The Supreme Court and Consumer Bankruptcy: A Year (or so) in Review and Its Effect on Your Practice

Prof. Ralph Brubaker | University of Illinois College of Law
Champaign, Ill.

2010 Educational Materials

American Bankruptcy Institute

Bankruptcy Law Letter

Vol. 30, No. 5 **May 2010**

Consumer Bankruptcy Practice Is Just a Little Bit Harder: *Milavetz Gallop and Milavetz, P.A. v. U.S.*

By Christopher W. Frost

In *Milavetz Gallop and Milavetz, P.A. v. U.S.*,[1] the Supreme Court addressed a split between the Fifth and Eighth Circuits over the constitutionality of the debt relief agency provisions of BAPCPA. The Court concluded that that section 526(a)(4)'s prohibition against advice to incur debt "in contemplation of bankruptcy" was not an overbroad restriction on attorney's free speech rights because the restriction could be read only to prohibit advice that was principally motivated by the prospect of the client's bankruptcy filing.[2] The Court also concluded that attorneys were included within the definition of the term "debt relief agency," a question which divided lower courts, and upheld section 528's mandatory disclosure requirements against a First Amendment challenge.[3]

The debt relief agency provisions of BAPCPA have generated substantial controversy. At the time of enactment, several scholars took a dim view of the application of the provisions to attorneys, and the American Bar Association supported an amendment that would exclude attorneys from the definition of "debt relief agency."[4] On the day that the reforms took effect, one court issued a sua sponte order finding that, despite clear language, Congress could not possibly have meant to intrude on state regulation of attorneys.[5] The Supreme Court case attracted amicus briefs from the American Bar Association,[6] the Commercial Law League of America,[7] the National Association of Consumer Bankruptcy Attorneys, and others[8]—all supporting the petitioner's claim that the provisions should not apply to attorneys.[9]

The provisions that most concern attorneys fall in two categories: required disclosures by debt relief agencies[10] and the limit on advising assisted persons to incur debt "in contemplation of" bankruptcy.[11] Sections 527 and 528 require that debt relief agencies provide extensive disclosures to assisted persons. Section 527 focuses on the required disclosures to individual clients. Debt relief agencies must provide assisted persons a disclosure form that includes statements about potential debtor's ability to represent himself, the filing fee requirements, the need to conduct a means test analysis, an examination of various forms of bankruptcy relief, and other general statements.[12] Section 528 requires debt relief agencies to include in advertisements of bankruptcy assistance services or advertisements of the benefits of bankruptcy, a statement substantially similar to the following: "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code."[13] Attorneys claimed that the statement could be confusing and misleading because it appears to be required even for an attorney or firm that does not represent consumer debtors, a contention that the Supreme Court rejected.[14]

Section 526(a)(4) has generated even more controversy. That section provides that a debt relief agency may not:

> [A]dvise an assisted person or prospective assisted person to incur more debt in contemplation of such person filing a case under this title or to pay an attorney or bankruptcy petition preparer a fee

In This Issue

WEST®

40836877

> or charge for services performed as part of preparing for or representing a debtor in a case under this title.[15]

The prohibition on attorney advice, lawyers urged, was broad enough to include lawful advice and, as such, was an infringement of attorneys' free speech rights. This was the issue that split the circuit courts. The Eighth Circuit held, in *Milavetz*, that the statute was an unconstitutionally overbroad limitation on free speech.[16] The Fifth Circuit, however, in *Hersh v. U.S. ex rel. Mukasey,* held that the restriction only applied to advice to incur debt that would be an abuse of the bankruptcy process, and therefore the statute was not an overbroad limitation on attorneys' free speech rights.[17] The Supreme Court agreed with the Fifth Circuit that the statute was appropriately limited to survive constitutional scrutiny.[18]

Milavetz was, perhaps, the most closely watched bankruptcy case this term. Since the enactment of BAPCPA, the application of the provisions to attorneys has generated substantial controversy. Bankruptcy lawyers chafe not only at the title, "debt relief agency," but also at the rules limiting particular types of advice. In the end, however, *Milavetz* provided a practical interpretation of the debt relief agency provisions that took some of the sting out of the rules and was also generally unsurprising.

Attorneys as Debt Relief Agencies

Despite the claims of the bankruptcy bar and the ABA that Congress could not possibly have meant to interfere so severely with the attorney-client relationship, it seems quite clear that Congress acted with some intention in targeting attorneys. One House Report issued in connection with BAPCPA cited a report of a U.S. Trustee Civil Enforcement Initiative that indicated that the U.S. Trustee's program had "consistently identified... misconduct by attorneys."[19] That same House Report stated that the consumer bankruptcy protections in the bill include "provisions strengthening professionalism standards of attorneys and others."[20] Although Justice Scalia found these references irrelevant to the task of statutory interpretation,[21] the Court found them reliable enough to include in a footnote.[22]

Based on the plain language of the Code, the Court held that the debt relief agency provisions of BAPCPA apply to attorneys. Section 101(12A) defines the term as "any person who provides any bankruptcy assistance to an assisted person."[23] Section 101(4A), which defines the term "bankruptcy assistance" includes "providing legal representation with respect to [a bankruptcy case]."[24] It would appear then, that "the statutory text clearly indicates that attorneys are debt relief agencies when they provide qualifying services to assisted persons."[25]

The Court made short work of Milavetz's arguments to the contrary. Milavetz argued that because the definition does not expressly include attorneys but expressly includes bankruptcy petition preparers, Congress must have intended to exclude attorneys.[26] The Court rejected this argument, noting that that implausible reading would exclude all professionals and that the plain language should trump this implied exclusion.[27] The Court also rejected Milavetz's claims that the regulation of attorneys under the provisions "impermissibly trenches on an area of traditional state regulation," noting that Congress and the bankruptcy courts have long overseen the conduct of attorneys in bankruptcy.[28]

Milavetz also argued that the application of the provisions to attorneys might obligate all of the lawyers in a law firm to comply with the debt relief agency provisions based on the practice of the firm's bankruptcy attorneys. Section 101(12A) excludes from the definition of debt relief agency, any "officer, director or employee or agent of a person who provides bankruptcy assistance."[29] Because law firms are normally organized as partnerships, Milavetz argued, Congress's failure to include partners within the exemption list must have been due to the fact that lawyers were never intended to be included within the definition.[30] The Supreme Court rejected this claim, noting that the partnership form is not unique to law practice and that officers and agents of partnerships would be exempt from the provisions to the same extent as officers and agents of other entities.[31] The Court, however, hedged this observation, noting, "To the extent that partners may be subject to the debt-relief-agency provisions

BANKRUPTCY LAW LETTER (USPS 0674-930) (ISSN 0744-7871) is issued monthly, 12 times per year; published and copyrighted by Thomson Reuters, 610 Opperman Drive, P.O. Box 64526 St. Paul, MN 55164-0526. Periodicals postage paid at St. Paul, MN, and additional mailing offices.

Subscription Price: USA, US Possessions, and Canada—$464.50 annually. For subscription information: call (800) 221-9428, or write West, Credit Order Processing, 620 Opperman Drive, PO Box 64833, St. Paul, MN 55164-9753

POSTMASTER: Send address changes to: *Bankruptcy Law Letter*, 610 Opperman Drive, P.O. Box 64526 St. Paul, MN 55164-0526.

by association, that result is consistent with the joint responsibilities that typically flow from the partnership structure."[32]

Milavetz's argument reflects a concern about the scope of the debt relief agency disclosure provisions that may be overblown. While it is true that the activities of a bankruptcy group within a law firm may render the entire firm (and perhaps even each of the partners) a debt relief agency, the disclosure provisions are limited to advertising about the bankruptcy services that the firm provides.[33]

The clarity of the statutory language also led the Court to reject Milavetz's final argument: that the canon of constitutional avoidance requires an interpretation of the term debt relief agencies that excludes attorneys.[34] The free speech arguments related to the disclosure and other provisions of sections 526, 527, and 528 would, Milavetz argued, be avoided by an interpretation that excluded attorneys from the scope of the definition.[35] It is unclear precisely why simply excluding attorneys from the provision would avoid the constitutional questions since others might raise similar arguments. In any event, the Court noted that the canon only permits the court to consider constructions that are "fairly possible" and that "the text and statutory context of §101(12A) foreclose a reading of 'debt relief agency' that excludes attorneys."[36]

Advertising Disclosure Requirements Under Section 528

Section 528 provides that debt relief agencies must, in their advertising of bankruptcy assistance services, the benefits of bankruptcy, or general advertising of services relating to credit problems, disclose that their services involve bankruptcy relief.[37] In addition, the section requires the now-notorious disclosure, "We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code," or a substantially similar statement in debt relief agency advertising.[38]

Milavetz argued that the disclosure requirements could not survive a First Amendment "as-applied" challenge, although there appeared to be some confusion regarding whether Milavetz's challenge was a facial or as-applied challenge.[39] The question was an important one, given the Court's reluctance to strike statutes based on facial challenges.[40] Milavetz maintained at oral argument that it brought an as-applied challenge; however, the Court noted that the record was not well developed due to a lack of specific information about the advertisements that Milavetz claimed were prohibited.[41] This lack of information left the Court to rely only on Milavetz's status as an attorney or law firm and general claims about the nature of the advertisements to ground its analysis.[42]

The controversy in the lower courts centered on the level of scrutiny to be applied to the disclosure requirements.[43] In *Central Hudson Gas & Elec. Corp. v. Public Service Commission of New York,* the Court applied an intermediate standard to the review of restrictions on non-misleading commercial speech.[44] This intermediate standard requires that the restrictions "directly advance a governmental interest" that they be "no more extensive than is necessary to serve that interest"[45] By contrast, the Court, in *Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio*, applied a relaxed standard to restrictions on misleading speech, holding that a state bar regulation requiring that attorneys disclose in advertising of contingency-fee services that the client might be responsible for some costs of litigation.[46] That standard requires only that the regulation be "reasonably related to the State's interest in preventing deception of consumers."[47] The *Milavetz* Court held that the "less exacting scrutiny described in *Zauderer*" governed its review.[48]

The misleading/non-misleading distinction was critical to the Court's analysis. In *Central Hudson,* the restriction on all utility advertising prohibited not only misleading speech but also speech that was neither misleading nor related to an unlawful activity.[49] *Zauderer*, on the other hand, considered a requirement that attorneys include factual information to ensure that the remainder of the advertisement was not misleading.[50] The attorney in *Zauderer* had included in his advertisement the statement "if there is no recovery, no legal fees are owed by our clients."[51] The Court noted that most laypeople would not understand that there is a distinction between fees, which would not be owed, and costs, which the client would be called upon to pay, and that the advertising might suggest that employing the attorney would be a "no-lose proposition."[52] Thus the required disclosures were necessary to make the rest of the advertisement non-misleading. On the other side of the equation, the *Zauderer* Court found that because the First Amendment protection for commercial speech is justified, in part, by the value of the information to consumers, the "constitutionally protected interest [of the attorney] in *not* providing any particular factual information in his advertising" was "minimal."[53]

The *Milavetz* Court found that the disclosures required by section 528 "share the essential features of the rule at issue in *Zauderer*."[54] The Court noted that Congress was concerned about advertisements that offered debt relief but that did not disclose to potential clients that the relief might involve bankruptcy.[55] Thus the disclosures that the advertiser is a "debt relief agency"

and that the services may involve bankruptcy relief are necessary to inform consumers of the whole story.[56]

Of course, the application of the *Zauderer* standard turns on whether the required disclosure is itself truthful. Milavetz argued that the term "debt relief agency" is misleading and confusing.[57] The Court, however, dismissed this general contention, noting that it amounted to little more that Milavetz's own preference for referring to itself as an attorney or law firm rather than a "debt relief agency."[58] Because attorneys can be debt relief agencies, as defined in the Code, the disclosure is necessarily accurate. In addition, the Court noted that nothing in section 528 prohibits Milavetz from referring to itself as a law firm.[59]

Finally, Milavetz raised one of the most common objections to the advertising disclosures: that the disclosures apply even to attorneys that do not represent consumer debtors but that only represent creditors in bankruptcy cases.[60] Milavetz argued that this application indicates that the statute is not reasonably related to any governmental interest and, in this context, the required disclosures would be "counterfactual and misleading."[61]

The *Milavetz* Court found this concern to be premised on an incorrect reading of the statute. From the text and structure of the statute, the Court found that the application of the disclosure provisions to advertisements aimed at creditors by creditors' lawyers would be anomalous and create an absurd result.[62] The Court noted that the term "assisted person" is defined with reference to a person's debts and that the text and structure of sections 526, 527, and 528 make it evident that the disclosure requirements apply only to professionals who offer services to consumer debtors.[63] Also, the Court observed that the advertising disclosures are required in advertisements of "bankruptcy assistance," which term refers back to the definition of assisted person. Finally, the Court found it important that the debt relief agency provisions were codified under Chapter 5, subchapter II; a subchapter entitled "Debtor's Duties and Benefits."[64] All of these statutory clues lead to a conclusion that the concerns expressed by the bar over the potential application of the disclosure requirements to creditors' attorneys, or in situations in which the advertising is directed toward creditors, have been exaggerated.[65]

The Court was not called upon to address the constitutionality of the client disclosures that are required under section 527, but its analysis of section 528 leads to the conclusion that those disclosures would also likely pass constitutional muster. Section 527(b) provides a form of disclosure that an attorney or bankruptcy petition preparer must provide to an assisted person. This form includes narrative information about the services that will be provided, the bankruptcy process, and certain rights of the debtor, including the right to self-representation.[66]

Like the argument against the constitutionality of section 528, the argument that section 527 violates the First Amendment turns, in part, on the government's interest in the matter and whether the compelled speech is itself misleading.[67] In *Hersh*, the Fifth Circuit found that the government had a "compelling interest" in providing debtors contemplating bankruptcy some idea about what the process entails.[68] The fact that some of the disclosures may be misleading in some contexts[69] is not fatal, because the attorney is always free under the statute to provide other information or to tailor the statement to suit the particular factual context.[70] Given the Supreme Court's reluctance in *Milavetz* to credit arguments based on various hypothetical readings of the debt relief agency provisions, it seems unlikely that the Court would find section 527(b) unconstitutional.

