

# Chapter 7 Issues

## Part II: Consumer



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## **Chapter 7 Issues Part II: Consumer**

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**WHAT HAPPENED TO MY ABSOLUTE RIGHTS?  
GOOD FAITH ISSUES IN CHAPTER 7 CONSUMER CASES<sup>1</sup>**

For years it was accepted law that 11 U.S.C. § 706 provided an absolute right to convert a chapter 7 case to chapter 13 at any time for any reason. After all, 11 U.S.C. § 706 (a) clearly states:

The debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title. Any waiver of the right to convert a case under this subsection in unenforceable.

The only restriction on this right for one seeking to convert for the first time is the provision in 11 U.S.C. § 706(d) that the debtor must be eligible to “be a debtor under such chapter.”

This right was so absolute in the Fourth Circuit that a debtor who had his discharge denied in chapter 7 due to “bad faith” transfers was allowed to convert the case to chapter 11. *In re Finney*, 992 F.2d 43 (4<sup>th</sup> Cir. 1993). The arguments and the facts in *Finney* were very similar to *Marrama*. The Fourth Circuit left open the possibility that § 105(a) could be grounds to deny a § 706(a) motion but said this misconduct was “insufficiently ‘egregious’ to warrant such extreme action.” 992 F. 2d at 44.

**The *Marrama* Decision<sup>2</sup>**

In 2006, the United States Supreme Court in a narrow 5-4 decision held that the absolute right to convert was not so absolute. *Marrama* involved a debtor who falsely denied that he had transferred a significant asset to a trust pre-petition, falsely listed the value of the transferred

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<sup>1</sup>The views expressed herein are the views of the author/speaker and are not intended to represent the views of the Department of Justice, the Executive Office for United States Trustees, or any other United States Trustee. The propositions discussed are to raise participants’ awareness of possible issues and are not intended to reflect any position that would be taken by the speaker or the Office of the United States Trustee.

<sup>2</sup> *Marrama v. Citizens Bank of Massachusetts*, 549 U.S. 365, 127 S.Ct. 1105, 166 L.Ed.2d 956 (2007).

property as zero, and failed to disclose an \$8,745.86 tax refund. When debtor saw that the trustee was going to administer the asset, he attempted to convert to chapter 13, as provided by 11 U.S.C. § 706. The bankruptcy court refused, and was affirmed by the First Circuit BAP, the First Circuit, and the Supreme Court. The court's decision was based on the proposition that, because the debtor's bad faith would allow the bankruptcy court to immediately convert the case back to chapter 7 pursuant to 11 U.S.C. § 1307(c), the debtor was not eligible to be a chapter 13 debtor. The ruling was bolstered by the court's authority under § 105 and the inherent power of the court to sanction abusive practices. The court also pointed out that the prohibition against waiver of the right to convert did not mean that the debtor could not "forfeit" the right to convert.

#### **Cases Interpreting *Marrama***

Debtor, facing a denial of discharge complaint based on understating the amount of money in his possession following the sale of a former marital residence and spending money that he had promised to turn over to the trustee, was denied conversion because the conversion was motivated by desire to dismiss the denial of discharge complaint. *In re Visconti*, 448 B.R. 617 (Bankr. D.N.H. 2011). The court denied the conversion in *Visconti*, even though it was part of a settlement in which debtor's former counsel agreed to pay the estate more than \$50,000.

Debtor, who failed to schedule a license plate valued at \$200,000 was allowed to convert to chapter 13 based largely on the factual finding by the court that it was uncertain that the debtor knew the value of the license plate. *In re Murray*, 377 B.R. 464 (Bankr.D.Del. 2007). The debtor was 85 years of age and paid nothing for the license plate that he had had for 45 years.

Does the timing of the bad faith matter? What if it were pre-petition conduct? See *In re Lilley*, 91 F. 3d 491 (3rd Cir. 1996) (holding that debtor who was convicted of failing to file federal tax returns and had large tax debt was not ineligible for chapter 13 relief based on pre-

petition conduct). The case was remanded for a determination of whether the filing was in bad faith. See also *In re Hua*, 411 B.R. 671 (Bankr. S.D. Cal. 2009) (holding pre-petition conduct did not make one ineligible for chapter 13 relief).

### **Factors in Determining Good Faith**

Factors considered in evaluating good faith include: (1) the debtor's accuracy in stating debts and expenses; (2) the debtor's honesty in the bankruptcy process, including whether he has attempted to mislead the court or whether he has made any misrepresentation; (3) whether the Bankruptcy Code is being unfairly manipulated; (4) the type of debt sought to be discharged; (5) whether the debt would be dischargeable in a chapter 7 proceeding; and (6) the debtor's motivation and sincerity in seeking chapter 13 relief. *In re Sullivan*, 326 B.R. 204, 212 (1st Cir. BAP 2005); *Visconti*, 448 B.R. at 622. See also *McDow v. Smith*, 295 B.R. 69, 74 (D. E. D. Va. 2003) (In general, a debtor's "bad faith" or "lack of good faith" is evidenced by the debtor's deliberate acts or omissions that constitute a misuse or abuse of the provisions, purpose, or spirit of the Bankruptcy Code.<sup>FN7</sup> Similarly, a debtor's unreasonable delay, failure to pay required fees and failure to meet filing deadlines are all acts or omissions that may reflect a debtor's misuse of the bankruptcy process; in the absence of inadvertence or excusable neglect, they bespeak a debtor's lack of good faith in invoking the bankruptcy process. It follows, therefore, that a debtor's bad faith acts or omissions fall into the same class of such acts or omissions as do the three illustrative examples of "cause" for dismissal set forth in [§ 707\(a\)](#), namely the class of acts or omissions that involves a misuse or abuse of the bankruptcy process.").

One common test that makes sense is found in *In re Murray*, 377 B.R. 464 (Bankr. D.Del. 2007). That test is simply (1) the timing of the motion; (2) the debtor's motive in filing

the motion; and (3) whether the debtor has been forthcoming with the bankruptcy court and creditors.

### ***Marrama* and Debtor Motions to Dismiss**

The cases are divided as to whether the *Marrama* concept applies to debtors' motions to dismiss chapter 13 cases after fraud or other bad faith is discovered. *In re Williams*, 435 B.R. 552 (Bankr. N.D. Ill. 2010) held the right to dismiss absolute in spite of the debtor's bad faith, reasoning that, while *Marrama* is based on the eligibility to be a debtor under chapter 13, there is no eligibility requirement to not be in bankruptcy. Other cases follow this view. *See, e.g., In re Campbell*, 2007 WL 4553596 (Bankr. N.D.W.Va. 2007).

The cases finding that *Marrama* does call for the denial of motions to dismiss chapter 13 cases do so on the theory that *Marrama* is more a case of the inherent power of the court to police bad faith and abuse of process. *See, e.g., In re Jacobsen*, 609 F. 3d 647 (5<sup>th</sup> Cir 2010); *In re Rosson*, 545 F. 3d 764 (9th Cir. 2008); *In re Kotche*, 457 B.R. 434 (Bankr. D. Md. 2011) (holding that *Marrama* is not to be narrowly applied and that debtor's bad faith can forfeit the right to convert); *In re Armstrong*, 408 B.R. 559, 569 (Bankr. E.D.N.Y. 2009) ("Important point of *Marrama* is that otherwise unqualified rights . . . are qualified by the bankruptcy court's power under § 105(a) to police bad faith and abuse of process."). The court in *Kotche* found that the denial of the motion did not have a captive effect on the debtor because the court was granting the UST motion to convert pursuant to §1307(c).

