

# **Consumer Workshop I: Ice Dancing: Scoring a “10” with the Top 10 “Must Know” Cases for Consumer Attorneys**

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## CONSUMER BANKRUPTCY CASES THAT EVERY PRACTITIONER SHOULD KNOW

### *Long v. Bullard*, 117 U.S. 617 (1886)

The case stands for the general proposition that the bankruptcy discharge only affects a debtor's *in personam liability* for a particular debt, and that any *in rem* interest against collateral associated with the debt is not affected by the discharge.

### *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934)

Hunt borrowed money from the Local Loan Company and securitized it through an assignment of his future wages, an act which created a lien under state law. Hunt thereafter filed for bankruptcy and received a discharge; the finance company sought to enforce the assignment of wages post-discharge. Based upon the “clear and unmistakable policy” of bankruptcy law, the Court refused to enforce the lien, and in doing so arguably offered the most judicially significant statement of consumer bankruptcy law in history:

“One of the primary purposes of the Bankruptcy Act is to ‘relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes . . . .’ This purpose of the act has been again and again emphasized by the courts as being of public as well as private interest, in that it gives to the honest but unfortunate debtor who surrenders for distribution the property which he owns at the time of bankruptcy, a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of pre-existing debt.”

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**Butner v. United States, 440 U.S. 48 (1979)**

“Property interest are created and defined by state law. Unless some federal interest requires a different result, there is no reason for why such interests should be analyzed differently simply because an interested party involved in a bankruptcy proceeding.”

**U.S. v. Whiting Pools, Inc., 462 U.S. 198 (1983)**

The case stands for the proposition that the IRS is no better than any other creditor and has to file the bankruptcy laws similar to other creditors. The issues involved i) what is property of the estate; ii) is under-secured property also property of the estate; and iii) is property that the IRS has seized pre-petition, property of the estate.

The Court held that the IRS must return the property of the debtor that it seized pre-petition even though the property is in the possession of the IRS and is under-secured. In this case, one of the IRS's arguments was that it was exempt from the Bankruptcy Code's provision that related to other secured creditors.

**In re Dewsnup, 502 U.S. 410 (1992)**

A debtor's suit to “strip down” a creditor's lien on the debtor's property to equal the property's fair market value and declare the remainder dischargeable was dismissed because the creditor's claim had been “allowed” and was “secured.” *Dewsnup* is often referred to as the reason why section 506 of the Code is not available to strip down undersecured liens in the context of chapter 7. Nevertheless, such strip downs are available in Chapter 13 because of the existence of section 1322(b)(2).

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*The Progeny of Dewsnup*

**Nobleman v. American Savings Bank, 508 U.S. 324 (1993)**

The “anti-modification” provision as contained in section 1322(b)(2) prevents the use of § 506(a) to “strip down” the lien of a mortgage to its value with regard to real estate when the creditor’s claim is secured only by a lien on the debtor’s principal residence. Subsequent cases have held that a wholly unsecured mortgage may be stripped down.

**In re Griffey, 335 B.R. 166 (B.A.P. 10th Cir. 2005)**

The BAP reversed the bankruptcy court and held that the antimodification clause of § 1322(b)(2) does not apply to the holder of a wholly unsecured claim. The court noted that the creditor/bank “is thus the holder of an ‘unsecured claim,’ pure and simple — and if the words of § 1322(b) mean what they plainly say, the rights of a creditor holding such a claim ‘may’ be modified by the debtors’ Chapter 13 plan.”

**Woolsey v. CitiBank, N.A. (In re Woolsey), 696 F.3d 1266 (10th Cir. 2012)**

In their Chapter 13 bankruptcy case, the Woolseys attempted to avoid a wholly unsecured second mortgage on their home utilizing § 506(d) of the Code. Because of the construction problem engendered by *Dewsnup v. Timm*, 502 U.S. 410 (1992) in the definition of a “secured claim” in §§ 506(a) and (d), the Woolseys essentially argued that the court should interpret the term “secured claim” in § 506(d) differently depending on whether the case fell under Chapter 7 or Chapter 13. That is, for Chapter 7 cases, the Woolseys argued that *Dewsnup* should control, namely, that any claim secured by property is protected from removal, even if backed by no value. But in the Chapter 13 context, however, the Woolseys argued that a creditor should be required to prove some value in the collateral and if not, the lien may be stripped. While the court acknowledged the attractiveness of the Woolseys argument particularly in light of the policy behind Chapter 13 bankruptcy, it declined to stray from *Dewsnup* and ascribe multiple meanings to a single statutory provision. As the court stated: “*Dewsnup* may