The Prohibition Against Advice to Incur Debt "in Contemplation of Bankruptcy"

By far, the most controversial of all of the debt relief agency provisions added by BAPCPA is the prohibition in section 526(a)(4) against advice to incur debt "in contemplation of bankruptcy."[71] Not only does this prohibition restrict the attorney's speech but it seems to strike at the very heart of the attorney-client relationship. As the National Association of Consumer Bankruptcy Attorneys argued in its amicus brief:

> This Court has recognized that the attorney-client relationship serves to support the goal of "sound legal advice [and] advocacy." Legal advice can successfully guide a client through the complexities of the bankruptcy system and, indeed, can make the difference between a satisfactory outcome and financial disaster. The Debt Relief Agency Provisions, if applied to attorneys, would profoundly disrupt the attorney-client relationship, at a time when it is most needed by ordinary consumers.[72]

Of course, "sound legal advice [and] advocacy" does not include advice to take actions that are either illegal or that would, if followed, result in an undesirable outcome for the client. However, while ethical rules circumscribing attorneys' speech may be permissible under certain limited circumstances, the regulation must impose "only narrow and necessary limitations on lawyers' speech."[73] The real problem with the provision is not that it prohibits advice but that it seems to prohibit advice to take incur debt when that incurrence would not be illegal or abusive. The Eight Circuit in *Milavetz*, therefore, found that section 526(a)(4) was unconstitutionally overbroad.[74]

While an individual's decision to take on debt on the eve of bankruptcy is often found to be an abuse of the bankruptcy process, there are situations in which new debt would not be abusive. Hypothetical examples of such situations are easy to devise—an individual obtains a mortgage refinancing on the eve of bankruptcy to secure a lower interest rate or better terms, a prospective debtor buys a car on secured credit because of the need to obtain reliable transportation, a person anticipating the need for bankruptcy incurs debt to obtain needed medical treatment. Under each of these circumstances, the debtor's decision to incur the debt might not be considered abusive, but as Milavetz and the amici argued, an attorney's advice to incur the debt would be proscribed by the plain language of section 526(a)(4).[75]

The interpretive problem focuses on the meaning of the term "in contemplation of bankruptcy." Milavetz argued that the phrase includes advice to incur debt while the debtor is considering filing a petition or with awareness that the debtor might soon file.[76] Going further, Milavetz claimed that the provision not only prohibits advice incur debt but also discussions about the "advantages, disadvantages, or legality of incurring more debt."[77] The U.S. argued, in lower court cases and again in *Milavetz*, that the phrase "in contemplation of bankruptcy" can and should be read only to prohibit advice that would, if followed, constitute an abuse of the bankruptcy process.[78] On this substantially narrower reading of the statute, the statute would limit only the language that the government could legitimately restrict.[79] In fact, Milavetz only challenged the constitutionality of the provision, as narrowed, on vagueness grounds, which challenge the Court rejected.[80]

Although the government met mixed results in the lower courts,[81] the Supreme Court adopted a reading of the statute that was similar, but not identical to, the U.S.'s approach.[82] Citing Black's Law Dictionary and early American and English decisions, the government argued that the phrase "in contemplation of bankruptcy" has long been understood to be associated with abusive conduct.[83] In addition to these textual sources, the government argued that the context of the provision supports this limited reading. The remaining provisions of section 526(a) all provide professional responsibility rules that are intended to protect debtors from abusive practices of debt relief agencies.[84] The remedies for violation of the debt relief agency provisions in section 527 also reflect a focus on debtor protection.[85] These provisions, the government contended, show that Congress was only concerned with abusive debt, debt which might harm both creditors and debtors.[86]

The Court agreed that these factors warranted a narrower reading of section 526(a)(4) than that suggested by Milavetz.[87] The reading that the Court gave, however, was slightly different from the one that the government suggested.[88] Rather than limit the prohibition to abusive debt, the Court concluded that the section only prohibits advising an assisted person to incur more debt "when the impelling reason is the anticipation of bankruptcy."[89]

This slightly more nuanced formulation is based on the Court's decision in *Conrad, Rubin & Lesser v. Pender*,[90] a case that involved attorney's fees under the Bankruptcy Act. Section 60d of the Act required the court to reexamine prepetition attorney's fees that had been paid "in contemplation of the filing of a petition by or against him."[91] The law firm whose fees were to be reexamined argued that the section did not apply and that the court had no jurisdiction to reexamine the fees because the attorneys were paid to engage in negotiations aimed at avoiding bankruptcy and not for the purpose of filing bankruptcy.[92] The Court rejected that argument, holding that the phrase meant to cover payments made where bankruptcy was the "impelling cause of the payment."[93]

The difference between the Court's interpretation and the government's "abuse formulation" is likely to be a matter of approach rather than a matter of substance. Asking whether the advice to incur debt was impelled by bankruptcy focuses on the motive for the advice rather than simply asking whether the incurrence of debt can be found to be abusive. In most cases, the two inquiries are likely to lead to the same result. As the Court noted, Congress has long been concerned with the practice of "loading up" on debt with the expectation that the debt will be discharged in an ensuing bankruptcy.[94] Not only is such an action "abusive per se,"[95] but it is also true that the availability and expectation of bankruptcy relief is the impelling cause of the new debt.[96] Similarly, incurring secured debt to avoid the means test may be abusive under certain circumstance, but it is also true that if the purpose for incurring the debt is unrelated to bankruptcy—the need, for example, to purchase a reliable car—the incurrence of secured debt is unlikely to be found to be an abuse.[97] Thus although the Court's formulation may create some confusion regarding the scope of prohibited advice, in most cases it is likely to prohibit essentially the same advice as the governments "abuse" formulation.[98]

The *Milavetz* Court emphasized in a footnote that the proscription does not apply whenever bankruptcy is a possibility but requires that the advice was "principally motivated" by the likelihood of bankruptcy.[99] Based on this formulation, the Court stated that advice to a debtor to refinance a mortgage or purchase a reliable car is not principally motivated by bankruptcy but rather by the desire to improve his ability to pay or to improve his

financial prospects.[100] Similarly, advice to incur debt to make purchases '"reasonably necessary for the support or maintenance of the debtor or a dependent of the debtor"' is permissible, presumably because the debt is not motivated by bankruptcy but rather by the general needs of the debtor.[101]

Milavetz's last argument, and one commonly heard by bankruptcy lawyers, is that even if section 526(a)(4) is given a narrow construction, the provision is still impermissibly vague.[102] "Abuse," Milavetz claimed, is too indefinite a term, and "uncertainty regarding the scope of the prohibition will chill protected speech."[103] The Court rejected this claim, noting that even if "abuse" were the standard, attorneys are frequently required to provide advice regarding the consequences of debt on the discharge and on dismissal under § 707(b).[104] Further, the standard the Court actually used, whether the advice was principally motivated by bankruptcy, provides even further certainty to attorneys.[105] Even if attorneys are not sure whether incurring debt would be an abuse of the bankruptcy process, they can know whether the debtor has a nonbankruptcy reason to incur the debt.

At bottom, the complaint that attorneys cannot know whether advice that they provide to debtors runs afoul of the section 526(a)(4) prohibition seems overstated. Attorneys must often counsel clients regarding actions that may or may not have consequences that are detrimental to the clients' own interests, and this role requires attorneys to make close calls regarding what actions may or may not be legally permissible. For example, under the ABA Model Rules of Professional Conduct 1.2(d)[106]:

> [A] lawyer shall not counsel a client to engage, or assist a client, in conduct that the lawyer knows is criminal or fraudulent, but a lawyer may discuss the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope meaning or application of the law.

Consistent with the ABA rule, the Court held that the prohibition in section 526(a)(4) is only on advice and does not prohibit attorneys from discussing the subject of new debt.[107]

Incurring Debt as Abuse of the Bankruptcy Code

Although the Supreme Court chose to adopt a slightly different interpretation of the phrase "in contemplation of bankruptcy," cases that have examined debtors' prebankruptcy incurrence of new debt under the standard for abuse in section 707(b)(3) are helpful in determining what advice might run afoul of the section 526(a)(4) prohibition. As these cases show, the types of debt that might create difficulties for debtors and their attorneys are a far cry from simple advice to buy a reliable car or refinance a mortgage before a bankruptcy filing. The excessive purchases that generally constitute abuse are of a type that no conscientious lawyer would advise a client to make.

In re Deutscher[108] provides the most extreme example of abusive debt and sets forth a framework for the analysis of prebankruptcy purchases involving secured debt. The debtors had a combined income in the year before the bankruptcy of $68,416. In the 14 months before their bankruptcy filing, the debtors purchased a 42-foot yacht, another 15-foot boat, and a Lincoln SUV. The secured debts on these three purchases totaled almost $220,000, and the monthly debt service for the three debts was $2,286, nearly half of the debtors' total expenditures.[109] Not surprisingly, given this large amount of secured debt, the application of the means test did not result in a presumption of abuse, but the court went on to consider whether the "totality of the circumstances" test of section 707(b)(3) provided a basis for dismissal.

The court addressed the relationship between section 707(b)(3) and the means test. Because secured debt is a permitted reduction in the debtor's disposable income under the means test, courts should be careful when examining the level of secured debts in analyzing the totality of circumstances under section 707(b)(3). The concern is that "a court might simply use Section 707(b)(3) to substitute its own test for the means test.[110] Notwithstanding this concern, courts may review the amount and timing of secured debt in an effort to determine whether the debtor has incurred the debt in an effort to manipulate the means test as a component of the totality of the circumstances test.[111]

Under this analysis, the *Deutscher* court easily found that the prebankruptcy purchases constituted abuse of the bankruptcy process. Although the debtors' purchase of the yacht was more than a year before they filed their petition and the debtor purchased the smaller boat and SUV three months and five months, respectively, before the petition, the court had little difficulty finding the purchases abusive. The court noted that the "more expensive the purchase, the longer the time-frame before petition that it might still be seen as being on the eve of bankruptcy."[112] Even if they were not made on the eve of bankruptcy, the purchases were made at a time when the debtor was likely insolvent or at least sliding toward insolvency.[113] Given the fact that the debtor sought to reaffirm the debts on these luxury items, the fact that they were made during a time at which the debtor claimed to have been unemployed, and the related fact that the bankruptcy was not caused by "sudden illness, calam-

ity or disability," the purchases figured heavily into the court's determination that the debtors' petition constituted an abuse under section 707(b)(3).[114]

While cases like *Deustcher* show that a debtor's eve of bankruptcy incurrence of secure debt raises the specter of abuse, the reported cases relying on this factor usually involve circumstances that most bankruptcy attorneys would likely agree go beyond necessary and limited purchases that were made for legitimate non-bankruptcy reasons. Some examples:

—In *In re Violanti,* the court found abuse under section 707(b)(3) where the debtor purchased a new home, incurring a $2,500 monthly payment that took up more than 40% of debtor's monthly income.[115] In addition, three months prior to filing, debtor purchased a new $32,000 car with a monthly payment of $595.[116]

—In *In re Brenneman,* the court found abuse where shortly before filing their petition, debtors acquired two luxury vehicles, a 2008 Toyota, subject to a secured claim of $37,000 and another new leased Toyota.[117] These purchases raised their total expenditure for transportation to almost $2000.[118]

—In *In re Nissen,* just over one year prior to filing, debtors spent over $600,000 on a new home. At the time of the filing, the debtors had no equity in the home. Debtors' monthly mortgage payments totaled more than $5,000, more than 82% of debtors' combined monthly income. The court found that the debtors could pay their creditors in full even with a mortgage payment as high as $4,000 per month and, on this basis, found abuse.[119]

—In *In re O'Brien*, three months prior to bankruptcy, the debtor incurred debt of $270,000 for a home and $24,000 for a new car.[120] The court found that this "bankruptcy planning" was an important factor in its finding of abuse.[121]

—In *In re Kaminski*, immediately before bankruptcy, the debtors purchased a $36,000 new truck for the purpose of transporting Ms. Kaminski to her office job. The court found the purchase was an extravagance and factored that purchase into the abuse analysis.[122]

The only reported case that might give attorneys pause when considering whether how to advise a client regarding prebankruptcy incurrence of debt is *In re Hornung*.[123] In that case, which was decided a few days after the Supreme Court's decision in *Milavetz,* the debtors met with their attorney and discussed the idea of trading in two leased vehicles and reducing their monthly payments. The next week, and 12 days before the filing, the debtors purchased two new vehicles for a total cost of almost $70,000.[124] Although the purchases reduced the debtors' monthly payments by about $300, the court was concerned both with the expense of the vehicles and with the fact that the debtors had made no effort to shop around for more affordable transportation. The court also noted that the purchases decreased the debtor's monthly disposable income on the means test by $130.84, although the court did not explain how the reduction in payments resulted in this decrease.[125] Ultimately, the court found that these purchases were an attempt by the debtors to get a head start rather than a fresh start and that the purchases were "clearly in contemplation of bankruptcy."[126] This finding, coupled with other serious problems such as excessive housing expenses, inaccuracies on the debtors' schedules, and excessive prebankruptcy purchases on unsecured credit, led the court to dismiss the debtor's petition.[127]

With respect to debtors' prebankruptcy acquisition of the automobiles, bankruptcy lawyers may view *Hornung* as a something of a cautionary tale. One might speculate whether the attorney had any idea that "discussing" the trade in of the debtor's leased vehicles to reduce the monthly payments would lead to the debtor's purchase of two brand new cars—in turn incurring the court's wrath. Certainly, given section 526(a)(4) and the holding in *Milavetz*, any such discussion must be in terms that leave no room for uncertainty regarding the type of transportation that the debtor might reasonably acquire. In addition, to avoid prohibited "advice," the attorney might want to carefully couch the discussion as focusing on "the legal consequences of any proposed course of conduct with a client and may counsel or assist a client to make a good faith effort to determine the validity, scope, meaning or application of the law."[128]

Conclusion

Even though consumer bankruptcy lawyers must continue to feel the sting of the appellation "debt relief agency" and the accompanying rules related to their behavior, the *Milavetz* decision may put to rest some of their worst fears about the scope of those regulations. The Court adopted a common sense interpretation of the rules that largely track the kinds of practices that capable and careful attorneys have always been likely to adopt. Of course, particular cases may run close to the lines drawn—resulting in concern over whether an attorney with a particular kind of practice must provide the section 528 advertising disclosures; whether particular changes to the section 527 information rules are war-

ranted; and, perhaps most importantly, whether advice to incur prebankruptcy debt is permissible under particular circumstances. This type of line drawing is not, however, unique to bankruptcy practice. While *Milavetz* approval of the debt relief agency provisions presents challenges, the case also provides guidance necessary for an attorney to confront those challenges.