The distinction between the standards for conversion and dismissal seemed lost on the debtor in *Rossen*, and he conceded that, after *Marrama*, the court could deny the dismissal if it found bad faith. So the issue then turned on whether the conduct was bad faith. Debtor had agreed to use the proceeds of a \$185,000 arbitration award to fund his chapter 13 plan, but failed

to deliver it to the trustee as agreed, and, after some delay, only delivered \$104,000. The debtor used the remaining money to remodel his home. The court was in the process of converting the case to chapter 7 when he invoked his right to dismiss.

### Chapter 20 and Good Faith

A debtor not eligible for a discharge may file a chapter 13 case and seek the relief provided under that chapter. *In re Bateman*, 515 F.3d 272, (4th Cir. 2008). While *Bateman* involved a previous chapter 13 discharge, a holding that eligibility for a discharge was a requirement for being in chapter 13 would have also prohibited the typical chapter 20 case.<sup>3</sup>

Some chapter 20s are achieved by a conversion from chapter 13 to chapter 7.<sup>4</sup> The meaning of “at any time” in § 706(a) has been held by some courts to mean at any time before discharge. See *In re Lesniak*, 208 B.R. 902, 906 (Bankr. N.D. Ill. 1997). The court in *In re Mosby*, 244 B.R. 79, (Bankr. E.D.Va. 2000) held that the entry of a chapter 7 discharge was no bar to conversion to chapter 13. *Mosby* pointed out that creditors with “valid claims on the date the bankruptcy petition is filed do not lose them simply because the debtor is granted a discharge or the case is converted to another chapter.” 244 B.R. at 87.

Efforts to achieve the conversion by having the discharge revoked are not always successful. *In re Jymison* 2012 WL 709980 (Bankr D.N.M. 2012) (Motion to vacate filed only hours after entry of discharge was denied because debtor did not have standing to bring the motion.) The motion to vacate the discharge in *Jymison* was to reimpose or revive the automatic stay which ended with the entry of discharge. See § 362(c)(2)(C). Some courts do allow a debtor to have the discharge set aside on debtor’s motion. See *In re Jones*, 111 B.R. 674 (Bankr E.D.

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<sup>3</sup> A “chapter 20” is a reference to a chapter 7 discharge being followed closely by a chapter 13 filing. The debtor typically discharges the unsecured debt in chapter 7 and then deals with a specific problem, such as a mortgage arrearage, in chapter 13 without getting a discharge.

<sup>4</sup> The problems with the automatic stay for repeat filings will not be discussed in this outline, but counsel should be aware that the BAPCPA limited the automatic stay for repeat filings. See 11 U.S.C. §362(c)(3) and (4).

Tenn. 1990).

The decision to file under chapter 7 cannot always be undone. See *In re Leitner*, 2010 WL 5093300 (Bankr. D.S.C. 2010) for a case denying debtor's motion to reopen a chapter 7 case to have the discharge revoked and the case converted to chapter 13. The court noted that the debtor had the opportunity of filing a new chapter 13, but apparently the debtor wanted the benefit of a chapter 13 discharge instead of the chapter 7 discharge, or had concerns about the stay in a repeat filing case.

Many "chapter 20" cases are filed to strip off junior liens. This is generally permitted in chapter 13, but not in chapter 7. See *Dewsnup v. Timm*, 502 U.S. 410, 112 S.Ct. 773, 116 L.Ed. 2d 902 (1992). The problem is that sometimes the debt limitations of chapter 13 do not permit the debtor to file a chapter 13; so the debtor files a chapter 7, discharging the debt, and is then eligible for a chapter 13. The debtor waits a discrete amount of time and files chapter 13. There is a split as to whether a debtor may use chapter 13 to strip a lien on his residence if he is ineligible for a chapter 13 discharge. See *In re Davis*, 447 B.R. 738 (Bankr. D.Md. 2011) ("The Court acknowledges but declines to follow the weight of authority that favors TD Bank's argument that lien stripping pursuant to Section 506 is contingent on a debtor's eligibility to receive a Chapter 13 discharge."). Several courts hold that being eligible for a discharge is a requirement to strip the lien. See, e.g., *Prairie v. Picht (In re Picht)*, 428 B.R. 885 (10th Cir. BAP 2010); *In re Fenn*, 428 B.R. 494 (Bankr. N.D.Ill. 2010).

The courts allowing the debtor in a nondischargeable chapter 13 to strip liens usually require that the case be filed in good faith, because this is a requirement for plan confirmation. In *In re Scotto-DiClemente*, 459 B.R. 558 (Bankr. D.N.J. 2011), the court addressed the question of "good faith" by asking why the debtors did not initially file under chapter 13. The

factors considered were, “whether (1) “the debtor[ ] ... [has] a need for bankruptcy other than lien avoidance; (2) whether [the] debtor[ ] acted equitably in proposing the plan; (3) whether [the] debtor[ ] ... [is] devoting ... [his] income to the plan; and (4) whether the debtor[ ] used serial filings to avoid paying their creditors.” 459 B.R. at 568 (citing *In re Okosisi*, 451 B.R. 90, 102-04 (Bankr. D.Nev. 2011)).

The court in *Scotto-DiClemente* stated its ruling as follows:

The Court takes no issue with a debtor filing a “no discharge” Chapter 13 with a proper reorganization purpose (e.g., curing mortgage arrears) and then also taking advantage of the Code's permitted tools to strip-off a wholly unsecured junior mortgage lien. What the Court cannot abide are “no discharge” Chapter 13 cases which are filed *solely* to avoid liens or which undertake to cure recently “fabricated” arrears incurred as part of a stratagem to sidestep the limitations of *Dewsnup*.

459 B.R. at 569-70.

One does not have to be a complete cynic to form the belief that this transforms the rule to: if you have a good story, you can do it; but if you don't have a good story, you cannot. If the debtor creates the arrearage after the chapter 7, this will be a sign of bad faith.

#### **Other Cases Based on Bad Faith.**

The Fourth Circuit has held that the conduct of the debtor whose sole purpose for filing a bankruptcy petition was to favor certain creditors and to defraud his ex-wife was an abuse to the bankruptcy process. See *In re Kestell*, 99 F.3d 146 (4th Cir. 1996). Kestell failed to disclose two assets, and the court noted that, had he listed these assets, it “would have demonstrated his good faith efforts to comply with the bankruptcy process.” 99 F. 3d at 150. We cannot be certain that the result in *Kestell* would have been the same with either of these elements of bad faith standing alone, but together the debtor was hardly the “honest but unfortunate debtor” described in *Grogan v. Garner*, 498 U.S. 279 (1991).

The First Circuit recently held that fee-only chapter 13 plans are not *per se* bad faith. *In re Puffer*, 674 F.3d 78 (1st Cir. 2012). The court quoted *Marrama* as requiring a “totality of the circumstances” approach to §1325(b) analysis of good faith as well. The First Circuit said, “good faith is a concept, not a construct.” 674 F.3d at 82. The court expressed concerns about fee-only chapter 13 cases and said that a debtor proposing a fee-only plan would have a heavy burden to show good faith. *Id.* at 83.

