

Bankruptcy Law Round-Up

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Hon. Dale L. Somers

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Hon. Kathy Surratt-States

U.S. Bankruptcy Court (E.D. Mo.); St. Louis

Discussion Topic:

Is the discharge injunction violated by taking action post-bankruptcy to collect a non-dischargeable debt when the claim for that debt was litigated and disallowed by final order in the bankruptcy case? *Missouri Dep't of Soc. Servs. v. Spencer (In re Spencer)*, 550 B.R. 766 (B.A.P. 8th Cir. 2016).

On a related note – After discharge, can a creditor collect from a Chapter 7 debtor unpaid interest on a claim for a non-dischargeable debt when the claim was paid in full, together with interest at a lower rate allowed by the court? *Bank of Doniphan v. Graves*, 2016 WL 552676, Case No. 14-40491, Adv. No. 14-4031 (Bankr. D. Neb. Feb. 11, 2016).

Thomas L. Saladino, Chief Judge
United States Bankruptcy Court
District of Nebraska

Missouri Dep't of Soc. Servs. v. Spencer (In re Spencer), 550 B.R. 766 (B.A.P. 8th Cir. 2016)

Executive Summary

The Eighth Circuit's Bankruptcy Appellate Panel determined that the discharge injunction does not apply to a non-dischargeable domestic support obligation, even to a disallowed portion of the claim, so a creditor's post-discharge attempt to collect on a pre-petition domestic support obligation cannot constitute a willful violation of the discharge injunction.

Background

The debtors filed a Chapter 13 petition and schedules on which they listed a domestic support obligation as an unsecured priority claim held by a former spouse. The Missouri Division of Child Support Enforcement ("CSE") filed a proof of claim on behalf of the former spouse for support arrears as of the petition date in the amount of \$36,026.27. The CSE division then discovered it had miscalculated the amount owed by \$800 per month for six years, so it filed an amended proof of claim for \$88,026.27 as the total amount owed. The debtors objected to the amended claim.

After a hearing, the bankruptcy court sustained the debtors' objection. The court disallowed the amended claim and allowed the original claim of \$36,026.27. This decision was based on Missouri case law, under which the bankruptcy court determined that the CSE division, by acquiescing to lower payments from the debtor after the children were emancipated, had waived a portion of the support arrearage. The state did not move for reconsideration, appeal the order, object to confirmation of the debtors' proposed plan that included the claim in the lower amount, or, as the appellate court observed, do anything "to alert the debtors or the court to the fact that it did not feel bound by the court's determination of its claim." 550 B.R. at 768.

The debtors paid the allowed claim of \$36,026.27 in accordance with the confirmed plan. They completed all their plan payments early and moved for discharge. No objection was filed and the bankruptcy court granted them a discharge under § 1328(a).

About six weeks later, the CSE office issued an income-withholding order to the debtor's employer to collect past-due child and spousal support. Debtor's counsel asked the state to release the order, pointing out that the debtors had paid the support arrears debt under the plan and received a discharge, and the state's attempt to collect the debt violated the discharge order and was subject to sanction.

The debtors ultimately filed a motion for contempt and for sanctions against the CSE division. The agency's response argued that the support arrears were non-dischargeable domestic support obligations excepted from discharge under §§ 1328(a)(2) and 523(a)(5), so they were not affected by the discharge injunction, and that the bankruptcy court lacked subject-matter jurisdiction to decide issues relating to the modification of a child support order and child support obligations.

The bankruptcy court granted the motion for contempt, finding that the attempt to collect the support arrears willfully violated the discharge injunction because the debtor's pre-petition support obligation had been satisfied in full and the debtor owed no pre-petition or pre-discharge debt. The bankruptcy court awarded the debtors \$1,335 in attorney's fees against the CSE division as a sanction. The agency appealed, arguing (1) that the discharge injunction does not apply to domestic support obligations, (2) the bankruptcy court violated comity principles by making a broad determination of the debtor's personal liability on the domestic support obligation as part of the claims allowance process, and (3) the bankruptcy court lacked subject-matter jurisdiction to reduce the amount of the obligation under the domestic relations exception to federal jurisdiction.

The Decision

With regard to jurisdiction, the appellate panel concluded that the resolution of the amount owed pursuant to a dissolution decree does not fall within the domestic relations exception to federal jurisdiction because it does not concern the validity, issuance, or modification of the decree itself.

With regard to comity, the appellate panel declined to consider the issue as it was raised for the first time on appeal.

With regard to the discharge injunction, two-thirds of the appellate panel agreed with the CSE division that the discharge injunction does not apply to non-dischargeable domestic support obligations, even when a portion of such claims have been disallowed. The panel reasoned:

By operation of § 1328(a)(2), when the debtors received a chapter 13 discharge under § 1328(a), the support arrears debt was excepted from the debtors' discharge because it was a § 523(a)(5) domestic support obligation. Since the support obligation was not subject to the debtor's chapter 13 discharge under § 1328(a)(2), it was also not subject to the discharge injunction under § 524(a)(2).

550 B.R. at 771.

One member of the panel dissented, on the grounds that the majority characterized the underlying motion and the bankruptcy court's order too narrowly. Rather than making findings of contempt and sanctions for "violating the discharge injunction," the dissent concluded, the bankruptcy court sanctioned the CSE division for abuse of the bankruptcy process in attempting to collect a debt that had been fully paid through the plan. The dissent stated:

[T]he bankruptcy court ordered the division to reimburse the debtors for attorney fees spent defending the division's attempts to collect a debt that had been determined in a contested matter and paid under the Chapter 13 plan. Clearly, the bankruptcy court had the authority under § 105 and the inherent power to issue such a sanction. Referencing the discharge injunction may have been incorrect; sanctioning a creditor trying to collect a debt that had been paid in full was not.

550 B.R. at 773.

Both sides have appealed the matter to the Eighth Circuit Court of Appeals. The debtors are appealing the judgment, and the CSE division is appealing the comity and subject-matter jurisdiction issues. The appeals were filed in late July 2016 and are currently pending.

Bank of Doniphan v. Graves, 2016 WL 552676, Case No. 14-40491, Adv. No. 14-4031 (Bankr. D. Neb. Feb. 11, 2016)

Executive Summary

The court ruled that the debtor remains personally liable for all ancillary amounts still owing in connection with a judgment, if the judgment is found to be non-dischargeable. Therefore, the debtor would owe the judgment rate of interest on the debt until it is paid in full. Here, summary judgment was denied so a trial could be held to determine dischargeability.

Background

The debtor owed more than \$1.1 million to the Bank of Doniphan based on two promissory notes. After she failed to pay the notes when they became due, the bank sued and obtained a judgment against her for the amount due on the notes plus post-judgment interest at the rate of 16 percent. The debtor filed her Chapter 7 bankruptcy petition shortly after that judgment was entered.

The debtor's mother passed away not long after the bankruptcy case was filed, and the bankruptcy estate received significant cash distributions as a result. Those assets allowed the estate to pay all claims in full, including the claim filed by the Bank of Doniphan. A small sum of money remained from which the Chapter 7 trustee paid interest of 0.1 percent to each claimant. The bank did not object to this interest payment.

Thereafter, the bank filed an adversary complaint seeking to except its debt from discharge and to deny the debtor a discharge based on allegations that the debtor submitted false financial statements to the bank, made a false oath on her bankruptcy documents, failed to explain the loss or deficiency of assets, removed or transferred estate property post-petition, and failed to deliver property of the estate to the trustee.

The debtor moved for summary judgment, arguing that the matter was moot because the bank's claim had been paid in full. The court denied that motion, for the reasons explained below, and the matter is currently set for trial in October 2016.

The Decision

The issue on summary judgment was whether the bank is entitled to recover post-petition interest according to the terms of its indebtedness on a debt that is non-dischargeable.

The bankruptcy court agreed with the majority of courts that have addressed the issue, finding that when a creditor holds a non-dischargeable debt, the disallowed post-petition interest continues to accrue, and the creditor may collect the debt and post-petition interest after the debtor receives a discharge. The court said:

I agree that if the judgment debt is found to be nondischargeable, then Ms. Graves remains personally liable for all "ancillary" amounts still owing in connection with

the judgment. *Jennen v. Hunter (In re Hunter)*, 771 F.2d 1126, 1131-32 (8th Cir. 1985). When a debt is nondischargeable and is not satisfied in the bankruptcy case, it can be enforced as if the bankruptcy had not occurred. *See, e.g., Lynd v. Ries (In re Genmar Holdings, Inc.)*, 490 B.R. 833, 836 (B.A.P. 8th Cir. 2013). The judgment in this case provides that post-judgment interest accrues at the rate of 16% per annum. The bank was not paid that amount, so this adversary proceeding is not moot.

Slip. op. at 3.

With regard to the debtor's argument that the bank waived its right to collect 16 percent interest when it failed to object to the trustee's proposed distribution of interest at the much lower 0.1 percent rate, the court found it to be unpersuasive. First, an objection would have been fruitless because the estate clearly did not have sufficient funds to pay more than the trustee's proposed amount. In addition, nothing in the proposed distribution indicated the bank, by failing to object, would lose its rights in this adversary proceeding, which was pending at the time the trustee's final report was filed in the bankruptcy case. Second, the bank was not seeking payment of the interest from the estate. Rather, it asked for the judgment debt to be declared non-dischargeable so it could collect from the debtor personally. Third, the court said collateral estoppel should not prevent the bank's pursuit of the interest owed, based on Eighth Circuit precedent stating that collateral estoppel does not preclude actions attempting to enforce claims for unmatured interest under § 502.

As noted above, the case is currently scheduled for a three-day trial in October on the discharge and dischargeability issues.

ABI Midwestern Bankruptcy Conference Roundtables
September 30, 2016

Structured Dismissals: Law and Expediency

Judge Robert E. Nugent III
U.S. Bankruptcy Court, District of Kansas

I. What They Are and Why They Happen.

Structured dismissals are used to control or divert the statutory chapter 11 process to resolve roadblocks to restructuring thrown up by troublesome factual issues or cantankerous constituencies. The United States Supreme Court will wade into this topic during the 2016-17 term in *Czyzewski v. Jevic Holding Corp.*¹ A typical structured dismissal involves a chapter 11 case in which time is of the essence, there is little money to go around, and the limited pot is distributed in a way that seemingly defies the priority scheme found in 11 U.S.C. § 507 and the fair and equitable provisions found in 11 U.S.C. § 1129(b)(2).

II. Statutory Predicates: 11 U.S.C. §§ 105(a), 305(a), 349(b), and 1112(b).

Structured dismissal advocates find statutory support in four Code sections. Section 105(a) grants the court power to issue any order that is necessary or appropriate to carry out the provisions of Title 11. Section 305(a) allows a court to dismiss a case at any time if the interests of the debtor and the creditors would be better served by dismissal.²

Section 349 generally provides that dismissal has three default results. Prepetition proceedings, avoided transfers and voided liens are reinstated. Certain court orders are vacated. And, estate property is revested in the entity that owned it prepetition. The prefatory language of § 349(b) states that “unless the court, for cause, orders otherwise,” the above reinstatement, vacation, and revesting will occur upon dismissal.

¹ *Official Comm. of Unsecured Creditors, et al. v. CIT Group/Business Credit Inc., et al. (In re Jevic Holding Corp.)*, 787 F.3d 173 (3rd Cir. 2015), *cert. granted*, *Czyzewski, et al. v. Jevic Holding Corp., et al.*, ___ U.S. ___, 2016 WL 3496769 (U.S. June 28, 2016) (No 15-649).

² Section 305(c) limits appellate review of abstention orders under § 305(a), and for that reason, dismissal under § 305(a) is an extraordinary remedy that is to be invoked sparingly. *See In re Efron*, 529 B.R. 396, 404-05 (1st Cir. BAP 2015) (Dismissal orders not reviewable by the court of appeals or Supreme Court per §305(c), but bankruptcy appellate panel (or a district court) may review); *In re Naartjie Custom Kids, Inc.*, 534 B.R. 416, 424-25 (Bankr. D. Utah 2015) (noting the lack of any Tenth Circuit authority and citing 7 factors to consider in determining whether to dismiss case under § 305(a)).

Finally, § 1112(b) gives the court power to dismiss a chapter 11 case for cause.

III. Case Law Supporting and Opposing Structured Settlement.

Three Circuit Court cases illustrate the pros and cons of structured settlements. In *In re Iridium Operating LLC*, the Second Circuit analyzed a settlement agreement between senior lenders and the unsecured creditors committee that resolved the committee's challenges to the lender's liens while funding ongoing litigation by the committee against Motorola, Iridium's parent, for corporate domination.³ The lender would release collateral proceeds to pay professionals and to create a litigation vehicle to further pursue Motorola in litigation that the estate was otherwise unable to fund. Despite Motorola's objection that this arrangement ignored its own claims, violated the Code's priority scheme, and flouted the provisions of § 1129(b), the bankruptcy court approved it. The district court affirmed, and Motorola appealed. The Circuit noted that a *per se* rule that would apply the fair and equitable test to all settlements would deprive bankruptcy courts of their ability to "accommodate the dynamic status" of settlements while an unfettered leave to approve settlements without considering those factors would feed collusion.

Seeking the middle ground, the Second Circuit held that whether a settlement complies with the Code's priorities is the most important factor in approving a settlement under Rule 9019, and "where the remaining factors weigh heavily in favor" of the deal, the court can depart from the statutory scheme "in some minor respects" so long as the parties justify the departure and the court articulates its reasons for doing so. In this case, the court concluded and the Circuit agreed that the estate's risk in pursuing twin litigation tracks against the lenders and Motorola was too great—it would likely consume all of the estate's cash to the prejudice of administrative creditors while leaving its potentially meritorious claims against Motorola subject to the lender's encumbrance. The panel found this to be a proper business justification, not a *sub rosa* plan of reorganization.⁴

³ *Motorola, Inc. v. Official Comm. of Unsecured Creditors, et al (In re Iridium Operating LLC)*, 478 F.3d 452, 462, 464-65 (2nd Cir. 2007) (applying 7 factors for approval of pre-plan settlement distribution plan under Fed. R. Bankr. P. 9019). *See also, Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 424 (1968) ("fair and equitable" standard for cram down confirmation of plans in § 1129(b)(2) also applies to compromises presented as part of a plan).

⁴ *Cf. Pension Benefit Guar. Corp. v. Braniff Airways, Inc. (In re Braniff Airways, Inc.)*, 700 F.2d 935, 940 (5th Cir. 1983) (short circuiting confirmation requirements by establishing the terms of the plan *sub rosa* in connection with purported sale of all assets under § 363(b); reversing and remanding bankruptcy and district courts' approval of transaction and settlement).

Contrast this with the Fifth Circuit’s earlier opinion in *In re AWECO, Inc.*, where the debtor proposed to settle an unsecured creditor’s suit against it by paying that single creditor cash and property, some of which was encumbered by IRS liens and secured creditors’ liens.⁵ In *AWECO*, the Circuit concluded that the bankruptcy court had proceeded too quickly and that some extension of the fair and equitable standards should be applied to approving settlements even though no plan of reorganization had been filed. That panel reversed and remanded the case to the bankruptcy court to develop a better record about the circumstances of the settlement.

In *In re Jevic*, the underlying Third Circuit case now before the Supreme Court, two undersecured creditors, both of whom were owed far more than their collateral was worth, agreed to make a small distribution to the administrative and unsecured creditors classes from that collateral and consented to dismissal of the case.⁶ This settlement “skipped” a class of WARN Act plaintiffs, employees who asserted priority claims for lost pay. The bankruptcy court concluded that this settlement was the “least bad alternative” -- neither a confirmed chapter 11 plan nor a chapter 7 would yield any distribution to anyone other than these undersecured creditors, confirmation was not in prospect, and conversion would not help because the undersecured creditors wouldn’t agree to their collateral being used to fund the liquidation process. The circuit affirmed the settlement, confirming that the bankruptcy court had the authority to enter this dismissal in “rare circumstances” given the circumstances.⁷

IV. How Far is Too Far? Discussion.

A. Should these dismissals be permissible?

This departure from the express scheme of the Code can be viewed as an expedient approach to a practical problem or a random application of the bankruptcy courts’ dubious “equitable powers.” There is no express authority for it, yet one could cobble together a statutory predicate from §§ 105(a), 305(a), 349(b), and 1112(b). The recent ABI Chapter 11 Commission’s report made no recommendation beyond urging “strict compliance ... in terms of orders ending the chapter 11 case,” suggesting that

⁵ *United States v. AWECO, Inc., et al (In the Matter of AWECO, Inc.)*, 725 F.2d 293 (5th Cir. 1984), *cert. denied*, *AWECO, Inc., et al. v. United States*, 469 U.S. 880 (Oct. 9, 1984).

⁶ *Official Comm. of Unsecured Creditors, et al. v. CIT Group/Business Credit Inc., et al. (In re Jevic Holding Corp.)*, 787 F.3d 173, 181-82 (3d Cir. 2015).

⁷ Bankruptcy courts have approved similar settlements. *See e.g., In re Petersburg Regency LLC*, 540 B.R. 508 (Bankr. D.N.J. 2015) (settlement with all creditors except debtor’s insiders, that would result in negotiated distribution on their non-insider claims from litigation proceeds that constituted estate’s only asset); *In re Narrtjie Custom Kids, Inc.*, 534 B.R. 416 (Bankr. D. Utah 2015) (section 305(a) structured dismissal of case while permitting court orders to remain in effect, including exculpation clauses and general releases).

confirmation, conversion, or dismissal are the exit alternatives and should “satisfy the applicable provisions of, and ... not permit the parties to work around, the Bankruptcy Code.”⁸

B. What about *Law v. Siegel* and Equity Limitations?

Did *Law v. Siegel* walk back bankruptcy courts’ ability to use § 105(a) to fashion results that fall “in the cracks?”⁹

C. What kinds of facts should supporters and opponents of structured settlements be prepare to prove?

As the Commission report notes, reported structured dismissal cases feature similar fact patterns. Consider these and discuss whether they are “rare” enough to warrant departure from the Code’s strictures.

- Substantially all of the debtor’s assets have been sold pursuant to a section 363 sale.
- Deterioration of the estate requires immediate action—the “melting ice cube.”
- The debtor’s estate is essentially reduced to cash to be distributed.
- The secured creditors are undersecured and there are insufficient funds to pay the administrative claims associated with the case (the case is administratively insolvent).
- A detailed settlement agreement (or similar) that disposes of significant issues in the case has been approved by the court and may have been consummated.
- As a result of the settlement agreement (or similar), the proceeds of the sale of the debtor are transferred from the estate to the undersecured lender.
- There is an alternative claims-allowance process.
- There are third-party release provisions.

⁸ AM. BANKR. INST., Commission to Study Reform of Chapter 11, 2012-2014 Final Report and Recommendations, 272-73 (2014) (“Commission Report”). See generally Commission Report, pp. 269-73 regarding structured dismissals and proposed recommendations.

⁹ *Law v. Siegel*, 134 S. Ct. 1188, 1194-95 (2014) (Court’s use of § 105(a) powers cannot contravene another section of the Code, thus trustee could not surcharge a debtor’s exemptions where § 522 exhaustively dealt with them.).

- A portion of the sale proceeds have been carved out to create a “gift” trust to benefit lower priority creditors, proceeds to which they would likely not be entitled in a chapter 11 plan.
- The court retains jurisdiction over the case after dismissal and all prior court orders survive the dismissal.¹⁰

D. What are the consequences of chapter 11 as we knew it getting away from us and how does it affect the perception of the bankruptcy system?

Note that the Commission’s exit order recommendations come in the context of its recommendations that § 1129 be amended to address approving settlements and compromises in plans,¹¹ that third-party releases be conspicuously highlighted in plans and be reviewed by balancing several equitable factors,¹² and that all-asset sales short of a plan be governed by a new § 363x provision that would afford creditors the same level of protection they’d receive in the chapter 11 plan process.¹³

Consider whether a “legal” system (parties, advocates, judges) garners respect when it permits “expediency” to trump the law.

¹⁰ Commission Report, pp. 270-71.

¹¹ *Id.*, pp. 266-67.

¹² *Id.*, pp. 252-56.

¹³ *Id.*, pp. 201, 204-06.

ABI Midwestern Bankruptcy Institute
Bankruptcy Law Round-Up

September 30, 2016
Hon. Janice Miller Karlin

TOPIC: Is a creditor who has a pending 11 U.S.C. § 523(a)(2) action to determine a debt's dischargeability stayed under 11 U.S.C. § 362(a) (or enjoined under § 524) from attempting to collect from Debtor or Debtor's [exempted] property after the Debtor receives his general discharge, given the language of § 362(c)(2)(C).

FACTS: Prior to bankruptcy, Creditor obtains state court judgment against Debtor. Debtor files a Chapter 7 petition, exempting both his home and a lake property. No party (including Trustee) objects. Creditor does file an 11 U.S.C. § 523(a)(2) action against the debtor. While the § 523(a)(2) is awaiting trial, Debtor receives his general discharge under § 727. Creditor, a few months before the trial on the AP, and relying on the fact Debtor exempted the lake property, docketed its judgment lien in the county where Debtor's lake property is located to stop what it believes is an insider sale for less than fair market value.

Questions

1. Did creditor violate the § 362(a) stay by docketing the judgment against the exempt property?
2. Did creditor violate the § 524 discharge injunction by docketing the judgment against the exempt property?
3. Did creditor violate both?
4. Did creditor violate neither?

Pertinent Statutes

11 U.S.C. § 362(c): Except as provided in subsections (d), (e), (f), and (h) of this section—

- (1) the stay of an act against property of the estate under subsection (a) of this section continues until such property is no longer property of the estate;
- (2) the stay of any other act under subsection (a) of this section continues until the earliest of—
 - (A) the time the case is closed;
 - (B) the time the case is dismissed; or
 - (C) if the case is a case under chapter 7 of this title concerning an individual or a case under chapter 9, 11, 12, or 13 of this title, the time a discharge is granted or denied;

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11 U.S.C. § 522(c): Unless the case is dismissed, property exempted under this section is not liable during or after the case for any debt of the debtor that arose, or that is determined under section 502 of this title as if such debt had arisen, before the commencement of the case, except—

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(1) a debt of a kind specified in paragraph (1) or (5) of section 523(a) (in which case, notwithstanding any provision of applicable nonbankruptcy law to the contrary, such property shall be liable for a debt of a kind specified in such paragraph);

(2) a debt secured by a lien that is—

(A)(i) not avoided under subsection (f) or (g) of this section or under section 544, 545, 547, 548, 549, or 724(a) of this title; and

(ii) not void under section 506(d) of this title; or

(B) a tax lien, notice of which is properly filed;

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11 U.S.C. § 524(a): A discharge in a case under this title—

(1) voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived;

(2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived;

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**Language on Back of Official Form 18
Discharge Order (effective Dec. 2015)**

“Some debts are not discharged” Examples of debts that are not discharged are: “debts that the bankruptcy court has decided or will decide are not discharged in this bankruptcy case.” (emphasis added)

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Caselaw

In re Gibellino-Schultz, 446 B.R. 733, 738 (Bankr. E.D. Pa. 2011) (disagreeing with *Eastburg* (below) by finding entry of chapter 7 discharge replaces § 362 stay with statutory injunction found in § 524(a) and holding that until such time as bankruptcy court makes determination that a debt is not discharged under § 523, creditor is enjoined by § 524(a)(2), impliedly holding that § 362 stay not applicable even with pending § 523 action and essentially holding § 524 applies even to non-discharged debt).

In re Eastburg, 440 B.R. 851, 857 (Bankr. D.N.M. 2010), *aff'd* on other grounds, 447 B.R. 624 (10th Cir. BAP 2011) (parties stipulated that § 362 stay terminated with general discharge, and Court held discharge injunction not yet applicable because no final determination of dischargeability of debt).

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In re Gray, Case No. 00-C-0042-C, 2000 WL 34239244, at *5 (W.D. Wis. Apr. 12, 2000) (holding that because the automatic stay was not converted to a § 524 injunction, judge did not violate the § 524(a) statutory injunction by granting creditors-appellees' relief from the stay to pursue claims).