1. Milavetz, Gallop & Milavetz, P.A. v. U.S., 2010 WL 757616 (U.S. 2010).
2. See Milavetz, 2010 WL 757616 at *11.
3. See Milavetz, 2010 WL 757616 at * 13.
4. See Letter from Denise A. Cardman, Acting Director of the ABA Governmental Affairs Office, to the Subcommittee on Commercial and Administrative Law, Committee on the Judiciary, U.S. House of Representatives (May 1, 2007), available online at: http://www.abanet.org/poladv/letters/bankruptcy/2007may01_BAPCPAh_l.pdf.
5. See In re Attorneys at Law and Debt Relief Agencies, 332 B.R. 66, 71, 54 Collier Bankr. Cas. 2d (MB) 1608, Bankr. L. Rep. (CCH) P 80374 (Bankr. S.D. Ga. 2005) ("It would be a breathtakingly expansive interpretation of federal law to usurp state regulation of the practice of law via the ambiguous provisions of this Act, which in no clear fashion lay claim to the right to do any such thing").
6. See Brief for Amicus Curiae, The American Bar Association Supporting the Petitioners, Milavetz, Gallop and Milavetz v. U.S., 2009 WL 2875367 (Sept. 1, 2009).
7. Brief for Amicus Curiae, The Commercial Law League of America Supporting the Petitioners, Milavetz, Gallop and Milavetz v. U.S., 2009 WL 2875366 (Sept. 1, 2009).
8. Brief for Amicus Curiae, National Association of Consumer Bankruptcy Attorneys, Connecticut Bar Association, Brennan Center for Justice, and AARP in Support of Petitioners, Milavetz, Gallop and Milavetz v. U.S., 2009 WL 2777649 (Aug. 28, 2009).
9. Interestingly, several public interest groups, including Public Good, The Center for Science in the Public Interest, and two environmental groups filed an amicus brief supporting the U.S. Although these groups have little interest in bankruptcy, it turns out that they were interested in supporting the U.S.'s argument for maintaining the relaxed level of Constitutional scrutiny for mandatory disclosures, which question was raised in connection with the Court's analysis of section 528. See Brief for Amicus Curiae, Public Good, The Center for Science in the Public Interest, The Environmental Law Foundation, and The Center for Environmental Health in Support of Respondent, United States, Milavetz, Gallop and Milavetz v. U.S., 2009 WL 3550275 (Oct. 28, 2009).
10. See 11 U.S.C.A. §§ 527, 528.
11. See 11 U.S.C.A. § 526(a)(4).
12. See 11 U.S.C.A. § 527(b).
13. 11 U.S.C.A. § 528(a)(4) and (b)(2).
14. Milavetz, 2010 WL 757616 at *13.
15. 11 U.S.C.A. §526(a)(4).
16. See Milavetz, Gallop & Milavetz, P.A. v. U.S., 541 F.3d 785, 794, 50 Bankr. Ct. Dec. (CRR) 136, 60 Collier Bankr. Cas. 2d (MB) 886, Bankr. L. Rep. (CCH) P 81313 (8th Cir. 2008), cert. granted, 129 S. Ct. 2766, 174 L. Ed. 2d 269 (2009) and cert. granted, 129 S. Ct. 2769 (2009) and judgment aff'd in part, rev'd in part, 2010 WL 757616 (U.S. 2010).
17. See Hersh v. U.S. ex rel. Mukasey, 553 F.3d 743, 764, 60 Collier Bankr. Cas. 2d (MB) 1616, Bankr. L. Rep. (CCH) P 81381 (5th Cir. 2008), cert. denied, 2010 WL 1005956 (U.S. 2010).
18. Milavetz, 2010 WL 757616 at *11.
19. H.R. Rep. No 109-31 at 5; 2005 U.S. Code Cong. And Admin. News 88, 92 (2005) (citing Antonia G. Darling & Mark A. Redmiles, Protecting the Integrity of the System: The Civil Enforcement Initiative, 12 Am. Bankr. Inst. J. (Sept 2002)).
20. H.R. Rep. No 109-31 at 17; 2005 U.S. Code Cong. And Admin. News at 103.
21. See Milavetz, 2010 WL 757616 at *14 (Scalia, J., concurring).
22. See Milavetz, 2010 WL 757616 at *5, n. 3.
23. 11 U.S.C.A. § 101(12A).
24. 11 U.S.C.A. § 101(4A).
25. Milavetz, 2010 WL 757616 at *5.
26. See Milavetz, 2010 WL 757616 at *5.
27. See Milavetz, 2010 WL 757616 at *5 (citing Heintz v. Jenkins, 514 U.S. 291, 294, 115 S. Ct. 1489, 131 L. Ed. 2d 395 (1995)).
28. Milavetz, 2010 WL 757616 at *5 (citing Conrad, Rubin & Lesser v. Pender, 289 U.S. 472, 477-79, 53 S. Ct. 703, 77 L. Ed. 1327 (1933) (finding that courts could examine the reasonableness of prepetition attorney's fees)).
29. 11 U.S.C.A. § 101(12A)(A).
30. See Milavetz, 2010 WL 757616 at *5.
31. See Milavetz, 2010 WL 757616 at *5.
32. Milavetz, 2010 WL 757616 at *5 (citing Strang v. Bradner, 114 U.S. 555, 561, 5 S. Ct. 1038, 29 L. Ed. 248 (1885)).
33. See 11 U.S.C.A. § 528.
34. Milavetz, 2010 WL 757616 at *6.
35. Milavetz, 2010 WL 757616 at *6.
36. Milavetz, 2010 WL 757616 at *6.
37. See 11 U.S.C.A. § 528(a)(3) and (b)(2)(A).
38. 11 U.S.C.A. § 528(a)(4) and (b)(2)(B).
39. See Milavetz, 2010 WL 757616 at *11, *17 (Thomas, J., concurring).
40. See Milavetz, 2010 WL 757616 at *17 (Thomas, J., concurring) (noting the Court's reluctance to approve facial challenges); Erwin Chemerinsky, Constitutional Issues Posed in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, 79 Am. Bankr. L.J. 571, 580 (2005) (noting the Court's preference for as-applied challenges).

41. See Milavetz 2010 WL 757616 at *11, n.7, *17 (Justice Thomas concurring).
42. See Milavetz, 2010 WL 757616 at *11, n.7.
43. See Milavetz, 541 F.3d at 796; Hersh, 553 F.3d at 766.
44. See Central Hudson Gas & Elec. Corp. v. Public Service Commission of New York, 447 U.S. 557, 566, 100 S. Ct. 2343, 65 L. Ed. 2d 341, 6 Media L. Rep. (BNA) 1497, 34 Pub. Util. Rep. 4th (PUR) 178 (1980).
45. Milavetz, 2010 WL 757616 at *11 (citing Central Hudson, 447 U.S. at 566).
46. See Zauderer v. Office of Disciplinary Counsel of Supreme Court of Ohio, 471 U.S. 626, 651, 105 S. Ct. 2265, 85 L. Ed. 2d 652, 1985-2 Trade Cas. (CCH) ¶ 66645 (1985).
47. Milavetz, 2010 WL 757616 at *12 (citing Zauderer, 471 U.S. at 651).
48. Milavetz, 2010 WL 757616 at *11.
49. See Central Hudson, 447 U.S. at 566.
50. See Zauderer, 471 U.S. at 650.
51. Zauderer, 471 U.S. at 652.
52. Zauderer, 471 U.S. at 652.
53. Milavetz, 2010 WL 757616 at *12 (citing Zauderer, 471 U.S. at 651). Justice Thomas' concurring opinion made clear that, in an appropriate case, he would be willing to reconsider the relaxed standard of review provided in *Zauderer.* See Milavetz, 2010 WL 757616 at *15 (Thomas, J., concurring).
54. Milavetz, 2010 WL 757616 at *12.
55. See Milavetz, 2010 WL 757616 at *12 ("Evidence in the congressional record demonstrating a pattern of advertisements that hold out the promise of debt relief without alerting consumers to its potential cost... is adequate to establish that the likelihood of deception in this case 'is hardly a speculative one.'" (citations omitted)).
56. See Milavetz, 2010 WL 757616 at *13.
57. Milavetz, 2010 WL 757616 at *13.
58. Milavetz, 2010 WL 757616 at *13.
59. Milavetz, 2010 WL 757616 at *13.
60. See Chemerinsky, 79 Am. Bankr. L.J. at 577 (noting that the advertising disclosures would apply to "a purely creditor's lawyer if one or more of the lawyer's clients has debts that are primarily consumer debts, even if the representation is not with respect to those debts but instead deals only with the creditor's claims in a bankruptcy case").
61. Milavetz, 2010 WL 757616 at *13; see also Connecticut Bar Ass'n v. U.S., 394 B.R. 274, 290 (D. Conn. 2008) (noting that the statement "We help people file for bankruptcy relief under the Bankruptcy Code" required by § 528 is, in many instances, a false statement).
62. Milavetz, 2010 WL 757616 at *13.
63. Milavetz, 2010 WL 757616 at *13.
64. Milavetz, 2010 WL 757616 at *13.
65. See Milavetz, 2010 WL 757616 at *13.
66. See 11 U.S.C.A. § 527(b).
67. See Samuel L. Bufford and Erwin Chemerinsky, Constitutional Problems in the 2005 Bankruptcy Amendments, 82 Am. Bankr. L.J. 1, 18-22.
68. See Hersh, 553 F.3d at 766-67, see also Conn. Bar Ass'n, 394 B.R. at 286.
69. See Hersh, 553 F.3d at 767-68 (discussing some of the "generalizations" that the attorney claimed might be misleading).
70. Hersh, 553 F.3d at 767-68 (noting that the attorney is free to add information and otherwise tailor the statement).
71. 11 U.S.C.A. § 526(a)(4).
72. Brief for Amicus Curiae, National Association of Consumer Bankruptcy Attorneys, Connecticut Bar Association, Brennan Center for Justice, and AARP in Support of Petitioners, Milavetz, Gallop and Milavetz v. U.S., 2009 WL 2777649, * 2 (Aug 28, 2009), (quoting Upjohn Co. v. U.S., 1981-1 C.B. 591, 449 U.S. 383, 389, 101 S. Ct. 677, 66 L. Ed. 2d 584, Fed. Sec. L. Rep. (CCH) P 97817, 1980-81 Trade Cas. (CCH) ¶ 63797, 81-1 U.S. Tax Cas. (CCH) P 9138, 7 Fed. R. Evid. Serv. 785, 30 Fed. R. Serv. 2d 1101, 47 A.F.T.R.2d 81-523 (1981)).
73. Gentile v. State Bar of Nevada, 501 U.S. 1030, 1075, 111 S. Ct. 2720, 115 L. Ed. 2d 888 (1991).
74. See Milavetz, 541 F.3d at 794.
75. See Milavetz, 2010 WL 757616 at *11; Brief of Amici Curiae National Association of Consumer Bankruptcy Attorneys, 2009 WL 2777649 at *9.
76. Milavetz, 2010 WL 757616 at *10.
77. Milavetz, 2010 WL 757616 at *7.
78. See Milavetz, 2010 WL 757616 at*7; Milavetz, 541 F.3d at 793; Hersh, 553 F.3d at 754.
79. See Hersh, 553 F.3d at 754-56 (discussing permissible limits on attorney's speech based on governmental interest).
80. Milavetz, 2010 WL 757616 at *10.
81. See Milavetz, 541 F.3d at 794; Hersh, 553 F.3d at 761; Conn. Bar. Ass'n, 394 B.R. at 284.
82. See Milavetz, 2010 WL 757616 at *8.
83. Milavetz, 2010 WL 757616 at *7.
84. See 11 U.S.C.A. § 526(a)(1) (requiring debt relief agencies to performed promised services); 526(a)(2) (prohibiting advice to debtors to make false or misleading statements in bankruptcy case); 526(a)(3) (prohibiting misrepresentations regarding the services to be provided or the benefits and risks of bankruptcy).
85. See 11 U.S.C.A. § 526(c) (providing liability for actual damages and attorney's fees).
86. See Milavetz, 2010 WL 757616 at *8.
87. See Milavetz, 2010 WL 757616 at *8.
88. See Milavetz, 2010 WL 757616 at *8.
89. Milavetz, 2010 WL 757616 at *11.
90. Pender, 289 U.S. 472.
91. See 11 U.S.C.A. § 96(d) (repealed 1979).
92. Pender, 289 U.S. at 478.

93. Pender, 289 U.S. at 479.
94. Milavetz, 2010 WL 757616 at *9.
95. Milavetz, 2010 WL 757616 at *9.
96. Milavetz, 2010 WL 757616 at *9.
97. Milavetz, 2010 WL 757616 at *11, n.6.
98. Milavetz, 2010 WL 757616 at *11.
99. Milavetz, 2010 WL 757616 at *11.
100. Milavetz, 2010 WL 757616 at *11, n.6.
101. See Milavetz, 2010 WL 757616 at *11, n.6.
102. See Milavetz, 2010 WL 757616 at *10.
103. Milavetz, 2010 WL 757616 at *10.
104. Milavetz, 2010 WL 757616 at *11.
105. Milavetz, 2010 WL 757616 at *11.
106. ABA Model Rule of Professional Conduct 1.2(d) (2009).
107. Milavetz, 2010 WL 757616 at *10 ("Even if the statute were not clear in this regard, we would reach the same conclusion about its scope because the inhibition of frank discussion serves no conceivable purpose within the statutory scheme").
108. In re Deutscher, 419 B.R. 42 (Bankr. N.D. Ill. 2009).
109. Deutscher, 419 B.R. at 44.
110. Deutscher, 419 B.R. at 45.
111. Deutscher, 419 B.R. at 45-46.
112. Deustcher, 419 B.R. at 46.
113. Deustcher, 419 B.R. at 46.
114. Deustcher, 419 B.R. at 46.
115. In re Violanti, 397 B.R. 852, 856 (Bankr. N.D. Ohio 2008).
116. Violanti, 397 B.R. at 859 (the court queried whether "reliable vehicles for transportation now cost at least $32,000.00?").
117. In re Brenneman, 397 B.R. 866, 870 (Bankr. N.D. Ohio 2008).
118. Brenneman, 397 B.R. at 873. As in *Violanti*, the court refused to believe that the only safe and reliable transportation available to debtors required spending almost $2,000 per month.
119. In re Nissen, 2007 WL 2915648, *3 (Bankr. D. Neb. 2007).
120. In re O'Brien, 373 B.R. 503, 505 (Bankr. N.D. Ohio 2007).
121. In re O'Brien, 373 B.R. at 507.
122. In re Kaminski, 387 B.R. 190, 198 (Bankr. N.D. Ohio 2008).
123. In re Hornung, 2010 WL 843765 (Bankr. M.D. N.C. 2010).
124. Hornung, 2010 WL 843765 at *4.
125. Hornung, 2010 WL 843765 at *4.
126. Hornung, 2010 WL 843765 at *5.
127. Hornung, 2010 WL 843765 at *5-10.
128. ABA Model Rule of Professional Conduct 1.2(d) (2009).

American Bankruptcy Institute

Bankruptcy Law Letter

Vol. 30, No. 6 June 2010

Supreme Court Upholds "Discharge by Declaration" of Student Loan Debts in Chapter 13 (or Does It?)

By Ralph Brubaker

The Bankruptcy Code and Rules clearly provide that to discharge a student loan debt in the bankruptcy court, the debtor must initiate an adversary proceeding in which the bankruptcy court must specifically find that "excepting such debt from discharge… would impose an undue hardship on the debtor and the debtor's dependents."[1] Nonetheless, a practice known as "discharge by declaration" has taken hold in Chapter 13 cases whereby the debtor inserts a provision in the proposed Chapter 13 plan that provides for full discharge of a student loan debt upon successful completion of all plan payments (perhaps also including a recitation that paying any more on the student loan debt would constitute an undue hardship), hoping that the student loan creditor will not object to confirmation of the plan by insisting upon an undue hardship determination in a separate adversary proceeding. If the creditor fails to object and the court confirms the plan, the debtor then relies upon the statutory finality that "[t]he provisions of a confirmed plan bind the debtor and each creditor"[2] as effectuating the so-called "discharge by declaration" in the confirmed plan.