### **Procedural Issues**

In his dissent in *Marrama*, Justice Alito worried that the majority’s ruling lacked the structure of “the statutory scheme—conversion to chapter 13 followed by notice and a hearing on the question of reconversion” that “would at least provide some structure to the process of identifying those debtors whose ‘bad faith’ meets the Court’s standard for consignment to liquidation, *i.e.* ‘bad faith’ conduct that is ‘atypical’ and ‘extraordinary.’” Rather than simply deny motions to convert from chapter 7 to 13, some courts have established by local rule a procedure that requires notice and hearing on the issue of conversion to chapter 13. *See Local Rule 1017-3* (Bankr. W.D. Va., adopted May 31, 2007). If the case is converted, the trustee or a creditor could file a motion to reconsider under Fed. R. Civ. P. 59 made applicable to bankruptcy cases by Fed. R. Bankr. P. 9023, but such motion must be made within 14 days after entry of the order of conversion. *See In re Nordin*, 2012 WL 1614742, (Bankr. D.Colo May 9, 2012).

**WHAT HAPPENS TO THAT RETIREMENT CASE IF A DEBTOR “FORGETS” TO  
SCHEDULE IT?  
JUDICIAL ESTOPPEL AND OTHER HORRORS**

A consumer debtor who has a cause of action at the time of the filing of a Chapter 7 bankruptcy petition must disclose that cause of action to the trustee. Such a cause of action is property of the estate, and a failure to disclose its existence could have dire consequences for the debtor and debtor’s counsel, such as the application of judicial estoppel, loss of the ability to claim a proper exemption in the proceeds of the cause of action, (or worse!) loss of attorney’s fees.

**What is Judicial Estoppel?<sup>5</sup>**

It is a fact specific, equitable remedy applied at the discretion of the court. *See New Hampshire v. Maine*, 532 U.S. 742 (2001). The theory aims to preserve the integrity of the judicial process by precluding a party from pursuing a legal position that is inconsistent with a position previously successfully asserted in a prior legal proceeding. *Id.* In other words, it prevents a litigant from “playing fast and loose with the courts.” *Scarano v. Central R. Co. of N.J.*, 203 F.2d 510 (3d Cir. 1953). The doctrine is applied in the most egregious cases when the inconsistent positions would amount to a “knowing misrepresentation to or fraud on the court.” *Total Petroleum, Inc. v. Davis*, 822 F.2d 734-38 (8th Cir. 1987).

Typically, in the bankruptcy context, it is asserted as an affirmative defense by a defendant who asserts that a debtor or a trustee is precluded from pursuing a cause of action against the defendant because the debtor failed to include or accurately value the cause of action in his Schedules or Statement of Financial Affairs. However, judicial estoppel may also be

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<sup>5</sup> The information in this article is not intended to be legal advice. Cases are highly fact intensive and any practitioner should consult the law in the applicable circuit prior to proceeding.

raised by the Court *sua sponte*. *Krystal Cadillac-Oldsmobile GMC Truck, Inv. v. Gen. Motors Corp.*, 337 F.3d 314 (3d Cir. 2003).

In its extreme form, the debtor's case against the defendant is dismissed and neither the debtor nor the trustee on behalf of the creditors of the debtor may pursue the litigation. Because the consequences for the debtor, the debtor's counsel, the trustee and the creditors can be severe, we examine below the widely divergent application of the theory and offer practical pointers to avoid having a court apply it against your client's claim.

### **When do courts apply Judicial Estoppel ?**

1. The party to be estopped must have taken two positions that are irreconcilably inconsistent. (The responsible party must have succeeded in persuading a court to accept its prior position. *Alternative Sys. Concepts*, 374 F.3d 23, 32-33 (1st Cir. 2004)).
2. The party to be estopped changed his or her position in bad faith.
3. No lesser sanction would adequately remedy the damage done by the litigant's misconduct.

*In re: Krystal Cadillac*, 337 F.3d at 319-20.

### **Debtor's Obligation to Disclose Causes of Action**

A debtor is required to file the schedule of assets and liabilities and a statement of the debtor's financial affairs under oath. 11 U.S.C. § 521(a). The schedules must disclose, *inter alia*, "contingent and unliquidated claims of every nature" and provide an estimated value for each one. *In re: Kane*, 628 F.3d 631 (3d Cir. 2010) (citing *Ryan Operations G.P. v. Santiam-Midwest Lumber Co.*, 81 F.3d 355 (3d Cir. 1996)); See also, obligations imposed on debtor and counsel pursuant to Fed. R. Bankr. P. 9011(b). Contingent assets include causes of action that the debtor may have against another party. *Krystal Cadillac*, 337 F.3d 314.

Property of the bankruptcy estate includes “all legal or equitable interests of the debtor in property as of the commencement of the case.” 11 U.S.C. § 541(a)(1). The trustee has the capacity to pursue the debtor’s litigation claims under 11 U.S.C. § 323, and it is therefore essential that the debtor disclose all contingent and unliquidated claims so that the trustee can make a determination of whether to pursue those claims for the benefit of the debtor’s estate. *In re: Costello*, 255 B.R. 110 (Bankr. E.D.N.Y. 2000). Courts have interpreted § 541 broadly to include “all kinds of property, including tangible or intangible property, [and] causes of action.” *Westmoreland Human Opportunities, Inc. v. Walsh*, 246 F.3d 233, 241 (3d Cir. 2001) (quoting *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 205 n.9 (1983)). Additionally, courts have also held that there is a duty to amend the schedules to disclose a claim that arises during the pendency of the bankruptcy, as any interest in property that the estate acquires after the commencement of the case is property of the estate. 11 U.S.C. § 541(a)(7); see e.g., *Robinson v. Tyson Foods, Inc.*, 595 F.3d 1269 (11th Cir. 2010) (claim was filed during the Chapter 13 bankruptcy and prior to the conversion to Chapter 7).

### **Trustee’s Right to Pursue Litigation**

Upon the filing of a Chapter 7 bankruptcy, the trustee becomes the real party in interest with the sole authority to pursue the litigation for the benefit of the creditors. See 11 U.S.C. § 323 - the trustee is the representative of the estate and has the power to sue and be sued, and 11 U.S.C. 704(a)(1) - which requires the trustee to collect and reduce to money the property of the estate. Even after a bankruptcy case is closed, undisclosed litigation remains property of the estate if it has not been abandoned or administered by the trustee, 11 U.S.C. § 554(d), and the trustee can seek to reopen the bankruptcy to administer assets of the estate. 11 U.S.C. § 350(b).