In re Edler, 416 B.R. 147, 152 (Bankr. E.D. Pa. 2009) (stating that until creditor prevails on § 523 action, resumption of state court litigation “would run afoul of the discharge injunction” after general discharge granted, but then impliedly holding that creditor needs to seek relief from stay under § 362 while § 523 action is pending, even after debtor has received general discharge, by stating that to the extent that a creditor might contend that it has the right to proceed in state court after termination of the automatic stay because the discharge injunction is inapplicable to the debt whose dischargeability is as yet undetermined, it would be within the bankruptcy court's power to restrain the creditor from proceeding in state court pending the conclusion of the dischargeability proceeding).

In re Parker, 334 B.R. 529 (Bankr. D. Mass. 2005) (finding that “schools violate the automatic stay when they refuse to release a student-debtor’s transcript, regardless of whether or not the debt has been found nondischargeable, because the automatic stay remains in effect in the absence of the entry of a § 727 discharge) (rejecting the 9th Circuit BAP’s analysis in *Watson*).

In re Arneson, 282 B.R. 883 (9th Cir. BAP 2002) (refining and reiterating the court’s analysis from *Watson* and holding that a creditor holding a debt that has been excepted from discharge *in the same case* need not ask the court for relief from the stay in order to execute on its judgment).

In re Gray, Case No. 00-C-0042-C, 2000 WL 34239244, at *5 (W.D. Wis. Apr. 12, 2000) (holding that because the automatic stay of creditors-appellees' state court suit was not converted into an injunction, the bankruptcy judge did not violate the § 524(a) statutory injunction by granting creditors-appellees relief from the stay to pursue their claims).

In re Embry, 10 F.3d 401 (6th Cir. 1993) (holding that the automatic stay was not violated when a creditor garnished the debtor’s wages after an entry of judgment by the bankruptcy court that its debt was not dischargeable but prior to the order granting discharge) (adopting the 9th Circuit’s analysis under *Watson*).

In re Martin, 162 B.R. 710, 715 (Bankr. C. D. Ill. 1993) (finding that a business’s Chapter 7 trustee violated the automatic stay in an individual debtor’s case when he sued the debtor in the business’s bankruptcy without first requesting relief from stay in the debtor’s case even though it was likely the debtor would not be granted a discharge) (“The trustee asserts that because the action in this case is not attempting to deplete the assets of the estate the automatic stay should not apply. . . . One of the fundamental purposes of the automatic stay in a Chapter 7 case is to protect the debtor against actions by his creditor. Unless relief from the stay is granted by the court, the stay continues in effect until the debtor is denied a discharge. If the debtor is granted a

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discharge, the permanent injunction of § 524 replaces the automatic stay of § 362 and prevents creditors from ever collecting a discharged debt.”).

In re Calder, 973 F.2d 862, 867 (10th Cir. 1992) (finding that a creditor’s execution of a garnishment after the debtor was denied a discharge but before the court granted his conversion to chapter 13 did not violate the automatic stay).

Dantes v. Tyhurst (In re Tyhurst), Case No. 91-2347, 1992 WL 25372 (D. Kan. Jan. 9, 1992) (adopting the reasoning of the bankruptcy court in *Watson* and holding that a creditor cannot pursue collection on a nondischargeable debt until the stay has lifted or relief has been granted).

In re Watson, 78 B.R. 232 (9th Cir. BAP 1987) (*Watson I*) (holding that a "creditor may pursue its non-dischargeable judgment . . . upon property not within the bankruptcy estate" without waiting "until the closing or dismissal of the case or the general discharge of the debtor" and "There is a lack of logic in allowing a creditor release from a discharge only to hold him in place as if he were still affected by the discharge or the prospect thereof.")

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Fees in Defense of Fees – The Aftermath of *Baker Botts*

Honorable Dennis R. Dow

Lori Locke, Law Clerk

Sharon Loftspring, Law Clerk

I. INTRODUCTION

In *Baker Botts L.L.P. et al. v. ASARCO LLC*, 135 S.Ct. 2158 (2015), the Supreme Court held that estate professionals are not entitled to fees for defending their fee applications. The decision has stirred much debate and has prompted professionals to propose creative ways to attempt to recover their fees in this context.

II. *Baker Botts LLP et al. v. ASARCO LLC*

A. Case Summary

Issue: Whether §330(a)(1) permits a bankruptcy court to award attorney's fees for work performed in defending a fee application.

Facts: Baker Botts (and another firm) represented the debtor in a Chapter 11 proceeding and, among other things, obtained a judgment on fraudulent transfer claims worth between \$7 and \$10 billion, which resulted in the payment in full of creditors. The firms sought compensation under §330(a)(1). Debtor challenged the fee application. The bankruptcy court rejected the objections and awarded the firms \$120 million, plus a \$4.1 million enhancement for exceptional performance. It also awarded the firms over \$5 million for time spent litigating in defense of their fee applications. Debtor appealed to the District Court which upheld the fees. The Fifth Circuit reversed based on the American Rule- each side pays its own attorney fees absent explicit statutory or contractual authority. The Supreme Court granted certiorari and affirmed.

Analysis:

Majority -- The Court agreed that the American Rule controls. It provides that each litigant pays his own attorney's fees unless a statute or contract provides otherwise. The

majority determined that Congress did not expressly depart from the American Rule to permit fee-defense litigation by professionals hired to assist trustees in bankruptcy proceedings. Section 330(a)(1) provides for “reasonable compensation for actual, necessary services rendered” This phrase does not specifically nor explicitly authorize courts to shift the costs of adversarial litigation from one side to the other.

The word “services” refers to “labor performed for another” and time spent litigating a fee application against the administrator of the estate is not labor performed “for” that administrator. Other sections of the Code expressly transfer the costs of litigation from one adversarial party to another while §330 does not.

The firms argued that fee-defense litigation is part of the “services rendered” under §330(a)(1). The majority disagreed and declined to adopt such a reading that would allow courts to pay professionals for arguing for fees they were found not to have been entitled to. This would be an unusual deviation from the American Rule as most fee-shifting provisions permit a court to award fees only to a prevailing party.

The Government argued that compensation for fee-defense” is properly viewed as part of the compensation for the underlying services in the bankruptcy proceeding.” The majority found this theory does not reconcile with the text of §330(a)(1) as it only awards compensation for “actual, necessary services rendered by” the professional and fee-defense is not such a service.

The Government also argued that because §330(a)(6) permits compensation for preparing a fee application it also must permit compensation for time spent defending it. The Court disagreed and drew the opposite inference since §330 contains no reference to fees for time spent

defending the application. The majority again disagreed that the fee-defense falls under the permitted “services rendered” necessary to deviate from the American Rule.

Holding: Section 330(a)(1) does not explicitly override the American Rule with respect to fee-defense litigation and thus does not permit bankruptcy courts to award compensation for such litigation. Court of Appeals affirmed.

Dissent -- The dissent agreed with the majority that fee-defense litigation is not a “service” under the Code but it agreed with the Government that compensation for such litigation “is properly viewed as part of the compensation *for the underlying services* in [a] bankruptcy proceeding.” The dissent determined a bankruptcy court may take into account the expenses incurred in defending a fee application when determining “reasonable compensation” and that the cost and effort expended to recover fees should be considered as a “relevant factor.”

The dissent found that Congress did in fact make specific and explicit provision for the allowance of attorneys’ fees in §330(a) and displaced the American Rule and it should not be a requirement that a statute explicitly mention fee defense in order to provide compensation for that work. It is irreconcilable with the Court’s decision in *Jean* which held the Equal Access to Justice Act authorized compensation for fee-defense work and that statute did not expressly mention such work either.

The purpose of §330(a) was to maintain comparable compensation for professionals in bankruptcy and in order to ensure a professional is paid reasonably for compensable services, a court must have discretion to authorize compensation for fee-defense work. The statute permits such discretion as part of compensation *for the underlying services*. Further, §330(a)(6) assumes pre-existing authorization of fee-litigation costs under §330(a) by its language “any

compensation awarded” and is direct statutory evidence of Congress’ intent to give courts the authority to account for such costs.

III. WORK-AROUNDS

A. Contractual

Bankruptcy attorneys could attempt to enter into an agreement with the debtor that the debtor will reimburse the professional for reasonable fees on fee-litigation if there is a dispute in the future. The American Rule, as noted by the Supreme Court in *Baker Botts*, allows for the reimbursement of attorneys’ fees “by statute *or contract*.”

B. Retain under §328

In an engagement letter, a professional could enter into an agreement with the estate under §328(a) which allows the bankruptcy court to approve employment of professionals on retainer, on an hourly basis or on a contingent-fee basis, so long as the terms are reasonable.

IV. JUDICIAL RESPONSE AFTER *BAKER BOTTS*

A. *In re Boomerang Tube, Inc.*, 548 B.R. 69 (Bankr. D. Del. 2016)

The Committee Counsel sought approval under §328(a) of a provision in their retention applications entitling them to compensation from Debtors’ estates for any fees, costs or expenses arising from the successful defense of their fees. The UST objected that such provision is precluded by *Baker Botts v. ASARCO*; that §328(a) does not create an exception to the American Rule’s general prohibition against fee shifting; and that the provisions cannot be approved under §328(a) because they are unreasonable.

The UST argued that *Baker Botts* is applicable because although the Committee Counsel were retained under §328, they can only be compensated under §330. The Committee asserted that §328 is an express exception to §330 and allows compensation to professionals that would not be available under §330. The bankruptcy court agreed with the UST and concluded that although §328 is an exception to §330, it also is not “specific and explicit” to allow fee-litigation fees per *Baker Botts*.

The court also agreed with the UST regarding the second argument. The contract exception to the American Rule was not precluded by *Baker Botts* but the parties cannot, by contract, violate another provision of the Code so any such contract to except the American Rule must be consistent with the other provisions of the Bankruptcy Code.

Finally, the court agreed with the Committee that the retention agreement was a contract. However, it is not bi-lateral and is subject to objection by other parties and to approval by the court. The Court agreed with the UST that the retention agreements were not contractual exceptions to the American Rule because they provide a third party (the estate) will pay defense costs even if not the party that objected. Also, the bankruptcy court must approve the terms of employment in accordance with the Code regardless of the terms of the employment contract. Further, the fee defense provisions contained in the agreement are not reasonable terms for the employment of Committee Counsel because they do not involve any services for the Committee. Rather, they are for services performed by Committee Counsel solely for their own interests.

Ultimately, the court concluded that *Baker Botts* prevents the court from concluding that §328 permits defense fees even if they were routinely allowed by the market in bankruptcy or non-bankruptcy contexts prior to that ruling. There is no difference in the analysis between

approving defense costs as fees or as expenses- both are subject to the American Rule and *Baker Botts*. Further §328(a) permits fees for performing services *for* the Committee; the fee litigation would be services performed for the professionals, not the Committee.

B. *In re New Gulf Resources L.L.C.*, Case No. 15-12566 (Bankr. D. Del. 2016)

In this case, Judge Brendan Shannon agreed with and applied Judge Walrath's ruling in *Boomerang Tube* in sustaining an objection to a fee application containing a fee premium payable in the event of litigation over counsel's fee application.

C. *In re 29 Brooklyn Ave.*, 548 B.R. 642 (Bankr. E.D.N.Y. 2016)

The receiver in this case filed a proof of claim for expenses, commissions and legal fees incurred in connection with the receiver's management of real property. The debtor objected to the proof of claim. After trial, the receiver's claim was allowed in a reduced amount. The receiver subsequently filed a motion seeking allowance of his attorney's fees.

The bankruptcy court determined that the majority of the fees were related to the defense of the proof of claim and of the debtor's application to surcharge the receiver. Distinguishing *Baker Botts*, the court held that it was inapplicable to the request by the receiver for fees incurred in defense of the proof of claim under §§ 503(b)(3)(E) and 543. Section 503(b)(4) is a fee shifting statute, the court reasoned, and grants compensation for professional services to an entity that has expenses allowable under §503(b)(3)(E). That section grants administrative expense status to custodians who have incurred expenses under §543. The receiver did not pursue the litigation in this case to incur and increase fees for his counsel. Litigation was the only way the receiver could receive his compensation. Furthermore, *Baker Botts* did not hold

that all fees incurred in defending fee applications were unrecoverable, but rather that § 330(a) does not authorize the recovery of those fees. Here, a different Code provision was applicable.

D. *In re Huepenbecker*, 546 B.R. 381 (Bankr. W.D. Mich. 2015)

The court disallowed a portion of the fees billed for defense of fees under *Baker Botts*. Worth noting is the court's commentary on the issue. It noted that the reduced amount approved for fees resulted in an effective rate of \$146.00 per hour. Because of such a reduction in compliance with the American Rule and *Baker Botts*, it suggested it will have to rely more heavily on Fed. R. Bankr. P. 9011, 28 U.S.C. §1927 and other authorities to police frivolous or vexatious objections to fee petitions. The court forewarned counsel that it should be aware the court will use appropriate measures, including sanctions, to deter unfounded objections and to mitigate the peculiar hardships the American Rule may visit upon bankruptcy professionals entitled to reasonable compensation under §330(a).

E. *In re River Road Hotel*, 536 B.R. 228 (Bankr. N.D.Ill. 2015)

A financial advisor retained by the debtors sought reimbursement of its attorney's fees incurred in defense of its fee request. It argued that both §330(a) and the pre-approved engagement letter provided for that reimbursement. Relying on *Baker Botts*, the court denied those fees. The court found that the contract provisions specifically subjected any reimbursement request to review under §330. Additionally, the requested fees were not incurred in connection with "services rendered" nor were they encompassed by the contractual language. Finally, the court noted that the fees were not reasonably likely to benefit the estate or be necessary for the administration of the case.

Dealing With The Non-Filing Spouse in A Consumer Bankruptcy

Kathleen A. Laughlin,

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I. Introduction

Handling the non-filing spouse is complex. Detecting spousal collusion is often a good faith question because the applicable statutes and Form 122 (C) are inadequate to provide a clear standard. In most situations, the mathematical calculations and particular married couple's factual circumstances morph into an evidentiary question: "Whether sufficient evidence exists to show the bankruptcy process is being used by the debtor and the non-filing spouse to treat the unsecured creditors so unfairly to justify objection or dismissal."

From this Chapter 13 Trustee's thirty-year perspective, after the enactment of BAPCPA, dealing with non-filing spouses in bankruptcy has become like "wadding through bubble gum". The underlying reason is because married couples present financial circumstances as varied as their lifestyles and attitudes about payment of each others' respective debts prior to the marriage, as well as debts acquired during the marriage. The fundamental question, "would you pay the debts of your spouse" encompasses an answer based in the subjective. Non-filing and filing spouses possess viewpoints of spousal responsibilities regarding debt that often cannot be found in the "check the box" statutory language and mathematical calculations. Nevertheless, scrutiny by counsel of BAPCPA language, the Official Forms 122A and 122C, (sometimes conflicting) judicial opinions, and bankruptcy trustee requirements must be done when analyzing debtor behavior to try to prevent spousal collusion in order to effect equitable solutions for both debtors and creditors.

II. Relevant Statutes¹

Handling non-filing spouse issues requires an analysis and understanding of current monthly income, disposable income in a Chapter 13 bankruptcy, and the relevant state's marital

¹ The Chapter 13 Trustee gratefully acknowledges the contribution staff made to a portion of the written materials for the presentation.

property law.

A. 11. U.S.C. §101 (10A), Definition of “Current Monthly Income”

The applicable Bankruptcy Code sections in Chapter 7 are: §§ 707(b)(2)(A)(i), 707(b)(2)(A)(ii)(I), 707(b)(2)(A)(ii)(II), 707(b)(2)(C), and 707(b)(3)(B).

For Chapter 13, the pertinent Code sections are: §§ 1306(a)(2), 1322(d), 1325(b)(1)(B), 1325(b)(2), 1325(b)(3), and 1325(b)(4). The following sections apply in both Chapter 7 and 13: §§ 101(10A), 101(10B), 101(13), 541(a)(2).

The BAPCPA means testing statutes, 11 U.S.C. § 101(10A), 11 U.S.C. § 707(b) (2)(A) and (B) and 11 U.S.C. § 1325(b)(3) lack definitive guidance. One commentator describes language as follows:

“The general statement of the problem is that in the definition of CMI in § 101(10A) and again in § 707(b)(2)(A) and (B), the drafters of BAPCPA seem to have misconceived of joint debtors as one “debtor” and one “debtor’s spouse,” rather than as two debtors. But this misconception appears inconsistently so that in some places spouses of debtors are treated the same as “debtors” for all purposes even when it is not a joint case; 2 in other places spouses of debtors are left out entirely; 3 in still other places, the debtor’s spouse counts only if the spouse is also a “dependent”; 4 and in still other places, the debtor’s spouse is accounted for only if not also a dependent. 5 This erratic treatment of spouses by BAPCPA means that accounting for the income and expenses of a spouse for purposes of the disposable income test in § 1325(b) and in other

contexts is illogical and difficult and requires the exercise of much judgment.”

Keith M. Lundin & William H. Brown, *Chapter 13 Bankruptcy*, 4th Edition, § 473.1, at § 473.1 Accounting for Spouses, Sec. Rev. Mar. 24, 2006, www.Ch13online.com

11 U.S.C. § 101(10A) The term “current monthly income”—

- (A) means the average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor’s spouse receive) without regard to whether such income is taxable income, derived during the 6-month period ending on—
- (i) the last day of the calendar month immediately preceding the date of the commencement of the case if the debtor files the schedule of current income required by section 521(a)(1)(B)(ii); or
 - (ii) the date on which current income is determined by the court for purposes of this title if the debtor does not file the schedule of current income required by section 521(a)(1)(B)(ii); and
- (B) includes any amount paid by any entity other than the debtor (or in a joint case the debtor and the debtor’s spouse), on a regular basis for the household expenses of the debtor or the debtor’s dependents (and in a joint case the debtor’s spouse if not otherwise a dependent), but excludes benefits received under the Social Security Act, payments to victims of war crimes or crimes against humanity on account of their status as victims of such crimes, and payments to victims of international terrorism (as defined in section 2331 of title 18) or domestic terrorism (as defined in section 2331 of title 18) on account of their status as victims of such terrorism.

B. The Chapter 13 Setting

11 U.S.C. § 1325(b) – CONFIRMATION OF A PLAN

(b)(1) If the trustee or the holder of an allowed unsecured claim objects to the 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 beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

(2) For purposes of this subsection, the term “disposable income” means current monthly income received by the debtor (other than child support payments, foster care payments, or disability payments for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended—

(A)

(i) for the maintenance or support of the debtor or a dependent of the debtor, or for a domestic support obligation, that first becomes payable after the date the petition is filed; and

(ii) for charitable contributions (that meet the definition of “charitable contribution” under section 548(d)(3)) to a qualified religious or charitable entity or organization (as defined in section 548(d)(4)) in an amount not to exceed 15 percent of gross income of the debtor for the year in which the contributions are made; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

(3) Amounts reasonably necessary to be expended under paragraph (2), other than subparagraph (A)(ii) of paragraph (2), shall be determined in accordance with subparagraphs (A) and (B) of section 707(b)(2), if the debtor has current monthly income, when multiplied by 12, greater than—

(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus \$525 per month for each individual in excess of 4.

(4) For purposes of this subsection, the “applicable commitment period”—

(A) subject to subparagraph (B), shall be—

(i) 3 years; or

(ii) not less than 5 years, if the current monthly income of the debtor and the debtor’s spouse combined, when multiplied by 12, is not less than—

(I) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(II) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or,

(III) in the case of a debtor in a household exceeding 4 individuals, the highest median family Income of the applicable State for a family of 4 or fewer individuals, plus \$525 per month for each individual in excess of 4; and

(B) may be less than 3 or 5 years, whichever is applicable under subparagraph (A), but only if the plan provides for payment in full of all allowed unsecured claims over a shorter period.

C. Chapter 7 Setting

**11 U.S.C. § 707 – DISMISSAL of a Chapter 7 case or
CONVERSION of a Chapter 7 to Chapter 13**

11 U.S.C. § 707(b)(1) provides that a court may dismiss a case filed under Chapter 7 of an individual debtor whose debts are primarily consumer debts “if it finds that the granting of relief would be an abuse of the provisions of this chapter.”

11 U.S.C. § 707(b)(2) outlines the “means test” to determine whether a “presumption of abuse” arises. This test takes “current monthly income” reduced by certain expenses, into account.

11 U.S.C. § 707(b)(3) provides in pertinent part: In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter in a case in which the presumption in subparagraph (A)(i) of such paragraph 2 does not arise or is rebutted, the court shall consider –

- (A) whether the debtor filed the petition in bad faith; or
- (B) the totality of the circumstances. . .of the debtor’s financial situation demonstrates abuse.

Thus, even if the presumption of abuse does not arise under § 707(b)(2), one must still determine whether the granting of Chapter 7 relief case will constitute an abuse. The standard for such determination are set by Section 707(b)(3), mainly bad faith or the totality of the circumstances of Debtor’s financial situation.

It should be pointed out that if the non-filing spouse's income is included in the debtor's "current monthly income," and the presumption of abuse arises, the case can be dismissed. If the non-filing spouse's income is not included so that abuse is not presumed, the case can be dismissed anyway because 707(b)(1) and 707(b)(3) do not incorporate a consideration of "current monthly income" in determining abuse.

III. Official FORM 122 (C) Requirements²

Line 13 is the first marital adjustment provision. To figure the applicable commitment period, Line 13 instructs the debtor to take a "marital adjustment" for the portion of a non-debtor spouse's income that is not paid on a regular basis to the household expenses of the debtor or debtor's dependents. Specifically, the language is as follows:

Line 13. Marital adjustment. If you are married, but are not filing jointly with your spouse, and if you contend that calculation of the commitment period under §1325(b)(4) does not require inclusion of the income of your spouse, enter on Line 13 the amount of the income listed in Line 10, Column B that was not paid on a regular basis for the household expenses of you or your dependents and specify, in the lines below, the basis for excluding this income (such as payment of the spouse's tax liability or the spouse's support of persons other than the debtor or the debtor's dependents) and the amount of income devoted to each purpose. If necessary, list additional adjustments on a separate page. If the conditions for entering this adjustment do not apply, enter zero.

² For space limitations and sake of brevity, only Form 122 C is addressed herein.

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Line 19 is the second marital adjustment provision. “If a debtor's non-filing spouse has income, that portion of the spouse's income not dedicated to payment of household expenses is deducted from the debtor's current monthly income. This deduction is taken on Line 19 of Form 22C as a "marital adjustment" for amounts "not regularly contributed" to the household expenses and effectively reduces the amount an above-median debtor is required to pay unsecured creditors.” *In re VanDyke*, 450 B.R. 836, 838 n. 2 (Bankr. C.D. Ill. 2011). See instructions as follows:

Line 19. Marital adjustment. If you are married, but are not filing jointly with your spouse, enter on Line 19 the total of any income listed in Line 10, Column B that was not paid on a regular basis for the household expenses of the debtor or the debtor’s dependents. Specify in the lines below the basis for excluding the Column B income (such as payment of the spouse’s tax liability or the spouse’s support of persons other than the debtor or the debtor’s dependents) and the amount of income devoted to each purpose. If necessary, list additional adjustments on a separate page. If the conditions for entering this adjustment do not apply, enter zero.

IV. Case Law

A. The Eighth Circuit Approach to Interpreting Applicable Statutes

- 1. *Fink v. Thompson (In Re Thompson)*, 2010 WL 3583400 (8th Cir. 2010).**

NOTE: Though this is not a non-filing spouse case, the opinion has relevance for non-filing spouse circumstances in that it illustrates the Court's approach when interpreting the applicable statute.

This had been an appeal to the 8th Circuit Bankruptcy Appellate Panel (Chief Judge Kressel, Bankruptcy Judges Schermer and Mahoney) from the U.S. Bankruptcy Court for the Western District of Missouri (Honorable Jerry W. Venters). The Chapter 13 Trustee argued that the Debtors' plan should not have been confirmed because it did not meet the good faith standard pursuant to 11 U.S.C. § 1325(a)(3). Judge Barry Schermer authored the opinion, holding that the debtors' failure to devote all of their social security income to the plan, without more, did not establish lack of good faith based upon the statutory provisions excluding social security benefits from disposable income. Judgment entered for the debtors/appellees.