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be a gnarled bramble blocking what should be an open path. But it is one only the Supreme Court and Congress have the power to clear away.” *Significantly*, the Woolseys did not raise the issue on appeal whether § 1322(b)(2) enables debtors to strip off a wholly unsecured mortgage, and they specifically declined to have this issue decided by the court when giving the opportunity to do so through supplemental briefing. Consequently, the court did not address the issue of whether § 1322(b)(2) allows debtors to strip off a wholly unsecured mortgage irrespective of § 506(d) of the Code. In dicta, nonetheless, the Tenth Circuit referred to this secondary attach as a “potentially promising argument” for future debtors.

**Marrama v. Citizens Bank of Massachusetts, 549 U.S. 365 (2007)**

Section 706(a) in part provides that the “debtor may convert a case under this chapter to case under chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case is not been converted ... .In spite of the plain language of the statute, the Supreme Court held that the debtor has no “absolute right” to convert a Chapter 7 case to Chapter 13. The Court held that nothing in the text of either section 706 or 1307(c) limited the authority of a court to take appropriate action in response to fraudulent conduct by the atypical litigant who demonstrated that he was not entitled to relief available to the typical debtor. The broad authority granted to bankruptcy judges per section 105(a) was adequate to authorize an immediate denial of a motion to convert per section 706(a).

***Dissent:***

The dissent Justices disagreed with the Court’s construction of § 706(a) for several reasons. First, in comparing the statutory language of § 706(a) with the language of §§ 1112(a), 1208(a) and 1307(a), the dissent concluded that § 706(a) does not provide any discretion for a bankruptcy judge to deny conversion to Chapter 13 so long as the case had not been previously converted to Chapter 7 and the debtor satisfies § 706(d). Second, the dissent argued that Chapter 13 has its own set of mechanisms for dealing with debtors that engage in pre-petition fraudulent conduct, such as conversion from Chapter 13, the denial of the debtor’s plan for

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lack of good faith, and the denial of a discharge; thus, the dissent maintained, § 706(a) is not needed to act as a prophylactic shield for Chapter 13. Third, the dissent argued that the court's implicit holding, namely, that a "bad faith" Chapter 7 debtor is not eligible for Chapter 13 relief, essentially eviscerates the chapter-specific eligibility requirements found in § 109 of the Bankruptcy Code.

**Till v. SCS Credit Corp., 541 U.S. 465 (2004)**

This involved a Chapter 13 case where the parties could not agree on the cram down interest rate. In a plurality opinion, the Supreme Court ruled that the "formula approach" should be used and specifically, starting with a relatively risk-free rate such as the prime rate and then add the appropriate risk adjustment. Generally, the risk factor is between 1% to 3% on top of the prevailing rate.

Courts have applied *Till*'s formula rate approach in the Chapter 11 context, including for individual Chapter 11 cases. *See, e.g., In re L.B. Bryant*, 439 B.R. 724 (Bankr. E.D. Ark. 2010) (adopting *Till* in an individual Chapter 11 case); *Wells Fargo Bank, N.A. v. Texas Grand Prairie Hotel Realty, L.L.C. (In re Texas Grand Prairie Hotel Realty, L.L.C.)*, 710 F.3d 324, 333 (5th Cir. 2013) (noting that the "vast majority" of bankruptcy courts follow *Till* in determining a cramdown rate of interest in Chapter 11). However, the use of the cramdown interest rate of *Till* in the Chapter 11 context is not a foregone conclusion. That is, some courts have held that a prerequisite to applying the *Till* formula approach in Chapter 11 is a finding that no "efficient market" exists for the cramdown loan, based on footnote 14 in *Till*. *See, e.g., General Electric Credit Equities, Inc. v. Brice Road Developments, LLC (In re Brice Road Developments, LLC)*, 392 B.R. 274, 280 (B.A.P. 6th Cir. 2008) (stating that in a Chapter 11 case where an efficient market exists, the market interest rate should be applied; but where no efficient market exists, the formula approach to interest rates endorsed by the Supreme Court in *Till* should be applied).