**Is non-disclosure of the cause of action by itself sufficient to cause the court to apply judicial estoppel?**

The Third Circuit has held that a rebuttable inference of bad faith arises when averments in the pleadings demonstrate both knowledge of a claim and a motive to conceal that claim in the face of an affirmative duty to disclose. *Krystal Cadillac*, 337 F.3d at 321, citing *Oneida Motor Freight, Inv. v. New Jersey Bank*, 848 F.2d 414, 416-18 (3d Cir. 1988). There is no requirement in the Third Circuit that the party who failed to disclose actually benefitted from the lack of disclosure. Rather, the presence or absence of a benefit is one factor that the courts consider in determining if there has been bad faith. The Third Circuit has specifically left open the question of whether nondisclosure in and of itself is sufficient to find that the debtor has asserted inconsistent positions or demonstrated bad faith. *Oneida*, 848 F.2d at 419; *Ryan*, 81 F.2d at 363. Compare *Moses v. Howard Univ. Hosp.*, 606 F.3d 789, 798 (D.C. Cir. 2010) (failure to identify a claim as an asset in bankruptcy is a prior inconsistent position barring the debtor from pursuing the claim in a later proceeding).

**Courts distinguish between estopping the Trustee and estopping the Debtor**

The Fifth Circuit in a recent *en banc* opinion and the Seventh, Tenth, and Eleventh Circuits have distinguished between applying judicial estoppel to a claim brought by a non-disclosing debtor and applying it to the trustee pursuing that claim on behalf of the estate. These courts have found that the trustee should not be estopped as he is the real party in interest, but that the debtor should be estopped so that any excess proceeds from the litigation after the satisfaction of all claims would not go to the debtor, but rather would go back to the defendant. The reasoning behind these cases is that the purpose of judicial estoppel is to protect the integrity of the bankruptcy process and to preserve assets of the estate for distribution to creditors. *Reed v. City of Arlington*, 650 F.3d 571 (5th Cir. 2011) (*en banc*).

## MID-ATLANTIC BANKRUPTCY WORKSHOP

In *Reed*, the debtor obtained a \$1,000,000.00 judgment against the City on a Family Medical Leave Act claim which was on appeal at the time of the filing of his Chapter 7 petition. The debtor failed to disclose the claim, the judgment, or the legal fees owed to his FMLA counsel on his schedules. FMLA counsel was unaware of the bankruptcy filing; the debtors received a discharge and the bankruptcy case was closed. Thereafter, the FMLA counsel learned of the bankruptcy and informed the former trustee, who moved to reopen the bankruptcy and to substitute into the litigation as the real party in interest. When the City learned of the bankruptcy, it argued that the trustee should be estopped from collecting the judgment. The District Court held that the trustee could collect the judgment for the benefit of the creditors, but that any remaining funds after full distribution would go back to the City and not to the debtor. The City appealed.

The 5th Circuit affirmed, reaching its decision by considering the ends of the bankruptcy system, i.e. to “bring about an equitable distribution of the bankrupt’s estate among creditors holding just demands” (*Kothe v. R.C. Taylor Trust*, 280 U.S. 224, 227 (1930)) and “grant a fresh start to the honest but unfortunate debtor . . .” *Marrama v. Citizens Bank of Mass.*, 549 U.S. 365, 367 (2007). To balance these two ends, the court determined that judicial estoppel should be applied to deter dishonest debtors who fail to disclose assets, but also protect the rights of creditors.

Other courts have taken similar positions. *Parker v. Wendy’s International, Inc.*, 365 F.3d 1268 (11th Cir. 2004) (the trustee didn’t abandon the claim or take an inconsistent position with respect to the claim, therefore, the trustee should not be judicially estopped). *Eastman v. Union Pacific Railroad Co.*, 493 F.3d 1151 (10th Cir. 2007) (trustee not estopped from pursuing debtor’s undisclosed personal injury claim), accord *Riazuddin v. Schindler Elevator Corp.* (*In re*

*Riazuddin*), 363 B.R. 177 (10th Cir. B.A.P. 2007) (trustee takes cause of action subject to the defenses that existed at the time of the bankruptcy filing, not after). *Biesek v. Soo Line Railroad Co.*, 440 F.3d 446, 448 (7th Cir. 2006) (suggesting that the trustee should be able to pursue claim for the benefit of the creditors even if debtor is judicially estopped).

While the specific issue has not been addressed by the Third Circuit, in a different context the Third Circuit has recognized the distinction between the debtor and the trustee in its analysis of claims preclusion and equitable estoppel. The court recognizes that while the trustee may be the successor to the debtor's property, the trustee is not the successor in interest to the debtor for all purposes. *In re: Montgomery Ward, LLC et al.*, 09-1735 / 1736 (3d. Cir. June 2, 2010) (slip op.).

#### **Other Recent Decisions Applying Judicial Estoppel**

*Guay v. Burak*, 2012 WL 1252251 (1st Cir. 2012).

The debtors filed a Chapter 11 bankruptcy which was later converted to Chapter 7. Post-petition, but pre-conversion the debtors were involved in a police and environmental investigation which the debtors asserted violated the 4th, 5th and 14th Amendments, among other things. The debtor filed a *pro se* complaint post-conversion against the State of New Hampshire and others. Although the debtors orally discussed the litigation with the trustee (after the claims were brought to the trustee's attention by the State of New Hampshire), the claims were not included in their schedules and the debtors had repeatedly asserted under oath that their schedules were accurate and needed no amendment. The debtors did disclose the litigation in a Notice of Unpaid Chapter 11 Obligations, and thereafter the Chapter 7 trustee filed a Notice of Abandonment with respect to the litigation. The 1st Circuit affirmed the District Court which applied judicial estoppel to bar the debtors' claims.

*Jones v. United States of America*, 2012 WL 833320 (11th Cir. 2012)

The debtor asserted a claim under the FTCA for \$10 million related to her assertion that water at Camp Lejeune had been contaminated and caused her to develop cancer. The debtor failed to disclose the claim in her Chapter 13 filing. The debtor converted to Chapter 7 and again failed to disclose the claim and received a discharge. Similarly, the debtor failed to disclose the bankruptcy in response to discovery in the FTCA litigation. After the government learned of the bankruptcy, the debtor sought to reopen the bankruptcy arguing that her failure to list the claim was because it was too speculative. The bankruptcy court reopened the case and reappointed the trustee, but two days later the government filed for summary judgment in the FTCA case on the basis of judicial estoppel. The trustee moved to be substituted in the FTCA case, but the district court granted the government's motion for summary judgment without addressing the substitution motion. The debtor filed an appeal but the trustee did not. On appeal, the 11th Circuit determined that the district court had not abused its discretion in its application of judicial estoppel to the debtor's cause of action. The Court reasoned that the trustee had not appealed and, therefore, apparently decided not to pursue the claim, and that the debtor had no standing to challenge the denial of the substitution motion. Further, citing to *Reed v. City of Arlington* and *Parker v. Wendy's International, Inc.*, the Court reasoned that the debtor couldn't put herself in the position of an innocent trustee and only the trustee would have the right to pursue the claim if it went forward.