2. *Zahn v. Fink, (In Re Zahn), 526 F.3d 1140 (8th Cir. 2008)*

When the U.S. Bankruptcy Court for the Western District of Missouri had previously denied confirmation of the debtor's plan because she had not included her non-filing spouse's IRA distributions as "current monthly income (CMI)" and filed a 36-month plan, the debtor/appellant appealed to the 8th Circuit Bankruptcy Appellate Panel (BAP). The BAP dismissed the appeal as interlocutory. The debtor then amended her plan to include the non-filing spouse's IRA and to extend the plan to 60 months. Then, Zahn objected to her own plan. The bankruptcy court confirmed the debtor's plan over debtor's objection to it. Debtor appealed. BAP concluded that the debtor lacked standing.

Debtor appealed the BAP's decision to the 8th Circuit Court of Appeals, with the only issue being whether the debtor had standing to appeal the confirmation order. The Eighth Circuit Court of Appeals (Circuit Judge Riley authoring the opinion) held that the debtor was an "aggrieved party", and as such, had standing. The case was remanded.

3. Nebraska Cases

- a. No published cases in Chapter 13 on this issue exist.

- b. *In Re Tina M. Childers*, Bk. No. 08-43026 (Bankr. D. Nebr. May 20, 2009) is an unpublished Chapter 7 case. Judge Timothy J. Mahoney considered the case law in the district along with the favored treatment Congress has given repayments during bankruptcy. His finding:the Chapter 7 debtor was not required to add back into her income the \$157.74 for the 401k loan payments and 401k regular monthly deduction. The facts had been that Debtor was married, and her spouse did not file bankruptcy. Debtor worked two (2) jobs and had total monthly net income of -\$17.44. Debtor was paying \$55.48 per month to her 401k and \$102.26 per month for 401k loan payments. Debtor did not have any ownership but, was on the debt for three (3) new vehicles and recreational items of\$80,712. Debtor and her spouse also had three vehicles with outstanding loan balances totaling \$80,712. The U.S. Trustee suggested that it was not equitable to allow Debtor and her spouse to retain unnecessary recreational items and vehicles with substantial loan balances when unsecured creditors did not receive a distribution. Debtor had approximately \$43,000 in unsecured credit debts, mostly credit cards. Judgment for the Debtor.
- c. *In the Matter of Swanson*, Bk. No. 08-81388 (Bankr. D. Nebr. October 7, 2008) is an unpublished Chapter 7 case. Chief Judge Thomas L. Saladino held that presumption of abuse arose pursuant to 11 U.S.C. § 707(b)(2). The facts of the case were that Debtor and Patricia Swanson had been married in September 1987, and divorced in December 2006.

Two children were born to this couple for whom the Debtor paid child support of \$1000 per month and alimony of \$700 per month. On September 27, 2005, a paternity order was entered in the District Court of Sarpy County, Nebraska, requiring Debtor to make child support payments in the amount of \$500.00 per month to the mother of another child fathered by Debtor. Debtor filed the Chapter 7 proceeding on May 30, 2008. Then, shortly after filing, on June 4, 2008, Debtor married the mother of the child, Kristine. On the date of bankruptcy filing, Debtor was residing with Kristine. Debtor testified at the § 341 meeting of creditors that he had no rent or mortgage payment. Yet, when completing his Form 22C Means-Test Calculation, Debtor claimed a mortgage/rent expense in the amount of \$1,211.00. Although Debtor was living with Kristine on the date of bankruptcy filing, he did not include any financial contributions by Kristine on Line 8 of his means test form, which calls for "any amounts paid by another person or entity, on a regular basis, for the household expenses of the debtor or the debtor's dependents, including child support paid for that purpose."

Debtor included the \$500.00 per month child support payments he was ordered to pay to Kristine on Line 28 of the means test form, in addition to the court ordered payments he was required to pay to Patricia, his former wife.

The U.S. Trustee had asserted that the presumption of abuse arose under 11 U.S.C. § 707(b)(2) when several "corrections" are made. Specifically,

the U.S. Trustee asserted that Debtor could only be entitled to claim a household size of three, and that Debtor should not be entitled to claim a mortgage/rent expense since Debtor had no such expense. The U.S. Trustee also argued that Kristine's income and contribution to household expenses should be included since Debtor had been living with her on the date of bankruptcy filing and married her days later. Finally, the U.S. Trustee argued that Debtor was not be entitled to a \$500.00 deduction for child support paid to Kristine since they had been married. The U.S. Trustee also had filed this motion under 11 U.S.C. § 707(b)(3).

The Credit Union joined in the U.S. Trustee's motion, and argued that Debtor would receive a windfall if Debtor were allowed to proceed under Chapter 7. Specifically, in late 2007, Debtor and Patricia agreed to amend their divorce decree to reduce the amount Patricia would receive from Debtor's pension by approximately \$17,000.00 in exchange for Debtor obtaining a release for Patricia from the joint indebtedness they owed to the Credit Union for their former home. As part of that transaction, the Credit Union approved a "short sale" of the home and accepted a promissory note from Debtor for the unsecured deficiency balance. The U.S. Trustee and the Credit Union both urged that allowing Debtor a Chapter 7 discharge in a case filed within six months after the closing of that transaction constituted a windfall to Debtor. Specifically, by virtue of the transaction, he essentially traded a non-dischargeable obligation owed to his former spouse for a potentially dischargeable unsecured claim owed

to the Credit Union. Since it is clear that the presumption of abuse under § 707(b)(2) arose in this case, it was not necessary to address the issue of whether the case should be dismissed under 11 U.S.C. § 707(b)(3) based on bad faith or the totality of the circumstances of a debtor's financial situation. Judgment for the U.S. Trustee and the Credit Union (creditor).

B. Tenth Circuit Cases

District of Colorado

In Re Toxvard (Bankr. D. Colo. 2013) The Bankruptcy Court for the District of Colorado allowed a married debtor to take a marital adjustment for the mortgage and car payments the debtor's non-filing spouse made toward the couple's home and car, which the non-filing spouse acquired prior to the marriage and solely owned and remained liable for during the marriage.

District of Kansas

- a. *In Re Shahan*, 367 B.R. 732 (Bankr. Kan. 2007) The Bankruptcy Court for the District of Kansas (Chief Judge Nugent, Wichita) allowed a married debtor to take a marital adjustment for the mortgage and car payments the debtor's non-filing spouse made toward the couple's home and car, which the non-filing spouse acquired prior to the marriage and solely owned and remained liable for during the marriage.
- b. *In Re Dugan*, 2008 WL 3558217, Case No. 07-40899-13, (Bankr. Kan. 2008) The U.S. Bankruptcy Court (Judge Karlin, Topeka) held that the definition of "current monthly income" includes income received by the debtor's spouse only when the debtor has filed a joint case with his or her spouse.

- c. *In Re Vollen*, 426 B.R. 359 (Bankr. Kan. 2010) The Bankruptcy Court (Judge Nugent, Wichita) properly held that a non-filing spouse's wages which were not regularly contributed to the household expenses of the debtor or a dependent of the debtor should be included in determining the applicable commitment period.

C. Some Cases From Other Bankruptcy Courts

- a. *In Re Travis*, 353 B.R. 520 (Bankr. E.D. Mich. 2006)
- b. *In Re Sale*, 397 B.R. 281 (Bankr. M.D. N.C. 2007)
- c. *In Re Grubbs*, 2007 WL 4418146 Case No. 07-32822-KRH 2007 (Bankr. E.D. Va. 2007)
- d. *In Re Borders*, Case No. 07-12450, 60 Collier Bankr. 639 (Bankr. S.D. Ala. 2008)
- e. *In Re Sharp*, 394 B.R. 207 (Bankr. C.D. Ill. 2008)
- f. *In Re Ariyaserbsiri*, 2008 WL 5191200 (Bankr. E.D. Tex. 2008) Case No. 07-41348, 2008 Bankr. Lexis 3304 (Bankr. E.D. Tex. 2008)
- g. *In Re Stansell*, 395 B.R. 457 (Bankr. D. Idaho 2008)
- h. *In Re Durczynski*, 405 B.R. 880 (Bankr. N.D. Ohio 2009)
- i. *In Re Clemons*, No. 08-82968, 62 Collier Bankr. Cas. 2d (MB), 2009 Bankr. Lexis 1959 at *17 - *18 (Bankr. C.D. Ill 6162009)
- j. *In Re Trimarchi*, 421 B.R. 914 (Bankr. N.D. Ill. 2010) The court rejected this classic attempt at a double dip. This case is also noteworthy regarding the debtor's claim of \$250 per month for heating their swimming pool.

- k. *In Re Duran*, 2010 WL 3947318, 2010 Bankr. LEXIS 3533 (Bankr. S.D. Cal. 2010)
- l. *In Re Charles*, 375 B.R. (Bankr. E.D. Tex. 2007)
- m. *In Re Louviere*, 2008 WL 925824 (Bankr. E.D. Tex. 2008)
- n. *In Re Quarterman*, 342 B.R. 647 (Bankr. M.D. Fla. 2006) Burden is on the objecting party to prove how much of a non-filing spouse's income should be imputed to the debtor in determining the disposable income calculation.
- o. *In Re Vandyke*, 450 B.R. 836 (Bankr. C.D. Ill. 2011)
- p. *In Re Simms*, 2011 Bankr. LEXIS 2570 at *11 - *12 & *15 - *16 (Bankr. Md. 2011)
- q. *In Re Sturm*, 483 B.R. 312 (Bankr. N.D. Ohio 2012)
- r. *In re Abisso*, 490 B.R. 464 (Bankr.Mass., 2013) the Debtor is entitled to the marital adjustment on Line13 of the B22C Form to deduct the portion of her non-filing spouse's income that is not contributed on a regular basis to the Debtor's household expenses for the purpose of determining her applicable commitment period.

V. Hypotheticals: Non Filing Spouses in Chapter 13 Cases

In practice, the burden of proof requires that evidentiary support exist to establish a single debtor's (lower) income. For example, when analysis of the bank statements may show a different practice than what the single debtor claims, counsel must have sufficient evidence to explain the (apparent) discrepancy. This means that counsel should be prepared to sufficiently answer: How do you document what is (or what is not) being devoted to the debtor's expenses?

Today, for discussion purposes, please assume that the following facts are true for each situation.

A. Hypothetical Fact Patterns

1. The Case of Debtor, Sally Spender and Her Non Filing Spouse, Fred Frugal

Sally Spender appears in debtor's office. She says she is unemployed, and has been sued by several creditors. "A large burly man with a beard and a tow truck is trying to take away my Lexus!" she exclaims. She lives in an older part of town in an old home owned solely by her husband of two years, Fred Frugal. Mr. Frugal is a self-employed, sole owner of an inherited, prosperous family business. When questioned, Sally cannot really explain the nature of her husband's business, but she knows that there were approximately two hundred (200) people at the company picnic this summer. Sally also knows that Fred Frugal owns what he refers to as "the farm" out west where he keeps about two dozen (24) "really tall" horses in one (1) barn and about fifty (50) very shiny, old cars with "names she cannot pronounce" in another barn. Her husband drives a ten (10) year old Ford pickup, does all his own lawn work, and cuts his own hair. Mr Frugal bought her a new Ford Focus as a wedding present, but she shortly thereafter traded that in for the Lexus, which she was paying for with the generous household allowance he provided for her. While the couple married for love, Fred Frugal quickly tired of Sally's spending habits, and cut her household allowance to the bone. Sally thinks she will be able to return to her former job on a part-time basis, but between the slashed allowance and her wages, she will have less than \$500 a month after expenses. This means that Sally would be barely able to pay for her Lexus. She has about \$20,000 in credit card debt. During Sally's conversation with you, it seems that Sally's main concern is her Lexus. Sally really wants to keep her Lexus,

but, she cannot catch up the payments. Fred Frugal will not participate in filing a bankruptcy or cooperate in any way.

Can Sally Spender file a Chapter 13 bankruptcy? Should she file? What would her schedules look like? Should the Chapter 13 Trustee try to block confirmation?

2. The Case of Debtor, Patricia Penniless, and Her Non Filing Spouse, I.M. Shielding

Patricia Penniless makes her two o'clock appointment after leaving her demanding, full-time job as an intensive care nurse making \$60,000 a year. Her husband, I.M. Shielding, is with her and is helpful but states that he will not be filing bankruptcy with her. He says this is out of pride. They are in their fifties. Mr. Shielding is disabled and gets a monthly VA disability payment. His income is about \$30,000 a year. They have a reasonably nice house, but it is fully encumbered. Except for the mortgage and his new truck loan, most of the debt seems to be in Patricia's name because she has always handled all of the finances. Up until now, they have always pooled their money in a joint account from which all the expenses were paid. They are current on the house and her car loan. He is going to keep his new pickup truck and make the \$700.00 monthly payments himself. I.M. Shielding says that he has a couple of other debts he needs to cover, but he will not be specific about what they are. He also intends to start funding an IRA because the couple has no savings. The first payment on his new truck is due this month. Mr. Shielding recently opened a bank account solely in his name where his VA funds will be deposited going forward. The majority of the debt is owed to her credit union on a signature note. It now totals over \$50,000. The debt was originally incurred on credit cards for furniture, household maintenance, car repairs, clothing for the family, and family vacations. Patricia used the credit union loan to consolidate the debt and lower the interest expense, but the debt is still there and growing because of her inability to make any real progress on the principal balance.

The credit union extended the note three times, but has refused to do it again. Patricia and her husband are struggling now because they have a son who is out of work, and they have been helping him and their daughter-in-law to make sure that their grandchildren have a stable home life.

Can Patricia file Chapter 13 by herself? What would her schedules look like? What should they look like? Could the credit union block confirmation? Should the Chapter 13 Trustee try to block confirmation?

3. The Case of Debtor, Wanda Worker, and Her Non Filing Spouse, John Slacker

Debtor, Wanda Worker, has missed three (3) appointments but made this one because her house is being sold tomorrow. She has two jobs but struggles to make the house payment on her two-bedroom ranch because she has five (5) kids in school and has an old car with mechanical issues. She owes about \$5,000 to an orthodontist for several sets of braces and is six (6) months behind on the house. The doctor is angry, and is not going to let this go. The doctor has scared her by threatening to take the children's braces back. The father of the children is in prison. Wanda's current husband of 12 years is John Slacker. Mr. Slacker is almost no help. She thinks her current husband makes "decent money" on a city road crew, but Wanda does not really know much about his finances. They have always kept separate bank accounts, and have always filed separate tax returns. He says: "it's her house, her kids, her problem." He just lives there. He helps her out by working on her car (assuming she pays for the parts).

He pays for most of their meals if they eat out, and covers the utilities ("because he is a nice guy"). His position is that there is no way he is going to file for bankruptcy, nor use any of his money to buy stuff for "her" kids. After all, "her" kids hate him. She is unable to tell you what he does with his extra money. His car is an old Camaro, and is not worth much, and as far

as she knows, he has no bills. Wanda admits that she occasionally takes money out of his wallet when he is sleeping. He knows she does this, and has never gotten too upset nor made her pay it back. That being said, Wanda does not know how much longer that can go on like this.

When she files a Chapter 13 bankruptcy, what would her schedules look like? Can the orthodontist block confirmation?

B. Analysis Applicable to Hypotheticals

1. The Case of Debtor, Sally Spender and Her Non Filing Spouse, Fred Frugal

First, the means test is historical. It asks for the debtor's historical income in the six months prior to filing. The form 122C demands a listing of the non-filing spouse's income as well. What if she does not know that figure? How can she list it? Guess? Estimate? Then deduct everything as a marital adjustment? At a minimum, she has to list whatever the non-filing spouse provided to her during that time on her side of the ledger. If she claims a change in circumstance going forward, she will have to establish that as a matter of fact.

Schedules I and J ask for present information. The issue of good faith depends on whether the debtor and her husband are in conspiring to defraud her creditors. If not, is it bad faith to be married to someone who maintains a separate fortune and a separate financial life? Would the world be better if she came back to bankruptcy after he divorced her? Consider with regard to an individual creditor, there may be an issue of whether the debtor should be allowed to discharge a debt that was incurred after the debtor knew her income had been cut.

2. The Case of Debtor, Patricia Penniless, and Her Non Filing Spouse, I.M. Shielding

First, as noted, the means test is historical. It asks for the debtor's historical income in the six months prior to filing. Second, the Form 122C demands that you insert the full income of the non-filing spouse at the top, and remove whatever was not devoted to the household. (But

does the form match the statute?) In this case, in any event, the debtor has to list the total income of the non-filing spouse during that time, because it was totally devoted to the household. If she claims a change in circumstance going forward, she will have to establish that as a matter of fact and overcome a charge of bad faith.

Schedules I and J ask for present information. Is it bad faith to take advantage of the right of a spouse to change how he manages his finances? What result if the spouse's income is social security instead of a VA pension? Or is this going too far? Is allowing her to use the bankruptcy code under these circumstances run counter to the principles that underlie the bankruptcy system? If the credit union blocked confirmation and obtained dismissal, it would be able to garnish her wages, which would almost certainly cause this spouse to make up the slack from his income. arguably, that is a more equitable result. Also it could be argued that in this particular marriage, confirmation of the plan would result in the payment of the debts of the non-filing spouse in full, while those of the debtor, even though incurred for the benefit of the household as a whole, would be largely discharged. Is this such an unfair result as to require dismissal? Possibly. The household is clearly one unit, and its creditors would be treated very differently on an arbitrary basis.

3. The Case of Debtor, Wanda Worker, and Her Non Filing Spouse, John Slacker

Form 122c is historical. Was the money provided by the non-filing spouse in the past, both voluntarily or involuntarily, provided on a "regular basis" so that it has to be included? If so, the monthly average amount should be included.

Schedules I and J ask for present information. The orthodontist would not have much luck trying to get the non-filing spouse's income added to the debtor's.

Would a bankruptcy court consider the purposeful separate economic lifestyle of Wanda and Slacker bad faith if Wanda sought bankruptcy protection?

C. Takeaways for Discussion

Filing a Chapter 13 bankruptcy for a single individual with a non-filing spouse who has income and assets is a complex analysis. The income of a debtor includes the income of a non-filing spouse only to the extent that such income is devoted to the payment of the debtor's expenses. However, Official Form 122c approaches the calculation backwards, asking that all the non-filing spouse's income be listed to be reduced by the non-filing spouse's expenses. The remainder is assumed to be contributed to the debtor's expenses; and therefore, not included in the debtor's income.

Because factual circumstances differ, this method does not work if the non-filing spouse does not actually pool his/her money with the debtor. The hypotheticals, while using exaggerated names, provide examples of situations financially struggling couples in new or second marriages find themselves in when contemplating bankruptcy relief. When a non-filing spouse separately retains his/her money as a lifestyle choice, whether a Chapter 13 Trustee should file an objection depends upon not only a mathematical calculation, but, also, scrutiny of the fact pattern presented by the debtor. Is the bankruptcy process being used in good faith? Is the bankruptcy being used by the debtor and the non-filing spouse to treat the unsecured creditors so unfairly as to justify refusing to confirm a plan or grant a discharge? Does it appear from circumstantial evidence that the bankruptcy was not filed as a result of collusion between the spouses? An example where collusion may not be found is when the non-filing spouse is not cooperating because that is his/her history of behavior with the filing spouse. Another example may be a non-filing spouse with a gambling and substance abuse addictions which consumes the money. Analysis of the factual circumstances brings questions: Is it equitable to have debtor pay

for the house and cars? Is it punishment to the debtor and the debtor's dependents by denying the debtor a discharge?

The answers to these questions are not easy because a non-filing spouse cannot be *forced* to pay his/her money and/or exempt funds into the plan. Even entering a dismissal does not automatically result in the creditors being able to make the non-filing spouse pay the debtor's debt. Demanding higher payments when the non-filing spouse refuses to cooperate is often futile. Also, if the debtor is below the garnishment amount threshold, creditors are also not helped if the debtor is denied bankruptcy relief. (In contrast, if the debtor is high income, the creditors could garnish, either forcing the non-filing spouse to pay some of the shortfall or collapse the household.)

D. Fact-gathering Questions for Practitioners

When assessing the likelihood of which route a debtor's case may take: (i) proceeding towards confirmation of a plan the debtor can afford based upon the money available to the debtor, or (ii) seeking dismissal, practitioners should consider asking these fact-finding questions.

- Is the non-filing spouse exercising good judgment for the family unit going forward by not volunteering to use exempt assets that may be needed in the future for the family to live a reasonable existence?
- Is the couple engaged in some kind of short-term strategy to hold on to their housing or obtain additional employment or income by multiple filings?
- Does the evidence strongly suggest that the debtor is taking advantage of the non-filing spouse's lack of cooperation (tantamount to if not actual collusion)?
- Does it appear that the debtor is being forced to seek bankruptcy because the non-filing spouse is acting solely in his own individual best interest and not as a

member of a family unit? (Practically speaking, could a court conclude that the non-filing spouse appears to act like a selfish jerk without justification (suggesting collusion)) Or, is the non-filing spouse a new spouse, recently married, and so understandably reluctant to pay the debtor's pre-petition debts which he/she did not incur or from which she/he did not benefit?

- Does the financial history suggest that the non-filing spouse is defending himself/herself against a historically high spending spouse who cannot be prevented from taking all of his/her/their money and blowing it?
- Is the non-filing spouse really so bogged down with his/her own independent debts that the non-filing spouse has little or no money to put in any way?

Complementary or Contradictory: Filing Stale Proofs of Claim in Bankruptcy, the Fair Debt Collection Practices Act, and the Bankruptcy Code

Introduction

In 1977, the Fair Debt Collection Practices Act (FDCPA) was signed into law. Just one year later, Congress passed the Bankruptcy Reform Act of 1978. While both laws were forged in an era of economic hardship and with intent to simplify some of the more difficult tensions between Debtors and Creditors, now almost forty years later, those same statutory regimes which were meant to clarify the rights held by each party are seemingly at odds with one another. Competing interpretations of the statutes and their intersection have resulted in a split among Courts of Appeal addressing the issue of whether a Creditor's filing of a stale proof of claim in bankruptcy violates the FDCPA. The Second, Seventh, Eighth, and Ninth Circuits have held an FDCPA claim is not available to Debtors in Bankruptcy where a Creditor filed a stale proof of claim.¹ The Third and Eleventh Circuits have held a FDCPA claim is available to Debtors in Bankruptcy where a Creditor has filed a stale proof of claim.² The Eighth Circuit and Eleventh Circuit Courts of Appeal have both issued opinions outlining the inherent tension between the two statutes and the respective holdings of these Courts are illustrative of both sides of the split.

Issue before the Courts of Appeal

“[W]hether a proof of claim to collect a stale debt in Chapter 13 bankruptcy violates the Fair Debt Collection Practices Act.”³

Filing a Stale Proof of Claim in Bankruptcy Violates the FDCPA

The Eleventh Circuit Court of Appeals has adopted the view that filing a stale proof of claim in bankruptcy is a violation of the FDCPA.⁴ In the first case to address the inherent tension between the Bankruptcy Code and the FDCPA in the context of stale proofs of claim, the Eleventh Circuit Court of Appeals held that by filing a time-barred proof of claim creditors engaged in “deceptive,” “misleading,” “unconscionable,” or “unfair” under the FDCPA.⁵ In reaching its determination, the Eleventh Circuit Court of Appeals adopted the “least sophisticated consumer” standard to determine whether a debt collector's conduct was “unfair” and determined this standard applied in a bankruptcy context.⁶ Finding the filing of a time-barred proof of claim was similar to the filing of a “stale lawsuit,” the Court ultimately held the time-barred proof of claim created a “misleading” impression to the “least sophisticated

¹ Simmons v. Roundup Funding, LLC, 622 F.3d 93(2d Cir. 2010), Owens v. LVNV Funding, LLC, No. 15-2044, 2016 WL 4207965 (7th Cir. Aug. 10, 2016), Nelson v. Midland Credit Mgmt. Inc., No. 15-2984, 2016 WL 3672073 (8th Cir. July 11, 2016), Walls v. Wells Fargo Bank, N.A., 276 F.3d 502 (9th Cir. 2002).