*Grogan v. Garner*, 498 U.S. 279 (1991)

The issue was what standard of evidence should be used by the bankruptcy courts in considering whether a debt was a result of “actual fraud” under section 523(a). The Supreme Court concluded that the standard of evidence should be by a preponderance of the evidence and not clear and convincing.

*Hamilton v. Lanning*, 560 U.S. 505 (2010)

A Chapter 13 debtor typically is required to commit “projected disposable income” to the repayment of creditors over 3 to 5 years under a repayment plan in accordance with § 1325(b)(1). In calculating the amount of projected disposable income required, some courts took a mechanical approach by averaging the debtor’s monthly income during a 6-month look-back period, generally preceding the date of the filing of the bankruptcy petition. Other courts used a forward-looking approach which adopts the mechanical approach as a starting point and, in unusual cases, takes “into account other known or virtually certain information about the debtor’s future income or expenses.” The Court adopted the forward-looking approach to measure a debtor’s CMI for the means test.

Writing for a majority of eight Justices, Justice Alito authored an opinion holding “that when a bankruptcy court calculates a debtor’s projected disposable income, the court may account for changes in the debtor’s income or expenses that are known or virtually certain at the time of confirmation.” According to the Court, the forward-looking approach is supported by the ordinary meaning of the term “projected.” Moreover, and as the Court further noted, in a legislative context Congress rarely has used the word “projected” to refer to simple multiplication. Rather, in the Bankruptcy Code, when Congress wants to mandate simple multiplication, it uses the term “multiply.” In further support of its holding, the Court held that the forward-looking approach continues the pre-2005 amendment approach used by the courts to determine projected disposable income in which courts exercised judicial discretion to account for known or virtually certain changes in the debtor’s income. Absent a clear indication that Congress intended to

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change pre-2005 amendment practice, the Court declined to interpret the Code so as to effectively erode past practice

**United Student Aid Funds, Inc. v. Espinosa, 559 U.S. 260 (2010)**

The question before the Court was whether the Bankruptcy Court's order confirming the debtor's plan was void for the purpose of Federal Rule of Civil Procedure Rule 60(b)(4). Rule 60(b)(4) permits a court to relieve a party from a final order or judgment if that order or judgment is void. United argued that the order confirming the plan was void for two reasons. First, United claimed that it was denied due process because it had not been served with a summons and complaint in an adversary proceeding to determine undue hardship. Second, United argued that the confirmation order was void because the Bankruptcy Court lacked statutory authority to confirm Espinosa's plan absent a finding of undue hardship.

The Supreme Court held that because United had actual notice of the court's error and failed to object to the plan or timely appeal the order confirming the plan, the order remained enforceable. United had received notice of Espinosa's intent to discharge his student loan debt twice: when it received a copy of Espinosa's plan after his Chapter 13 filing, and when the trustee sent notice after confirmation. The Court found that the two notices received by United satisfied United's due process rights because due process requires notice reasonably calculated to apprise interested parties of the pending action and afford them an opportunity to present their objections.

**In re Parker, 313 F.3d 1267 (10th Cir. 2002)**

Unscheduled debt in no-asset, no-bar date Chapter 7 case is discharged despite lack of notice to the creditor and it is not necessary to reopen the case to list the debt. Adopting the mechanical approach, the Tenth Circuit held that equitable principles, including the debtor's intent in failing to schedule debt, are irrelevant to the bankruptcy court's decision to reopen a case in which there are no assets and no bar date to file claims. Note that this will not help a debtor who fails to notify a

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creditor who holds a claim of the sort described in sections 523(a)(2), (4) or (6). Also of importance to practitioners the Court adopted the “conduct theory” in determining the date on which a claim arose, that is, date of claim is determined by date of the conduct giving rise to the claim.