**So judicial estoppel hasn't been raised by the defendant, what else could happen?**

**A non-disclosing debtor may lose his exemption in the proceeds of the cause of action:**

In *Clark v. Pope*, the debtors did not initially disclose as an asset their personal injury ("PI") case. *Clark v. Pope*, 274 B.R. 127 (Bankr. W.D. Pa. 2002). Upon learning of the PI case

at the 341 Meeting, the trustee advised that the PI case was an asset of the estate and that the trustee must be notified of and approve settlement of the same. The debtors later amended their schedules to include the PI case, as well as to claim an exemption in the proceeds in the amount of \$7,500.00. Several years later, the trustee learned that the PI case was settled without his knowledge or approval. Not only did the debtors' PI attorney fail to disclose the settlement, he also failed to obtain approval from the bankruptcy court of his employment. The trustee then filed a complaint seeking turnover of the PI attorney's fees from the settlement, as well as disallowance of the debtors' claimed exemptions. On the same day, the debtors amended their schedules yet again to increase the claimed exemption in the PI case, to which the trustee further objected. *Id.*

The court held that the debtors' conduct was sufficient to cause disallowance of any exemption above the initially claimed \$7,500.00. The court also found that because the debtors' PI attorney's employment was never authorized by the court, he was not entitled to compensation. *Id.*

In *In re Agee*, the court held that a debtor's attempt to conceal a PI claim from the trustee constituted bad faith. This action ultimately cost the debtor his ability to claim an exemption in the proceeds of the PI action. *In re Agee*, 456 B.R. 740 (Bankr. M.D.N.C. 2011). *But see In re Williams*, 337 B.R. 846 (E.D. Va. 2005) (wherein a lack of diligence by the debtors in updating their previously prepared schedules at the time of filing was insufficient for the court to deny the debtors their scheduled exemption).

**Other tangential issues involving a debtor's cause of action:**

Because PI actions are property of the estate, a trustee has the ability to retain his own counsel to prosecute the same. In *Cottrell v. Schilling (In re Cottrell)*, the Sixth Circuit found

that a PI action is property of the estate, and affirmed the bankruptcy court's order allowing the trustee to appoint his own counsel to prosecute that action, instead of the debtors' PI attorneys. The debtors' attorneys argued that because a PI action was not assignable under state law, it did not become property of the estate upon the debtors' bankruptcy filing. Relying on the broad definition of property of the estate from the Bankruptcy Reform Act of 1978, and persuasive authority thereafter, the court found otherwise. *Cottrell v. Schilling*, 876 F.2d 540 (6th Cir. 1989). See also *Sierra Switchboard Co. v. Westinghouse Electric Corp.*, 789 F.2d 705 (9th Cir. 1986).

A debtor's contingency fee contract with his PI attorney is an executory contract, which the trustee has the ability to assume or reject. *In re Ashley*, 41 B.R. 67 (Bankr. E.D. Mich. 1984). In *In re Ashley*, the trustee never assumed the debtor's contingency fee contract with her PI attorney pursuant to 11 U.S.C. §365. Upon the passage of 60 days from the petition date, the contract was rejected as a matter of law, with the rejection relating back to the time of the petition filing, a date prior to the settlement of the PI action. Therefore, when the debtor's PI attorney completed the settlement of that action, he was not contractually related to the debtor, and could not enforce his contingency fee arrangement. It was the trustee's decision whether to accept the settlement achieved by the debtor's PI attorney. If the trustee so accepted, the PI attorney would be entitled to his fees. If not, he would be entitled to a rejection damages claim pursuant to the state's attorney's charging lien. *Id.*

In *In the Matter of Wischan*, the Fifth Circuit considered the interesting argument that settlement proceeds for future pain and suffering received post-petition for pre-petition personal injuries were excluded from the property of the estate as they related to post-petition activity.

The court, in following the settled law that PI actions were property of the estate, rejected this argument. *In the Matter of Wischan*, 77 F.3d 875 (6th Cir. 1996).

In *Cassell v. Krippendorf*, the debtor attempted to exempt proceeds from a wrongful death action pursuant to Virginia law exempting PI proceeds from creditor execution. The court, relying on the state's differential treatment of wrongful death and PI actions, and the statutory omission of wrongful death actions from the exemption statute, refused to allow the debtor's exemption in the wrongful death proceeds. *Cassell v. Krippendorf*, 158 B.R. 963, (W.D. Va. 1993).

**Practical Pointers - How do I avoid having this happen to my client's case?**

1. Communicate with the client on more than one occasion the importance of complying with the requirements of the Bankruptcy Code. Explain what is required by the Code and impress upon them the consequences of failing to comply.
2. Have the client confirm in writing that they have no claims or *potential* claims against anyone for anything.
3. Provide the debtor with written instructions concerning when the debtor has a duty to amend to include claims arising post-petition.
4. If you learn of a potential claim that was not disclosed, amend the schedules immediately as courts have held that oral notification to the Trustee or even notification in writing is not sufficient. *Rodriguez-Torres v. Government Development Bank of Puerto Rico*, 750 F. Supp. 2d 407 (D. Puerto Rico 2010); *Ibok v. Siac-Sector Inc.*, 2011 WL 293757 (S.D.N.Y. 2011); Don't wait because courts want to encourage compliance with the Bankruptcy Code and have applied judicial estoppel where the debtor filed the

amendment only after the claim was brought to the court's or trustee's attention by a third party.

**WHAT LIABILITY? DIDN'T I SURRENDER THIS PROPERTY?  
SURRENDER ISSUES AND CONTINUING POST-PETITION LIABILITY**

Over the last few years many debtors have been unpleasantly surprised to find themselves liable for post-petition obligations on real property that they believed had been surrendered. In the typical scenario, a debtor files a Chapter 7 petition and on her statement of intention indicates that she is surrendering the real estate she owns to her secured lender. The debtor may even consent to allowing the stay to be lifted so the secured lender can proceed to foreclose. The lender, being the party with the exclusive say over the timing of moving forward with the foreclosure, does nothing for months, perhaps even years. After the debtor receives her discharge and her case is closed, she receives notification from her condo association that post-petition fees are due.

You, as debtor's counsel, are faced with trying to explain an inexplicable situation to your client. You are also very frustrated by having your efforts to help someone get a fresh start be for naught (or less of a benefit than you had hoped) because your client is now saddled with an unexpected financial obligation and is ineligible to file for Chapter 7 relief for a long time.

This outline will discuss the law regarding surrender in Chapter 7 cases, provide an updated analysis of case law and suggest alternative methods of addressing the problem.

**Legal Analysis**

I. What Constitutes Surrender With Regards to Personal Property?

In *Pratt v. GMAC (In re Pratt)*, 462 F.3d 14 (1<sup>st</sup> Cir. 2006), the 1<sup>st</sup> Circuit addressed the issue of surrender of a vehicle within the broader context of whether or not the secured lender's actions constituted a violation of the discharge injunction. The Pratts had purchased a new Chevrolet in 1994 financed by GMAC. In 1998 they filed a Chapter 13 case and valued the car at \$4900. The Bankruptcy Court valued the secured claim for the amount of the outstanding loan

balance plus interest of \$3,291.35 and GMAC received \$1,083.62 in payments on its unsecured claim under the plan. *Pratt* at 16.

In 1999 the Pratts converted their case to Chapter 7 by which time the balance due to GMAC on its secured claim was \$2,620. The Pratts gave notice to GMAC of their intention to surrender the car and the Court lifted the stay as to GMAC. After concluding that the cost of repossession was greater than the remaining value of its secured claim, GMAC wrote off the balance of the loan and did not repossess the car. The Pratts received a discharge which included their personal liability for the balance of the GMAC loan. *Pratt* at 16.

Things became difficult for the Pratts when they tried to junk the car after it became inoperable. Salvage dealers required that GMAC release their lien before they would take possession of the car. The Pratts repeatedly contacted GMAC and requested that it either repossess the car or release the lien. GMAC refused to release the lien until the balance was paid in full. The Pratts then sought and obtained Court approval to reopen their case and filed an adversary proceeding against GMAC alleging breach of the discharge injunction contained in section 524(a)(2) of the Bankruptcy Code. *Pratt* at 16.