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consumer”, and given the automatic allowance provision, the Creditor could be liable under the FDCPA.⁷

This year, the Eleventh Circuit Court of Appeals had the opportunity to review its earlier ruling in *Crawford*.⁸ A district court judge had determined the Bankruptcy Code was inherently at odds with the FDCPA and repealed the statute insofar as it did not apply in the bankruptcy context. The Eleventh Circuit Court of Appeals held, that in fact, “[t]he FDCPA easily lies over the top of the Code’s regime, so as to provide an additional layer of protection against a particular kind of creditor. It kicks in only when the creditor is a debt collector that ‘regularly collects’ or is in ‘any business the principal purpose of which is the collection’ of debts.”⁹ The Court further held that the Code and the FDCPA were complementary, “providing different tiers of sanctions for creditor misbehavior in bankruptcy.”¹⁰

Filing a Stale Proof of Claim in Bankruptcy Does Not Violate the FDCPA

Both the Eighth Circuit Court of Appeals and the Bankruptcy Appellate Panel of the Eighth Circuit have rejected the Eleventh Circuit’s interpretation of the interplay between the FDCPA and the Bankruptcy Code.

In 2014, the Bankruptcy Appellate Panel heard the same question regarding whether the filing of a proof of stale proof of claim in bankruptcy constituted a violation of the FDCPA.¹¹ While the Bankruptcy Appellate Panel agreed with the Eleventh Circuit that filing a proof of claim was effectively an action to collect a debt¹² and invoked a threat of litigation¹³, however, the Court held the Debtor was inherently protected by the bankruptcy process and filing an accurate proof of claim could not be considered an “unfair” or “unconscionable” action given the oversight of the court and the ability of the trustee to move to disallow the claim.¹⁴

In July of this year, the Eighth Circuit Court of Appeals expressly rejected the Eleventh Circuit Court of Appeals’ holdings in *Crawford* and *Johnson*.¹⁵ The Court of Appeals determined that *Crawford* “ignored the differences between a bankruptcy claim and actual or threatened litigation.”¹⁶ The Court of Appeals held that in adopting the “least sophisticated consumer” standard in a bankruptcy context the Eleventh Circuit Court of Appeals did not account for how “[t]he bankruptcy process protects against such harassment and deception.”¹⁷ The Eighth Circuit further drew the distinction between filing a proof of claim and filing an independent collection action in holding, “[u]nlike defendants facing a collection lawsuit, a bankruptcy debtor is aided by ‘trustees who owe fiduciary duties to all parties and have a statutory obligation to object to unenforceable claims’”.¹⁸

⁷ *Crawford*, 758 F.3d at 1261.

⁸ *Johnson v. Midland Funding, LLC*, No. 15-14116, 2016 WL 2996372 (11th Cir. May 24, 2016).

⁹ *Johnson*, 2016 WL 2996372 at *5.

¹⁰ *Id.*

¹¹ *Gatewood v. CP Medical, LLC (In re Gatewood)*, 533 B.R. 905 (B.A.P. 8th Cir. 2015).

¹² *Gatewood*, 533 B.R. at 907.

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¹⁴ *Gatewood*, 533 B.R. at 910.

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¹⁶ *Nelson*, No. 15-2984, 2016 WL 3672073 at *2

¹⁷ *Id.*

¹⁸ *Id.* (citations omitted).

A Split Decision: Owens

In a recent 2-1 decision, the Seventh Circuit Court of Appeals recently held debt collectors conduct in filing proofs of claim on stale debt was not “misleading, deceptive, unfair, or otherwise abusive.” under the FDCPA.¹⁹ In determining whether filing a proof of claim on a time-barred debt was “unfair” under the FDCPA, the Court of Appeals considered the protection for the debtor inherent to the bankruptcy process, including a Trustee who is “duty-bound” to object to claims.²⁰ The Court also noted that in the consolidated cases before it, all Debtors were represented by attorneys and all proofs of claim filed were accurate, so “abuse” was not present in this instance.²¹ Chief Judge Wood dissented in this case, holding the realities of the bankruptcy court process do not protect the Debtor in every instance, and the FDCP should be available to Debtors as a result.²²

Reconciling the Differences

The difference between the Court of Appeals’ respective interpretations of the whether a debt collector can violate 15 U.S.C. §§ 1692(e)-(f) in a bankruptcy context is explained most readily by the Eleventh Circuit’s adoption of the “least sophisticated consumer” standard in a bankruptcy setting.²³ This standard also seems to be embraced, at least implicitly, by Chief Judge Wood in the Owens dissent.²⁴ Both the Eleventh Circuit and Chief Judge Wood hinge their analyses on the Debtor’s level of knowledge and understanding in a bankruptcy proceeding regardless of any protection afforded by the bankruptcy process. On the other hand, the majority of Circuit Courts of Appeal that have addressed the issue, acknowledge that filing a proof of claim is litigation in furtherance of collecting a debt, but have held a Creditor cannot be liable under §§ 1692(e)-(f) because of the protection the Debtor receives from the trustee and the bankruptcy court.

Conclusion

This issue is not one which will likely be conclusively determined in the near of future. Additional appeals on whether filing a stale proof of claim in a bankruptcy proceeding is a violation of the Fair Debt Collection Practices Act have also been filed in the First, Third, and Sixth, Circuit Courts of Appeal.²⁵ Two more cases have been appealed to the Eleventh Circuit.²⁶ At this time, no parties have filed for certiorari with the United States Supreme Court.

¹⁹ Owens, No. 15-2044, 2016 WL 4207965 at *1.

²⁰ Id., No. 15-2044, 2016 WL 4207965 at *6.

²¹ Id., No. 15-2044, 2016 WL 4207965 at *6-7.

²² Id., No. 15-2044, 2016 WL 4207965 at *10.

²³ See Crawford, 758 F.3d at 1259.

²⁴ Owens, No. 15-2044, 2016 WL 4207965 at *10.

²⁵ In re Martel, 539 B.R. 192 (Bankr. D. Me. 2015), *appeal docketed*, No. 16-1653 (1st Cir. May 25, 2016); Torres v. Cavalry SPV I, LLC, 530 B.R. 268 (E.D. Pa. 2015), *appeal docketed*, No. 15-2131 (3d Cir. May 05, 2015); In re Broadrick, 532 B.R. 60 (Bankr. M.D. Tenn. 2015), *appeal docketed*, No. 15-505 (6th Cir. Sept. 08, 2015).

²⁶ Brock v. Resurgent Capital Servs., No. 14-032, 2015 WL 4985700 (S.D. Ala. Aug. 20, 2015), *appeal docketed*, No. 15-14115 (11th Cir. Sept. 14, 2015); Castellanos v. Midland Funding, LLC, No. 2:15-CV559 (M.D. Fla. Jan. 01, 2016), *appeal docketed*, No. 161-487 (11th Cir. Feb. 05, 2016).

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The difference between the Court of Appeals’ respective interpretations of the whether a debt collector can violate 15 U.S.C. §§ 1692(e)-(f) in a bankruptcy context is explained most readily by the Eleventh Circuit’s adoption of the “least sophisticated consumer” standard in a bankruptcy setting.²³ This standard also seems to be embraced, at least implicitly, by Chief Judge Wood in the Owens dissent.²⁴ Both the Eleventh Circuit and Chief Judge Wood hinge their analyses on the Debtor’s level of knowledge and understanding in a bankruptcy proceeding regardless of any protection afforded by the bankruptcy process. On the other hand, the majority of Circuit Courts of Appeal that have addressed the issue, acknowledge that filing a proof of claim is litigation in furtherance of collecting a debt, but have held a Creditor cannot be liable under §§ 1692(e)-(f) because of the protection the Debtor receives from the trustee and the bankruptcy court.

Conclusion

This issue is not one which will likely be conclusively determined in the near of future. Additional appeals on whether filing a stale proof of claim in a bankruptcy proceeding is a violation of the Fair Debt Collection Practices Act have also been filed in the First, Third, and Sixth, Circuit Courts of Appeal.²⁵ Two more cases have been appealed to the Eleventh Circuit.²⁶ At this time, no parties have filed for certiorari with the United States Supreme Court.

¹⁹ Owens, No. 15-2044, 2016 WL 4207965 at *1.

²⁰ Id., No. 15-2044, 2016 WL 4207965 at *6.

²¹ Id., No. 15-2044, 2016 WL 4207965 at *6-7.

²² Id., No. 15-2044, 2016 WL 4207965 at *10.

²³ See Crawford, 758 F.3d at 1259.

²⁴ Owens, No. 15-2044, 2016 WL 4207965 at *10.

²⁵ In re Martel, 539 B.R. 192 (Bankr. D. Me. 2015), *appeal docketed*, No. 16-1653 (1st Cir. May 25, 2016); Torres v. Cavalry SPV I, LLC, 530 B.R. 268 (E.D. Pa. 2015), *appeal docketed*, No. 15-2131 (3d Cir. May 05, 2015); In re Broadrick, 532 B.R. 60 (Bankr. M.D. Tenn. 2015), *appeal docketed*, No. 15-505 (6th Cir. Sept. 08, 2015).

²⁶ Brock v. Resurgent Capital Servs., No. 14-032, 2015 WL 4985700 (S.D. Ala. Aug. 20, 2015), *appeal docketed*, No. 15-14115 (11th Cir. Sept. 14, 2015); Castellanos v. Midland Funding, LLC, No. 2:15-CV559 (M.D. Fla. Jan. 01, 2016), *appeal docketed*, No. 161-487 (11th Cir. Feb. 05, 2016).

Bankruptcy & Tax: Tips and Traps

Hon. Robert D. Berger

1. Never-Filed and Late-Filed Returns

- (a) *In re McCoy*, 666 F.3d 924 (5th Cir. 2012)
- (b) *In re Mallo*, 774 F.3d 1313 (10th Cir. 2014)
- (c) *In re Colsen*, 446 F.3d 836 (8th Cir. 2006)

2. Understanding Dischargeability – Basics

- (a) See 11 U.S.C. § 523(a)(1), 11 U.S.C. § 507(a)(8), and 11 U.S.C. § 1328(a).

3. Fraudulent Returns/ Willful Evasion 523(a)(1)(C)

- (a) Where a debtor has “made a fraudulent return or willfully attempted in any manner to evade or defeat such tax”

4. Tolling Periods

- (a) 507(a)(8): Anytime during which an offer in compromise with respect to that tax was pending or in effect during the 240-day period, plus 30 days
- (b) 507(a)(8) Hanging Paragraph: “An otherwise applicable time period specified in this paragraph shall be suspended for any period during which a governmental unit is prohibited under applicable nonbankruptcy law from collecting a tax....plus 90 days.”

5. Joint Tax Refunds and Non-Filing Spouse

- (a) *In re Crowson*, 431 B.R. 484 (2010)

6. Keeping a Tax Refund

- (a) Tax Assignments
- (b) Earned Income Credit Exemption
 - (i) *In re Earned Income Credit Exemption Constitutional Challenge Cases*, 477 B.R. 791 (Bankr. D.Kan. August 2, 2012)
 - (ii) *In re Westby*, 473 B.R. 392 (Bankr. D. Kan. April 4, 2012)
- (c) Application of Refund to Next Year’s Tax Liability
 - (i) *In re Graves*, 609 F.3d 1153 (10th Cir. 2010)

7. Short-Year Election – When to Use It and How It Benefits Your Client

- (a) An individual debtor in a chapter 7 or 11 case may elect to close the debtor's tax year for the year in which the bankruptcy petition is filed, as of the day before the date on which the bankruptcy case commences. If the debtor makes this election, the debtor's tax year is divided into 2 short tax years of less than 12 months each. The first tax year

ends on the day *before* the commencement date and the second tax year begins on the commencement date.

- (b) If the election is made, the debtor's federal income tax liability for the first short tax year becomes an allowable claim against the bankruptcy estate arising before the bankruptcy filing. Also, the tax liability for the first short tax year is not subject to discharge under the Bankruptcy Code.
- (c) Note: The debtor cannot make a short tax year election if no assets, other than exempt property, are in the bankruptcy estate. See IRC § 1398 for deadlines.

8. Trustee's Power – Re-filing Your Client's Taxes

- (a) Small Business Jobs Act of 2010 – Sect. 2012: General business credits of eligible small businesses for 2010 carried back 5 years
 - (i) The new law allows an eligible small business to carry back general business credits five years. Previously, the credits could only be carried back one year. The carryback is for credits determined in the first taxable year beginning after December 31, 2009.
 - (ii) An “eligible small business” in general is defined as follows:
 - (1) A corporation whose stock is not publicly traded, a partnership, or a sole proprietorship, and
 - (2) The taxpayer must have \$50,000,000 or less in average annual gross receipts over the three preceding tax years.
 - (iii) This is a one year initiative applicable only to the tax year 2010 (For fiscal year filers, the effective tax year is the first tax year beginning after December 31, 2009). The five-year carryback period is available only for credits earned in the tax year 2010.

9. 100% Garnishment for Tax Debt

- (a) K.S.A. 60-2310(e)(3)

10. KPERS Offset for Taxes

11. 1099-C – Do Not Ignore Them

- (a) Form 982 – Reduction of Tax Attributes Due to Discharge of Indebtedness

12. Discharge of Indebtedness Standards

- (a) Publication 4681
- (b) Insolvency Exception – Do not include a canceled debt in income to the extent that you were insolvent immediately before the cancellation. You are insolvent immediately before the cancellation to the extent that the total of all of your liabilities were more than the FMV of all of your assets.

13. What to Do When the IRS Doesn't File a Claim

- (a) Is tax debt dischargeable?
- (b) File Proof of Claim for IRS?

14. Notice Requirements

- (a) Local Bankruptcy Rule 2002.2

15. Trust Fund and Other Miscellaneous Taxes

- (a) Property Taxes
 - (i) Property tax debts incurred before the commencement of the bankruptcy case and last payable without penalty within one year before the date of the filing of the bankruptcy petition are not discharged.
- (b) Payroll and Sales Taxes
 - (i) This includes withholding taxes and sales taxes that are required to be collected or withheld and for which the debtor is liable in any capacity. Trust fund tax obligations are excepted from discharge regardless of age.
 - (ii) Note: there is a statute of limitations on the collection of IRS taxes, including trust fund taxes, which is generally 10 years from the date of assessment.

16. Federal Tax Liens

- (a) Federal tax liens attach to personal property acquired by the debtor before the bankruptcy case is filed. The federal tax lien usually cannot be avoided in bankruptcy, although it may be subject to avoidance if it is improperly perfected.

17. Withholding Change Post-Petition

18. Chapter 13 – Post-Petition Taxes - § 1305

Ordering the Appointment of a Chapter 11 Trustee under 11 U.S.C. §1104 –
What Standard of Proof Properly Applies?

by

Michael J. Bujold, Beth Roberts Derrick and Walter W. Theus, Jr.¹

The Bankruptcy Code provides that a debtor in a Chapter 11 case is a “debtor-in-possession” and has most of the rights and duties of a “trustee.”² Under certain conditions, the debtor in possession can be replaced by a chapter 11 trustee. This article addresses the appropriate standard of proof of a party seeking appointment of a trustee. A review of the Code and applicable case law suggests that the preponderance of the evidence standard more properly applies than the clear and convincing standard.

1. *Status of the Law*

Section 1104(a), which provides for the appointment of a trustee in a chapter 11 case, does not state the applicable standard of proof. The Supreme Court has not directly ruled on the standard of proof applicable to section 1104(a) motions.

Two circuits have held that the appropriate standard is clear and convincing evidence. *Adams v. Marwil (In re Bayou Group, LLC)*, 564 F.3d 541, 546 (2nd Cir. 2009); *In re Sharon Steel Corp.*, 871 F.2d 1217, 1226 (3rd Cir. 1989).³

Other courts have relied upon the 1991 Supreme Court decision in *Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991) and the significant statutory changes to the Bankruptcy Code in 2005, in determining that a preponderance of the evidence standard is mandated. See e.g., *Keeley & Grabanski Land P’ship v. Keeley (In re Keeley and Grabanski Land P’ship)*, 455 B.R. 153, 162-163 (8th Cir. BAP 2011); *Tradex Corp. v. Morse*, 339 B.R. 823, 8329 (D. Mass. 2006); *In re Veblen West Dairy LLP*, 434 B.R. 550, 555-56 (Bankr. D. S.D. 2010).

The general rule is that when a statute does not prescribe the standard of proof in a civil action, the preponderance of the evidence standard presumptively applies unless “particular important individual interests or rights are at stake.” *Grogan v. Garner*, 498 U.S. at 286. In *Grogan*, the Supreme Court held that the preponderance of the evidence standard applies to the denial of discharge of debts in bankruptcy cases under 11 U.S.C. § 523. The *Grogan* court reasoned as follows:

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² See, 11 U.S.C. §§ 1101(1) and 1107(a).

³ See also *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463 (3rd Cir. 1998) and *G-I Holdings, Inc.*, 385 F.3d 313, 319-320 (3rd Cir. 2004) citing *In re Sharon Steel Corp.*

Because the preponderance-of-the-evidence standard results in a roughly equal allocation of the risk of error between litigants, we presume that this standard is applicable in civil actions between private litigants unless “particularly important individual interests or rights are at stake.” We have previously held that a debtor has no constitutional or “fundamental” right to a discharge in bankruptcy We are unpersuaded by the argument that the clear-and-convincing standard is required to effectuate the “fresh start” policy of the Bankruptcy Code...[T]he Act limits the opportunity for a completely unencumbered new beginning to the “honest but unfortunate debtor.”

Grogan at 659.

In 1994, the Sixth Circuit extended the *Grogan* holding to Section 727 actions. *Barclays/American Bus. Credit, Inc. v. Adams (In re Adams)*, 31 F.3d 389, 394 (6th Cir. 1994) *cert denied*, 513 U.S. 1111, 115 S.Ct. 903, 130 L.Ed.2d 786 (1995). (“We believe the reasoning in *Grogan* is equally applicable to Sections 523(a) and 727 of the Bankruptcy Code. Accordingly, we join our sister circuits in holding that the exceptions to dischargeability under Section 727, including the exception for fraud, require proof by a preponderance of the evidence.”). *See also In Keeney v. Smith*, 227 F.3d 679, 683 (6th Cir. 2000).

There is no principled reason why the same presumptive standard should not apply equally to civil actions under section 1104(a). In sections 523, 727 and 1104, the statutory language and legislative history are silent as to the applicable evidentiary standard, which “is inconsistent with the view that Congress intended to require a special, heightened standard of proof” as to either provision. *Grogan*, 498 U.S. at 286. “Because the preponderance-of-the-evidence standard results in a roughly equal allocation of the risk of error between litigants,” *id.* at 286, it should apply to section 1104(a) just as it applies to sections 523 and 727.

In addition, in *Grogan*, the Court found that in creating exceptions to discharge, Congress had “evidently concluded” that there were some scenarios where “the creditors’ interest in recovering full payment of debts . . . outweighed the debtors’ interest in a complete fresh start.” *Id.* at 287. Similarly, by providing grounds to appoint a trustee to replace management of a debtor in possession, Congress evidently concluded that there are situations where a debtor’s right to remain in possession is outweighed by the creditors’ interests in the appointment of a trustee.

2. *Recent Supreme Court opinions support the “preponderance of evidence” standard in civil matters.*

In *Octane Fitness, LLC v. ICON Health & Fitness, Inc.*, 134 S.Ct. 1749, 572 U.S. ___, 188 L.Ed.2d 816 (2014), the United States Supreme Court held that the clear and convincing standard of proof for awards of attorney fees under section 285 of the Patent Act imposed a heightened standard of proof which had no basis under the section. Section 285, as revised in 1952, provides that “[T]he court in exceptional cases may award reasonable attorney fees to the

prevailing party.”⁴ Since 1982, the Federal Circuit has been vested with the exclusive appellate jurisdiction in patent cases.⁵ The *Octane* Court rejected the Federal Circuit’s “clear and convincing standard of proof” in awarding attorney fees under Section 285.

Finally, we reject the Federal Circuit’s requirement that patent litigants establish their entitlement to fees under § 285 by “clear and convincing evidence.” [citations omitted]. We have not interpreted comparable fee-shifting statutes to require proof of entitlement to fees by clear and convincing evidence. [citations omitted] And nothing in § 285 justifies such a high standard of proof. Section 285 demands a simple discretionary inquiry, it imposes no specific evidentiary burden, much less such a high one. Indeed, patent-infringement litigation has always been governed by a preponderance of the evidence standard [citations omitted] and that is the “standard generally applicable in civil actions,” because it “allows both parties to ‘share the risk of error in roughly equal fashion.’” *Herman v. MacLean v. Huddleston*, 459 U.S. 375, 390, 103 S.Ct. 683, 74 L.Ed.2d 548 (1983).

Octane at p. 1758.

In *Halo Electronics, Inc. v. Pulse Electronics, Inc. et al.*, 136 S.Ct. 1923 (2016), the Supreme Court rejected the clear and convincing burden of proof used by the Federal Circuit in reviewing the award of treble damages under 35 U.S.C. § 284 in patent infringement cases. Section 284 provides that, in a case of infringement, courts “may increase the damages up to three times the amount or assessed.” The Federal Circuit had long utilized a two-part test for determining when section 284 treble damages could be imposed; each of the parts required proof by clear and convincing evidence. See *In re Seagate Technology, LLC*, 497 F.3d 1360, 1371 (D.C. Circuit 2007). In *Halo*, the Court held that the two-part test and the standard of proof were not consistent with § 284.

The *Seagate* test is also inconsistent with § 284 because it requires clear and convincing evidence to prove recklessness. On this point *Octane Fitness* is again instructive. There too the Federal Circuit had adopted a clear and convincing standard of proof, for awards of attorney’s fees under § 285 of the Patent Act. Because that provision supplied no basis for imposing such a heightened standard of proof, we rejected it. See *Octane Fitness*, 572 U.S., at —, 134 S.Ct., at 1758. We do so here as well. Like § 285, § 284 “imposes no specific evidentiary burden, much less such a high one.” *Ibid.* And the fact that Congress expressly erected a higher standard of proof elsewhere in the Patent Act, see 35 U.S.C. § 273(b), but not in § 284, is telling. Furthermore, nothing in historical practice supports a heightened standard. As we explained in *Octane Fitness*, “patent-infringement litigation has always been governed by a preponderance of the evidence standard.” 572 U.S., at —, 134 S.Ct., at 1758. Enhanced damages are no exception.

⁴ 35 U.S.C. § 285.

⁵ 28 U.S.C. § 1295.

Halo at 1934.

Just as in the patent infringement cases, section 1104 of the Bankruptcy Code imposes no specific evidentiary burden, much less one of clear and convincing proof. Consistent with the Supreme Court’s guidance in *Grogan*, *Halo* and *Octane Fitness*, absent specific evidentiary requirements set forth in the examined statutory section, the preponderance of the evidence is the correct standard of proof in civil matters.

3. *Congress did not intend for section 1104 to impose a higher evidentiary burden for the authorization to appoint a chapter 11 trustee.*

The Supreme Court was quite clear in the *Halo* decision that “the fact that Congress expressly erected a higher standard of proof elsewhere in the Patent Act... but not in § 284, [was] telling.” *Halo* at 1934. Similarly, Congress’ imposition of a “clear and convincing evidence” standard in other sections of the Bankruptcy Code, but not in section 1104 is also quite telling.

Congress added Section 362(c)(3) and (4) in 2005 to provide that in certain defined cases of repeat filers, the automatic stay would expire in 30 days and in other certain defined cases filed by repeat filers the automatic stay would be available only upon request by a party in interest and then only in certain circumstances.⁶ In each scenario, Congress provided that the current “case is presumptively filed not in good faith” but that “such presumption may be rebutted by *clear and convincing* evidence to the contrary.” (*emphasis added*).

Congress also added section 502(k)⁷ in 2005 which expressly included a “clear and convincing burden of proof.” Addressing a perceived lack of creditor cooperation, that section allows for the reduction of a valid claim if a creditor fails to negotiate with the debtor prepetition regarding the repayment of debt. In order to reduce the claim, the debtor must show by “clear and convincing evidence” that

1. The creditor unreasonably refused to consider the debtor’s proposal; and
2. The proposed alternative repayment schedule was made prior to expiration of the 60-day period specified in paragraph [502(k)](1)(B)(i).

11 U.S.C. § 502(k)(c)(3)(C).

Congress amended section 1104 in 2005 and again in 2010. In 2005, it added section 1104(a)(3) which allowed the bankruptcy court to appoint a trustee or examiner if cause existed to convert or dismiss a chapter 11 case and if such appointment was in the best interests of creditors and the bankruptcy estate;⁸ and it added section 1104(e) which required the U.S.