**Marine Midland Business Loans, Inc. v. Carey, 938 F.2d 1073 (10th Cir. 1991)**

**The conversion of non-exempt property for the purpose of placing it out of the reach of creditors, without more, will not deprive the debtor of the exemption to which he would otherwise be entitled.** But after quoting the legislative history – to the effect that converting nonexempt property into exempt property before filing bankruptcy is not fraudulent to creditors – the Tenth Circuit then goes on to warn that simple exemption planning can be found fraudulent (resulting in denial of discharge under section 727(a)(2)) when tested under the classic badges of fraud, such as whether the conversion was concealed or disclosed, whether the conversion took place “immediately before the filing of the petition,” and the monetary value of the assets converted.

For a more nuanced approach to the application of the badges of fraud to bankruptcy exemption planning, check out *Murphey v. Crater (In re Crater)*, 286 B.R. 756 (Bankr. D. Ariz. 2002).

Also, recall the famous companion cases of *Hansen v. First National Bank in Brookings*, 848 F.2d 866 (8th Cir. 1988) and *Norwest Bank Nebraska, N.A. v. Tveten*, 848 F.2d 871 (8th Cir. 1988) decided on the same day by the same court but reaching contrasting conclusions on exemption planning. In *Hansen*, the Eighth Circuit Court of Appeals found no evidence of fraudulent intent where the debtors (who were farmers) sold personal property worth \$31,000 on the eve of bankruptcy to their relatives for fair market value and used to sale proceeds to purchase exempt life insurance policies and to pre-pay their mortgage. In *Tveten*, however, the Eighth Circuit denied the debtor (a physician) his discharge after he converted \$700,000 worth of non-exempt property into exempt property (a life insurance policy) on the eve of bankruptcy while seeking to discharge \$19M in debt. The purported difference in the two results was the degree of the exemptions

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taken; that is, the exemptions in *Hansen* were statutorily capped at a reasonable amount while the debtor in *Tveten* utilized his statutory exemption with an unlimited cap.

***Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987)**

In perhaps the seminal case regarding the “undue hardship” standard for the dischargeability of student loans under § 523(a)(8), the Second Circuit Court of Appeals adopted the following three-part test that a debtor must satisfy to demonstrate “undue hardship”: i) the debtor cannot maintain, based on current income and expenses, a “minimal” standard of living for herself and her dependents if forced to repay the loans; ii) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and iii) the debtor has made good faith efforts to repay the loans. In its decision, the Second Circuit noted certain factors that may cause the standard to be met, namely, whether: the debtor has a disability, is elderly, has dependents, or has evidence of a “total foreclosure of job prospects in [his or] or area of training.”

***The Progeny of Brunner***

While the *Brunner* standard for dischargeability of student loans remain good law, some courts have utilized the § 105 equitable power to grant partial discharges of student loan debt. See, e.g., *Tennessee Student Assistance Corp. v. Hornsby (In re Hornsby)*, 144 F.3d 433, 439 (6th Cir. 1988) (“where undue hardship does not exist, but where facts and circumstances require intervention in the financial burden on the debtor, an all-or-nothing treatment thwarts the purpose of the Bankruptcy Act”). Other courts will afford partial discharges of student loan debt under § 105 of the Bankruptcy Code only so long as the portion of debt being discharged satisfies the requirements of § 523(a)(8). See, e.g., *Saxman v. Educational Credit Management Corp. (In re Saxman)*, 325 F.3d 1168 (9th Cir. 2003);

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*Miller v. Pennsylvania Higher Education Assistance Agency (In re Miller)*, 377 F.3d 616 (6th Cir. 2004) (holding same).

On another issue involving student loan debt, at least one court has permitted the separate classification of such debt in a Chapter 13 plan (despite the prohibition on unfair discrimination contained in § 1322(b)(1)) where the failure of the debtor to remain current on her student loans would be cause for the revocation of her professional license under state law. Such a prospect would jeopardize her ability to earn income sufficient to support a dividend to other unsecured creditors; accordingly, the court found that the separate classification would serve as a benefit to the estate. *See In re Kalfayan*, 415 B.R. 907 (Bankr. S.D. Fla. 2009).