The Bankruptcy Court entered judgment for GMAC finding that GMAC's *in rem* right under Maine law to enforce its lien survived the discharge, under Maine law a secured creditor had an unqualified right to refuse to release its lien until the loan balance was paid in full and that the situation was no more coercive than had GMAC offered the Pratts the opportunity to enter into a reaffirmation agreement.

On appeal to the 1<sup>st</sup> Circuit, the Pratts argued that GMAC's refusal either to repossess the vehicle or release its lien "effectively negated their right to 'surrender' the vehicle pursuant to Bankruptcy Code § 524(a)(2)." *Pratt* at 17. The Court noted that although section 521(a)(2) of

the Bankruptcy Code does not define the term “surrender,” “one reasonably may assume that ‘surrender’ does not necessarily contemplate that the debtor physically have transferred the collateral to the secured creditor ...Thus, the most sensible connotation of ‘surrender’ in the present context is that the debtor agreed to make the collateral *available* to the secured creditor - ...to cede his possessory rights in the collateral...within 30 days of the filing of the notice of intention to surrender possession of the collateral.” *Pratt* at 18-19. The 1<sup>st</sup> Circuit continued its analysis and stated that nothing in section 521(a)(2) suggests that the secured creditor is required to accept possession of the vehicle at the end of the 30 day period “as such a reading would be at odds with well-established law that a creditor’s decision whether to foreclose and/or repossess collateral is purely voluntary and discretionary.” *Id.*

The *Pratt* Court found that GMAC did violate the discharge injunction and its refusal to release its lien was objectively coercive and amounted to a demand for a reaffirmation. *Pratt* at 19. The Court was also troubled by the fact that GMAC’s actions “confronted the Pratts with the grim prospect of retaining indefinite possession of a worthless vehicle unless they paid the GMAC loan balance, together with the attendant costs of possessing, maintaining, insuring and/or garaging the vehicle. Therefore, the GMAC refusal had the *practical effect* of eliminating the Pratts’ ‘surrender’ option under § 521(a)(2)” and was a willful violation of the discharge injunction for which the Pratts were entitled to recover compensatory damages. *Pratt* at 20.

## II. What Constitutes Surrender With Regards to Real Property?

The analysis starts with section 523(a)(16) of the Bankruptcy Code which provides that a debtor shall not receive a discharge for condominium fees and assessments that became due and payable after the bankruptcy petition is filed as long as the debtor or the trustee has a legal, equitable or possessory ownership interest in the unit. *In re Ames*, 447 B.R. 680, 682 (Bankr. D.

Mass. 2011). Section 523(a)(16) was amended in 2005 to significantly broaden the exception to discharge with respect to condominium fees. Prior to the amendment, postpetition condominium fees were dischargeable as long as the debtor did not occupy or rent the premises. *Id.* at 683, n.4.

In the *Ames* case, before he filed his Chapter 7 petition, the debtor stopped making monthly payments for his share of common area fees and assessments and vacated his unit. He filed a statement of intent indicating his intention to surrender his unit. The company that managed the condominium filed a lift stay seeking three forms of relief: (i) to establish its statutory lien on the unit for unpaid fees and assessments under Massachusetts law, (ii) to realize on its lien by public auction sale and (iii) seeking to hold the debtor personally liable for all postpetition fees and assessments. The debtor consented to the first two requests but objected to the third.

The debtor in *Ames* argued that he surrendered the unit in accordance with the 1<sup>st</sup> Circuit's ruling in *Pratt* when he declared his intention to surrender because in *Pratt*, the 1<sup>st</sup> Circuit held that the debtor is not required to take any affirmative action to effectuate the surrender of secured property beyond merely making the collateral available to the secured creditor. *Pratt* at 18-19.

The *Ames* Court stated that the surrender issues addressed in *Pratt* were under section 521(a)(2) of the Bankruptcy Code and not section 523(a)(16) and the debtor's reliance on *Pratt* was thus misplaced. Moreover, the *Ames* Court stated that the section 521(a)(2) analysis addresses only the issue of possessory interest and not the issue of legal or equitable ownership interest which is the issue addressed in section 523(a)(16). *Ames* at 683.

In *Canning v. Beneficial Maine, Inc. et al (In re Canning)*, 442 BR 165 (Bankr. D. Me. 2011), the debtors took a creative approach to the problem of how one surrenders residential real

estate. The Cannings filed a Chapter 7 case and filed a statement of intention declaring that they would surrender their home to HSBC, the secured lender. At the time the Cannings filed their case, HSBC was prosecuting a foreclosure action on the property in state court. After they received their discharge, HSBC sent a letter to the Cannings stating that it was electing not to proceed with foreclosure, that it relinquished possession of the property, that it would no longer pay for insurance and real estate taxes on the property and that the debtors were solely responsible for paying the insurance and real estate taxes on the property as well as maintaining the property. In the letter HSBC also reminded the debtors of their obligation to repay the money that was borrowed. *Canning* at 167.

In response to the letter the debtors received from HSBC, their counsel sent a response informing HSBC that it was prohibited from collecting the debt as it had been discharged, that HSBC withdraw its demand for payment within 10 days, and that HSBC either (i) immediately commence foreclosure proceedings or (ii) immediately discharge the mortgage on the property. *Canning* at 168. HSBC did not respond and debtor's counsel sent a second letter stating that since HSBC had not withdrawn its demand for payment, it was required to execute and record a formal discharge of the mortgage and that if she did not receive said withdrawal by a date certain, she would seek relief from the Bankruptcy Court for violations of the discharge provision. HSBC responded in writing stating that it would not release the lien unless the balance of the loan was paid although they would consider a settlement option or a short sale and that it recognized that the Cannings were no longer personally obligated on the mortgage because of their discharge. *Id.*

The parties in *Canning* continued to squabble through counsel with debtor's counsel finally informing HSBC that the Cannings had abandoned the property and had advised the town

and utility companies that HSBC was the responsible party for the obligations on the home. *Canning* at 169. Debtor's counsel then filed an adversary proceeding seeking sanctions for HSBC's violations of the discharge injunction.

The Bankruptcy Court found that although the letter HSBC sent to the debtors asserting the debtors' continued personal liability of the mortgage "...plainly qualifies as an 'act to collect, offset, or recover' a discharged debt," HSBC's refusal to proceed with foreclosure or execute and record a withdrawal of the mortgage was not a violation of the discharge injunction. *Canning* at 171-72. The Court stated that the debtors' analogy of the facts of its case to the *Pratt* decision was rough.

The Cannings' argument neglects telling points that distinguish the two cases. Though HSBC is undersecured, its collateral is real estate, not personal property. The Cannings' demand of 'foreclose or release, now' ignores the prospect that real estate values change (up, as well as down) over time. A critical component of *Pratt*'s holding was the collateral's worthlessness and the fact that, unlike real estate, 'vehicles rarely appreciate in value over time.'...Moreover, unlike the *Pratt*'s secured creditor, HSBC did not simply require that the Cannings 'pay in full.' Rather it responded by suggesting either a voluntary settlement or a 'short sale.' That invitation plainly reveals that HSBC sought to collect no more than the value securing its lien....HSBC's refusal to act in response to the Cannings' ultimatum of 'foreclose or release' neither objectively operated to coerce the Cannings to pay in full, nor did it frustrate their § 521(a)(6) surrender rights.