Discharge-by-declaration, though, highlights a fundamental tension that pervades bankruptcy practice. The ambitious nature of bankruptcy's comprehensive restructuring of a debtor's affairs, when combined with its equally ambitious desire for expeditious administration, requires a difficult balance between (i) the demands of affording all parties a fair opportunity to assert their rights and (ii) the repose and finality interests necessary for any effective judicial process and especially so for the bankruptcy process. Notwithstanding the statutory finality attributed to confirmed Chapter 13 plans, the speed with which Chapter 13 plans are filed and confirmed and the less-than fastidious form and process for many confirmed Chapter 13 plans can test the ultimate binding effect of the plan in many different ways,[3] and this has certainly been the case with the practice of discharge-by-declaration.[4] Indeed, the general consensus of the courts of appeals has been that discharge-by-declaration should not be given effect.[5] The Ninth Circuit stood alone in affording absolute finality to discharge-by-declaration.[6]

On certiorari from the Ninth Circuit's *Espinosa* decision, in which Judge Kozinski not only emphatically reaffirmed the binding effect of discharge-by-declaration in that circuit but also endorsed its propriety in the first instance as a matter of sound practice, the Supreme

In This Issue

WEST®

40836879

Court unanimously affirmed the Ninth Circuit position with respect to the finality of discharge-by-declaration.[7] With respect to whether the practice itself is or is not appropriate, though, the Court sent mixed signals that will likely perpetuate extreme nonuniformity in the prevalence of and attitudes toward discharge-by-declaration.

Espinosa: Mere Creditor Inaction or Fatal Process Defect?

The facts of *Espinosa* nicely demonstrate the finality dilemma of discharge-by-declaration. In 1988 and 1989, Francisco Espinosa obtained four federally guaranteed student loans. United Student Aid Funds, Inc., a guaranty agency that administers the collection of federally guaranteed student loans, was the holder of Espinosa's student loan debt. On December 7, 1992, Espinosa filed a Chapter 13 petition when the principal amount owing on his student loan debt was $13,250. Three days later, on December 10, the clerk of the bankruptcy court sent a copy of Espinosa's proposed plan and a notice of the plan confirmation hearing to Espinosa's creditors, in accordance with Bankruptcy Rules 2002(b), (g)(2) and 3015(d), including to United at United's post office box address.

In boldface type, immediately below the caption, Espinosa's proposed plan stated: "**WARNING IF YOU ARE A CREDITOR YOUR RIGHTS MAY BE IMPAIRED BY THIS PLAN.**"[8] A specific provision of the plan, captioned "Educational Loan(s)," listed all of Espinosa's student loans held by United and the total principal balance owing of $13,250. The plan provided that this amount would be paid in full over the course of the plan, followed by this statement: "The amounts claimed by United Student Loan Aid Funds, Inc., *et. al.* for capitalized interest, penalties, and fees shall not be paid for the reasons that the same are penalties and not provided for in the loan agreement between the Debtor and the lender."[9] The next paragraph of the plan then provided: "Any amounts or claims for student loans unpaid by this Plan shall be discharged."[10]

Paragraph 7 of Espinosa's proposed plan, titled "PROOF OF CLAIM," stated: "As a creditor you must file a proof of claim in order to get paid the amounts provided for in this plan. If you do not file your proof of claim by the deadline date you will not receive anything even if the Plan provides for payment."[11] The accompanying notice of the confirmation hearing and deadline for filing objections thereto also included notice of the deadline for filing proofs of claim. United did file a timely proof of claim for $17,832.15, an amount that included all unpaid accrued interest on Espinosa's student loans, but United did not object to Espinosa's proposed plan. The bankruptcy court held a confirmation hearing on Espinosa's proposed plan on April 15, 1993 and entered an order confirming Espinosa's plan on May 6, 1993. In June 1993, the Chapter 13 trustee mailed United a form notice stating that "[t]he amount of the claim filed differs from the amount listed for payment in the plan. Your claim will be paid as listed in the plan," but qualified this by further stating:

> If an interested party wishes to dispute the above stated treatment of the claim, it is the responsibility of the party to address the dispute. The claim will be treated as indicated above unless the Trustee receives within 30 days from this mailing, a written request for different treatment. The request should set forth the specific grounds for alternative treatment and should be filed with the Clerk of the Court, with a copy mailed to the Trustee.[12]

United did not file anything in response to this notice.

In May 1997, Espinosa successfully completed all of his plan payments, and on May 30, 1997, the bankruptcy court entered a discharge order. Three years

BANKRUPTCY LAW LETTER (USPS 0674-930) (ISSN 0744-7871) is issued monthly, 12 times per year; published and copyrighted by Thomson Reuters, 610 Opperman Drive, P.O. Box 64526 St. Paul, MN 55164-0526. Periodicals postage paid at St. Paul, MN, and additional mailing offices.
Subscription Price: USA, US Possessions, and Canada—$464.50 annually. For subscription information: call (800) 221-9428, or write West, Credit Order Processing, 620 Opperman Drive, PO Box 64833, St. Paul, MN 55164-9753
POSTMASTER: Send address changes to: *Bankruptcy Law Letter*, 610 Opperman Drive, P.O. Box 64526 St. Paul, MN 55164-0526.

later, in 2000, the U.S. Department of Education (having acquired Espinosa's notes from United pursuant to the terms of the federal guaranty) began efforts to collect unpaid interest on Espinosa's student loans, in particular by intercepting Espinosa's income tax refunds by way of setoff. In June 2003, Espinosa reopened his bankruptcy case and filed a motion to enforce his discharge injunction. At this point, United requested and received a recall of Espinosa's notes from the Department of Education and filed a cross-motion seeking to set aside Espinosa's discharge order as void under Civil Rule 60(b)(4), made applicable to bankruptcy proceedings by Bankruptcy Rule 9024.

The bankruptcy court denied United's motion, holding that Espinosa's plan was final when confirmed, notwithstanding any procedural defects (to which United did not object). The bankruptcy court also held that the subsequent postdischarge collection activity therefore violated Espinosa's discharge injunction and ordered United and the Department of Education to cease and desist all collection efforts. The district court, however, reversed on appeal, holding that United was denied due process because discharge of Espinosa's student loan debt was ordered without an adversary proceeding establishing undue hardship.

On further appeal, the Ninth Circuit panel actually read the bankruptcy court's discharge order, which expressly provided that Espinosa was "discharged from all debts provided for by the plan… except any debt… for a student loan."[13] Of course, this is a standard provision in discharge orders, which recognizes the fact that a "discharge order is an adjudication of a debtor's entitlement to a general discharge of all prebankruptcy debts *other than* those debts excepted from discharge by a statutory discharge exception."[14] Moreover, the § 523(a)(8) discharge exception for student loan debts was specifically "intended to be self-executing" such that the creditor "is not required to file a complaint to determine the nondischargeability of any student loan."[15] Indeed, as the Supreme Court has stated, "[u]nless the debtor affirmatively secures a hardship determination, the discharge order will not include a student loan debt."[16]

In Espinosa's case, though, this standard discharge order carve-out conflicted with the express terms of Espinosa's previously confirmed plan, which provided that "[a]ny amounts or claims for student loans unpaid by this Plan shall be discharged."[17] Nonetheless, as Judge Kozinsky noted, as things stood, *Espinosa* was easily resolved in United's favor and against Espinosa:

> [T]he discharge order in this case simply did not discharge Espinosa's student loan debt. Indeed, it specifically excluded the student loan debt from the discharge. This order was, to be sure, inconsistent with Espinosa's Chapter 13 plan's terms; in effect, the bankruptcy court did not make good on its promise to the debtor that, if he satisfied the terms of the plan, it would discharge all of his listed debts.
>
> Whether the bankruptcy court could have been held to that promise, and compelled to issue an order discharging the student debt, is an open question. Espinosa could have tested that proposition by asking the bankruptcy court to modify its order to discharge the student loan debt and, failing that, taken an appeal. But he did not. Rather, he allowed the bankruptcy court's discharge order to become final, and the time to appeal has lapsed long ago. Nor did Espinosa seek to reopen the judgment by way of Federal Rule of Civil Procedure 60. *See* Fed. R. Bankr. P. 9024. Instead, Espinosa sought to enforce the discharge injunction against [United]. The obvious problem, of course, is that the discharge injunction simply does not run against [United] because the bankruptcy court's discharge order did not cover its debt. [United] was thus free to collect its debt, and the bankruptcy court seems to have misread its own order when it held otherwise.[18]

Suspecting, though, that the bankruptcy court's discharge order was automatically generated and that the failure to tailor it to the terms of Espinosa's confirmed plan was simply an oversight, the Ninth Circuit panel remanded to the bankruptcy court with "express leave to consider whether its discharge order in this case was entered as a result of a clerical error and, if so, whether to correct it so as to conform to Espinosa's Chapter 13 plan"[19] pursuant to Civil Rule 60(a). On remand, the bankruptcy court confirmed the Ninth Circuit's suspicion that the language excluding student loan debts from Espinosa's discharge order "was inserted because of a clerical mistake, because it was the clear intent of

the Court, as reflected in the Chapter 13 Plan, as approved by the Court, that all student loan-related obligations were to be discharged if the debtor successfully performed and completed the Plan."[20] The bankruptcy court thus struck that language from Espinosa's discharge order.

With this, the effect of discharge-by-declaration in a confirmed Chapter 13 plan was squarely presented to the Ninth Circuit. Disagreeing with all other circuits to address the issue, the Ninth Circuit reaffirmed its earlier *Pardee* decision[21] and the circuit split that it spawned, holding that Espinosa's discharge-by-declaration of his student loan debt was fully effective. The Supreme Court granted certiorari to resolve the circuit split and affirmed the Ninth Circuit's view on the binding effect of discharge-by-declaration.

Finality of (and Relief from) a Judgment, *Not* Res Judicata

Beginning with a matter of analytical clarity and coherence, much of the circuit case law on discharge-by-declaration was a bit muddled by a preoccupation with the preclusion principles of res judicata. As Judge Kozinski correctly pointed out in his *Espinosa* opinion, though, this was misguided.

> [W]hat we have here is not a question of res judicata—giving the judgment in the bankruptcy case preclusive effect in another case. The debtor here—like those in [other circuit court cases on discharge-by-declaration]—sought to reopen the original case in order to enforce the discharge injunction, which came into force by operation of law upon entry of the discharge. A discharge injunction does not operate by way of res judicata; it is, rather, an equitable remedy precluding the creditor, on pain of contempt, from taking *any* actions to enforce the discharged debt.… This includes garnishments, attachments, self-help and all other means of collection—not merely the filing of another lawsuit. 11 U.S.C. § 524(a)(2)…. A discharge could also have res judicata effect, if the creditor were to try to enforce the debt by bringing a post-discharge lawsuit, but the discharge injunction prevents him from even commencing the second suit where the res judicata could be litigated. There was no second lawsuit in our case, nor (insofar as we can tell) in [other prominent discharge-by-declaration circuit court cases]. Res judicata thus has no application to a case like ours, or those considered by [other circuits].[22]

Justice Thomas's *Espinosa* opinion for a unanimous Supreme Court obviously agreed with Judge Kozinski's analytical admonition. The starting point for the Court's analysis of discharge-by-declaration was the observation that "[t]he Bankruptcy Court's order confirming Espinosa's proposed plan was a final judgment from which United did not appeal,"[23] and "[o]rdinarily, 'the finality of [a] Bankruptcy Court's orders following the conclusion of direct review' would 'stan[d] in the way of challenging [their] enforceability.'"[24] While the two topics are related and sometimes overlap in their analyses,[25] the Supreme Court analyzed the *Espinosa* case according to the grounds on which relief from a final judgment may be obtained from the court issuing the judgment and not according to the preclusion principles of res judicata.

Civil Rule 60(b), Bankruptcy Rule 9024, and Code § 1330(a)

The appropriate analytical framework for *Espinosa*, therefore, is determining the availability of relief from a final judgment. When that final judgment is an order confirming a plan, though, there is some ambiguity regarding the available grounds for relief.

Finality of a confirmed plan is a sufficiently important matter that it is explicitly addressed by statute in all of the Code's rehabilitation chapters (11, 12, and 13). Code § 1327(a) expressly provides that "[t]he provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan,"[26] and Chapters 11 and 12 contain similar statutory provisions in § 1141(a) and § 1227(a). The binding effect of a confirmed Chapter 13 plan is further reinforced by Code § 1330(a) (paralleled in Chapters 11 and 12 by §§ 1144, 1230(a)), which provides that "[o]n request of a party in interest within 180 days after the date of the entry of an order of confirmation…, and after notice and a hearing, the court may revoke such order if such order was procured by fraud."[27]

Thus while the typical "'exception to finality' that 'allows a party to seek relief from a final judgment, and request reopening of his case, under a limited set of circumstances,'"[28] is Civil Rule 60(b), entitled "Grounds for Relief from a Final Judgment, Order, or Proceeding," Code § 1330(a) seems to limit relief from a final confirmation order to only one of the several grounds available under Rule 60(b)—fraud—and only if raised within the 180-day time limit set by § 1330(a), rather than the one-year time limit[29] for raising fraud under Rule 60(b)(3).[30] Moreover, Bankruptcy Rule 9024, which provides that "Rule 60 F.R.Civ.P. applies in cases under the [Bankruptcy] Code," qualifies the general applicability of Civil Rule 60(b) with the proviso "except that… (3) a complaint to revoke an order confirming a plan [for fraud] may be filed only within the time allowed by § 1144, § 1230, or § 1330" in order to "make it clear that the time periods established by [the Bankruptcy Code] may not be circumvented by the invocation of F.R.Civ.P. 60(b)."[31]

If this is the appropriate interpretation of Code § 1330(a)—that it essentially precludes resort to Rule 60(b) to obtain relief from a final confirmation order—then § 1330(a) is a formidable reinforcement of the effectiveness of discharge-by-declaration. United did not contend that Espinosa procured confirmation of his plan by "fraud," nor did United seek relief from Espinosa's confirmation order within 180 days of its entry. Courts refusing to give effect to discharge-by-declaration, though, created uncertainty as to whether that is, in fact, the appropriate interpretation of Code § 1330(a). For example, the Second Circuit concluded that a student loan creditor's action to invalidate a discharge-by-declaration provision "is not, however, an action to revoke a confirmation order, but rather to declare one of the provisions of a confirmed plan void *ab initio* [under Civil Rule 60(b)(4)]. Accordingly, [the creditor] was bound only by the 'reasonable time' limitations of Rule 60(b)(4), which have been interpreted permissively."[32]

The Supreme Court in *Espinosa*, while noting the disagreement among the circuits regarding the appropriate interpretation of Code § 1330(a), did not resolve that issue because the parties had not raised it in the lower courts. Thus Espinosa had effectively waived reliance on Code § 1330(a) as protecting the discharge-by-declaration provision of his confirmed plan, and the Supreme Court noted that "even under a theory that would treat United's Rule 60(b)(4) motion as a 'complaint to revoke' the plan, United's failure to file its motion within § 1330's 180-day deadline and its failure to seek relief on the basis of fraud" were not "jurisdictional" defects that could be raised (and that the Court was obligated to address) for the first time on appeal.[33] The Court, therefore, limited its decision to whether the discharge-by-declaration provision of Espinosa's plan was "void" within the meaning of Civil Rule 60(b)(4).

