325(b)(2) of $1,114 which could be distributed to unsecured creditors.

The Chapter 13 Trustee objected to the confirmation of the Debtor's plan because the plan failed to provide that all of the Debtor's projected disposable income to be received in the applicable commitment period would be applied to make payments to unsecured creditors under the plan as required by 11 U.S.C. § 1325. The Chapter 13 Trustee argued that § 1325(b)(2) and Form B22C provided a rigid, mechanical test by which a debtor's projected income was to be determined, despite the potential for a different result under an "I minus J" analysis.

Procedural Posture:

The United States Bankruptcy Court for the District of Kansas adopted the "forward looking" approach and held that the term "projected" in § 1325(b)(1)(B) is "a forward-looking concept that not only allows, but requires, this Court to consider at confirmation the debtor's

actual income as it is reported on Schedule I as well as any reasonably anticipated changes in that income during the life of the proposed Chapter 13 plan." *In re Lanning*, 2007 Bankr. LEXIS 1369, *19 (Bankr. D. Kansas 2007). The bankruptcy court followed the *In re Kibbe* line of cases, which held that the income shown on Form B22C was the appropriate starting point for a court's inquiry into whether a debtor was in compliance with the projected disposable income requirement. "The Court will presume that the number resulting from Form B22C is the debtor's 'projected disposable income' unless the debtor can show that there has been a substantial change in circumstances such that the numbers contained in Form B22C are not commensurate with a fair projection of the debtor's budget in the future." *In re Lanning* at *24, citing *In re Kibbe*, 361 B.R. 302 (BAP 1st Cir. 2007).

The Chapter 13 Trustee appealed the bankruptcy court's decision to the United States Bankruptcy Appellate Panel (BAP) for the Tenth Circuit. The BAP affirmed the decision of the bankruptcy court agreeing that "disposable income" was the starting point in determining projected disposable income under § 1325(b)(1)(B). "Where it is shown that Form B22C disposable income fails accurately to predict the debtor's actual ability to fund a plan, that figure may be subject to modification." *In re Lanning*, 380 B.R. 17, 25 (BAP 10th Cir. 2007). The BAP emphasized that any deviation from the Form B22C determination of disposable income would be the exception rather than the rule.

The Chapter 13 Trustee appealed the BAP's ruling to the United States Court of Appeals for the Tenth Circuit. The Tenth Circuit affirmed the BAP and found "as to the income side of the § 1325(b)(1)(B) inquiry, the starting point for calculating a Chapter 13 debtor's 'projected disposable income' is presumed to be the debtor's 'current monthly income,' as defined in 11

U.S.C. § 101(10A)(A)(i), subject to a showing of a substantial change in circumstances." *In re Lanning*, 545 F.3d 1269, 1282 (10th Cir. 2008).

Argument:

I. Petitioner

The Petitioner argues that the mechanical approach in determining the disposable income available to fund a Chapter 13 plan is supported by the plain text of 11 U.S.C. § 1325(b) and is supported by the legislative history of BAPCPA, and is the only approach that is faithful to both. The mechanical approach begins with the historical average of the income received by the debtor during the six month period prior to the filing of the bankruptcy, i.e. debtor's "current monthly income." The next step determines whether a debtor is "above median income" or "below median income." The debtor's "current monthly income" is compared to the median income figures for households of the same size in the same geographic area in which the debtor resides. If the debtor is found to be a below median income debtor, then the debtor's may deduct his actual expenses. If the debtor is an above median income debtor, expense allowances, most of which are based upon IRS standards, are deducted through the incorporation of the expense side of the Chapter 7 "means test" calculation. The resulting amount is the statutorily defined "disposable income" for the debtor. This calculation in the mechanical approach determines the amount to be paid to unsecured creditors.

The Petitioner argues that part of Congress' intent in enacting BAPCPA was to divest bankruptcy courts of their broad power to determine what should be paid to creditors. Prior to BAPCPA, the courts would examine the debtor's Schedules I and J to determine what was available for unsecured creditors. Courts were required to make determinations as to what were allowable expenses and theses determinations, often times, negatively impacted how much

unsecured creditors received under a Chapter 13 plan. The Petitioner argues that BAPCPA limited that ability. The Petitioner points to the legislative history of both 2000 and 2005 to support this contention that Congress wanted above median income debtors to pay more to their unsecured creditors and that it wanted to limit the discretion of the courts in determining that amount.

The Petitioner also argues that the plain language of the statutes support the mechanical approach. The Petitioner states that § 1325(b)(2) explicitly provides a definition of "disposable income" and that the term "projected" is merely meant to modify that newly defined term. Under the mechanical approach, a debtor simply multiplies the debtor's net monthly disposable income by the number of months in the applicable period.

The Petitioner agrees that the mechanical approach may have unfortunate and sometimes harsh results for debtors who have experienced a change in their level of income prior to filing their bankruptcy petition, but disputes the suggestion that the mechanical approach produces absurd results. The Petitioner suggests that the debtor can control this negative impact in several ways: (1) delaying the filing until the six-month look-back period is more representative of the debtor's financial circumstances; (2) dismiss a case and then re-file; (3) initially filing a Chapter 7 or converting to Chapter 7; and (4) changing the six-month look-back period through leave of the court pursuant to § 101(10A)(A)(ii).

II. Respondent

The Respondent argues that the lower courts properly calculated the debtor's "projected disposable income" using the forward-looking approach by rightfully taking into account the debtor's future income and expenses and how they had changed from the historic look as represented on Form B22C. The Respondent suggests that only the forward-looking approach

can be reconciled with the text, structure and purposes of the bankruptcy code. The Respondent argues that "projected" means more than merely multiplying the disposable income amount from Form B22C by the number of months in the plan. Like the Petitioner, the Respondent agrees that the ordinary meaning of "projected" is to calculate, estimate or predict (something in the future), based on present data or tends. Unlike the Petitioner, the Respondent believes that part of the data to be considered, with the "disposable income," is other information that may demonstrate that the debtor's recent income and expenses will not continue mechanically into the future. The Petitioner suggests that if Congress had intended to adopt the mechanical approach proposed by the Respondent, then it could have removed the term "projected" from the statute or could have used a different term like "multiplied."

The Respondent further suggests that Congress intended the term "projected" to account for known changes in the debtor's financial circumstances is further supported by the language of § 1325(b)(1)(B). The Respondent argues that Congress specified that the debtor's "projected disposable income" is that which is "to be received" during the "commitment period." In addition, Congress directed the courts to assess the debtor's projected disposable income at a particular time which is "as of the effective date of the plan." The Respondent suggests that the mechanical approach does not address this language in the statute.

The Respondent also argues that a defining feature of Chapter 13 is that the debtor's plan be feasible in light of his actual economic circumstance. The Respondent suggests that the basic structure of Chapter 13 calls for a reality-based determination of a debtor's capabilities to repay creditors, and that the forward-looking approach achieves this objective by looking beyond the historical information and taking into consideration how a debtor's circumstances have changed. The Respondent believes the forward-looking approach is able to more appropriately address

those situations where a debtor has experienced a decrease in income or a debtor has experienced an increase in income prior to or around the time of filing. In either instance, the change causes the "disposable income" as determined by Form B22C to longer be representative of the debtor's financial situation.