*Id.*

The Bankruptcy Court recognized that HSBC's action, or failure to act, did not make things easy for the Cannings.

Forces remained at work that could make their continued ownership of the real estate uncomfortable – forces like accruing real estate taxes and the desirability of maintaining liability insurance for the premises. But those forces are incidents of ownership. Though the Code provides debtors with a surrender option, it does not force creditors to assume ownership or take possession of collateral. And though the Code provides a discharge of personal liability for debt, it does not discharge the ongoing burdens of owning property.

*Canning* at 172.

On appeal, the 1<sup>st</sup> Circuit BAP affirmed the lower court decision. *Canning v. Beneficial Maine, Inc. et al*, 462 BR 258 (1<sup>st</sup> Cir. BAP 2011). The Court distinguished *Pratt* primarily on the basis that the property at issue in *Canning* had significant value, and such a finding was sufficient to justify HSBC's refusal to discharge its mortgage. *Id.* at 267.

### **Possible Solutions to Consider**

The Court in *Ames* refused to give unconditional relief to the condo association - it granted relief from the stay to hold the debtor liable for post-petition assessments and fees with the caveat that the condo association first seeks recovery through the sale of the unit. “[T]he Trust will be given relief from the stay to proceed against the debtor individually for any post-petition fees and assessments which are subject to § 523(a)(16) but only for amounts which remain unpaid after a sale of the debtor's condominium unit.” *Ames* at 684.

In *In re Burgueno*, 451 B.R. 1 (Bankr. AZ. 2011) the Court discussed a possible solution in the Chapter 11 context. The Chapter 11 debtor in *Burgueno* was a loan officer employed with a mortgage company. When he filed his individual Chapter 11 case he owned a residence, a vacant lot and five single family residences. All of the investment properties were under water including a condominium. The debtor stipulated to allowing Wells Fargo to lift the stay on the condominium but Wells Fargo waited over one year to foreclose on the property during which time assessments continued to accrue. Although the Court found that the debtor's post-petition liability for the condo fees was not terminated either by the stay relief or confirmation of the plan, it noted that the fees were post-petition administrative expenses that should have been paid in full on the effective date of the plan. However, the condo association neither filed a proof of claim nor a motion requesting payment of its administrative claim. Since the condo fees were not paid in full on the effective date, section 1142(d)(2) “makes clear that individual Chapter 11

debtors are not discharged from any debts that are excepted from discharge under § 523.” *Burgueno* at 5-6. The Court suggested an effective means of terminating the debtor’s post-petition liability for HOA fees was for the debtor to quit claim the property either to the bank or the HOA; this would require motion, notice, hearing and court order pursuant to section 363(b)(1) of the Bankruptcy Code. *Id* at 8.

In the Chapter 7 context, under the analysis set forth above, it appears essential for a debtor to take action before the Bankruptcy Court to terminate the debtor’s ownership interest in real property in order to stop any continuing accrual of financial and liability obligations on the part of the debtor.

**WHY CAN'T I ACCESS MY BANK ACCOUNT?  
QUESTIONS TO ASK AND ISSUES TO ADDRESS WITH THE CHAPTER 7 TRUSTEE**

Every evening, Wells Fargo uses an automated computer program to ascertain whether account holders have filed for Chapter 7 bankruptcy. Once they determine an account holder has filed, an administrative freeze is placed on all of the debtor's accounts. The Chapter 7 Trustee is then sent a letter requesting instructions on whether the funds should be held, turned over, partially released or released in full to the debtor. The debtor is also sent a letter that the estate funds are now in bankruptcy status, which means the funds are no longer available.

Wells Fargo has routinely defended that its position maintains the status quo and is authorized by the turnover provision of 542(a) and (b). Section 542(a) provides that an entity in "possession, custody or control" of estate property shall deliver the property to the Trustee, as well as "property the debtor may exempt under Section 522...unless such property is of inconsequential value or benefit to the estate." Section 542(b) provides that an entity owing a debt that is "property of the estate and that is matured, payable on demand or payable on order, shall pay such debt to, or on the order of the Trustee, except to the extent that such debt maybe offset under Section 553...".

However, there is a question as to whether the Bank's conduct in impounding accounts without any prompting by a Trustee or Court amounts to an "act to exercise control over property of the estate in violation of the automatic stay under §362(a)(3).

Most courts have looked to the Supreme Court's case of *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286 133L.Ed. 2d 258 (1995). The *Strumpf* case dealt with an administrative hold in the context of setoff with most of the decision focused on §362(a)(7). The Supreme Court determined that the stay was not violated in this regard, observing a

distinction between an actual act of setoff and a measure to protect a right of setoff until stay relief can be obtained. This is grounded in sound logic, as the turnover requirements of §542(b) contain an exception from turnover for property that may be offset under §533.

The Supreme Court was careful to note that the *Strumpf* decision was limited to the context of setoff. Nevertheless, Courts have interpreted *Strumpf* to allow administrative holds such as those imposed by Wells Fargo where there are no setoff issues.

In *In re Calvin*, 329 B.R. 529 (2005) the Bankruptcy Court for the Southern District of Texas approved Wells Fargo's policy, finding it in compliance with both §542(b) and the automatic stay. More specifically, the Bank's decision to temporarily withhold funds pending instruction from the Trustee was within the contemplation of §542(b), as deposited funds equate to a debt that automatically becomes part of the estate and that is "payable on demand, or payable on order."

The District Court for the District of New Mexico embraced similar reasoning in *Wells Fargo Bank, N.A. v. Jimenez* 406 B.R. 935 (D.N.M. 2008), finding that the debtor lacks standing in the face of Wells Fargo's administrative freeze and that the freeze did not amount to an act to "obtain possession" or "exercise control" of estate property, nor did it interfere with the Trustee's ability to evaluate assets and liquidate the estate. There was also no violation of the automatic stay under §362(a)(3) as the withheld bank accounts "constituted a promise to pay" with the freeze amounting "to a refusal to perform that promise to the debtor – not an exercise of control over debtor's property." Many other Bankruptcy Courts have followed in this direction, such as *In re Bucchino*, 439 B.R. 761 (Bankr. D.N.M. 2010), and *In re Young*, 439 B.R. 211 (Bankr. M.D. Fla. 2010). See also *In re Randolph Towers Coop., Inc.*, 458 B.R. 1 (Bankr. D.D.C. 2011).

However, other Courts, specifically in the Ninth Circuit, have viewed the situation differently. In *In re Mwangi*, 432 B.R. 812 (9<sup>th</sup> Cir. B.A.P. 2010), the debtors had \$17,075.06 spread over four accounts with Wells Fargo and claimed 75 percent of that amount exempt. Wells Fargo impounded the funds shortly after the Petition was filed and requested instructions from the Trustee. Instructions from the Trustee never came, and with Wells Fargo refusing to lift the freeze without the Trustee's assent, the debtors sought relief from the Bankruptcy Court.