A Discharge-by-Declaration Provision Is Not Void

United sought to set aside the discharge-by-declaration provision of Espinosa's confirmed plan under Civil Rule 60(b)(4), which authorizes relief from a final judgment if "the judgment is void." Since "a motion under Rule 60(b)(4) is not a substitute for a timely appeal,"[34] the conditions that render a judgment void are extremely limited. Justice Thomas described those conditions as follows:

> [I]t suffices to say that a void judgment is one so affected by a fundamental infirmity that the infirmity may be raised even after the judgment becomes final. The list of such infirmities is exceedingly short; otherwise, Rule 60(b)(4)'s exception to finality would swallow the rule.
>
> "A judgment is not void," for example, "simply because it is erroneous.… Instead, Rule 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.[35]

The Court concluded that neither of these deficiencies existed that could deprive the discharge-by-declaration provision of Espinosa's confirmed plan of its presumptive binding effect.

Jurisdiction to Confirm a Discharge-by-Declaration Provision

Neither aspect of the two procedural defects exploited by discharge-by-declaration is properly characterized as "jurisdictional" in nature. First, discharge-by-declaration is accomplished without initiation of an adversary proceeding by the debtor to have the student loan

debt declared dischargeable—the process that is clearly required by Bankruptcy Rule 7001(6). However, seeking a discharge determination through a contested matter rather than an adversary proceeding does not deprive the bankruptcy court of subject-matter jurisdiction to order the requested relief. Indeed, the Bankruptcy Rules, by their terms, do not even purport to (nor could they) circumscribe bankruptcy courts' jurisdiction.[36] "Only Congress may determine a lower federal court's subject-matter jurisdiction,"[37] and consequently, the Bankruptcy Rules are "'procedural rules adopted by the Court for the orderly transaction of its business' that are 'not jurisdictional.'"[38]

Second, although Code § 523(a)(8) requires a finding of undue hardship in order to discharge a student loan debt, discharge-by-declaration is characteristically accomplished (as in Espinosa's case) without any showing or even a plan recital of undue hardship. While it may be reversible error to confirm a plan discharging student loan debt without an affirmative finding of undue hardship, that "is a precondition to obtaining a discharge order, not a limitation on the bankruptcy court's jurisdiction" to discharge the debt.[39]

Given that "a judgment is void because of a jurisdictional defect" only in "the exceptional case in which the court that rendered judgment lacked even an 'arguable basis' for jurisdiction"[40] and given that the defects producing discharge-by-declaration are not even properly characterized as jurisdictional in nature, a discharge-by-declaration provision of a confirmed plan cannot be considered void for want of jurisdiction.

Due Process and Discharge-by-Declaration

Because discharge-by-declaration denies a student loan creditor the benefit of service of a summons and complaint initiating an adversary proceeding seeking an undue hardship determination, three circuits had held that it denies the student loan creditor the due process of law guaranteed by the Fifth Amendment.[41] Indeed, in a different context, the Third Circuit has gone so far as to hold that "where the Rules require an adversary proceeding—which entails a fundamentally different, and heightened, level of procedural protections—to resolve a particular issue, a creditor has the due process right not to have that issue resolved without one."[42] Judge Kozinski's *Espinosa* opinion was particularly critical of this line of reasoning:

> The standard for what amounts to constitutionally adequate notice… is fairly low; it's "notice reasonably calculated under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections." *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 314 (1950).…
>
> …. If a party is adequately notified of a pending lawsuit, it is deemed to know the consequences of responding or failing to respond, even if gaining actual knowledge requires inquiry into court files, hiring a lawyer, or conducting legal research. Indeed, it would be virtually impossible to operate a legal system if due process required more notice than that.
>
> As noted, [United] here did receive actual notice of Espinosa's [proposed plan] …. Because "due process does not require actual notice," *Jones v. Flowers,* 547 U.S. 220, 225 (2006), it follows a fortiori that actual notice satisfies due process. We find the argument that the Constitution requires something *more* than actual notice strained to the point of the bizarre.
>
> The notices [United] received also warned of the consequences of failing to object—which is more than due process requires. A creditor receiving such notice would have known that its debt could be adversely affected by the proposed plan, and that it needed to file an objection if it wished to avoid that result. [United] raised no such objection, nor did it appeal the order confirming the plan. We cannot say that [United] was taken by surprise or was denied due process.…
>
> The three circuits that have held that the creditor is denied due process in circumstances such as these appear to have a different understanding of what due process requires. As best we can follow their reasoning, it is that a creditor who is entitled to heightened notice by statute is also entitled to such heightened notice as a matter of due process.…
>
> …. [W]e find it both wrong and dangerous to hold that the standard for what amounts to con-

> stitutionally adequate notice can be changed by legislation. The constitutional standard, as we understand it, requires that a party affected by the litigation obtain sufficient notice so that it is able to take steps to defend its interests. Congress can, of course, give rights to additional notice, but we find it difficult to see how this can affect the floor provided by due process—either to increase or diminish it.
>
> …. We reject the idea that a creditor who is in the business of administering student loans has a *constitutional* right to ignore a properly served notice that clearly specifies that its debt will be discharged on successful completion of the plan.[43]

The Supreme Court's unanimous *Espinosa* opinion essentially summarily adopted Judge Kozinski's analysis, noting that "[h]ere, United received *actual* notice of the filing and contents of Espinosa's plan. This more than satisfied United's due process rights."[44]

The Supposed Statutory Conflict Between Plan Finality and Plan Confirmation

Two circuits refused to give binding effect to discharge-by-declaration provisions of a confirmed plan by pointing to a supposed statutory conflict between Code § 1327(a), affording finality to the provisions of a confirmed plan, and the Code's plan confirmation requirements.[45]

Code § 1328(a)(2) provides that "after completion by the debtor of all payments under the plan,… the court shall grant the debtor a discharge of all debts provided for by the plan…, except any debt… of the kind specified in… paragraph… (8)… of section 523(a)," and Code § 523(a)(8) categorically excepts student loan debts from discharge "unless excepting such debt from discharge… would impose an undue hardship on the debtor and the debtor's dependents." This student loan discharge exception was "intended to be self-executing" such that the creditor "is not required to file a complaint to determine the nondischargeability of any student loan,"[46] and "[u]nless the debtor affirmatively secures a hardship determination, the discharge order will not include a student loan debt."[47]

Code § 1325(a)(1) requires confirmation of a plan only if "the plan complies with the provisions of this chapter [13] and with the other applicable provisions of" the Bankruptcy Code. Inclusion of a plan provision providing for discharge-by-declaration of a student loan debt without an undue hardship determination of course does not comply with the applicable requirements of the Code outlined above. Because a bankruptcy court has no authority to confirm a plan containing such a provision, so the argument goes, such a plan provision is void.

Judge Kozinski's observation regarding the supposed conflict between these plan confirmation requirements and the Code's plan finality provision, § 1327(a), once again, is most apt: There is "no such conflict; both [sets of] provisions can operate fully, within their proper spheres."[48] Justice Thomas characterized this argument as an attempt "to expand the universe of judgment defects that support Rule 60(b)(4) relief."[49] Indeed, at bottom, it seems to be nothing more than an argument that legal error renders the resulting judgment void. This, of course, runs directly counter to Justice Thomas's basic admonitions that "a motion under Rule 60(b)(4) is not a substitute for a timely appeal," and "[a] judgment is not void… simply because it is or may have been erroneous."[50] Thus Justice Thomas also saw no "conflict" between the Code's confirmation requirements and the Code's plan finality provision that could render the discharge-by-declaration provision of Espinosa's confirmed plan void:

> Given the Code's clear and self-executing requirement for an undue hardship determination, the Bankruptcy Court's failure to find undue hardship before confirming Espinosa's plan was a legal error. But the order remains enforceable and binding on United because United had notice of the error and failed to object or timely appeal.… Rule 60(b)(4) does not provide a license for litigants to sleep on their rights.…
>
> Rule 60(b)(4) strikes a balance between the need for finality of judgments and the importance of ensuring that litigants have a full and fair opportunity to litigate a dispute. Where, as here, a party is notified of a plan's contents and fails to object to confirmation of the plan before the time for appeal expires, that party has been afforded a full and fair opportunity to litigate, and the party's failure to avail itself of that opportunity will not justify Rule 60(b)(4) relief.[51]

The Future of Discharge-by-Declaration

There are two opposite-extreme attitudes toward the practice of discharge-by-declaration of student loan debts. One camp views the practice as an improper attempt to obtain discharge of student loans by stealth—a view that obviously colored the finality analysis of the majority circuits before *Espinosa*. Professor Frost nicely summarizes this sentiment:

> [T]he heart of the concern that student lenders have with discharge-by-declaration [is] that the notice the debtors provide in discharge-by-declaration cases is not intended by the debtors to apprise the student loan creditor of the effect of the plan on its claim. On the contrary, the debtor has every hope that the lender will miss the notice…. Further, the heightened notice requirement in the Code and Rules reflects the reality that student lenders face.… [T]he flood of paperwork that characterizes the bankruptcy process requires clear rules to permit creditors to "know what notices to notice as opposed to the notices that are deafening legal background noise." At the same time, it is nearly costless for a debtor to insert language into the plan in an effort to achieve a discharge of student loan debt without the need to prove undue hardship.[52]

The opposite attitude is that discharge-by-declaration is an efficient practice that has evolved to facilitate discharge without costly and unnecessary additional procedural hurdles in those cases where undue hardship is (or would be in any event) uncontested—a triumph of the flexibility of judicial processes to accommodate the factual and economic realities of particular cases. Judge Kozinski articulates this laudable vision of discharge-by-declaration, which obviously reinforced his conviction regarding finality of discharge-by-declaration:

> If a debtor proposes to discharge a student loan debt without invoking the special procedures applicable to such debts, the creditor can object to the plan until the debtor shows undue hardship in an adversary proceeding.
>
> But there are many reasons a student loan creditor might not object to such a Chapter 13 plan. The creditor might, for example, believe that the debtor would be able to make a convincing showing of undue hardship, and thus, sees no point in wasting the debtor's money, and its own, litigating the issue. Or, the creditor may decide that a Chapter 13 plan presents its best chance of collecting most of the debt, rather than spending years trying to squeeze blood out of a turnip. Or, the creditor may hope that the debtor will make some payments on the plan but ultimately fail to complete it [and receive no Chapter 13 discharge], in which case the creditor will have collected a portion of the debt and still be free to collect the rest later. Or, the creditor may overlook the notice or fail to understand its legal implications.
>
> Regardless, when the creditor is served with notice of the proposed plan, it has a full and fair opportunity to insist on the special procedures available to student loan creditors by objecting to the plan on the ground that there has been no undue hardship finding. Rights may, of course, be waived or forfeited, if not raised in a timely fashion. This doesn't mean that those rights are ignored, or that a judgment that is entered after a party fails to assert them conflicts with the statutory scheme or is somehow invalid.
>
> * * *
>
> ….[T]he creditor in our case (as in those other cases) did get proper notice of the proposed Chapter 13 plan, and so knew perfectly well that if the plan were approved and satisfied, the debtor would be granted a discharge of the student debt listed in the plan.… But [United] didn't object to the plan and didn't appeal the order confirming the plan, as it well could have. Instead, it accepted the payments made by the debtor during the plan's life and then acted as if the whole thing never happened.
>
> It makes a mockery of the English language and common sense to say that [United] wasn't given [adequate] notice, or was somehow ambushed or taken advantage of.… [I]t's not clear why letting the creditor know, in plain terms, that its rights will be impaired by the proposed plan—and then leaving it up to the creditor and his lawyers to figure out what objections or remedies are available—doesn't satisfy the [applicable] notice[] standard. After all, we aren't talking here about destitute

> widows and orphans, or people who don't speak English or can't afford a lawyer. The creditors in such cases are huge enterprises whose business it is to administer the very kinds of debts here in question. If this kind of notice to sophisticated parties who have ample resources to protect their rights is inadequate …, then the concept of notice has no meaning and [finality] is a fairy tale.[53]

Indeed, Judge Kozinsky was so committed to the "efficiency" vision of discharge-by-declaration that he overruled all Ninth Circuit case law holding that bankruptcy judges have the authority to sua sponte withhold confirmation of (and perhaps even sanction debtors or debtors' counsel proposing) plans containing discharge-by-declaration provisions in the absence of creditor objection:

> We find it highly unlikely that a creditor whose business it is to administer student loans will be misled by the customary bankruptcy procedures [for plan confirmation] or somehow be bamboozled into giving up its rights by crafty student debtors. If the creditor is notified and fails to object, it is doubtless the result of a careful calculation that this course is the one most likely to yield repayment of at least a portion of the debt. In such circumstances, bankruptcy courts have no business standing in the way. Cases [withholding confirmation in such circumstances] are, to that extent, overruled.[54]

Judge Kozinski thus held "that bankruptcy courts *must* confirm a plan proposing the discharge of a student loan debt [through a plan provision and] without a determination of undue hardship in an adversary proceeding unless the creditor timely raises a specific objection."[55] The Supreme Court, though, disagreed with this aspect of Judge Kozinski's *Espinosa* opinion, saying that it "was a step too far."[56] The Supreme Court divined from Code § 1325(a)(1) an affirmative obligation "that the bankruptcy court must make an undue hardship finding even if the creditor does not request one."[57]

> Given the Code's clear and self-executing requirement for an undue hardship determination, the Bankruptcy Court's failure to find undue hardship before confirming Espinosa's plan was a legal error.…
>
> * * *
>
> …[A] Chapter 13 plan that proposes to discharge a student loan debt without a determination of undue hardship violates §§ 1328(a)(2) and 523(a)(8). Failure to comply with this self-executing requirement should prevent confirmation of the plan even if the creditor fails to object, or to appear in the proceeding at all. That is because § 1325(a) instructs a bankruptcy court to confirm a plan only if the court finds, *inter alia*, that the plan complies with the "applicable provisions" of the Code. Thus, contrary to the Court of Appeals' assertion, the Code makes plain that bankruptcy courts have the authority—indeed, the obligation—to direct a debtor to conform his plan to the requirements of §§ 1328(a)(2) and 523(a)(8).[58]

How, then, does a Chapter 13 debtor conform his plan to the requirements of §§ 1328(a)(2) and 523(a)(8) after *Espinosa*? Because Espinosa's plan made no mention of undue hardship and justified discharge-by-declaration of Espinosa's student loan debt on other (apparently spurious) grounds, it plainly did not comply with §§ 1328(a)(2) and 523(a)(8). Therefore, a conscientious bankruptcy judge confronted with such a proposed plan after *Espinosa*, attempting good faith compliance with the statutory directive articulated therein, would be compelled to deny confirmation of that proposed plan even in the absence of creditor objection.