⁶ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. 109-8, 119 Stat. 23 § 302 (April 20, 2005) effective for all cases filed on or after October 17, 2005.

⁷ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. 109-8, 119 Stat. 23 § 201(a) (April 20, 2005) effective for all cases filed on or after October 17, 2005.

⁸ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. 109-8, 119 Stat. 23 § 442 (April 20, 2005) effective for all cases filed on or after October 17, 2005

Trustee to move for an appointment of a trustee in certain defined circumstances.⁹ In 2010, Congress deleted Section 1104(a)(3).¹⁰ At no time did Congress add a specific evidentiary burden of proof to section 1104. The omission of a clear and convincing standard of proof in section 1104, according to the Supreme Court, is “telling” in light of the imposition of the clear and convincing standard in other sections of the bankruptcy code at the same time Congress was significantly revising section 1104.

4. *The preponderance of the evidence standard should be applied because no “particularly important individual interests or rights” are at stake.*

The preponderance of the evidence standard equally allocates the risk of error between litigants. *Grogan* at 286. When a statute does not prescribe the standard of proof in a civil action, the preponderance of the evidence standard presumptively applies unless “particularly important individual interests or rights are at stake.” *Id.* Examples of civil actions involving “particularly important individual interests or rights” include proceedings to terminate parental rights and involuntary commitment proceedings. See *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983).

But if such rights are not implicated, then proof by a preponderance of the evidence will suffice – even when civil sanctions may be severe. *Id.* Accordingly, the Supreme Court has affirmed the use of the preponderance of the evidence standard in orders stripping an individual of his citizenship in an expatriation proceeding and permanently barring an individual from practicing his profession in an SEC proceeding. *Id.* at 390.

This rule is the same in bankruptcy. In *Grogan*, the Supreme Court held that a debtor’s interest in obtaining a discharge of a debt did not warrant a heightened standard of proof in resolving a nondischargeability complaint for a fraud claim under 11 U.S.C. § 523(a)(2). *Grogan*, 498 U.S. at 286-7. In *Keeney v. Smith*, 227 F.3d at 683, the Sixth Circuit Court of Appeals relied upon the reasoning in *Grogan* for its holding that the debtor’s interest in obtaining a discharge of all of his debts did not warrant a heightened standard of proof under 11 U.S.C. §§ 727(a)(2)(A) (concealment of assets) and 727(a)(4)(A)(false oath). Also relying on *Grogan*, the Bankruptcy Appellate Panel for the Eighth Circuit Court of Appeals held that the appointment of a trustee based on allegations of the debtor’s fraud or misconduct did not warrant a heightened standard of proof under 11 U.S.C. § 1104. *Keeley v. Grabanski Land P’ship*, at 162-3.

The *Grogan* Court first reasoned the preponderance of the evidence standard reflected a “fair balance” between the interests of the debtor and the creditors. *Grogan* at 287. Second, because the preponderance of the evidence standard was sufficient to establish the nondischargeability of some types of claims, the omission of any language suggesting a different burden of proof “implies that the legislators intended the same standard to govern.” *Id.*, at 287-88. Third, the Court explained that because Congress chose the preponderance of the evidence standard for substantive causes of action for fraud, it was reasonable to conclude that Congress intended the same standard to apply under the fraud discharge exception. *Id.* at 288.

⁹ Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub.L. 109-8, 119 Stat. 23 § 1405 (April 20, 2005) effective for all cases filed on or after October 17, 2005

¹⁰ Bankruptcy Technical Corrections Act of 2010, Publ. L. 111-327, 124 Stat 3557 (Dec. 22, 2010).

Grogan's reasoning applies equally to section 1104. A chapter 11 debtor's individual interest in retaining control over the estate is not a "fundamental" or "particularly important interest" like parenthood or liberty. *Id.*; see H.R. Rep. 95-595 (1977) at 233, *reprinted in* 1978 U.S.C.C.A.N. 5787, 6192. Certainly, if permanently prohibiting an individual from engaging in an entire profession does not require a heightened standard of proof, then neither does being denied the right to control the administration of an estate in bankruptcy, including the operation of a business entity. See *Herman & MacLean*, 459 U.S. at 389.

5. *A heightened standard of proof under section 1104 is inconsistent with the statutory context.*

Furthermore, the statutory context does not suggest the interests of creditors and the estate should be put at a disadvantage by requiring clear and convincing evidence to appoint a chapter 11 trustee. After all, Congress allows the bankruptcy court to order the appointment of a chapter 11 trustee for two reasons. None are particularly exacting.

The first requires "cause," such as the debtor's misconduct or incompetence, for the appointment. 11 U.S.C. § 1104(a)(1). The other does not concern the debtor at all; it considers only the interests of creditors and the estate. That Congress allows trustees to be appointed without requiring the bankruptcy court to consider the interests of the debtor demonstrates Congress did not consider the debtor's "fundamental" or "particularly important interests" to be at risk. See *Tradex*, 339 B.R. at 829 (stating that the bankruptcy court's "sweeping discretion under subsection (a)(2)" shows Congress did not intend to require a heightened standard of proof when ordering the appointment of a trustee under section 1104(a)).

Second, an equal allocation of risk makes sense because all parties in interest – debtor and creditors alike – share the same primary interest in the outcome of the proceeding: increasing the value of the estate for the benefit of creditors. The chapter 11 debtor's ability to obtain relief from the bankruptcy court while retaining possession of the estate is conditioned upon the debtor's responsibility to fulfill the same fiduciary duties as a trustee. 11 U.S.C. §§ 323, 1101, 1106-08.

Yet requiring a heightened standard of proof to appoint a trustee places the debtor's personal interest in operating the estate in a position superior to the interests of creditors and the estate. That is inconsistent with the plain text of subsection (a)(2) which is concerned only with "the interests of the creditors, the equity security holders and other interests of the estate." *Cf. Veblen West Dairy*, 434 B.R. at 555-56 (holding that the preponderance of the evidence standard should apply because the debtor's interest in operating the estate "cannot reasonably be said to be any more important" than a debtor's interest in obtaining a discharge of debts).

Third, applying a heightened standard of proof under section 1104 would conflict with other sections of the Bankruptcy Code that contain the same statutory language, but require proof by a preponderance of the evidence. For example, the preponderance of the evidence standard applies to dismissal or conversion for "cause" under 11 U.S.C. § 1112(b). *Bal Harbour Club, Inc. v. AVA Development, Inc. (In re Bal Harbour Club, Inc.)*, 316 F.3d 1192, 1195 (11th Cir.

2003); *In re Woodbrook Assocs.*, 19 F.3d 312, 317 (7th Cir. 1994). Both sections 1104(a) and 1112(b) require a party to show “cause” to obtain relief, and include “gross mismanagement” as an example of “cause.” Compare § 1104(a)(1) with § 1112(b)(4)(B). Also, both sections address the “interests of creditors” in selecting the appropriate remedy. Compare § 1104(a)(2) with § 1112(b)(4)(B). See also *In re Gutierrez*, 528 B.R. 1, 15 (Bankr. D. Vt. 2014) citing *In re Aiello*, 428 B.R. 296, 299 (Bankr. E.D. N.Y. 2010) (applying the preponderance of the evidence standard to dismissal for “cause” under 11 U.S.C. § 707(a)).

If section 1104(a) required clear and convincing evidence for ordering the appointment of a trustee, it would mean the same language Congress used in related statutes, such as “cause,” would have different meanings. That outcome should be avoided because Congress generally intends to provide statutory language with a consistent meaning in a given context. *Graham Cnty. Soil and Water Conservation Dist. v. United States*, 130 S.Ct. 1396, 1404 (2010). And nothing suggests Congress intended anything different in enacting section 1104(a). See *Grogan*, 498 U.S. at 287-88.

It is important to note that while section 1104(a)(3) was deleted from the Bankruptcy Code with the 2010 amendments, section 1112(b)(1) was amended at the same time to provide that a court shall dismiss or convert a case to chapter 7 if cause is shown, unless the court determines that the appointment of a trustee under 1104(a) is in the best interest of creditors and the estate. As such, if cause is shown, the court can order the appointment of a trustee in a case as an alternate remedy to converting a case or dismissing it. If preponderance of the evidence is the standard for converting or dismissing a case under Section 1112(b) as the 11th and 7th Circuits held in *In re Bal Harbour Club, Inc.*, and *In re Woodbrook Associates*, respectively, it stands to reason that the same standard should apply to the court’s alternative remedy of ordering the appointment of a chapter 11 trustee for cause.

Finally, section 1104(e) was added in 2005 to require the U.S. Trustee to move for the appointment of a chapter 11 trustee under section 1104(a) if there are reasonable grounds to believe that the debtor’s management has participated in actual fraud, dishonesty, or criminal conduct in management or financial accounting. Section 1104(e) clearly does not establish a new ground for the appointment of a trustee; the U.S. Trustee still must allege and prove a ground for the appointment of a trustee under section 1104(a). It therefore makes little sense for Congress to require the U.S. Trustee to file a motion under section 1104(a) based only upon “reasonable grounds to suspect” fraud or other dishonest conduct if the motion may be granted by the court only if the U.S. Trustee is able to produce clear and convincing evidence in support of the motion.

6. *Courts requiring clear and convincing standard for the authorization to appoint a chapter 11 trustee provide no articulate basis for doing so.*

In *Sharon Steel*, the Third Circuit held that clear and convincing evidence applies in section 1104 because “[i]t is settled that appointment of a trustee should be the exception, rather than the rule.” *Id.* at 1225. Despite noting the “flexible standard” embodied by section 1104(a), the court relied upon a statement from the legislative history suggesting that section 1104(a) will not be frequently used because creditors would generally benefit from having the debtor continue

the operation of the business during the reorganization case. *Id* at 1226 (citing 1978 U.S.C.C.A.N. 5787, 6192).

First and foremost, the decision in *Sharon Steel* predates the Supreme Court's decision in *Grogan v. Garner* and its reasoning is incompatible with *Grogan's* test for when heightened evidentiary burdens are required. *See Grogan*, 498 U.S. at 286-87. Second, *Sharon Steel's* logic is flawed. That a remedy is rarely needed does not suggest it should be made harder to obtain. Finally, the Third Circuit's reliance on the legislative history was misplaced since that history was for legislation that was never enacted.

Conclusion

In short, debtors-in-possession must establish that "particularly important individual interests or rights are at stake" rather than argue simply for the status quo. In fact, the addition of section 1104(e) suggests that Congress intended the appointment of trustees to occur more frequently; that intention is contrary to a higher standard of proof. Every court that has recognized *Grogan* has held that the preponderance of the evidence standard is required for ordering the appointment of a Chapter 11 trustee under 11 U.S.C. § 1104. *See Keeley and Grabanski Land P'ships v. Keeley (In re Keeley and Grabanski Land P'ships)*, 455 B.R. 153 (B.A.P. 8th 2011); *Tradex*, 339 B.R. at 829; *Veblen West Dairy*, 434 B.R. at 555-56.

The Expanding Scope of Rule 3002.1

Lee Margaret Jackwig

United States Bankruptcy Judge

Southern District of Iowa

The Scope of the Current Rule.

Rule 3002.1 of the Federal Rules of Bankruptcy Procedure (captioned “Notice Relating to Claims Secured by Security Interest in the Debtor’s Principal Residence”) became effective on December 1, 2011. Creditors who hold claims governed by the rule must file notices of payment changes, notices of fees, expenses and charges, and responses to trustee notices of final cure payment. Who are those creditors? Current subdivision (a) indicates the rule applies only in Chapter 13 cases and only with respect to claims “secured by a security interest in the debtor’s principal residence” and “provided for under § 1322(b)(5) of the Code in the debtor’s plan.”

Though that language might seem straightforward, the interpretation of the language has varied. Some courts conclude the statutory “cure and maintain” provision requires a prepetition arrearage, and therefore a creditor need not be concerned about the rule if the creditor holds a claim for which the debtor is current on payments as of the petition date. Other courts hold the rule applies regardless of any prepetition arrearage. Meanwhile, some courts conclude a claim is provided for in the plan only if the debtor is making the postpetition payments. Other courts conclude it must be the trustee who is making those payments. Still other courts conclude it does not matter either way. Lastly, courts differ about the ongoing application of the rule when a creditor receives relief from the automatic stay.

The Scope of the Pending Amended Rule.

On April 28, 2016 the United States Supreme Court transmitted its adopted rule amendments to Congress. Rule 3002.1 was in the batch. Absent contrary action by Congress, amended subdivision (a) will become effective December 1, 2016. It continues to provide that the rule applies only in Chapter 13 cases and only with respect to claims “secured by a security interest in the debtor’s principal residence” but now states “for which the plan provides that

either the trustee or the debtor will make contractual installment payments.” Additionally, it states that the rule’s notice requirements no longer apply upon the effective date of an order terminating or annulling the automatic stay—unless the court orders otherwise.

The amended language seems to be straightforward. The elimination of the reference to the statutory “cure and maintain” provision appears to make the rule applicable regardless of any prepetition arrearage. (As of December 2015, the instruction at the beginning of *Official Form 410S1—Notice of Payment Change* and *Official Form 410S2—Notice of Postpetition Mortgage Fees, Expenses, and Charges* changed to be consistent with the pending amended rule.) Whether the trustee or the debtor is making the contractual installment payments is of no moment. With the exception of a court directing otherwise, the notice requirements will cease upon the creditor obtaining relief from the stay. Time will evidence whether the amended subdivision will resolve the problems it was meant to address—and not create new ones.

A Proposed Amendment to Limit the Scope Created.

Earlier this year the United States Judicial Conference Committee on Rules of Practice and Procedure approved publication of proposed amendments to certain rules. Rule 3002.1 was in the batch. With respect to the scope of the rule, one of the proposed amendments to subdivision (b) will permit courts to modify the notice of payment change requirements for home equity lines of credit (HELOCs). The Committee Note recognizes that payments on such loans adjust more often and in smaller amounts than many other home loans; however, the proposed amendment and the Committee Note are silent regarding daily simple interest accounts.

The comment period on the proposed amendments runs from August 12, 2016 through February 15, 2017. Comments must be submitted using the *Regulations.gov* portal.

Current Rule 3002.1. Notice Relating to Claims Secured by Security Interest in the Debtor's Principal Residence

(a) IN GENERAL. This rule applies in a chapter 13 case to claims that are (1) secured by a security interest in the debtor's principal residence, and (2) provided for under § 1322(b)(5) of the Code in the debtor's plan.

(b) NOTICE OF PAYMENT CHANGES. The holder of the claim shall file and serve on the debtor, debtor's counsel, and the trustee a notice of any change in the payment amount, including any change that results from an interest rate or escrow account adjustment, no later than 21 days before a payment in the new amount is due.

(c) NOTICE OF FEES, EXPENSES, AND CHARGES. The holder of the claim shall file and serve on the debtor, debtor's counsel, and the trustee a notice itemizing all fees, expenses, or charges (1) that were incurred in connection with the claim after the bankruptcy case was filed, and (2) that the holder asserts are recoverable against the debtor or against the debtor's principal residence. The notice shall be served within 180 days after the date on which the fees, expenses, or charges are incurred.

(d) FORM AND CONTENT. A notice filed and served under subdivision (b) or (c) of this rule shall be prepared as prescribed by the appropriate Official Form, and filed as a supplement to the holder's proof of claim. The notice is not subject to Rule 3001(f).

(e) DETERMINATION OF FEES, EXPENSES, OR CHARGES. On motion of the debtor or trustee filed within one year after service of a notice under subdivision (c) of this rule, the court shall, after notice and hearing, determine whether payment of any claimed fee, expense, or charge is required by the underlying agreement and applicable nonbankruptcy law to cure a default or maintain payments in accordance with § 1322(b)(5) of the Code.

(f) NOTICE OF FINAL CURE PAYMENT. Within 30 days after the debtor completes all payments under the plan, the trustee shall file and serve on the holder of the claim, the debtor, and debtor's counsel a notice stating that the debtor has paid in full the amount required to cure any default on the claim. The notice shall also inform the holder of its obligation to file and serve a response under subdivision (g). If the debtor contends that final cure payment has been made and all plan payments have been completed, and the trustee does not timely file and serve the notice required by this subdivision, the debtor may file and serve the notice.

(g) RESPONSE TO NOTICE OF FINAL CURE PAYMENT. Within 21 days after service of the notice under subdivision (f) of this rule, the holder shall file and serve on the debtor, debtor's counsel, and the trustee a statement indicating

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(1) whether it agrees that the debtor has paid in full the amount required to cure the default on the claim, and (2) whether the debtor is otherwise current on all payments consistent with § 1322(b)(5) of the Code. The statement shall itemize the required cure or postpetition amounts, if any, that the holder contends remain unpaid as of the date of the statement. The statement shall be filed as a supplement to the holder's proof of claim and is not subject to Rule 3001(f).

(h) DETERMINATION OF FINAL CURE AND PAYMENT. On motion of the debtor or trustee filed within 21 days after service of the statement under subdivision (g) of this rule, the court shall, after notice and hearing, determine whether the debtor has cured the default and paid all required postpetition amounts.

(i) FAILURE TO NOTIFY. If the holder of a claim fails to provide any information as required by subdivision (b), (c), or (g) of this rule, the court may, after notice and hearing, take either or both of the following actions: (1) preclude the holder from presenting the omitted information, in any form, as evidence in any contested matter or adversary proceeding in the case, unless the court determines that the failure was substantially justified or is harmless; or (2) award other appropriate relief, including reasonable expenses and attorney's fees caused by the failure.

(Added Apr. 26, 2011, eff. Dec. 1, 2011.)

Pending Amendment to Rule 3002.1 (effective December 1, 2016)

(a) IN GENERAL. This rule applies in a chapter 13 case to claims (1) that are secured by a security interest in the debtor's principal residence, and (2) for which the plan provides that either the trustee or the debtor will make contractual installment payments. Unless the court orders otherwise, the notice requirements of this rule cease to apply when an order terminating or annulling the automatic stay becomes effective with respect to the residence that secures the claim.

Fill in this information to identify the case:

Debtor 1 _____

Debtor 2 _____
(Spouse, if filing)

United States Bankruptcy Court for the: _____ District of _____
(State)

Case number _____

Official Form 410S1

Notice of Mortgage Payment Change

12/15

If the debtor's plan provides for payment of postpetition contractual installments on your claim secured by a security interest in the debtor's principal residence, you must use this form to give notice of any changes in the installment payment amount. File this form as a supplement to your proof of claim at least 21 days before the new payment amount is due. See Bankruptcy Rule 3002.1.

Name of creditor: _____ Court claim no. (if known): _____

Last 4 digits of any number you use to identify the debtor's account: _____

Date of payment change: _____
Must be at least 21 days after date of this notice

New total payment: \$ _____
Principal, interest, and escrow, if any

Part 1: Escrow Account Payment Adjustment

1. Will there be a change in the debtor's escrow account payment?

- No
- Yes. Attach a copy of the escrow account statement prepared in a form consistent with applicable nonbankruptcy law. Describe the basis for the change. If a statement is not attached, explain why: _____

Current escrow payment: \$ _____ New escrow payment: \$ _____

Part 2: Mortgage Payment Adjustment

2. Will the debtor's principal and interest payment change based on an adjustment to the interest rate on the debtor's variable-rate account?

- No
- Yes. Attach a copy of the rate change notice prepared in a form consistent with applicable nonbankruptcy law. If a notice is not attached, explain why: _____

Current interest rate: _____% New interest rate: _____%

Current principal and interest payment: \$ _____ New principal and interest payment: \$ _____

Part 3: Other Payment Change

3. Will there be a change in the debtor's mortgage payment for a reason not listed above?

- No
- Yes. Attach a copy of any documents describing the basis for the change, such as a repayment plan or loan modification agreement. (Court approval may be required before the payment change can take effect.)

Reason for change: _____

Current mortgage payment: \$ _____ New mortgage payment: \$ _____

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Debtor 1 _____
First Name Middle Name Last Name

Case number (if known) _____

Part 4: Sign Here

The person completing this Notice must sign it. Sign and print your name and your title, if any, and state your address and telephone number.

Check the appropriate box.

- I am the creditor.
- I am the creditor's authorized agent.

I declare under penalty of perjury that the information provided in this claim is true and correct to the best of my knowledge, information, and reasonable belief.

X _____ Date ____/____/_____
Signature

Print: _____ Title _____
First Name Middle Name Last Name

Company _____

Address _____
Number Street

City State ZIP Code

Contact phone (____) ____-____ Email _____

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Fill in this information to identify the case:

Debtor 1 _____

Debtor 2 _____
(Spouse, if filing)

United States Bankruptcy Court for the: _____ District of _____
(State)

Case number _____

Official Form 410S2

Notice of Postpetition Mortgage Fees, Expenses, and Charges 12/15

If the debtor's plan provides for payment of postpetition contractual installments on your claim secured by a security interest in the debtor's principal residence, you must use this form to give notice of any fees, expenses, and charges incurred after the bankruptcy filing that you assert are recoverable against the debtor or against the debtor's principal residence.

File this form as a supplement to your proof of claim. See Bankruptcy Rule 3002. 1.

Name of creditor: _____ Court claim no. (if known): _____

Last 4 digits of any number you use to identify the debtor's account: _____

Does this notice supplement a prior notice of postpetition fees, expenses, and charges?

- No
- Yes. Date of the last notice: ____/____/____

Part 1: Itemize Postpetition Fees, Expenses, and Charges

Itemize the fees, expenses, and charges incurred on the debtor's mortgage account after the petition was filed. Do not include any escrow account disbursements or any amounts previously itemized in a notice filed in this case or ruled on by the bankruptcy court.

Description	Dates incurred	Amount
1. Late charges	_____	(1) \$ _____
2. Non-sufficient funds (NSF) fees	_____	(2) \$ _____
3. Attorney fees	_____	(3) \$ _____
4. Filing fees and court costs	_____	(4) \$ _____
5. Bankruptcy/Proof of claim fees	_____	(5) \$ _____
6. Appraisal/Broker's price opinion fees	_____	(6) \$ _____
7. Property inspection fees	_____	(7) \$ _____
8. Tax advances (non-escrow)	_____	(8) \$ _____
9. Insurance advances (non-escrow)	_____	(9) \$ _____
10. Property preservation expenses. Specify: _____	_____	(10) \$ _____
11. Other. Specify: _____	_____	(11) \$ _____
12. Other. Specify: _____	_____	(12) \$ _____
13. Other. Specify: _____	_____	(13) \$ _____
14. Other. Specify: _____	_____	(14) \$ _____

The debtor or trustee may challenge whether the fees, expenses, and charges you listed are required to be paid. See 11 U.S.C. § 1322(b)(5) and Bankruptcy Rule 3002.1.

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Debtor 1 _____
First Name Middle Name Last Name

Case number (if known) _____

Part 2: Sign Here

The person completing this Notice must sign it. Sign and print your name and your title, if any, and state your address and telephone number.

Check the appropriate box.

- I am the creditor.
- I am the creditor's authorized agent.

I declare under penalty of perjury that the information provided in this claim is true and correct to the best of my knowledge, information, and reasonable belief.

X _____ Date ____/____/____
Signature

Print: _____ Title _____
First Name Middle Name Last Name

Company _____

Address _____
Number Street
City State ZIP Code

Contact phone (____) ____-____ Email _____

PROPOSED AMENDMENTS TO THE FEDERAL
RULES OF BANKRUPTCY PROCEDURE¹

1 **Rule 3002.1 Notice Relating to Claims Secured by**
2 **Security Interest in the Debtor's**
3 **Principal Residence**

4 * * * * *

5 (b) NOTICE OF PAYMENT CHANGES:

6 OBJECTION. The holder of the claim shall file and serve
7 on the debtor, debtor's counsel, and the trustee a notice of
8 any change in the payment amount, including any change
9 that results from an interest-rate or escrow-account
10 adjustment, no later than 21 days before a payment in the
11 new amount is due. For a claim arising from a home-equity
12 line of credit, this requirement may be modified by court
13 order. A party in interest that objects to the payment
14 change shall file a motion to determine whether the change
15 in the payment amount is required to maintain payments in

¹ New material is underlined in red; matter to be omitted is lined through.

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2 FEDERAL RULES OF BANKRUPTCY PROCEDURE

16 accordance with § 1322(b)(5) of the Code. If no motion is
17 filed within 21 days after service of the notice, the change
18 goes into effect, unless the court orders otherwise.