The Ninth Circuit BAP addressed the threshold questions of whether assets claimed as exempt by a debtor constitute estate property and, if so, what the extent of a debtor's interest is in the property, even though §542(a) explicitly requires turnover of that property claimed as exempt. The Code is hazy as to the initial relationship between the estate and exempt property, creating an issue as to the applicability of the automatic stay under §362. This ambiguity can lead to two distinct conclusions. The first view is that exempted property is not inherently incorporated in the estate but remains property of the debtor until the Trustee deems otherwise. The effect of this designation is to endow a debtor with a property interest sufficient to have standing to challenge Wells Fargo but casts exempt property outside the safe haven of the automatic stay. The other rationale is that the exempt property is considered property of the estate from the outset of a bankruptcy and only reverts with the debtor after the expiration of the Rule 4003(b) 30-day objection period; this is the position adopted by Wells Fargo.

The latter interpretation is also the view enunciated by the Supreme Court in *Schwab v. Reilly*, 130 S.Ct. 2652, 177 L.Ed.2d 234 (2010). The Supreme Court determined that an exemption essentially provides a debtor with an inchoate interest in the claimed property, with the debtor acquiring a right to payment once the Rule 4003 objection period elapses. Based on this interest, the BAP in *Mwangi* determined that the debtor did have standing to challenge Wells

Fargo's Policy. However, there was no turnover. Instead, Wells Fargo implemented its own remedy, unilaterally determining what funds would be impounded and creating a process by which funds, including exempt funds, could be released. The effect of the policy is to cast funds into a limbo state, one that is apart from the estate, and one in which every party's rights, except those of Wells Fargo, will be impacted by the administrative freeze such that their action will be needed. In essence, Wells Fargo created a quasi judicial process, beyond the provisions of the Code, thereby exercising control over property of the estate in direct contravention of §362(a)(3).

### **Policy Question**

While Courts acknowledge there is an inchoate interest that matures once the objection period passes without an objection, Courts believe that until such time, the property claimed as exempt belongs to the estate. However, couldn't it also be argued that the estate's interest to exempt property doesn't manifest until such time that there is a successful objection to the exemption? Is the property in a limbo state with a presumption that the interest will revert in the debtor unless established otherwise through an objection. This line of thinking may not help debtors, however, as the debtors would still lack a present ownership interest from which to suffer injury.

**WHAT HAPPENS TO PROPERTY WHEN DIVORCE AND A CHAPTER 7  
PROCEEDING INTERSECT?  
BE CAREFUL WHAT YOU WISH FOR**

On certain occasions, a debtor's spouse will file for Chapter 7 bankruptcy protection when equitable distribution or property settlement rights cannot be worked out in the State Court. Usually, the debtor/spouse thinks that they are getting the upper hand by making this tactical move. However, once a spouse files for bankruptcy, they have handed over negotiation of the division of marital property to an objective fiduciary who is only interested in doing what is in the best interest of the debtor's creditors.

The duly appointed Chapter 7 Trustee has the right to administer the assets of the bankruptcy estate of the debtor/spouse. The authority for the Trustee to participate in these arbitration proceedings emanates directly from the United States Bankruptcy Code (11 U.S.C. §101 et seq.). In particular, 11 U.S.C. §323 provides that the Trustee is the representative of the estate, going so far as to permit the Trustee to "sue and be sued" on behalf of the estate. 11 U.S.C. §541(a) sets forth what constitutes property of the bankruptcy estate, and includes "all legal or equitable interest of the debtor in property as of the commencement of the case", while 11 U.S.C. §704(b)1) directs the Trustee exclusively "to collect and reduce to money the property of the estate for which such Trustee serves..." Furthermore, under 11 U.S.C. §544(a), the Trustee has the rights of a hypothetical judgment creditor that has levied on the assets of the debtor/spouse as of the date of his bankruptcy filing. Thus, the debtor/spouse's bankruptcy filing is "the legal equivalent of a levy by the Trustee upon all of the debtor's property as of the Petition Date." *In re Becker*, 136 B.R. 113, 118 (Bankr. D.N.J. 1992). The practical result is that the Chapter 7 Trustee will participate in the matrimonial proceedings to decide how the property is distributed. The Trustee wants to get a fair share of the tangible assets and is not as

interested in trading support obligations on QDRO rights. Most importantly, the Trustee is guided by business judgment and not emotion in this process and will make prudent and practical decisions that divorcing spouses may not necessarily make.

**Sometimes Debtor Spouses File with an Aim at Discharging Equitable Distribution and Property Settlement Obligations**

In the New York case of Sinha v. Sinha, No. 89173, 2001 NY, 000S490 (N.Y. App. Div. July 12, 2001), the debtor wife claimed that the husband's claim for equitable distribution of marital property was barred by her discharge in bankruptcy, while the husband claimed that his claim remained viable against certain property that had been declared exempt property in the bankruptcy proceeding.

In this case, after the commencement of the divorce action, but before the divorce was final, the wife filed for bankruptcy under Chapter 7 of the Bankruptcy Code and listed the husband as a creditor. The husband did not file any objections in the bankruptcy proceedings nor did he seek a determination excepting any debts from discharge in bankruptcy. The bankruptcy petition was granted and all of the wife's dischargeable debts were discharged. Therefore, the wife claimed that the husband's claim for equitable distribution of marital property was barred by her discharge in bankruptcy, while the husband asserted that his claim remained viable against certain property that has been declared exempt property in the bankruptcy proceeding.

The wife relief on the provisions of the Bankruptcy Code that authorize the discharge of the debt, other than alimony, maintenance, or support, incurred in the course of a divorce and not determined to be excepted from discharge upon request of the creditor to whom the debt was owed. The wife contended that the husband's equitable distribution claim, which arose in the divorce action, was not excepted from discharge and that only the Bankruptcy Court has jurisdiction to determine whether the claim should be excepted. The Appellate Court stated, on

the contrary, that the issue is not whether the claim should be excepted from the discharge in bankruptcy, but rather whether the claim created a dischargeable debt within the meaning of the Bankruptcy Code. Finding a resolution to this issue depended upon the essence of the husband's right or interest in the marital property and thus involved a question of state law.

The Appellate Court noted that the right to equitable distribution vests only upon divorce. Here, the husband had no right to equitable distribution because the divorce was not yet final. The Court stated that "regardless of whether the husband could be viewed as having some inchoate interest in the couple's marital property as a result of the commencement of the divorce action," the couple's respective rights to their marital property could not be determined unless and until the lower court granted a divorce. Since the divorce was not yet final, no debt had been incurred in the divorce action when the Bankruptcy Court had discharged the wife from all dischargeable debts. The Appellate Court agreed with the lower court that upon granting a divorce, it had jurisdiction to determine the couple's respective rights in the marital property that was not reachable by the wife's creditors in the bankruptcy proceeding.

The 2005 Bankruptcy Abusive Prevention and Consumer Protection Act (BAPCPA) made it clear that equitable distribution judgments and marital property settlement debts were not dischargeable in a Chapter 7 Bankruptcy. The language of 11 U.S.C. §523(a)(15) excepts from discharge a debt "to a spouse, former spouse, or child of the debtor and not of the kind described in Paragraph (5) that is incurred by the debtor in the course of a divorce or separation or in connection with a separation agreement, divorce decree or other Order of a Court of Record.