What if, however, the debtor's proposed plan contained the following provision?: "Any student loan debt not paid under this Plan shall be discharged upon successful completion of this Plan because payment of any greater amount would impose an undue hardship on the debtor and the debtor's dependents." If notice of the confirmation hearing apprises student loan creditors of this proposed discharge-by-declaration provision and student loan creditors interpose no objections to that proposed plan, can the bankruptcy judge confirm that plan after *Espinosa*? The answer seems to be, yes, based on the following portion of the *Espinosa* opinion:

> We are mindful that conserving assets is an important concern in a bankruptcy proceeding. We thus assume that, in some cases, a debtor and creditor may agree that payment of a student loan debt will cause the debtor an undue hardship suf-

> ficient to justify discharge. In such a case, there is no reason that compliance with the undue hardship requirement should impose significant costs on the parties or materially delay confirmation of the plan. Neither the Code nor the Rules prevent the parties from stipulating to the underlying facts of undue hardship, and neither prevents the creditor from waiving service of a summons and complaint. But to comply with § 523(a)(8)'s directive, the bankruptcy court must make an independent determination of undue hardship before a plan is confirmed, even if the creditor fails to object or appear in the adversary proceeding.[59]

Of course, seeking discharge through plan confirmation proceedings rather than a separate adversary proceeding, with no creditor objection, can certainly be construed as "the creditor… waiving service of a summons and complaint." Moreover, the most expeditious means of "stipulating to the underlying facts," particularly when one is "mindful that conserving assets is an important concern in bankruptcy proceedings," is not through formally filed or entered stipulations but rather is by simply requesting relief with accompanying allegations as to "the underlying facts" supporting the requested relief, which the bankruptcy court then grants in the absence of any objection to the requested relief. One can expect, therefore, that those bankruptcy judges who share Judge Kozinski's "efficiency" vision of discharge-by-declaration will continue to confirm uncontested discharge-by-declaration plans in the most efficient manner.

Those bankruptcy judges who consider discharge-by-declaration to lie somewhere between questionable practice and attempted theft, however, will undoubtedly deny confirmation of the posited, uncontested discharge-by-declaration plan without something more (e.g., some evidentiary showing or proffer at confirmation regarding undue hardship) or simply never permit discharge-by-declaration and require commencement of a separate adversary proceeding, with some courts perhaps even continuing to impose sanctions for the filing of a plan containing a discharge-by-declaration provision,[60] a possibility that the Supreme Court expressly acknowledged:

> United argues that our failure to declare the Bankruptcy Court's order void will encourage unscrupulous debtors to abuse the Chapter 13 process by filing plans proposing to dispense with the undue hardship requirement in the hopes the bankruptcy court will overlook the proposal and the creditor will not object. In the event the objectionable provision is discovered, United claims, the debtor can withdraw the plan and file another without penalty.
>
> We acknowledge the potential for bad-faith litigation tactics. But … "[d]ebtors and their attorneys face penalties under various provisions for engaging in improper conduct in bankruptcy proceedings." The specter of such penalties should deter bad-faith attempts to discharge student loan debt without the undue hardship finding Congress required.[61]

The Supreme Court, therefore, seems to have left open a wide range of permissible practices for discharge-by-declaration of student loan debt. Consequently, discharge-by-declaration will likely continue to be yet another aspect of Chapter 13 bankruptcies where the complex phenomenon often called "local legal culture"[62] will determine the prevailing practice.

1. 11 U.S.C.A. § 523(a)(8).
2. 11 U.S.C.A. § 1327(a).
3. See Ralph Brubaker, Use It or Lose It (But Don't Abuse It), 20 Bankr. L. Letter No. 9, (Sep. 2000) at 1, 7-10.
4. See Christopher W. Frost, Discharge-by-Declaration: The Ninth Circuit Flies Solo, 28 Bankr. L. Letter No. 11 (Nov. 2008) at 6-9.
5. See In re Mersmann, 505 F.3d 1033, 58 Collier Bankr. Cas. 2d (MB) 1112, Bankr. L. Rep. (CCH) P 81039 (10th Cir. 2007) (abrogated by, United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010)); Whelton v. Educational Credit Management Corp., 432 F.3d 150, 204 Ed. Law Rep. 492, Bankr. L. Rep. (CCH) P 80486 (2d Cir. 2005) (abrogated by, United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010)); In re Ruehle, 412 F.3d 679, 54 Collier Bankr. Cas. 2d (MB) 770, 199 Ed. Law Rep. 84, Bankr. L. Rep. (CCH) P 80308, 2005 FED App. 0275P (6th Cir. 2005) (abrogated by, United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010)); In re Hanson, 397 F.3d 482, 53 Collier Bankr. Cas. 2d (MB) 1244, 195 Ed. Law Rep. 93, Bankr. L. Rep. (CCH) P 80233, 60 Fed. R. Serv. 3d 922 (7th Cir. 2005) (abrogated by, United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010)); In re Banks, 299 F.3d 296, 48 Collier Bankr. Cas. 2d (MB) 1655,

169 Ed. Law Rep. 22, Bankr. L. Rep. (CCH) P 78702 (4th Cir. 2002) (abrogated by, United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010)).

6. See Espinosa v. United Student Aid Funds, Inc., 553 F.3d 1193 (9th Cir. 2008), cert. granted, 129 S. Ct. 2791, 174 L. Ed. 2d 289 (2009) and judgment aff'd, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010); In re Pardee, 193 F.3d 1083, Bankr. L. Rep. (CCH) P 78022 (9th Cir. 1999).
7. United Student Aid Funds, Inc. v. Espinosa, 130 S. Ct. 1367, 176 L. Ed. 2d 158, Bankr. L. Rep. (CCH) P 81716 (2010).
8. Espinosa, 553 F.3d at 1201 n.4.
9. Espinosa, 553 F.3d at 1201 n.4.
10. Espinosa, 553 F.3d at 1201 n.4.
11. Espinosa, 553 F.3d at 1201 n.4.
12. Espinosa, 553 F.3d at 1197.
13. Espinosa v. United Student Aid Funds, Inc., 530 F.3d 895, 896, 234 Ed. Law Rep. 28, Bankr. L. Rep. (CCH) P 81262 (9th Cir. 2008).
14. Ralph Brubaker, Of State Sovereign Immunity and Prospective Remedies: The Bankruptcy Discharge as Statutory *Ex parte Young* Relief, 76 Am. Bankr. L. J. 461, 546 (2002).
15. S. Rep. No. 95-989, at 79 (1978).
16. Tennessee Student Assistance Corp. v. Hood, 541 U.S. 440, 450, 124 S. Ct. 1905, 158 L. Ed. 2d 764, 43 Bankr. Ct. Dec. (CRR) 1, 51 Collier Bankr. Cas. 2d (MB) 627, Bankr. L. Rep. (CCH) P 80098 (2004).
17. Espinosa, 553 F.3d at 1201 n.4.
18. Espinosa, 530 F.3d at 899 (citation omitted).
19. Espinosa, 530 F.3d at 899.
20. Espinosa, 553 F.3d at 1197.
21. In re Pardee, 193 F.3d 1083, Bankr. L. Rep. (CCH) P 78022 (9th Cir. 1999).
22. Espinosa, 553 F.3d at 1200.
23. Espinosa, 130 S.Ct. at 1376 (citation omitted).
24. Espinosa, 130 S.Ct. at 1376 (quoting Travelers Indem. Co. v. Bailey, 129 S. Ct. 2195, 2198-99, 174 L. Ed. 2d 99, 51 Bankr. Ct. Dec. (CRR) 210, 61 Collier Bankr. Cas. 2d (MB) 1441, Bankr. L. Rep. (CCH) P 81505 (2009)).
25. See David L. Shapiro, Civil Procedure: Preclusion in Civil Actions 6-7 (2001).
26. 11 U.S.C.A. § 1327(a)
27. 11 U.S.C.A. § 1330(a)
28. Espinosa, 130 S.Ct. at 1376.
29. See Fed. R. Civ. P. 60(c)(1) (time limits for Rule 60(b) motions).
30. See In re Fesq, 153 F.3d 113, 40 Collier Bankr. Cas. 2d (MB) 768, Bankr. L. Rep. (CCH) P 77778 (3d Cir. 1998).
31. Advisory Committee notes to Fed. R. Bankr. P. 9024.
32. Whelton, 432 F.3d at 156 n.2.
33. Espinosa, 130 S.Ct. at 1376 n.9.
34. Espinosa, 130 S.Ct. at 1377.
35. Espinosa, 130 S.Ct. at 1377.
36. See Fed. R. Bankr. P. 9030 ("These rules shall not be construed to extend or limit the jurisdiction of the courts or the venue of any matters therein").
37. Kontrick v. Ryan, 540 U.S. 443, 452, 124 S. Ct. 906, 157 L. Ed. 2d 867, 42 Bankr. Ct. Dec. (CRR) 100, 50 Collier Bankr. Cas. 2d (MB) 969, Bankr. L. Rep. (CCH) P 80031 (2004).
38. Espinosa, 130 S.Ct. at 1378 (quoting Kontrick v. Ryan, 540 U.S. at 454).
39. Espinosa, 130 S.Ct. at 1378.
40. Espinosa, 130 S.Ct. at 1377.
41. Ruehle, 412 F.3d 679; Hanson, 397 F.3d 482; Banks, 299 F.3d 296.
42. In re Mansaray-Ruffin, 530 F.3d 230, 242, Bankr. L. Rep. (CCH) P 81265 (3d Cir. 2008).
43. Espinosa, 553 F.3d at 1204 (footnotes omitted).
44. Espinosa, 130 S.Ct. at 1378.
45. Mersmann, 505 F.3d 1033; Whelton, 432 F.3d 150.
46. S. Rep. No. 95-989, at 79 (1978).
47. Hood, 541 U.S. at 450.
48. Espinosa, 553 F.3d at 1198.
49. Espinosa, 130 S.Ct. at 1378.
50. Espinosa, 130 S.Ct. at 1377.
51. Espinosa, 130 S.Ct. at 1380 (citation omitted).
52. Christopher W. Frost, Discharge-by-Declaration: The Ninth Circuit Flies Solo, 28 Bankr. L. Letter No. 11 (Nov. 2008) at 6, 8 (footnotes omitted).
53. Espinosa, 553 F.3d at 1198-1201 (citations omitted).
54. Espinosa, 553 F.3d at 1205.
55. Espinosa, 130 S.Ct. at 1380.
56. Espinosa, 130 S.Ct. at 1380.
57. Espinosa, 130 S.Ct. at 1379.
58. Espinosa, 130 S.Ct. at 1380-81 (citations omitted).
59. Espinosa, 130 S.Ct. at 1381.
60. See, e.g., In re Lemons, 285 B.R. 327 (Bankr. W.D. Okla. 2002); In re Hensley, 249 B.R. 318 (Bankr. W.D. Okla. 2000); In re Evans, 242 B.R. 407 (Bankr. S.D. Ohio 1999).
61. Espinosa, 130 S.Ct. at 1381-82 (citations omitted).
62. See Jean Braucher, Lawyers and Consumer Bankruptcy: One Code, Many Cultures, 67 Am. Bankr. L.J. 501 (1993).

American Bankruptcy Institute

Bankruptcy Law Letter

Vol. 30, No. 8 August 2010

The Supreme Court and Exemption Practice, or Why a Consumer Debtor Needs a Good Bankruptcy Lawyer

By Ralph Brubaker

In *Schwab v. Reilly*,[1] the Supreme Court has issued a decision with nearly as much practical significance to exemption practice as its 1992 decision in *Taylor v. Freeland & Kronz*,[2] which was an extremely effective prod to trustee diligence in timely objecting to unwarranted exemption claims. By contrast, *Schwab v. Reilly* puts the onus on debtors (or, more accurately, debtors' counsel) to very explicitly (and somewhat counterintuitively—thus the need for a good lawyer) declare their intentions for a claimed exemption under any dollar-capped exemption provision.

Taylor v. Freeland & Kronz: Property Claimed as Exempt Without Objection Is Exempt

Enactment of the Bankruptcy Code in 1978 effected a dramatic change in exemption practice. Under the Bankruptcy Act of 1898, as today, the bankrupt was "required to schedule all his property, and to make 'a claim for such exemptions as he may be entitled to.'"[3] Thereafter, though, it was "the duty of the trustees to 'set apart the bankrupt's exemptions and report the items and estimated value thereof to the court as soon as practicable after their appointment.'"[4] If the bankrupt disagreed with the trustee's exemption report, it was the bankrupt who had to file an objection thereto with the bankruptcy court, which was expressly vested with jurisdiction to "determine all claims of bankrupts to their exemptions."[5] In the absence of an objection by the debtor, the property reported as exempt by the trustee was exempt and never formed part of the bankrupt's estate.

In This Issue

This exemption regime, by virtue of the notion that the exempt property never became part of the bankrupt's estate at all, had the by-product of a significant limitation on federal bankruptcy court's jurisdiction over (and consequent power to protect) the bankrupt's exempt property, which was entirely relegated to state law and state courts.[6] The Bankruptcy Code codifies express protections of exempt property now guaranteed by federal law, such as (1) § 522(c), which provides that "[p]roperty that is properly exempted under § 522 is (with some exceptions) immunized against liability for prebankruptcy debts";[7] (2) § 522(e), which invalidates exemption waivers in favor of unsecured creditors; and (3) § 522(f), which gives the debtor the power to avoid certain exemption-impairing liens. To provide federal

WEST®

40836905

bankruptcy courts the jurisdictional basis to enforce these protections, Code § 541(a)(1) provides that "all legal or equitable interests of the debtor in property as of the commencement of the case" become property of the debtor's bankruptcy estate. Thus an effective claim of "exemption is an interest withdrawn from the estate (and hence from the creditors) for the benefit of the debtor."[8] "No property can be exempted (and thereby immunized [against liability for prebankruptcy debts under § 522(c)]), however, unless it first falls *within* the bankruptcy estate."[9]

The Code also changed the default rules regarding what property is or is not considered exempt. Whereas the trustee's exemption report was determinative in the absence of an objection under the 1898 Act, Code § 522(l) provides: "The debtor shall file a list of property that the debtor claims as exempt under subsection (b) of this section.… Unless a party in interest objects, the property claimed as exempt on such list is exempt." In *Taylor v. Freeland & Kronz*, the Supreme Court made clear that this applies to any claimed exemption, even one with no colorable claim to validity:

> [The debtor] claimed the lawsuit proceeds as exempt on a list filed with the Bankruptcy Court. Section 522(l), to repeat, says that "[u]nless a party in interest objects, the property claimed as exempt on such list is exempt." Rule 4003(b) gives the trustee and creditors 30 days from the initial creditors' meeting to object. By negative implication, the Rule indicates that creditors may not object after 30 days …. Section 522(l) therefore has made the property exempt. [The trustee] cannot contest the exemption at this time whether or not [the debtor] had a colorable statutory basis for claiming it.[10]

Schwab v. Reilly: When Is a Claimed Exemption Objectionable on Its Face?