19 * * * * *

20 (e) DETERMINATION OF FEES, EXPENSES, OR
21 CHARGES. On motion of ~~the debtor or trustee~~ a party in
22 interest filed within one year after service of a notice under
23 subdivision (c) of this rule, the court shall, after notice and
24 hearing, determine whether payment of any claimed fee,
25 expense, or charge is required by the underlying agreement
26 and applicable nonbankruptcy law to cure a default or
27 maintain payments in accordance with § 1322(b)(5) of the
28 Code.

29 * * * * *

Committee Note

Subdivision (b) is amended in two respects. First, it is amended to authorize courts to modify its requirements for claims arising from home equity lines of credit (HELOCs).

Because payments on HELOCs may adjust frequently and in small amounts, the rule provides flexibility for courts to specify alternative procedures for keeping the person who is maintaining payments on the loan apprised of the current payment amount. Courts may specify alternative requirements for providing notice of changes in HELOC payment amounts by local rules or orders in individual cases.

Second, subdivision (b) is amended to acknowledge the right of the trustee, debtor, or other party in interest, such as the United States trustee, to object to a change in a home-mortgage payment amount after receiving notice of the change under this subdivision. The amended rule does not set a deadline for filing a motion for a determination of the validity of the payment change, but it provides as a general matter—subject to a contrary court order—that if no motion has been filed within 21 days after service of the notice on the debtor, the debtor’s attorney, and the trustee, the announced change goes into effect. If there is a later motion and a determination that the payment change was not required to maintain payments under § 1322(b)(5), appropriate adjustments will have to be made to reflect any overpayments. If, however, a motion is made during the time specified in subdivision (b), leading to a suspension of the payment change, a determination that the payment change was valid will require the debtor to cure the resulting default in order to be current on the mortgage at the end of the bankruptcy case.

Subdivision (e) is amended to allow parties in interest in addition to the debtor or trustee, such as the United States trustee, to seek a determination regarding the validity of any claimed fee, expense, or charge.

The Fee Only Chapter 13 Good Faith Debate

Prof. Andrea Boyack

Although purportedly society's safety net, bankruptcy law's preferred debt relief remains financially out of reach for many of our nation's most impoverished individuals. Someone seeking a chapter 7 discharge must pay her attorney upfront because unpaid attorney's fee obligations do not receive any payment priority in bankruptcy in a chapter 7. (*Lamie v. U.S. Trustee*, 540 U.S. 526 (2004)) In a situation where upfront payment of attorney fees is infeasible, would it be appropriate to advise the client to file under chapter 13 for the sole and express purpose of repaying the attorney's fee over time, and no payments being made to unsecured creditors?

The struggle to provide bankruptcy access while allowing bankruptcy attorneys to be paid has led several jurisdictions to accept as inevitable such "fee-only" chapter 13 plans, however some jurisdictions have held that it is generally bad faith to offer a plan that leaves zero percentage paid to unsecured creditors and only essentially setting up a payment plan for the debtor's attorney. In a fee-only chapter 13 case, the only payment made by the debtor during the 3-5 years of the bankruptcy plan is the attorney's fee – a fee which, in a chapter 13 case – is of course significantly higher than the attorney's fee would have been had the filing been made under chapter 7.

Although bankruptcy courts have not found that fee-only chapter 13 plans do not indicate bad faith *per se*, but most jurisdictions assert that fee-only plans will receive very high scrutiny by the court, and that there is a high probability that the plan will not be confirmed. The eleventh circuit followed this approach in *Brown v. Gore (In re Brown)*, (742 F.3d 1309 (11th Cir. 2014)). The court resisted the idea that chapter 13 should be available merely to help finance attorney fees, citing ethical problems that inherent in such an arrangement. The judge in *Brown* denied confirmation of the plan, finding that it violated chapter 13's good faith provisions under 11 U.S.C. § 1325(a)(3) and 1325 (a)(7). The first circuit in *Berliner v. Pappalardo (In re Puffer)*, 674 F.3d 78, 83 (1st Cir. 2012), similarly noted that fee-only cases could be "vulnerable to abuse by attorneys seeking to advance their own interests without due regard for the interests of the debtors." Bankruptcy courts in Missouri seem to be following this general trend of hostility toward fee-only chapter 13 plans. See *In re Arlen*, 461 B.R. 550 (Bankr. W.D. Mo. 2011), and *In re Montry*, 393 B.R. 695 (Bankr. W.D. Mo. 2008).

Over the past year, bankruptcy courts in Kansas have taken a markedly different approach to fee-only chapter 13 plans. In Kansas, several judges have rejected *In re*

Brown's skeptical approach to fee-only chapter 13s and instead have adopted a significantly more receptive approach to fee-only chapter 13s. Courts and lawyers and chapter 13 trustees have argued that it is necessary to uphold fee-only chapter 13s in order to preserve bankruptcy access for poor debtors who lack resources to pay an attorney upfront for a chapter 7.¹ Furthermore, courts (and attorneys and trustees) assert that characterizing fee-only chapter 13s as bad faith ignores that there are other legitimate reasons that a debtor may be best served by seeking court protection in a chapter 13 rather than liquidating through a 7, and that debtors should not be denied the opportunity to file chapter 13 just because no disposable income is available to distribute to unsecured creditors under the plan. (After all, the unsecured creditors are not any worse off in a fee-only chapter 13 than they would have been in a chapter 7 – so who is harmed by the fee-only structure?) As Judge Nugent explained in the most recent no-fee chapter 13 opinion from Kansas, “[n]o Tenth Circuit case directly addresses a fee-only plan so there is no authority that prohibits attorney fee-only chapter 13 plans.” *In re Moore*, Case No. 15-12254 (Bankr. D. Kan. Aug. 5, 2016).

This discussion group seeks to explore the tensions inherent in the fee-only chapter 13 structure, as well as the need for broader bankruptcy access that this structure seeks to provide.

- Are fee-only chapter 13s problematic legally or ethically? If so, when and how can these problems be addressed?
- What approach should courts take in analyzing such fee-only plans?
- Should an attorney advise a client in a fee-only chapter 13 that she can convert to a chapter 7 should she wish to stop paying her attorney? Would any attorney actually give this advice?
- Is there a better way to address barriers to bankruptcy access, and, if so, what are they?

¹ Judge Karlin in *In re Wark* explained the practical necessity of no-fee chapter 13s thus: “this is a world where debtors are harassed by daily collection calls for admittedly delinquent debts. Where they are repeatedly required to miss work to attend a cattle call docket to explain why they haven't paid old medical bills. Where they cannot afford to keep the gas on, and feel compelled to incur title or payday loans at exorbitant rates to feed their families. Where their meager wages are reduced even further by garnishments. Where they opt not to seek necessary medical care or take prescribed medication because they cannot afford it. This is the world these Debtors live in, and this real world sometimes requires bankruptcy, even if the debtor cannot save enough to pay the up front [sic] attorney's fees required to file a Chapter 7.” 542 B.R. 522, 578 (Bankr. D. Kan. 2015).

Background materials to read to prepare for the discussion:

Alexander F. Clamon, *Per Se Bad Faith? An Empirical Analysis of Good Faith in Chapter 13 Fee-Only Plans*, 30 Emory Bankr. Dev. J. 473 (2014).

Decisions finding bad faith for fee-only plans:

- *In re Brown*, 742 F.3d 1309 (11th Cir. 2014) (fee-only plan was filed in bad faith).
- *In re Puffer*, 674 F.3d 78 (1st Cir. 2012) (indicating that fee-only plans should be scrutinized for bad faith and setting out a multi-factor test to apply to see whether “special circumstances” justified the confirmation of a fee-only plan); *In re Puffer*, 494 B.R. 1 (D. Mass. 2013) (applying the First Circuit’s multi-factor test and finding that there were no “special circumstances” justifying the fee-only plan).
- *Ingram v. Burchard*, 482 B.R. 313 (Bankr. N.D. Cal. 2013) (applying a totality of the circumstances test and finding that a fee-only plan was filed in bad faith).
- *In re Arlen*, 461 B.R. 550 (Bankr. W.D. Mo. 2011)(calling fee-only chapter 13 cases “little more than disguised Chapter 7 proceedings”).
- *In re Montry*, 393 B.R. 695 (Bankr. W.D. Mo. 2008) (stating that to allow fee-only chapter 13s would “unnecessarily raise the cost of filing a bankruptcy petition for debtors who do not need or are ill suited for Chapter 13; and subvert the Supreme Court’s holding in *Lamie v. U.S. Trustee* prohibiting the payment of post-petition attorney’s fees from a debtor’s Chapter 7 bankruptcy estate.”)
- *In re Jackson*, 2012 WL 909782 (Bankr. N.D. Ala. 2012) (stating that chapter 13 plans providing that unsecured creditors receiving only nominal or zero payments are presumptively made in bad faith).
- *In re Barnes*, 213 WL 153848 (Bankr. E.D.N.C. 2013) (holding that the ee-only plan was “in essence only a payment plan for the attorneys’ fees and this is unacceptable”).
- *In re Paley*, 390 B.R. 53 (Bankr. N.D.N.Y. 2008) (calling fee-only chapter 13s “basically chapter 7 cases hidden within Chapter 13 petitions” that “blur the distinctions between the chapters into a meaningless haze”).
- *In re Dicey*, 312 B.R. 456 (Bankr. D.N.H. 2004) (calling a fee-only chapter 13 plan “in essence only a payment plan for the Debtors’ bankruptcy attorney’s fees,” and asserting that “Congress did not create Chapter 13 as a vehicle solely for the payment of attorney’s fees”).

Decisions finding good faith for fee-only plans:

- *In re Wark*, 542 B.R. 522 (Bankr. D. Kan. 2015) (J. Karlin, in a lengthy and passionate opinion, holding that fee-only plans challenged by the U.S. Trustee were filed in good faith and could be confirmed).
- *In re Moore*, Case No. 15-12254 (Bankr. D. Kan. 2016) (J. Nugent, holding that the debtors’ circumstances justified confirmation of their no-fee chapter 13 plan, and applying the *Flygare* factors from *Flygare v. Borden* to find good faith).
- *In re Dunson*, 550 B.R. 537 (Bankr. D. Kan. 2016), and *In re Dugan*, 549 B.R. 790 (Bankr. D. Kan. 2016), and *In re Doucet*, No. 15-21531, 2016 WL 2603072 (Bankr. D. Kan. 2016), (in each case, J. Berger, holding that a fee-only plan proposed by a debtor who lacked financial resources to pay an attorney upfront was made with required “good faith”);
- *In re Cramer*, 691 F.3d 671 (5th Cir. 2012) (fee-only plan was not filed in bad faith based on the “particular circumstances” of the debtor).
- *In re Molina*, 420 B.R. 825 (Bankr. D. N.M. 2009) (finding no code-based barrier to fee-only chapter 13 plans, and explaining the necessity for debtors “in economic straits” to have the option to file a fee-only chapter 13 bankruptcy).

Complementary or Contradictory: Filing Stale Proofs of Claim in Bankruptcy, the Fair Debt Collection Practices Act, and the Bankruptcy Code

Introduction

In 1977, the Fair Debt Collection Practices Act (FDCPA) was signed into law. Just one year later, Congress passed the Bankruptcy Reform Act of 1978. While both laws were forged in an era of economic hardship and with intent to simplify some of the more difficult tensions between Debtors and Creditors, now almost forty years later, those same statutory regimes which were meant to clarify the rights held by each party are seemingly at odds with one another. Competing interpretations of the statutes and their intersection have resulted in a split among Courts of Appeal addressing the issue of whether a Creditor's filing of a stale proof of claim in bankruptcy violates the FDCPA. The Second, Seventh, Eighth, and Ninth Circuits have held an FDCPA claim is not available to Debtors in Bankruptcy where a Creditor filed a stale proof of claim.¹ The Third and Eleventh Circuits have held a FDCPA claim is available to Debtors in Bankruptcy where a Creditor has filed a stale proof of claim.² The Eighth Circuit and Eleventh Circuit Courts of Appeal have both issued opinions outlining the inherent tension between the two statutes and the respective holdings of these Courts are illustrative of both sides of the split.

Issue before the Courts of Appeal

“[W]hether a proof of claim to collect a stale debt in Chapter 13 bankruptcy violates the Fair Debt Collection Practices Act.”³

Filing a Stale Proof of Claim in Bankruptcy Violates the FDCPA

The Eleventh Circuit Court of Appeals has adopted the view that filing a stale proof of claim in bankruptcy is a violation of the FDCPA.⁴ In the first case to address the inherent tension between the Bankruptcy Code and the FDCPA in the context of stale proofs of claim, the Eleventh Circuit Court of Appeals held that by filing a time-barred proof of claim creditors engaged in “deceptive,” “misleading,” “unconscionable,” or “unfair” under the FDCPA.⁵ In reaching its determination, the Eleventh Circuit Court of Appeals adopted the “least sophisticated consumer” standard to determine whether a debt collector's conduct was “unfair” and determined this standard applied in a bankruptcy context.⁶ Finding the filing of a time-barred proof of claim was similar to the filing of a “stale lawsuit,” the Court ultimately held the time-barred proof of claim created a “misleading” impression to the “least sophisticated

¹ Simmons v. Roundup Funding, LLC, 622 F.3d 93(2d Cir. 2010), Owens v. LVNV Funding, LLC, No. 15-2044, 2016 WL 4207965 (7th Cir. Aug. 10, 2016), Nelson v. Midland Credit Mgmt. Inc., No. 15-2984, 2016 WL 3672073 (8th Cir. July 11, 2016), Walls v. Wells Fargo Bank, N.A., 276 F.3d 502 (9th Cir. 2002).

² Simon v. Fia Card Servs., N.A., 732 F.3d 259 (3d Cir. 2013), Crawford v. LVNV Funding, LLC, 758 F3d 1254, 1256 (11th Cir. 2014).

³ Crawford v. LVNV Funding, LLC, 758 F3d 1254, 1256 (11th Cir. 2014).

⁴ Id.

⁵ 15 U.S.C. §§ 1692(e)-(f)

⁶ Crawford, 758 F.3d at 1259.

consumer”, and given the automatic allowance provision, the Creditor could be liable under the FDCPA.⁷

This year, the Eleventh Circuit Court of Appeals had the opportunity to review its earlier ruling in *Crawford*.⁸ A district court judge had determined the Bankruptcy Code was inherently at odds with the FDCPA and repealed the statute insofar as it did not apply in the bankruptcy context. The Eleventh Circuit Court of Appeals held, that in fact, “[t]he FDCPA easily lies over the top of the Code’s regime, so as to provide an additional layer of protection against a particular kind of creditor. It kicks in only when the creditor is a debt collector that ‘regularly collects’ or is in ‘any business the principal purpose of which is the collection’ of debts.”⁹ The Court further held that the Code and the FDCPA were complementary, “providing different tiers of sanctions for creditor misbehavior in bankruptcy.”¹⁰

Filing a Stale Proof of Claim in Bankruptcy Does Not Violate the FDCPA

Both the Eighth Circuit Court of Appeals and the Bankruptcy Appellate Panel of the Eighth Circuit have rejected the Eleventh Circuit’s interpretation of the interplay between the FDCPA and the Bankruptcy Code.

In 2014, the Bankruptcy Appellate Panel heard the same question regarding whether the filing of a proof of stale proof of claim in bankruptcy constituted a violation of the FDCPA.¹¹ While the Bankruptcy Appellate Panel agreed with the Eleventh Circuit that filing a proof of claim was effectively an action to collect a debt¹² and invoked a threat of litigation¹³, however, the Court held the Debtor was inherently protected by the bankruptcy process and filing an accurate proof of claim could not be considered an “unfair” or “unconscionable” action given the oversight of the court and the ability of the trustee to move to disallow the claim.¹⁴

In July of this year, the Eighth Circuit Court of Appeals expressly rejected the Eleventh Circuit Court of Appeals’ holdings in *Crawford* and *Johnson*.¹⁵ The Court of Appeals determined that *Crawford* “ignored the differences between a bankruptcy claim and actual or threatened litigation.”¹⁶ The Court of Appeals held that in adopting the “least sophisticated consumer” standard in a bankruptcy context the Eleventh Circuit Court of Appeals did not account for how “[t]he bankruptcy process protects against such harassment and deception.”¹⁷ The Eighth Circuit further drew the distinction between filing a proof of claim and filing an independent collection action in holding, “[u]nlike defendants facing a collection lawsuit, a bankruptcy debtor is aided by ‘trustees who owe fiduciary duties to all parties and have a statutory obligation to object to unenforceable claims’”.¹⁸

⁷ *Crawford*, 758 F.3d at 1261.

⁸ *Johnson v. Midland Funding, LLC*, No. 15-14116, 2016 WL 2996372 (11th Cir. May 24, 2016).

⁹ *Johnson*, 2016 WL 2996372 at *5.

¹⁰ *Id.*

¹¹ *Gatewood v. CP Medical, LLC (In re Gatewood)*, 533 B.R. 905 (B.A.P. 8th Cir. 2015).

¹² *Gatewood*, 533 B.R. at 907.

¹³ *Gatewood*, 533 B.R. at 908.

¹⁴ *Gatewood*, 533 B.R. at 910.

¹⁵ *Nelson v. Midland Credit Mgmt, Inc.*, No. 15-2984, 2016 WL 3672073 (8th Cir. July 11, 2016).

¹⁶ *Nelson*, No. 15-2984, 2016 WL 3672073 at *2.

¹⁷ *Id.*

¹⁸ *Id.* (citations omitted).

A Split Decision: Owens

In a recent 2-1 decision, the Seventh Circuit Court of Appeals recently held debt collectors conduct in filing proofs of claim on stale debt was not “misleading, deceptive, unfair, or otherwise abusive.” under the FDCPA.¹⁹ In determining whether filing a proof of claim on a time-barred debt was “unfair” under the FDCPA, the Court of Appeals considered the protection for the debtor inherent to the bankruptcy process, including a Trustee who is “duty-bound” to object to claims.²⁰ The Court also noted that in the consolidated cases before it, all Debtors were represented by attorneys and all proofs of claim filed were accurate, so “abuse” was not present in this instance.²¹ Chief Judge Wood dissented in this case, holding the realities of the bankruptcy court process do not protect the Debtor in every instance, and the FDCP should be available to Debtors as a result.²²

Reconciling the Differences

The difference between the Court of Appeals’ respective interpretations of the whether a debt collector can violate 15 U.S.C. §§ 1692(e)-(f) in a bankruptcy context is explained most readily by the Eleventh Circuit’s adoption of the “least sophisticated consumer” standard in a bankruptcy setting.²³ This standard also seems to be embraced, at least implicitly, by Chief Judge Wood in the Owens dissent.²⁴ Both the Eleventh Circuit and Chief Judge Wood hinge their analyses on the Debtor’s level of knowledge and understanding in a bankruptcy proceeding regardless of any protection afforded by the bankruptcy process. On the other hand, the majority of Circuit Courts of Appeal that have addressed the issue, acknowledge that filing a proof of claim is litigation in furtherance of collecting a debt, but have held a Creditor cannot be liable under §§ 1692(e)-(f) because of the protection the Debtor receives from the trustee and the bankruptcy court.

Conclusion

This issue is not one which will likely be conclusively determined in the near of future. Additional appeals on whether filing a stale proof of claim in a bankruptcy proceeding is a violation of the Fair Debt Collection Practices Act have also been filed in the First, Third, and Sixth, Circuit Courts of Appeal.²⁵ Two more cases have been appealed to the Eleventh Circuit.²⁶ At this time, no parties have filed for certiorari with the United States Supreme Court.

¹⁹ Owens, No. 15-2044, 2016 WL 4207965 at *1.

²⁰ Id., No. 15-2044, 2016 WL 4207965 at *6.

²¹ Id., No. 15-2044, 2016 WL 4207965 at *6-7.

²² Id., No. 15-2044, 2016 WL 4207965 at *10.

²³ See Crawford, 758 F.3d at 1259.

²⁴ Owens, No. 15-2044, 2016 WL 4207965 at *10.

²⁵ In re Martel, 539 B.R. 192 (Bankr. D. Me. 2015), *appeal docketed*, No. 16-1653 (1st Cir. May 25, 2016); Torres v. Cavalry SPV I, LLC, 530 B.R. 268 (E.D. Pa. 2015), *appeal docketed*, No. 15-2131 (3d Cir. May 05, 2015); In re Broadrick, 532 B.R. 60 (Bankr. M.D. Tenn. 2015), *appeal docketed*, No. 15-505 (6th Cir. Sept. 08, 2015).

²⁶ Brock v. Resurgent Capital Servs., No. 14-032, 2015 WL 4985700 (S.D. Ala. Aug. 20, 2015), *appeal docketed*, No. 15-14115 (11th Cir. Sept. 14, 2015); Castellanos v. Midland Funding, LLC, No. 2:15-CV559 (M.D. Fla. Jan. 01, 2016), *appeal docketed*, No. 161-487 (11th Cir. Feb. 05, 2016).

Multiple Clawback Adversaries: Past Is Prologue

Thad J. Collins
Chief Bankruptcy Judge
Northern District of Iowa

36th Annual Midwestern Bankruptcy Institute
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Agriprocessors, Inc. was one of the nation’s largest kosher meatpacking and food-processing facilities in Postville, Iowa. On November 4, 2008, Debtor filed a Chapter 11 petition in the Bankruptcy Court for the Eastern District of New York. Debtor’s bankruptcy petition and accompanying documents recited that its financial difficulties resulted from a raid conducted by U.S. Immigration and Customs Enforcement. A total of 389 workers at the Postville facility were arrested. The raid led to numerous federal criminal charges, including a high-profile case against Debtor’s President, Sholom Rubashkin, who was convicted on 86 counts of financial fraud. Debtor had over 200 creditors and assets and liabilities in excess of \$50,000,000.

The Bankruptcy Court for the Eastern District of New York eventually approved the appointment of Joseph E. Sarachek as the Chapter 11 trustee. The Court concluded that appointing a trustee was necessary in part “for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management” under § 1104(a)(1). The case was later converted to Chapter 7.

On behalf of the estate, Mr. Sarachek filed over 150 adversary actions to recover fraudulent or preferential transfers.

A review of these adversary action reveal certain patterns. In particular, the need for trial. The Court repeatedly found genuine issues of material fact about whether the defenses applied to the kinds of transactions that led to the financial failure of Agriprocessors, Inc.

Moreover, in the cases that went to trial, the Court had to calculate liability for non-standard transactions. In particular, how preferential or fraudulent transfer statutes apply to check kiting, series of rapid loans and repayments—with “repayments” sometimes occurring before the “loan”—and exchanges without the intent to create a lending relationship. These decisions informed each other as the Court sought to apply the law consistently.

The following are cases that exemplify these trends and are intended to show that adversaries—although technically separate lawsuits—often share factual and legal issues and therefore are resolved similarly. Skilled advocates will use the history of other adversaries to successfully urge their position to the Court.

Selected cases from In re Agriprocessors, Inc.

Sarachek v. Meltzer (In re Agriprocessors, Inc.), No. 08-02751, Adv. No. 10-09194, 2011 WL 4621826 (Bankr. N.D. Iowa Sept. 30, 2011) (denied motion to dismiss preference complaint, trustee plausibly alleged fraudulent conveyance and preferential transfer)

Trustee filed an adversary complaint to avoid fraudulent conveyances or, alternatively, preferential transfers in the Agriprocessors bankruptcy case. Defendant moved to dismiss, arguing Trustee did not adequately plead fraudulent conveyances under Rule 9(b) or Rule 8(a). Defendant argued Trustee did not adequately plead Defendant was an insider under § 547(b). The Court held that Rule 8(a) notice pleading applied to claims sounding in constructive fraud under § 548(a)(1)(B), and Trustee's fraudulent conveyance claim met the Rule 8(a) pleading standards as interpreted by the Supreme Court in Iqbal and Twombly. The Court held Trustee alleged sufficient facts to support his allegation of Defendant's insider status under Rule 8(a). The Court denied Defendant's motion to dismiss.