## INSTRUCTIVE CASES ON RECURRING ISSUES

### Preclusive Effect of Default/Consent Judgments

*Shulman v. Lamphere*, 2011 WL 1667169 (10th Cir. May 11, 2011). **In classic default context the nature of the defendant's conduct was never "actually litigated" such that the judgment was not entitled to collateral estoppel effect in subsequent nondischargeability action.** Mere fact that debtor had initially participated in state court action against him, by filing answer, before he ultimately declined to participate in discovery and allowed entry of default, would not alter the fact that willful and malicious nature of his conduct was never actually litigated. The court distinguished the preclusive effect of defaults entered as a sanction for litigation misconduct as described in *Melnor, Inc. v. Corey (In re Corey)*, 583 F.3d 1249 (10th Cir. 2009). Application of the doctrines of claim preclusion and issue preclusion in subsequent bankruptcy proceedings is also discussed in *Clark v. Zwanziger (In re Zwanziger)*, 467 B.R. 475 (B.A.P. 10th Cir. 2012).

For two views on the preclusive effect of consent judgments, compare *EnTitle Insurance Company v. Durling*, 2013 WL 5524809 (Bankr. D. Utah Oct. 3,

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2013), with *Martin v. Hauck (In re Hauck)*, 2013 WL 6069271 (10th Cir. Nov. 19, 2013).

### **Judicial Estoppel**

*Eastman v. Union Pac. R.R. Co.*, 493 F.3d 1151 (10th Cir. 2007). **Debtors may be judicially estopped from pursuing undisclosed claims.** Applying the three factors identified by the Supreme Court in *New Hampshire v. Maine*, 532 U.S. 742 (2001) that inform the decision to apply the doctrine of judicial estoppel - (1) inconsistent position before two courts, (2) persuading a court to accept that party's inconsistent position, and (3) whether the party asserting an inconsistent position would gain an unfair advantage in the litigation if not estopped - the Tenth Circuit affirmed the district court's dismissal of a lawsuit that the debtor failed to disclose in his bankruptcy case. A more recent application of the doctrine in the context of the dismissal of a lawsuit that was undisclosed in a prior bankruptcy is found in *Queen v. TA Operating, LLC*, 2013 WL 4419322 (10th Cir. Aug. 20, 2013).

**Debtors judicially estopped from pursuing personal injury action.** After filing a slip and fall case in federal district court the plaintiffs filed a Chapter 7 bankruptcy case, but did not disclose the lawsuit in their bankruptcy papers. The defendant in the district court action blew the whistle on the debtors by notifying the bankruptcy trustee of the omitted claim. The debtors amended their bankruptcy filings to include the district court action, but they provided an estimate of its value that was far below what they had indicated in the proceedings before the district court and they claimed that the lawsuit was entirely exempt. Noting the three factors that inform the decision to apply the doctrine of judicial estoppel - (1) inconsistent position before two courts, (2) persuading bankruptcy court to accept that party's inconsistent position that they were not involved in any lawsuits, and (3) whether the party asserting an inconsistent position would gain an unfair advantage in the litigation if not estopped - the Tenth Circuit affirmed the district court's dismissal of the lawsuit. *Queen v. TA Operating, LLC*, 2013 WL 4419322 (10th Cir. Aug. 20, 2013).

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Note that several circuits have concluded that judicial estoppel does not bar a bankruptcy trustee from pursuing the claims that the debtor failed to disclose. See *Eastman*, 493 F.3d at 1155 n.3; *Reed v. City of Arlington*, 650 F.3d 571 (5th Cir. 2011); and *Stephenson v. Malloy*, 700 F.3d 265 (6th Cir. 2012).

### **Individual Chapter 11 Cases**

**Absolute priority rule applies in individual Chapter 11 cases.** The 2005 amendments to the Bankruptcy Code did not repeal the absolute priority rule as applied to individual Chapter 11 debtors. Section 1129(b) provides a “cram-down” mechanism whereby a plan may be confirmed without the consent of each class if, among other things, the plan is “fair and equitable.” Section 1129 outlines the “fair and equitable” criteria, which include the absolute priority rule that bars junior claimants, including debtors, from retaining any interest in property when a dissenting class of senior creditors has not been paid in full. Plan under which the debtors would retain possession and control of their property, while paying objecting class only 1% of their unsecured claim, did not satisfy the absolute priority rule. *Dill Oil Company, LLC v. Stephens (In re Stephens)*, 704 F.3d 1279 (10th Cir. 2013).

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