In *Schwab v. Reilly*, the debtor was Nadejda Reilly, a cook who operated a one-person catering business and who had filed a Chapter 7 petition. In her filed schedules, she attached to both Schedule B (Personal Property) and Schedule C (Property Claimed as Exempt) a handwritten list, denoted in each schedule's "Description of Property" as "See attached list of business equipment." The handwritten lists individually itemized all of the equipment from the debtor's catering business and for each item also listed the price paid for the item and an itemized amount designated "Today's Market Value." The debtor evidently totaled these latter figures to produce the "Current Market Value" figure of $10,718 that she listed on both Schedule B and Schedule C in the "See attached list of business equipment" entries on each schedule. In the Schedule C column for "Value of Claimed Exemption," the debtor had two sub-entries aligned with the listed "business equipment"—$1,850 claimed under the Code § 522(d)(6) "tools of the trade" exemption and $8,868 claimed under the Code § 522(d)(5) "wild card" exemption—which two amounts total the $10,718 that she scheduled as the "Current Market Value of Property Without Deducting Exemptions" for the listed "business equipment."

In summary form, the face of the debtor's schedules for these business equipment entries were as follows:

BANKRUPTCY LAW LETTER (USPS 0674-930) (ISSN 0744-7871) is issued monthly, 12 times per year; published and copyrighted by Thomson Reuters, 610 Opperman Drive, P.O. Box 64526 St. Paul, MN 55164-0526. Periodicals postage paid at St. Paul, MN, and additional mailing offices.
Subscription Price: USA, US Possessions, and Canada—$464.50 annually. For subscription information: call (800) 221-9428, or write West, Credit Order Processing, 620 Opperman Drive, PO Box 64833, St. Paul, MN 55164-9753
POSTMASTER: Send address changes to: *Bankruptcy Law Letter*, 610 Opperman Drive, P.O. Box 64526 St. Paul, MN 55164-0526.

SCHEDULE B — PERSONAL PROPERTY

TYPE OF PROPERTY	DESCRIPTION AND LOCATION OF PROPERTY	CURRENT MARKET VALUE OF DEBTOR'S INTEREST IN PROPERTY WITHOUT DEDUCTING ANY SECURED CLAIM OR EXEMPTION
27. Machinery, fixtures, equipment, and supplies used in business.	See attached list of business equipment.	10,718.00

SCHEDULE C — PROPERTY CLAIMED AS EXEMPT

DESCRIPTION OF PROPERTY	SPECIFY LAW PROVIDING EACH EXEMPTION	VALUE OF CLAIMED EXEMPTION	CURRENT MARKET VALUE OF PROPERTY WITHOUT DEDUCTING EXEMPTIONS
SCHEDULE B—PERSONAL PROPERTY			
* * * *	* * * *	* * * *	* * * *
See attached list of business equipment.	11 USC § 522(d)(6)	1,850.00	10,718.00
	11 USC § 522(d)(5)	8,868.00	

The listed values for both of the claimed exemptions applicable to the debtor's business equipment were within the then-applicable statutory dollar-value caps on the debtor's exemptible interest in the property, i.e., $1850 in § 522(d)(6) "tools of the trade" and $10,225 of § 522(d)(5) "wild card" property.

Before the meeting of creditors, an appraiser told the debtor's bankruptcy trustee that the debtor's catering equipment was worth at least $17,000, and at the meeting of creditors, the trustee informed the debtor that he planned to sell all of her business equipment. However, the trustee did not object to the debtor's claimed exemptions in her business equipment. After lapse of the Rule 4003(b) 30-day objection limitations period, the trustee moved the bankruptcy court for permission to sell the debtor's business equipment (and pay the debtor the value of her claimed exemptions from the sale proceeds). The debtor objected, contending that her business equipment was fully exempt upon the authority of *Taylor v. Freeland & Kronz*, by virtue of the trustee's failure to timely object to her exemption claims. In the alternative, the debtor moved to dismiss her Chapter 7 case entirely, stating that her business equipment not only had tremendous sentimental value because "Reilly's parents purchased [it] for her despite their own financial dif-

ficulties"[11] but also that "she wishe[d] to continue in restaurant and catering as her occupation" and so her "business equipment… is necessary to her livelihood and art."[12]

The bankruptcy court agreed with the debtor that her business equipment was wholly exempt because of the trustee's failure to interpose a timely objection and thus denied the trustee authority to sell the equipment (and correspondingly denied the debtor's motion to dismiss her Chapter 7 case). Both the district court and the Third Circuit affirmed on appeal. The Supreme Court, however, reversed, disagreeing with the contention that a straightforward application of *Taylor* rendered the debtor's business equipment wholly exempt. Both the reasoning and implications of the Court's holding are nuanced and thus require careful study.

Query: How Do You Claim the Full Value of an Asset as Exempt?

The complication that the *Schwab* case exposes is one that was also present in *Taylor* but that the Court and the parties evidently glossed over in *Taylor*: did the debtor claim an exemption for the entire value of the listed asset? The debtor in *Taylor* scheduled the proceeds of an ongoing lawsuit, as yet unliquidated, on her Personal Property schedule with a claimed value of "unknown," and her corresponding exemption claim for this asset appeared as follows:

SCHEDULE B-4 —PROPERTY CLAIMED EXEMPT

TYPE OF PROPERTY	LOCATION, DESCRIPTION, AND, SO FAR AS RELEVANT TO THE CLAIM OF EXEMPTION, PRESENT USE OF PROPERTY	SPECIFY THE STATUTE CREATING THE EXEMPTION	VALUE CLAIMED EXEMPT
Proceeds from lawsuit	Winn v. TWA Claim for lost wages	11 USC § 522(b)(d)	$ *unknown*

The parties in *Taylor* agreed that the debtor "did not have a right to exempt more than a small portion of these proceeds either under state law or under the federal exemptions."[13] The parties and the Supreme Court also evidently assumed that, through the above-described schedule entries, the debtor "in fact claimed the full amount as exempt."[14] That, however, is not an inevitable conclusion. Since the sum, if any, to be received from the pending lawsuit was indeed unliquidated and "unknown," scheduling the "value claimed exempt" as "unknown" is also fully consistent with a claim to exempt less than the entire proceeds of the lawsuit.

Many courts, therefore, have (not unreasonably) concluded that scheduling both the value of the property and the "value claimed exempt" as "unknown" was the determinative indication that the debtor in *Taylor* "claimed the full amount as exempt."[15] This was the view of the Third Circuit in *Schwab*:

> Just as we perceive it was important to the *Taylor* Court that the debtor meant to exempt the full amount of the property by listing "unknown" as both the value of the property and the value of the exemption, it is important to us that [debtor] Reilly valued the business equipment as $10,718 and

> claimed an exemption in the same amount. Such an identical listing put [trustee] Schwab on notice that Reilly intended to exempt the property fully.[16]

As the Eleventh Circuit deduced, "an unstated premise of the [*Taylor*] Court's holding was that a debtor who exempts the entire reported value of an asset is claiming the 'full amount,' whatever it turns out to be."[17]

In *Schwab*, though, the Court refuted this reading of *Taylor* in an opinion written by Justice Thomas (who also authored the *Taylor* opinion). Now we are told that the determinative facet of *Taylor* was not that the debtor had claimed the entire scheduled value of the asset as exempt (which was actually unclear in *Taylor*); rather, *Taylor* turned on the fact that the claimed exemption was objectionable on its face because the claim was not limited to a specific dollar amount:

> Critically, … the debtor in *Taylor* did *not*, like the debtor here, state the value of the claimed exemption as a specific dollar amount at or below the limits the Code allows. Instead, the debtor in *Taylor* listed the value of the exemption itself as "$ *unknown*" ….
>
> The interested parties in *Taylor* agreed that this entry rendered the debtor's claimed exemption objectionable on its face because the exemption concerned an asset (lawsuit proceeds) that the Code did not permit the debtor to exempt beyond a specific dollar amount.… In *Taylor*, the question concerned a trustee's obligation to object to the debtor's entry of a "value claimed exempt" that was *not* plainly within the limits the Code allows. In this case, the opposite is true. The amounts Reilly listed in the Schedule C column titled "Value of Claimed Exemption" *are* facially within the limits the Code prescribes and raise no warning flags that warranted an objection.[18]

Thus, in determining the "property that the debtor claims as exempt" under Code § 522(l) and that "is exempt" in the absence of an objection, the only relevant entries on Schedule C are the description of the property, the specification of the statutory provision under which the exemption is claimed, and the "Value of Claimed Exemption." *Schwab* holds that these are the only entries that comprise the "property that the debtor claims as exempt" under Code § 522(l) and thus are the only entries that the trustee need review in determining whether to object to the debtor's claimed exemptions. Indeed, the Court noted that the "current market value" column was not added to the exemptions schedule until 1991 and was not the result of any change in relevant statutory language.

The entry for the value of a claimed exemption, by contrast, is essential to the exemption claim because, as the *Schwab* Court noted, that which § 522(l) declares exempt in the absence of an objection is the "property that the debtor claims as exempt under subsection (b)." "[M]ost of these categories [of property exempted under subsection (b)] define the 'property' a debtor may 'clai[m] as exempt' as the debtor's 'interest'—up to a specified dollar amount—in the assets described in the category, *not* as the assets themselves."[19] This was the case with the debtor's claimed exemptions for her business equipment in *Schwab*:

> [Sections] 522(d)(5) and (6) define the "property claimed as exempt" as an "interest" in Reilly's business equipment, *not* as the equipment *per se*. Sections 522(d)(5) and (6) further and plainly state that claims to exempt such interests are statutorily permissible, and thus unobjectionable, if the value of the claimed interest is below a particular dollar amount. That is the case here, and Schwab was entitled to rely upon these provisions in evaluating whether Reilly's exemptions were objectionable under the Code.[20]
>
> * * * *
>
> Schwab's statutory duty to object to the exemptions in this case turns solely on whether the value of the property claimed as exempt exceeds statutory limits because the parties agree that Schwab had no cause to object to Reilly's attempt to claim exemptions in the equipment at issue, or to the applicability of the Code provisions Reilly cited in support of her exemptions.[21]

Answer to Query: Do Not Schedule a Value for "Value of Claimed Exemption"

Let us now explore the implications of the Court's emphasis on (1) the importance of the dollar value that the debtor assigns to "value of claimed exemption" on Schedule C; and (2) preserving the distinction between exemptions "that permit debtors to exempt certain property in kind or in full regardless of value"[22] and dollar-capped exemptions for which the debtor's exemption is technically just an "interest" in the property—up to the specified dollar-value cap—and not the property itself. For any dollar-value capped exemption claim, *Schwab* tells us that only the dollar value that the debtor enters as "value of claimed exemption" is the "property the debtor claims as exempt" and that "is exempt"[23] in the absence of an objection—and nothing more.

What that means for any dollar-capped exemption claim is that the property is always at risk of being seized and sold by the trustee if the trustee could (or believes that he could) sell the property for more than the dollar value assigned as "value of claimed exemption" on Schedule C, whether the trustee has objected to the exemption claim or not. That, of course, is the upshot of the *Schwab* holding for debtor Reilly in that case. She claims exemptions for $10,718 for her business equipment, out of the $12,075 total exemptible value available to her under Code § 522(d)(5)-(6) at the time. Because the property itself is property of the estate and Reilly cannot exempt the property itself but only a specified "interest" in that property, the trustee's failure to object to her exemption claims means that up to $10,718 of value from her business equipment is exempt—nothing more. The business equipment itself is still property of the estate that the trustee is free to sell, in the hopes of yielding more than $10,718 of net sales proceeds. If the trustee sells the business equipment for $17,000, the trustee would pay the debtor $10,718 with the balance ($6,282) available for distribution to creditors.

Note that the same is also true if the trustee only sells the property for $12,000—an amount less than the full $12,075 of exemptible value available to Reilly under Code §§ 522(d)(5)-(6). All Reilly theoretically would be entitled to receive is the value that she claimed as exempt on her Schedule C—$10,718—although a debtor's unfettered right to amend her schedules "as a matter of course at any time before the case is closed"[24] should enable Reilly to claim and capture the full sales proceeds as exempt. Amending her schedules to claim and capture the full $12,075 of exemptible value is also available to Reilly in the above-posited case of a sale for $17,000.

What if the trustee sells the property for only $10,000—less than the amount that the debtor claimed as exempt? Well, since the debtor's exemption is still only an "interest" in the property sold, that "interest" would seem to be limited by the property itself (in much the same way as a lien "interest" is so limited). This would mean that the debtor would only receive the $10,000 that an actual sale of the property fetched, notwithstanding the debtor's uncontested claim to more on Schedule C. Consequently, trustees will have an incentive to sell property in which the debtor has a dollar-capped exempt "interest" if the trustee believes the property may bring more than the full exemptible amount under the applicable statutory provision, especially since there seems to be no effective "penalty" to the trustee for being wrong—other than just handing all of the sales proceeds over to the debtor (if they turn out to be less than the full exemptible amount). Note that the trustee's power to (and thus the risk that the trustee may) sell the property continues until closing of the case.[25]

The resulting "cloud of uncertainty" that this casts over a debtor's ability to fully retain and use assets that the debtor has valued at less than the full statutory exemptible amount is what prompted a dissenting opinion in *Schwab* by Justice Ginsburg, joined by Justice Breyer and Chief Justice Roberts. Of course, one can expect debtors (or, more accurately, savvy debtors' counsel) to counter this risk by essentially negating the determinative effect that *Schwab* attributed to the dollar amount assigned to the "value of claimed exemption" on Schedule C, in much the same way as did the debtor in *Taylor*—by not assigning a dollar amount to the "value of claimed exemption."