Sarachek v. The Right Place Inc. (In re Agriprocessors, Inc.), No. 08-02751, Adv. No. 10-09123, 2011 WL 4621741 (Bankr. N.D. Iowa Sept. 30, 2011) (denied motion to dismiss preference complaint, granted trustee's request for leave to amend)

Trustee filed an adversary complaint to avoid fraudulent conveyances or, alternatively, preferential transfers in the Agriprocessors bankruptcy case. Defendant moved to dismiss. Defendant argued Trustee failed to state any plausible factual allegations in his fraudulent conveyance claim to indicate Debtor received less than a reasonably equivalent value for the payments as required by § 548(a)(1)(B)(i). Defendant also argued that Trustee failed to adequately plead Debtor was insolvent during the periods prescribed by § 548(a)(1)(B)(ii)(I). As to Trustee's preference claim, Defendant argued Trustee failed to allege a plausible factual basis sufficient to plead Defendant was an "insider" under § 547(b)(4)(B), and also argued Trustee did not adequately plead Debtor's insolvency at the time of the transfers—a prerequisite to recover under § 547(b)(3). The Court denied Defendant's Motion to Dismiss, but held that Trustee failed to adequately plead Debtor was insolvent under both counts of the complaint. The Court granted Trustee's request to amend the complaint.

Saracheck v. Schreiber (In re Agriprocessors, Inc.), Bankr. No. 08-02751, Adv. No. 10-09202, 2013 WL 1276506 (Bankr. N.D. Iowa Mar. 27, 2013) (denying summary judgment in preference action).

Trustee brought an adversarial proceeding against Defendant, the proprietor of a catering business conducting business with the Debtor, seeking recovery of preferential transfers under § 547(b). Defendant moved for summary judgment on two alternative grounds: (1) that the payments were made "in the ordinary course of business" and (2) that he provided "new value" after receiving the payments that would significantly limit the trustee's recovery. The Court found remaining genuine issues of material fact precluded the entry of summary judgment.

Saracheck v. Chabad of North Fulton, Inc. (In re Agriprocessors, Inc.), Bankr. No. 08-02751, Adv. No. 10-09131, 2013 WL 1332418 (Bankr. N.D. Iowa Mar. 28, 2013) (denying summary judgment in preference action).

Trustee brought an adversary action to recover a \$50,000.00 payment alleged to be a preferential transfer under § 547. Defendant classified itself as a non-profit charitable corporation supporting the Orthodox Jewish faith, and was operated by Hirsch Minkowicz, a second cousin of Sholom Rubashkin, the Debtor's President. Defendant moved for summary judgment arguing it was not an insider and therefore the one year preferential period of § 547(b)(4)(B) did not apply. Defendant also argued that even if it was an insider, the payment cannot be avoided under § 547(c) because the payment was made in the ordinary course of business. The Court agreed with Defendant that it was not a "statutory insider" by way of relation or control, but noted the statutory definition is non-exhaustive and found factual issues as to whether Defendant's "close relationship" with Debtor conveyed insider status. Additionally, Defendant's non-profit status and lack of formal loan documentation raised issues as to whether the payment was made in the ordinary course of business. The Court denied Defendant's Motion for Summary Judgment.

Sarachek v. Jaffe (In re Agriprocessors, Inc.), Bankr. No. 08-02751, Adv. No. 10-09170, 2013 WL 1332428 (Bankr. N.D. Iowa Mar. 28, 2013) (denying summary judgment in fraudulent transfer and preference action).

Trustee sought leave to amend its complaint pursuant to Fed. R. Bankr. P. 7015 and 7016 (incorporating Fed R. Civ. P. 15 and 16) which advanced fraudulent conveyance and preferential transfer theories for the recovery of payments from Defendant. Defendant resisted the Motion to Amend arguing correction of the complaint was futile due to Trustee's admission that Defendant was not a creditor of Debtor, and accordingly filed a Motion for Summary Judgment on the preferential transfer claim. The Court determined that despite the Trustee's admission, Defendant's own evidence indicated she owed a debt, and a factual issue remained. The Court also found factual issues regarding the Defendant's alleged "insider" status and accordingly denied the summary judgment motion.

Saracheck v. Wahls (In re Agriprocessors, Inc.), 490 B.R. 374 (Bankr. N.D. Iowa 2013) (dismissing fraudulent transfer action).

Trustee brought an action to avoid fraudulent conveyances allegedly made to Defendants within two years of the Debtor's bankruptcy petition date. Defendants were a local church and the church's president, Wahls, who assisted the Debtor in distributing funds to its labor force. Debtor would send payment to the Defendant Wahls, who would then cash the payments and distribute the funds to Debtor's numerous employees. Defendants moved for summary judgment arguing the transfers were not fraudulent. The Court found that Debtor had received reasonably equivalent value for the payments in the form of the employee's labor, and that therefore the payments were not fraudulent conveyances under § 548(a)(1)(B). The Court also made an

alternative determination that under any of the tests used by the Federal Circuit Courts of Appeal, including the Eighth Circuit's "Control Test," Defendants were not "initial transferees" within the meaning of the bankruptcy code. The Court granted summary judgment in favor of the Defendants.

Sarachek v. Lubicom, LLC (In re Agriprocessors, Inc.), Bankr. No. 08-02751, Adv. No. 10-09129, 2013 WL 1332270 (Bankr. N.D. Iowa Mar. 29, 2013) (denying summary judgment in preference action).

Trustee brought an adversarial bankruptcy action seeking to recover preferential transfers in the amount of \$60,000.00. Defendant moved for summary judgment on the majority of the Trustee's claimed transfer amount relying on the "contemporaneous exchange of new value," "ordinary course of business" and "subsequent new value" defenses found in 11 U.S.C. § 547(c). For each of these defense theories the Court found that genuine issues of material fact remained and denied Defendant's Motion for Summary Judgment.

Sarachek v. Cohen (In re Agriprocessors, Inc.), Bankr. No. 08-02751, Adv. No. 10-09197, 2013 WL 1385400 (Bankr. N.D. Iowa Apr. 3, 2013) (denying summary judgment on "insider" status in preference action).

Defendant and Trustee each filed a Motion for Summary Judgment. Defendant argued that the "new value" defenses to the preference claims found in § 547(c) applied. Trustee argued that the facts satisfied the preferential transfer elements of § 547(b) and that the equitable clean hands doctrine prevented Defendant's assertion of a § 547(c) defense. HELD: The Court addressed the preferential transfer merits after finding the clean hands doctrine was inapplicable because the § 547(c) "new value" defenses were not equitable affirmative defenses. The Court granted partial summary judgment in favor of the Trustee's § 547(b) preferential transfer claim except on the issue of whether Defendant was an "insider." The Court explained that the statutory definition of "insider" is not all-inclusive, and that material issues of fact remained under the Eighth Circuit's "Control Test" for non-statutory insiders. In addressing Defendant's motion, the Court found factual issues concerning whether Defendant provided "new value"

Sarachek v. Twin City Poultry (In re Agriprocessors, Inc.), Bankr. No. 08-02751, Adv. No. 10-09220, 2013 WL 1402414 (Bankr. N.D. Iowa Apr. 3, 2013) (denying summary judgment in fraudulent transfer and preference action).

Trustee's complaint sought to avoid five transfers totaling \$621,818.81 under fraudulent conveyance and preferential transfer theories. Defendant and Trustee each filed a Motion for Summary Judgment. Defendant argued that the "new value" defenses to preference claims found in § 547(c) applied. Trustee argued that the facts satisfied the preferential transfer elements of § 547(b) and that the equitable clean hands doctrine prevented Defendant's assertion of a § 547(c) defense. The Court concluded that none of the transfers could be recovered under § 548(a)(2) as constructively fraudulent because the undisputed facts showed the Debtor received

reasonably equivalent value on those transfers. After dispensing with the applicability of the clean hands doctrine, the Court found factual issues remained under each party's preferential transfer arguments and accordingly denied summary judgment.

Sarachek v. Crown Heights House of Glatt, Inc. (In re Agriprocessors, Inc.), Bankr. No. 08-2751, Adv. No. 10-09108, 2013 WL 5966120 (Bankr. N.D. Iowa Nov. 8, 2013) (ruling on motion to dismiss and motion for summary judgment).

Trustee alleged fraudulent conveyances or preferential transfers of \$5,364,090.33. Defendant filed a Motion to Dismiss for the fraudulent conveyance claims and a Motion for Summary Judgment for the preference claims. The Court found that there were significant factual disputes so both motions were inappropriate.

Sarachek v. Hilgar (In re Agriprocessors), Bankr. No. 08-2751, Adv. No. 10-09217, 2014 WL 1454187 (Bankr. N.D. Iowa Apr. 15, 2014) (ruling on motion for summary judgment).

Trustee alleged fraudulent transfers or preference claims. Defendant filed a Motion for Summary Judgment on the fraudulent transfer claims and on all but \$27,000 of the preference claim. The Court concluded that genuine issues of material fact precluded summary judgment, particularly about the new value defense.

Sarachek v. Luana Savings Bank (In re Agriprocessors, Inc.), 490 B.R. 852 (Bankr. N.D. Iowa 2013) (holding that debt is incurred for preferential transfer purposes when bank's provisional settlement becomes final).

Trustee sought to recover over \$5,000,000.00 in preferential transfers. Under U.C.C. Article 4 the payor bank of an instrument may make a provisional settlement with a presenting bank, and such settlement becomes final if the payor bank fails to revoke the settlement by its midnight deadline. Payor banks have a duty to pay instruments that are "properly payable," which includes at the bank's option the payment of instruments causing an overdraft on its customer's (the drawer's) account. Trustee argued that the payor bank's provisional settlements with presenting banks, which included numerous overdraft-causing debits on Debtor's accounts, constituted short-term loans and that the repayment of these overdrafts created a preference. The Court found that a debt is not incurred until the customer is legally obligated to pay; i.e. when the provisional settlement becomes final.

Sarachek v. Crown Heights House of Glatt, Inc. (In re Agriprocessors, Inc.), 521 B.R. 292 (Bankr. N.D. Iowa 2014) (finding transfers were constructively fraudulent and declining to use the "totality of the transfers" approach.).

Trustee sought to recover payments made to Defendant of over \$5 million in fraudulent conveyances or over \$4 million in preferential transfers. The Court declined to use a "totality of the transfers" approach to analyze constructively fraudulent transfers and addressed several

affirmative defenses. The Court found that the Defendant was an insider. The Court concluded that a majority of the transfers involved were constructively fraudulent and awarded over \$1 million to the Trustee.

Sarachek v. Luana Savings Bank (In re Agriprocessors, Inc.), 546 B.R. 811 (Bankr. N.D. Iowa 2015) (determining amount of preferential transfers).

Trustee brought this adversary to recover preferential transfers. The Court determined how to calculate the amount of antecedent debt to determine a preference, including the effect of Bank posting errors on the overdraft calculation. The Court concluded that the Bank's affirmative defenses did not apply and awarded the Trustee over \$1.5 million.

Settlement

Not only do previous adversary cases assist in forecasting the likely outcome of substantive legal issues—they can also help guide settlement. Looking to the amount that similar cases are settling for should serve as a starting point for pricing a case, then adjusting up or down based on the strengths or weaknesses of that case.

While Agriprocessors certainly followed this path, Judge Collins had a limited role in settlement discussions. He played a more prominent role in settlement discussions in the following case.

Selections from In re Petters Co., Inc.

In re Petters, a bankruptcy case that resulted from one of the largest Ponzi schemes in history, is still pending in the Bankruptcy Court for the District of Minnesota. Tom Petters was the CEO of Petters Group Worldwide, which he used to run a \$3.65 billion Ponzi scheme. In 2008, he was arrested and charged with multiple fraud-based federal criminal offenses.

Douglas Kelley was appointed receiver and took control of Tom Petters' assets, including his business entities. In October 2008, he filed petitions to commence cases under Chapter 11 for the entities. He was later appointed Trustee.

In 2010, Mr. Kelley filed over 200 adversary proceedings. In almost all of these cases, he sought to avoid preferential or fraudulent transfers. Judge Kishel decided to address the number of cases—and the similarity of the issues presented by those cases—by consolidating the common issues. He explored this based on the Trustee's proposal

to “consolidate” the presentation of issues that were common to the defense in large numbers of adversary proceedings, and that went either to the content of his pleading or to the applicable rule of decision as a matter of law alone. The vehicle for presentation would be motions for dismissal by defendants, under Rule 12(b)(6).

To get the issues before the court, there would be a coordinated effort by the defense and a single consolidated response by the Trustee. The proposal was aired via a “procedures motion” brought in the main bankruptcy cases. Numerous defendants gave their input. The court adopted the Trustee's proposal with some modifications. A “procedures order” then was entered . . . to identify these issues and to govern the coordination of briefing and argument on them in a semi-collective way. Separate rulings on particular issues were contemplated, to be memorialized in a general frame of reference and later applied to individual adversary proceedings via rulings on their specific fact-pleading. The court concluded that these broader rulings would be best set forth in one or more memoranda, styled in the main bankruptcy cases to make the best use of electronic means for general notice to the defense. Oral argument was presented on three separate days, on discrete groups of issues for each day. This is the first memorandum on the parties' submissions. It is set down for the group of issues that is most involved, difficult, and portentous, for the largest number of defendants.

In re Petters Co., Inc., 494 B.R. 413, 420 (Bankr. D. Minn. 2013). This procedure had many benefits. Judge Kishel wrote:

As massive as this docket was, its common origins offered some avenues to simplify the initial judicial administration. . . . Issues posed by particular defendants through early motions for dismissal were selected if they were purely legal in nature—i.e., those going to the adequacy of the Trustee's pleading, and those going to the choice of a substantive rule of decision if the underlying law was not settled in this jurisdiction. Issues that were common to a significant number of defendants were identified and grouped. The Trustee filed a consolidated responsive brief in the file for the main cases. Supplementary briefing was allowed for the defense. A controlled sequence of oral argument was entertained. These procedures did not make the issues themselves any simpler; many were matters of first impression in this jurisdiction, many were initially confounding. However, it did queue them up. The court's contemplation was to address these issues by rulings of general applicability to the whole litigation docket. In part, this was to provide a platform for the disposition of each defendant's motion for dismissal. In equal part, it was intended to better “position” the sides for settlement discussions or structured mediation, were defendants amenable to that avenue.

In re Petters Co., Inc., 495 B.R. 887, 892–93 (Bankr. D. Minn. 2013), as amended (Aug. 30, 2013).

These findings that are common to the cases—referred to as “Memorandum”—are referenced and relied upon by the Court in later decisions. In re Petters Co., Inc., 494 B.R. 413; In re Petters Co., Inc., 495 B.R. 887; and In re Petters Co., Inc., 499 B.R. 342 (respectively, the First, Second,

and Third Memoranda). These memoranda addressed “consolidated issues” in the adversary cases.

The First Memorandum “covered the deepest issue with most impact on the defendants collectively—the choice of the statute of limitations—plus other matters going to the timeliness of suit.” In re Petters Co., Inc., 495 B.R. at 893.

The Second Memorandum addressed the adequacy of the Trustee’s pleading. In re Petters Co., Inc., 495 B.R. at 893.

The Third Memorandum addressed the substance of Trustee’s constructive fraud theories. In re Petters Co., Inc., 499 B.R. at 346–347.

Judge Kishel recently ruled that “the equity-structured, federally-evolved approach previously adopted in the Second Memorandum still is viable here,” despite a Minnesota Supreme Court case that suggested otherwise. Kelley v. Opportunity Finance (In re Petters Co., Inc.), 550 B.R. 457, 481 (Bankr. D. Minn. 2016); see also Jeffrey Meitrodt, Petters Lawsuits Poised to Move Forward, StarTribune (June 4, 2016), <http://www.startribune.com/petters-lawsuits-poised-to-move-forward/381830721/> (describing the ruling, responses to it, and the history of the case).

For further discussion, a table with total transfer and settlement amounts that resulted from settlement mediation with Petters, Inc. employees is attached.

AMERICAN BANKRUPTCY INSTITUTE

Case 08-45257 Doc 1490 Filed 11/29/11 Entered 11/29/11 17:22:36 Desc Main Document Page 48 of 65
 PCI, PGW Trustee and Receiver
 Employee Mediation Claims and Settlements

NAME	Cash Transfers by PCI Trustee	Cash Transfers by PGW Trustee	Cash & EBP Holdings Transfers by Receiver	Est. Cash Value of EBP Holdings	Total Transfers by PCI/PGW and Receiver's Estates	EMPLOYEE SETTLEMENT AMOUNT (cash)	XL Cash (Phase I Payment Not Allocated to Individual Employee)	SETTLEMENT AMOUNT (EBP HOLDINGS) (All to Receiver)	TOTAL SETTLEMENT (CASH AND EBP HOLDINGS)	Payment Terms
XL Funds for Phase I Settlements	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 92,500	\$ -	\$ 92,500	Net 30
Anderson, Deanne	\$ 40,000	\$ 19,500	\$ 7,800	\$ -	\$ 67,300	\$ 5,000	\$ -	\$ -	\$ 5,000	Net 30
Carter, Dove	\$ 118,105	\$ 43,750	\$ 45,000	\$ -	\$ 206,855	\$ 6,667	\$ -	\$ -	\$ 6,667	Net 30
Chee-Awai, Camille ¹	\$ -	\$ 1,625,000	\$ 2,059,344	\$ 1,871,212	\$ 3,684,344	\$ 219,000	\$ 90,000	\$ 1,559,344	\$ 1,868,344	Net 30
Dorsey, Anastasia	\$ 7,500	\$ 11,000	\$ 42,700	\$ -	\$ 61,200	\$ 1,000	\$ -	\$ -	\$ 1,000	Net 30
Dunlap, William ¹	\$ 2,500,000	\$ 1,288,179	\$ 733,901	\$ 280,680	\$ 4,522,080	\$ 1,437,500	\$ 170,000	\$ 233,901	\$ 1,841,401	\$667.5k in 30 days, \$770k over 2 yrs
Hamm, Patricia	\$ 1,500,000	\$ 450,000	\$ 1,012,238	\$ 748,485	\$ 2,962,238	\$ 500,000	\$ 108,000	\$ 623,738	\$ 1,231,738	Net 30
Hardy, Scott	\$ 12,000	\$ -	\$ 251,839	\$ -	\$ 263,839	\$ 80,000	\$ 14,000	\$ -	\$ 94,000	\$25k 30 days; \$8k 4/1/12; \$33k each yr for 3 more years
Holzem, Rebecca	\$ 10,000	\$ -	\$ -	\$ -	\$ 10,000	\$ -	\$ -	\$ -	\$ -	Net 30
Honig, Kim	\$ 10,000	\$ 22,500	\$ 25,000	\$ -	\$ 57,500	\$ 5,000	\$ -	\$ -	\$ 5,000	\$208.33 / mo for 24 months
Jeffries, Mary	\$ 2,000,000	\$ 1,200,000	\$ 1,779,672	\$ 935,606	\$ 4,979,672	\$ 950,000	\$ 170,000	\$ 779,672	\$ 1,899,672	\$350k 30 days, \$300k within 1 year, \$300 within 2 yrs
Joe, Arthur	\$ 40,000	\$ 22,000	\$ 7,000	\$ -	\$ 69,000	\$ 15,000	\$ -	\$ -	\$ 15,000	Net 30
Jordan, John	\$ 35,000	\$ 130,229	\$ 58,374	\$ -	\$ 223,602	\$ 9,000	\$ -	\$ -	\$ 9,000	Net 30
Klassen, Tom	\$ 10,000	\$ 65,625	\$ -	\$ -	\$ 75,625	\$ 10,000	\$ -	\$ -	\$ 10,000	Net 30
Krusse, Lois	\$ 25,500	\$ 50,319	\$ 3,500	\$ -	\$ 79,319	\$ 10,000	\$ -	\$ -	\$ 10,000	Net 30
Lagermeier, Daniel	\$ 10,000	\$ -	\$ -	\$ -	\$ 10,000	\$ 2,500	\$ 3,500	\$ -	\$ 6,000	Net 30
Margolis, David	\$ 75,000	\$ 16,920	\$ 201,215	\$ -	\$ 293,136	\$ -	\$ -	\$ -	\$ -	Net 30
Mau, Cheryl	\$ 75,000	\$ 26,459	\$ 25,000	\$ -	\$ 126,459	\$ 18,250	\$ -	\$ -	\$ 18,250	Net 30
McGann, Jon	\$ 175,000	\$ 125,000	\$ 174,134	\$ 187,121	\$ 474,134	\$ 15,000	\$ 13,000	\$ 155,934	\$ 183,934	Net 30
Miller, Andrea	\$ 80,000	\$ 119,729	\$ 33,000	\$ -	\$ 232,729	\$ 35,000	\$ -	\$ -	\$ 35,000	Net 30
Monighan, Shawn	\$ 30,000	\$ -	\$ 15,500	\$ -	\$ 45,500	\$ 3,600	\$ 1,800	\$ -	\$ 5,400	\$100/ mo for 36 months
O'Brien, Mollie	\$ 22,500	\$ -	\$ 19,552	\$ -	\$ 42,052	\$ -	\$ -	\$ -	\$ -	Net 30
Pernula, Mary ²	\$ 50,000	\$ 110,000	\$ 260,000	\$ -	\$ 420,000	\$ 55,000	\$ 18,000	\$ -	\$ 73,000	Net 30
Riedl, Kevin	\$ 15,000	\$ 85,127	\$ -	\$ -	\$ 100,127	\$ 5,000	\$ -	\$ -	\$ 5,000	Net 30
Romenesko, Stuart	\$ 1,550,000	\$ 476,570	\$ 500,000	\$ -	\$ 2,526,570	\$ 720,000	\$ 105,000	\$ -	\$ 825,000	Net 30
Salmen, J. Thomas	\$ 300,000	\$ 50,000	\$ 77,966	\$ 93,559	\$ 427,966	\$ 66,000	\$ 14,000	\$ 77,966	\$ 157,966	Net 30
Salmen, R. Thomas	\$ 10,000	\$ 68,750	\$ -	\$ -	\$ 78,750	\$ 10,000	\$ -	\$ -	\$ 10,000	Net 30
Sarenna, Colleen	\$ 3,000	\$ 37,758	\$ -	\$ -	\$ 40,758	\$ 2,000	\$ -	\$ -	\$ 2,000	Net 30
Schmitt, Joseph	\$ 100,000	\$ 78,125	\$ 500,000	\$ -	\$ 678,125	\$ 10,000	\$ 27,000	\$ -	\$ 37,000	Net 30
Tesar, Tamara	\$ 45,000	\$ 9,643	\$ -	\$ -	\$ 54,643	\$ 2,500	\$ -	\$ -	\$ 2,500	Net 30
Zhang, Connie ³	\$ 15,000	\$ -	\$ -	\$ -	\$ 15,000	\$ 6,000	\$ -	\$ -	\$ 6,000	Net 30
TOTALS	\$ 8,863,605	\$ 6,132,182	\$ 7,832,735	\$ 4,116,663	\$ 22,828,523	\$ 4,199,017	\$ 826,800	\$ 3,430,555	\$ 8,456,372	

¹Dunlap has an additional "Other Payor" claim of \$65,000 not included above, ²Pernula has an additional "Other Payor" claim of \$20,000 not included above, ³Zhang has an additional "Other Payor" claim of \$23,000 not included above
⁴PGW funded certain bonuses paid to Ms. Chee-Awai by Petters Capital. PGW filed a Proof of Claim in the Petters Capital, LLC case and will accordingly amend the proof of claim in connection with this settlement.

PCI/PGW Trustee and Receiver Total Settlements and Allocations					
Total Settlements	PCI Trustee	PGW Trustee	Receiver - Cash	Receiver - EBP	Total Settlements
Employee Cash	\$ 2,434,568	\$ 811,523	\$ 952,926	\$ -	\$ 4,199,017
XL Cash	\$ 620,100	\$ 206,700	\$ -	\$ -	\$ 826,800
EBP Holdings	\$ -	\$ -	\$ -	\$ 3,430,555	\$ 3,430,555
Total Settlements	\$ 3,054,668	\$ 1,018,223	\$ 952,926	\$ 3,430,555	\$ 8,456,372

This table shows the total transfer and settlement amounts from Petters, Inc. employees. These settlements were the result of mediation. The average recovery for these settlements was 18.4% of the total transfers at issue. Nevertheless, the individual settlement percentage varied from 3% (\$7,000 of \$207,000 in total transfer) to 38% (\$1.9 million of \$4.98 million in total transfers). Three of the cases were settled for \$0.