Thus for any property that the debtor wishes and expects to fully retain, in kind, because its value is (accord-

ing to the debtor's valuation) less than the exemptible amount available under the exemption statute at issue, the debtor can bring finality to that expectation by scheduling the value of the property only in the "current market value" column of Schedule C but not in the "value of claimed exemption" column. In the "value of claimed exemption" column, the debtor should enter "full value," "entire value," "100%," or a similar statement indicating that the debtor is claiming the entire value of the asset as exempt, whatever that value may be. As the *Schwab* majority acknowledged, this move effectively invokes the *Taylor* objection regime (that the *Schwab* debtor failed to invoke):

> Where, as here, it is important to the debtor to exempt the full market value of the asset or the asset itself, our decision will encourage the debtor to declare the value of her claimed exemption in a manner that makes the scope of the exemption clear, for example, by listing the exempt value as "full fair market value (FMV)" or "100% of FMV." Such a declaration will encourage the trustee to object promptly to the exemption if he wished to challenge it and preserve for the estate any value in the asset beyond relevant statutory limits. If the trustee fails to object … the debtor will be entitled to exclude the full value of the asset.[26]

Of course, as the *Schwab* dissenters point out, this "trick" does not follow intuitively from the instructions accompanying Schedule C and the applicable entry headings and therefore provides yet another trap for the unwary pro se debtor.

1. Schwab v. Reilly, 2010 WL 2400094 (U.S. 2010).
2. Taylor v. Freeland & Kronz, 503 U.S. 638, 112 S. Ct. 1644, 118 L. Ed. 2d 280, 22 Bankr. Ct. Dec. (CRR) 1396, 26 Collier Bankr. Cas. 2d (MB) 487, Bankr. L. Rep. (CCH) P 74513A (1992).
3. Lockwood v. Exchange Bank of Ft. Valley, 190 U.S. 294, 298, 23 S. Ct. 751, 47 L. Ed. 1061 (1903) (quoting 1898 Act § 7).
4. Lockwood, 190 U.S. at 298 (quoting 1898 Act § 47).
5. 1898 Act § 2.
6. See Lockwood, 190 U.S. 298-301 (federal bankruptcy court had no jurisdiction to determine the enforceability of an exemption waiver in favor of an unsecured creditor under the 1898 Act).
7. Owen v. Owen, 500 U.S. 305, 308, 111 S. Ct. 1833, 114 L. Ed. 2d 350, 21 Bankr. Ct. Dec. (CRR) 1164, 24 Collier Bankr. Cas. 2d (MB) 850, Bankr. L. Rep. (CCH) P 73963 (1991).
8. Owen, 500 U.S. at 308.
9. Owen, 500 U.S. at 308 (emphasis in original).
10. Taylor v. Freeland & Kronz, 503 U.S. 638, 643-44, 112 S. Ct. 1644, 118 L. Ed. 2d 280, 22 Bankr. Ct. Dec. (CRR) 1396, 26 Collier Bankr. Cas. 2d (MB) 487, Bankr. L. Rep. (CCH) P 74513A (1992).
11. Schwab v. Reilly, 2010 WL 2400094, at *5 n.3 (U.S. 2010).
12. Schwab, 2010 WL 2400094 at *14 n.3 (Ginsburg, J., dissenting).
13. Taylor, 503 U.S. at 642.
14. Taylor, 503 U.S. at 642.
15. Taylor, 503 U.S. at 642.
16. In re Reilly, 534 F.3d 173, 178, Bankr. L. Rep. (CCH) P 81280 (3d Cir. 2008), cert. granted in part, 129 S. Ct. 2049, 173 L. Ed. 2d 1131 (2009) and rev'd and remanded, 2010 WL 2400094 (U.S. 2010).
17. In re Green, 31 F.3d 1098, 1100, 31 Collier Bankr. Cas. 2d (MB) 1449, Bankr. L. Rep. (CCH) P 76098 (11th Cir. 1994) (abrogated by, Schwab v. Reilly, 2010 WL 2400094 (U.S. 2010)).
18. Schwab, 2010 WL 2400094 at *10.
19. Schwab, 2010 WL 2400094 at *7 (emphasis in original).
20. Schwab, 2010 WL 2400094 at *8 (emphasis in original).
21. Schwab, 2010 WL 2400094 at *7 n.7.
22. Schwab, 2010 WL 2400094 at *8.
23. 11 U.S.C.A. § 522(l).
24. Fed. R. Bankr. P. 1009(a).
25. Upon closing of the case, unadministered scheduled property is abandoned to the debtor. See 11 U.S.C.A. § 554(c).
26. Schwab, 2010 WL 2400094 at *12.

Supreme Court Adopts the Forward-Looking Approach to Projected Disposable Income in Chapter 13

By Ralph Brubaker

In *Hamilton v. Lanning*,[1] the Supreme Court has resolved a very knotty issue of statutory interpretation introduced by the 2005 BAPCPA amendments. In an 8-to-1 decision (with Justice Scalia as the lone dissenter), the Court rejected the so-called "mechanical approach" to determining a debtor's § 1325(b)(1) "projected disposable income" for purposes of confirming the debtor's

Chapter 13 plan in favor of the so-called "forward-looking approach."

The Potential Catch-22 in *Lanning*

The entire reason for the Chapter 7 "means test" codified by BAPCPA is to kick supposed "can pay" debtors out of Chapter 7 on the rationale that they could repay a significant portion of their debts through a Chapter 13 repayment plan. This rationale seems to presuppose that the "can pay" debtor denied Chapter 7 relief will, in fact, be permitted to confirm a Chapter 13 repayment plan. BAPCPA's coordinating mechanisms, however, contain one serious glitch that threatened to deny some debtors relief under either Chapter 7 or Chapter 13—namely, those whose income declined significantly during the six-month period before the bankruptcy filing. This circumstance is well illustrated by the facts of *Lanning*.

When Stephanie Lanning filed Chapter 13 (owing nearly $37,000 in unsecured debt), her "current monthly income" under Code § 101(10A)(A)(i) (i.e., average monthly income for the six full months before her filing date) was $5,343.70—an amount in excess of the median income for a family of one in her home state of Kansas. This figure, however, was greatly inflated by a one-time buyout payment from her former employer; the monthly income from her new job was only $1,922—an amount below the state median. Using her statutory "current monthly income" and monthly expenses calculated pursuant to Code § 707(b)(2), Lanning had monthly "disposable income" of $1,114.98—a figure that would make a Chapter 7 filing by Lanning presumptively abusive under the Chapter 7 means test. Her actual ongoing repayment capacity, though, measured by the monthly income from her new job, minus her actual monthly expenses as reported on Schedule J, was only $149.03.

In accordance with her actual repayment capacity, Lanning filed a plan that proposed to devote $144 per month to creditor repayment. The Chapter 13 trustee objected, however, contending that Lanning's proposed plan failed the "best efforts" test of Code § 1325(b)(1):

> (b)(1) If the trustee or the holder of an allowed unsecured claim objects to confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—
>
> (A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or
>
> (B) the plan provides that all of the debtor's projected disposable income to be received in the applicable commitment period… will be applied to make payments under the plan.

Furthermore, Code § 1325(b)(2) goes on to precisely define "disposable income" for purposes of § 1325(b), with the starting point for the "disposable income" calculation being "current monthly income," which of course is statutorily defined by Code § 101(10A)(A)(i) as the debtor's average monthly income for the six full months before her petition filing date—i.e., $5,343.70 for Lanning.

The Chapter 13 trustee, therefore, contended that Lanning's "projected disposable income" required to be devoted to creditor repayment for the entire commitment period (60 months for a debtor above the median "current monthly income" like Lanning) was the $1,114.98 per month produced by Lanning's means-test calculations. Indeed, the trustee figured that Lanning would not even need to pay her creditors this entire amount, since a monthly payment of only $756 for 60 months would fully repay all of her creditors. Of course, Lanning was not actually making enough money in her new job to pay her creditors anywhere near that much, so if the trustee were correct, Lanning would simply be unable to confirm a Chapter 13 plan (and also be presumptively ineligible for any relief under Chapter 7 either). The bankruptcy court, BAP, Tenth Circuit, and the Supreme Court, though, all disagreed with the trustee's interpretation of Lanning's "projected disposable income" for purposes of Code § 1325(b)(1).

"Projected Disposable Income to Be Received" Is Not a Backward-Looking Concept

The seeming statutory contradiction embedded in Code § 1325(b) is that the definition of "disposable income" set forth in § 1325(b)(2) is strictly backward-

looking in measuring the debtor's income by virtue of its reliance on the statutorily defined concept of "current monthly income." That which the "best efforts" test of § 1325(b)(1) is trying to measure (and ensure is going to creditor repayment), though, is the forward-looking "projected disposable income to be received during" the coming term of the plan. Indeed, it is not possible for past income "to be received" in the future. Past income, of course, can be an accurate predictor of future income "to be received" over the course of the plan term if the debtor's relevant circumstances remain unchanged, but not otherwise. This was essentially the *Lanning* Court's reasoning for rejecting the mechanical approach.

Had Congress only employed the term "disposable income" in its Code § 1325(b)(1) "best efforts" test, with that term then defined mechanically in § 1325(b)(2) with "current monthly income" as the only determinant of income, then perhaps the mechanical approach would have been inescapable. The Code § 1325(b)(1) best-efforts test, though, refers to "projected disposable income to be received" over the course of the plan term, and the *Lanning* Court held that this statutory elaboration on the defined term "disposable income" expressly permits the forward-looking approach. The Court relied upon several cues to reach this conclusion.

Ordinary Meaning

The Court heavily relied upon the ordinary meaning of the term "projected" as a forward-looking modifier, "and in ordinary usage future occurrences are not 'projected' based on the assumption that the past will necessarily repeat itself."[2] Under the mechanical approach, the alternative interpretation is that the reference to "projected" is simply a multiplier "projecting" a monthly figure ("disposable income" derived from historical "current monthly income") over the entire "commitment period" of the plan. This, however, is an awkward construction of the term, at best, and the structure of the best-efforts test as drafted is fully consistent with a monthly "projected disposable income" figure and does not even require a conversion from monthly to plan-aggregate figures. The *Lanning* Court also pointed out that Congress has only rarely used the term "projected" to mean simple multiplication. Moreover, interpreting "projected" to mean future income harmonizes that term with the balance of § 1325 in a way that the multiplier/mechanical interpretation does not.

The biggest difficulty with the mechanical/multiplier approach is that the entire linguistic structure of § 1325(b)(1) is forward-looking: courts are directed to ensure that the debtor's plan provides, from the very first payment and for the balance of the required statutory commitment period, that the entirety of the debtor's "projected" disposable income "to be received" during that commitment period "will be applied to make payments under the plan." If past income amounts—used to mechanically determine a formulaic disposable income figure—actually will not "be received" in the future and thus will not (because they cannot) "be applied to make payments under the plan" (as in the *Lanning* case), then the statutory directive makes no sense. The statutory directive in § 1325(b)(1) to make this determination "as of the effective date of the plan" also suggests the forward-looking approach because "[h]ad Congress intended for projected disposable income to be nothing more than a multiple of disposable income in all cases, we see no reason why Congress would not have required courts to determine the value as of the *filing* date of the plan."[3]

Pre-BAPCPA Practice

The *Lanning* Court also relied upon the fact that pre-BAPCPA courts used a debtor's current monthly income to project disposable income over the life of the proposed plan, "[b]ut courts also had discretion to account for known or virtually certain changes in the debtor's income."[4] Noting that "Congress did not amend the term 'projected disposable income' in 2005," the Court leaned on the maxim that it "will not read the Bankruptcy Code to erode past bankruptcy practice absent a clear indication that Congress intended such a departure."[5]

This was an unfortunate makeweight argument by the Court, since Congress clearly did, for the first time, precisely define "current monthly income" (solely in terms of the debtor's past income) and clearly directed bankruptcy courts to use this statutory definition in determining the "disposable income" component of "projected disposable income." As Justice Scalia pointed out

in his dissent, the obvious question that this begs is why Congress would do that at all if it also intended to let bankruptcy courts simply ignore the new definition.

Of course, one reason why Congress might direct bankruptcy courts to the detailed definition of "current monthly income" in determining "projected disposable income" is to specify the kinds of income that should be considered (which are specified in detail) and not to specify the timing of the receipt of that income (since that portion of the definition conflicts, on its face, with § 1325(b)(1)).

The *Lanning* majority's response to the Scalia concern, though, is that the statutory definition (including its timing aspects) should be given effect in the vast majority of cases through a presumption.

> [A] court taking the forward-looking approach should begin by calculating disposable income, and in most cases, nothing more is required. It is only in unusual cases that a court may go further and take into account other known or virtually certain information about the debtor's future income or expenses.[6]
>
> * * * *
>
> [T]he [mechanical] method … should be determinative in most cases, but … in exceptional cases, where significant changes in a debtor's financial circumstances are known or virtually certain, a bankruptcy court has discretion to make an appropriate adjustment.[7]

As Justice Scalia pointed out, though, this rebuttable presumption has absolutely no basis in the text of the statute:

> The Court insists its interpretation does not render § 1325(b)(2)'s incorporation of "current monthly income" a nullity: A bankruptcy court must still begin with that figure, but is simply free to fiddle with it if a "significant" change in the debtor's circumstances is "known or virtually certain." That construction conveniently avoids superfluity, but only by utterly abandoning the text the Court purports to construe. Nothing in the text supports treating the definition of disposable income Congress supplied as a suggestion. And even if the word "projected" did allow (or direct) a court to disregard § 1325(b)(2)'s fixed formula and to consider other data, there would be no basis in the text for the restrictions the Court reads in, regarding when and to what extent a court may (or must) do so. If the statute authorizes estimations, it authorizes them in every case, not just those where changes to the debtor's income are both "significant" and either "known or virtually certain." If the evidence indicates it is merely more likely than not that the debtor's income will increase by some minimal amount, there is no reading of the word "projected" that permits (or requires) a court to ignore that change. The Court, in short, can arrive at its compromise construction only by rewriting the statute.[8]

Dealing with Congressional Indifference

BAPCPA is a poorly drafted statute. What's more, Congress knew that it was a poorly drafted statute and was warned repeatedly about all of the difficulties that it would pose for the courts, including the one at issue in *Lanning*. Congress just did not care, though, and enacted BAPCPA without attempting to fix even the most glaring drafting gaffes. Even Justice Scalia admitted that "[i]t may be that no interpretation of § 1325(b)(1)(B) is entirely satisfying."[9] Thus while it is easy to criticize the *Lanning* majority for essentially rewriting the statute, when Congress intentionally builds a machine with patent flaws, one can hardly fault the courts (who have to operate it and keep it running smoothly) for trying to fix it up to the best of their ability (at least until the next model comes along).

1. Hamilton v. Lanning, Bankr. L. Rep. (CCH) P 81780, 2010 WL 2243704 (U.S. 2010).
2. Lanning, 2010 WL 2243704 at *6.
3. Lanning, 2010 WL 2243704 at *8 (emphasis in original).
4. Lanning, 2010 WL 2243704 at *7.
5. Lanning, 2010 WL 2243704 at *7.
6. Lanning, 2010 WL 2243704 at *9.
7. Lanning, 2010 WL 2243704 at *6.
8. Lanning, 2010 WL 2243704 at *13 (Scalia, J., dissenting) (citations omitted).
9. Lanning, 2010 WL 2243704 at *19 (Scalia, J., dissenting).