ABI Midwestern Bankruptcy Conference Roundtables
September 30, 2016

Single Asset Real Estate Cases

Judge Dale L. Somers
U.S. Bankruptcy Judge, District of Kansas

I. A Brief History of the Special Treatment of Single Asset Real Estate Cases in Bankruptcy.

During the 1930s, as a result of the Depression, payment defaults on real property mortgages skyrocketed, and those defaults not only harmed the debtors who owed the mortgages, but also the lenders that held them.¹ As the lenders foreclosed, they began to hold title to enormous amounts of real property and were faced with the dilemma of (1) holding the property even though it produced little income but incurred tax, maintenance, and insurance debts, or (2) selling it into a thin market with few buyers and depressed prices.² In addition, many states imposed moratoriums on foreclosures, so the lenders there couldn't take the usual steps to try to protect their interests.³ These problems meant many lenders, much like their debtors, were facing insolvency.⁴ Congress also saw a risk of undermining the United States' economic system if real property defaults were allowed "to cause pervasive dispossession of private ownership."⁵ Partially to help this situation, Congress passed a new bankruptcy chapter that gave individual and partnership owners of real property a chance to reorganize.⁶ Without that new option, debtors who owned real estate that was in financial trouble could only seek revised agreements with their lenders or liquidate under either the 1898 Bankruptcy Act or state mortgage foreclosure laws.⁷

¹Kenneth N. Klee (UCLA Law Professor) "One Size Fits Some: Single Asset Real Estate Bankruptcy Cases," 87 Cornell L. Rev. 1285, 1289-90 (2002).

²*Id.*

³*Id.* at 1290.

⁴*Id.*

⁵*Id.*

⁶*Id.*

⁷*Id.* at 1291.

The 1978 Bankruptcy Code included no special provisions for single asset real estate (SARE) debtors, so they were able to use Chapter 11 to try to reorganize just like any other debtors. But by 1994, mortgage holders had convinced Congress that most SARE debtors (or at least those with secured debts below a certain amount) filed bankruptcy solely to delay foreclosure and seldom managed to get plans confirmed.⁸ So that year, Congress enacted two new provisions to address that perceived problem: § 101(51B), which defined a SARE case as one involving real property mortgaged for no more than \$4 million that was a single property or project that generated substantially all the debtor's gross income and on which the debtor conducted no substantial business other than operating the real property,⁹ and § 362(d)(3), which required the debtor in a SARE case either (1) to file a plan within 90 days that might reasonably be confirmed within a reasonable time or (2) to start making payments to its secured lender or lenders.¹⁰ By 2005, Congress had been convinced that these requirements should be applied to all SARE debtors, so in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, it removed the \$4 million cap from the definition of a SARE case.¹¹ At the same time, Congress amended § 362(d)(3)(B) to specify that the debtor could, if it chose, use the rents or other income generated by the property to make the monthly payments to its secured creditors that were required if it did not file a confirmable plan within 90 days; before that, the provision had said nothing about the source of such payments.¹²

A leading bankruptcy treatise offers this explanation of the SARE provisions:

The purpose of section 362(d)(3) is to address perceived abuses in single asset real estate cases, in which debtors have attempted to delay mortgage foreclosures even when there is little chance that they can reorganize successfully. Section 362(d)(3) attempts to shorten such cases by requiring that the court grant relief from the stay if a reasonable plan is not filed promptly or payments are not commenced.¹³

⁸*Id.* at 1291-92.

⁹Pub. L. No. 103-394, § 218(a) (1994).

¹⁰*Id.* at § 218(b).

¹¹Pub. L. No. 109-8, § 1201(5) (2005). Congress also made the SARE definition inapplicable to family farmers.

¹²*Id.* at § 444(2).

¹³3 *Collier on Bankruptcy*, ¶ 362.07[5][b] (Alan N. Resnick & Henry J. Sommer, eds.-in-chief, 16th ed. 2016).

Today, then, SARE debtors who are thinking about trying to reorganize under Chapter 11, typically because they are experiencing cash flow problems, must quickly either propose a confirmable plan or figure out a way to begin making payments to their secured creditors. Consequently, an attorney representing a debtor whose bankruptcy case might be a SARE case must decide how to answer a number of questions that are raised by the SARE provisions in the Bankruptcy Code.

II. The SARE Statutes

“Single Asset Real Estate” is defined in § 101(51B), which now reads:

The term “single asset real estate” means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.

In a SARE case, the holder of a mortgage on the real estate can obtain stay relief, as usual, under § 362(d)(1) for “cause” such as the lack of adequate protection of its interest in the property, but probably not under § 362(d)(2) because the real estate will always be “necessary to an effective reorganization,” even if the debtor has no equity in it. But only in SARE cases, the mortgage holder can also seek relief under § 362(d)(3), which provides:

(d) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay —

...

(3) with respect to a stay of an act against single asset real estate under subsection (a), by a creditor whose claim is secured by an interest in such real estate, unless, not later than the date that is 90 days after the entry of the order for relief (or such later date as the court may determine for cause by order entered within that 90-day period) or 30 days after the court determines that the debtor is subject to this paragraph, whichever is later —

(A) the debtor has filed a plan of

- reorganization that has a reasonable possibility of being confirmed within a reasonable time; or
- (B) the debtor has commenced monthly payments that —
- (i) may, in the debtor’s sole discretion, notwithstanding section 363(c)(2), be made from rents or other income generated before, on, or after the date of the commencement of the case by or from the property to each creditor whose claim is secured by such real estate (other than a claim secured by a judgment lien or by an unmatured statutory lien); and
 - (ii) are in an amount equal to interest at the then applicable nondefault contract rate of interest on the value of the creditor’s interest in the real estate.¹⁴

Because § 362(d)(3)(B)(i) establishes an exception to § 363(c)(2), it is also important to be aware of the latter provision. Section 363(a) defines “cash collateral” and § 363(c)(1) and (2) constrain the ability of a Chapter 11 debtor-in-possession (who is the “trustee” in such a case) to use cash collateral. They provide:

- (a) In this section, “cash collateral” means cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or

¹⁴Note that the payments are to be “equal to interest” at the contractual, nondefault rate on the secured debt, but are not in fact interest — presumably because postpetition interest is generally not allowable unless the claim is oversecured. *See* § 502(b)(2) and 506(b)

other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.

....

- (c) (1) If the business of the debtor is authorized to be operated under section 721, 1108, 1203, 1204, or 1304 of this title and unless the court orders otherwise, the trustee may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing, and may use property of the estate in the ordinary course of business without notice or a hearing.
- (2) The trustee may not use, sell, or lease cash collateral under paragraph (1) of this subsection unless —
 - (A) each entity that has an interest in such cash collateral consents; or
 - (B) the court, after notice and a hearing, authorizes such use, sale, or lease in accordance with the provisions of this section.

III. Questions for Discussion.

1. Some general questions about SARE cases.

- a. What type of SARE case is a good candidate for a successful Chapter 11?
- b. What is a successful Chapter 11?

UCLA Law Professor Ken Klee asserts that Congress has adopted confirmation of a plan as the benchmark for success in a Chapter 11 case,¹⁵ although he notes that commentators have criticized that standard.

- c. Does the size of a SARE debtor's debts or the value of its property affect the likelihood it can successfully reorganize?

Before Congress amended § 101(51B) to remove the \$4 million cap on the definition of single asset real estate, Professor Klee studied a number of SARE cases and

¹⁵87 Cornell L. Rev. at 1313-14.

found that once the value of the debtor's property exceeded somewhere between \$7 million and \$8.2 million, the chances the debtor would obtain plan confirmation increased substantially.¹⁶

2. What circumstances raise questions about whether the debtor is or is not a SARE debtor?

- a. What sorts of activities does a debtor have to engage in on its real estate to make the single asset real estate provisions not apply to it?

In *In re Scotia Pacific Co., Inc.*,¹⁷ the 5th Circuit affirmed the lower courts' conclusions that the debtor was not a SARE debtor. The debtor owned 200,000 acres of timber and earned its income by harvesting timber from its land and other land it had a contractual right to harvest. The debtor had 60 employees, mostly scientists, who operated its business of deriving maximum revenue from the timber grown on these lands while maintaining sustainable forests. The debtor planned, managed, and implemented harvesting plans for its timber. It also conducted the sale of the standing timber and then re-planted and managed future timber stands. Finally, the debtor attended to the varying harvesting requirements and environmental prescriptions of each of the nine watersheds on its land. However, the debtor's parent company conducted the actual timber harvesting operations.

In *In re Kara Homes, Inc.*,¹⁸ the bankruptcy court found that each of a number of affiliated debtors was a SARE debtor. Each debtor owned a single real estate development for which it designed homes or condominiums, arranged for construction of the homes or condos, built common space, amenities, and roadways needed for the development, and then marketed and sold the homes or condos to generate cash. The court pointed out a reasonable business person would not expect any of these activities to generate substantial revenue separate and apart from the sale of the underlying real estate.

- b. What if the debtor owns two or more parcels of real estate but treats them in some way as a single unit?
- c. Is a debtor a SARE if an affiliate conducts substantial business on

¹⁶87 Cornell L. Rev. at 1316-17.

¹⁷508 F.3d 214 (5th Cir. 2007).

¹⁸363 B.R. 399 (Bankr. D.N.J. 2007).

the property under a lease agreement with the debtor?

d. Can the complexity of the debtor's financial and organizational structure be sufficient to keep the case from being a SARE case?

In *In re Meruelo Maddux Props., Inc.*,¹⁹ the 9th Circuit refused to adopt the bankruptcy court's view that the debtor's relationship with its parent and sibling subsidiaries was sufficient to make it a non-SARE debtor. A company that owned and developed real property in the Los Angeles area through its network of subsidiaries, along with 53 of its subsidiaries, filed Chapter 11 cases that were jointly administered but not substantively consolidated. This opinion concerned the motion of one of the subsidiaries, which owned a 92-unit apartment complex, for a declaration that neither it nor any of the other subsidiaries was a SARE debtor, and the motion of a secured creditor of the subsidiary for a declaration that the SARE provisions did apply to the debtor. The bankruptcy court said the debtor appeared to have the characteristics of a SARE debtor but declined to apply the SARE provisions because of the consolidated, interrelated nature of the business operations of the parent and its subsidiaries. The district court reversed that ruling, declaring there was no "whole enterprise exception" to the SARE provisions. The 9th Circuit affirmed the district court's ruling, saying, "Absent a substantive consolidation order, we must accept [the debtor's] chosen legal status as a separate and distinct entity from its parent corporation and sister subsidiaries, and look only to its assets, income, and operations in determining whether [its apartment complex] is single asset real estate."²⁰

e. What if a single secured creditor requires its borrower to set up separate LLCs to hold two or more pieces of real property even though the principals of the LLCs are the same individuals or entities, and they did not intend to set up separate LLCs until the lender required it?

3. Questions raised by the provision allowing a SARE debtor to use rents to make payments to its secured creditor or creditors.

a. Is the ability after 90 days to make payments to the secured creditor from rents really a benefit to the debtor?

¹⁹667 F.3d 1072 (9th Cir. 2012).

²⁰*Id.* at 1077.

- b. Does § 362(d)(3)(B) mean the debtor's payments to its secured creditors can only be made from the net rents? Can the debtor also pay the ongoing operating expenses of the property from the rents? What constitutes gross income in a SARE case? Can the payments made to the secured creditor be applied to the principal owed to it, rather than to interest?
- c. Does an assignment of rents prevent the debtor from using the rents from the property to pay for anything other than its debt to the secured creditor?
- d. Does the extent of the secured creditor's interest in the debtor's rents affect the debtor's ability to use the rents under § 362(d)(3)(B)? For example, can the debtor get the bankruptcy court to restore it to possession and control of its asset in place of a receiver appointed in the creditor's state court foreclosure suit?

In *In re Bryant Manor, LLC*,²¹ the debtor owned a 100-unit apartment complex, but after it stopped making its mortgage payments, the mortgage holder filed a foreclosure suit in state court and a receiver was appointed to manage the complex. A month after the receiver was appointed, the debtor filed a Chapter 11 bankruptcy and soon sought the removal of the receiver and turnover of the complex. Chief Judge Karlin first ruled that the postpetition rents generated by the complex were property of the bankruptcy estate despite the appointment of the receiver because the debtor retained some interest in them under Kansas law and even if that were not true, § 541(a)(6) of the Bankruptcy Code would bring them into the estate. Then Judge Karlin noted that § 543(b) generally requires someone like the receiver to turn estate property over to the debtor-in-possession, but that § 543(d) authorized her to excuse the receiver from doing so. She proceeded to find that the evidence showed it would be in the best interest of the creditors to leave the receiver in place, at least for the time being, because (1) the debtor was not asking to manage the property itself, but to have a different third party than the receiver to do so, (2) the mortgage holder had raised serious questions about the possibility the debtor would be able to propose a confirmable plan, especially because (a) before filing bankruptcy, the debtor had failed to pay utility bills even though it was not paying the mortgage, (b) the property had deferred maintenance and upkeep issues and the mortgage holder had pledged to loan the receiver money to repair and maintain the property, but

²¹422 B.R. 278 (Bankr. D. Kan. 2010).

would not do the same for the debtor, and (c) either the debtor or its management company had mismanaged the property before the bankruptcy filing and the receiver had been a more effective property manager, at least in the early stages of its appointment, (3) the receiver has retained the local employees who were managing the day-to-day operations of the property, so continuity in that respect was being maintained, and (4) the receiver could operate the property for the same or less money than the debtor had been spending.

Student Loans Addressed in Chapter 13

A Brief History of Student Loan Debt and Changes

In November of 1965, President Lyndon B. Johnson signed into law the “Higher Education Act” that increased federal money given to universities, creating scholarships and low interest loans for students. The act has been reauthorized multiple times.

Over the last 10 years Americans over the age of 60 have seen their student loan debt grow faster than any other demographic group according to The Federal Reserve Bank of New York. By 2014 that sum had hit 58 billion dollars for those 60+ year olds up from 6 billion in 2004. It appears that borrowers over the age of 40 are taking out new student loans at nearly the twice the increase of borrowing by the younger borrowers during the same period.

Student loan debt is not good news since Americans in their 40s, 50s and 60s have much less time to repay their loans and try to save for their other financial goals. Senior citizens are ending up retiring while still owing substantial sums for federal student loans on their own behalf or they have co-signed said loan for their children.

A student loan in the bankruptcy context under 11 U.S.C. § 523(a)(8)(A) makes non-dischargeable “an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or nonprofit institution or an obligation to repay funds received as an educational benefit, scholarship, or stipend”.

Following BAPCPA under 11 U.S.C. § 523(a)(8)(B) make non-dischargeable “any other education loan that is a qualified educational loan, as defined in § 221(d)(1) of the Internal Revenue Code of 1986, incurred by a debtor who is an individual”. – Private student loans

It appears that many debtors are attempting to utilize Chapter 13 to address, postpone, or at a minimum, delay student loan collections. This has increased substantially in the last several years since 2005, when BAPCPA became effective and additionally made dischargeability of all private student loans the same as government loans subject to the “undue hardship” standard. At the same time student loan dollar amounts have increased substantially due to the increasing cost of higher education and universities are not subsidizing lower income students as they have in previous years. One study indicated that several universities once reimbursed or reduced tuition up to 55% in the past and now they are down to under 20%.

8th and 10th Circuit Student Loan Cases

The most recent cases in this area that best indicate current student loan problems are three Kansas decisions and the 8th Circuit B.A.P. decision *Jordahl* 539 B.R. 567 (2015). Three of the four Kansas bankruptcy judges have recent decisions regarding student loans being paid either directly, pro rata or as a special class.

Two of the cases are above-median: 12-11696 Stull (489 B.R. 217) decided by Judge Robert E. Nugent on March 27, 2013 and Knowles 13-40602 (501 B.R. 409) decided by Judge Janice Miller Karlin on November 4, 2013. The below median case was decided by Judge Dale Somers, Salazar 15-21309 on October 9, 2015. As Judge Somers so interestingly notes on page 2 of the Salazar decision: “This case concerns a rather strange intersection in Chapter 13 practice. Congress has been sufficiently concerned about student loan debts to make them usually not dischargeable in Chapter 13, but not concerned enough to give them payment priority over other unsecured debts. Because interest on non-dischargeable debts continues to accrue while a debtor is performing under a Chapter 13 plan but cannot be paid unless the debtor is paying all unsecured claims in full, a debtor with student loan debts runs a very real risk of paying into a plan for three to five years only to find that she finishes her plan owing more on those debts than she did when she filed for bankruptcy.”

In Salazar, an excellent tutorial as one trustee stated calling it “the Rosetta Stone” of student loan decisions. It discusses the above-median debtor’s situation being different from the below median case and how an above median debtor can, in certain situations, after paying the required amount of their disposable income to their unsecured creditors, go on and pay their student loans to the amount they are able to or in full.

In this below median case, the debtor proposed a plan payment amount of \$185.00 per month she would have paid her attorney’s fees, filing fee and trustee’s fee in month 17. At that point she proposed all funds would be directed to the student loan, a claim which was filed by Mohela for \$6,136.66. This would have paid approximately one half of the claim. This remaining balance at the end of her 36 month plan would probably include interest and penalties that would have accrued during the penancy of the Chapter 13 case.

The trustee contended in his reply brief, responding to the Debtor’s reply alleging there was no other relief available for her, that she could have filed a Chapter 7 case for less than one third of what the Chapter 13 was going to cost. The Debtor would have been discharged in 3-4 months and could have started making payments directly on the Mohela claim. At a payment of \$185.00 per month it would have taken approximately 33 months and less than 40 months from the date of the initial Chapter 7 being filed and paid in full.

The Court expressed the following concerns in denying confirmation:

1. There would be a balance remaining on her student loan at the conclusion of the Chapter 13 case that will need to be addressed.
2. The plan unfairly discriminated against her non-student loan creditors.
3. The below-median debtor did not have discretionary income as required by § 1325 (B) (1)(b).
4. The debtor’s plan failed each step of the Bentley test as it does not honor the code’s requirement of equality of distribution.
5. Her student loans are not entitled to priority under § 507(a).
6. A Chapter 13 fresh start is not a guarantee that the debtor will emerge from Chapter 13 free of all debts.
7. Debtor’s suggestion that the Bentley requirements requiring a comparison of what her plan would give her non-student loan creditors under Chapter 7 liquidation is incorrect.

Discussion Points:

- Had the debtor amended her plan to pay all unsecured debts pro rata during the first 36 months and to extend her plan to 60 months, or until a time necessary to pay her student loans in full, would that have been confirmable?
- If it were confirmable she still could not pay interest on the student loan as it would be in violation of § 1322 (b)(10).
- The question as to how the creditor will apply the payments received from the trustee on their claim cannot be easily verified or controlled even in the order of confirmation directing for the payments to be applied a certain way.
- If debtor’s plan pays the student loan creditor direct how can the Court be sure the debtor makes those payments and direct payments include interest and would be in violation of § 1322 (b)(10)? This issue is discussed in more detail by Judge Nugent and Judge Karlin in their respective decisions and Judge Schermer in *Jordahl* for the 8th Circuit B.A.P.
- All Judges have stated that in their particular cases that it is not allowable to pay interest under 11 U.S.C. § 1322 (b)(10). Judge Nugent stated that the Courts have concluded that “very specific terms of § 1322 (b)(10) trump the earlier and more general provisions of § 1322 (b)(5)”.

Code sections that affect student loan repayment in Chapter 13

Section 1322(b) contains eleven subsections pertaining to a Chapter 13 plan. The following are relevant to the student loan issue:

(b) ... the plan may —

(1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims;

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

(10) provide for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are nondischargeable under section 1328(a), except that such interest may be paid only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims.

The 10th Circuit has adopted the Bentley test In re *Bentley* 266 B.R. 229 (B.A.P. 1st Cir. 2001) that many commentators have critiqued because it is out of touch with the current student loan situation and current level of debt load on graduates. Both Judge Karlin and Judge Nugent determined that the Bentley test still “was the better one”, even after the passage of BAPCPA in 2005. Specifically the Bentley Court looked at:

- (1) a quality of distribution;
- (2) non-priority of student loans;
- (3) mandatory versus optional contributions (a comparison of what the dischargeable unsecured creditors would have received in a pro rata distribution of the mandatory contributions under Chapter 13); and
- (4) the debtor’s fresh start

Judge Nugent found in *Stull*, that debtor had what was called “discretionary income” in addition to the “projected disposable income” the code required him to pay into his plan. Further, the debtor proposed to use that discretionary income to pay his student loan debts in full while paying his other unsecured creditors only about one half of their claims. The discrimination was not unfair because the debtor was paying his non-student loan creditors all of his projected disposable income as required by the code and paying student loan creditors only out of the additional income he had available.

Judge Karlin, in *Knowles* found, like Judge Nugent, that the above-median debtors had committed their discretionary income to their student loan payments. She went on to say “Debtors’ student loan and non-student loan creditors are receiving exactly what the Code requires Debtors to pay them – a pro rata payment of PDI (projected disposable income). The fact that the student loan creditors are also receiving a discretionary payment from Debtors does not entitle the remaining unsecured creditors to additional moneys, nor ‘dis-entitle’ student loan creditors from receiving a pro rata payment.”¹ In applying the Bentley test Judge Karlin found that Courts are directed to look at the “principles and structure of Chapter 13 itself” for “the baseline against which to evaluate discretionary provisions for fairness”.

In *Jordahl* the 8th Circuit referred to its four-part test, known as the Leser/Wolff test, for unfair discrimination 8th Circuit has “adopted a four-part test for unfair discrimination” under § 1322 (b)(1). *Jordahl*, 539 B.R. at 572; *Copeland*, 742 F.3d at 813.

- (1) whether the discrimination has a reasonable basis;
- (2) whether the debtor can carry out a plan without the discrimination;
- (3) whether the discrimination is proposed in good faith; and
- (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination.

¹ See, e.g., *In re Sharp*, 415 B.R. 803, 813 (Bankr. D. Colo. 2009) (citing *Bentley* and concluding that the debtors’ pro rata payment to student loan creditors in addition to a monthly discretionary payment to student loan creditors was not unfair discrimination because equal distribution of plan payments, by

definition, did not discriminate). I also note that no party expects this double recovery to actual occur, because the plan anticipates no payments to the student loan creditors under the plan.

STUDENT LOANS

By the Numbers...

- ▶ \$1.26 trillion in total U.S. student loan debt
- ▶ 43.3 million Americans with student loan debt
- ▶ Student loan delinquency rate of 11.6%
- ▶ Average monthly student loan payment (for borrower aged 20 to 30 years): \$351
- ▶ Median monthly student loan payment (for borrower aged 20 to 30 years): \$203
- ▶ (<https://studentloanhero.com/student-loan-debt-statistics-2016/>; Data via newyorkfed.org; clevelandfed.org)

STUDENT LOAN DEBT FACTS

- ▶ Direct Loans – \$911.6 billion;
30.5 million borrowers
- ▶ FFEL Loans – \$342.6 billion;
16.8 million borrowers
- ▶ Perkins Loans – \$8.0 billion;
2.7 million borrowers

STUDENT LOAN DEBT STATISTICS BY LOAN PROGRAM



- ▶ Stafford Subsidized – \$266.7 billion; 28.9 million borrowers
- ▶ Stafford Unsubsidized – \$423.5 billion; 27.1 million borrowers
- ▶ Stafford Combined – \$690.3 billion; 31.9 million unique recipients
- ▶ Grad PLUS – \$50.2 billion; 1.0 million borrowers
- ▶ Parent PLUS – \$74.5 billion; 3.3 million borrowers
- ▶ Perkins – \$8.0 billion; 2.7 million borrowers
- ▶ Consolidation – \$439.2 billion; 12.0 million borrowers
- ▶ (<https://studentloanhero.com/student-loan-debt-statistics-2016/>; Data via Studentaid.ed.gov)

STUDENT LOAN DEBT STATISTICS BY LOAN TYPE

- ▶ Loans in repayment – \$468.1 billion; 15.7 million borrowers
- ▶ Loans in deferment – \$101.7 billion; 3.4 million borrowers
- ▶ Loans in forbearance – \$102.8 billion; 2.7 million borrowers
- ▶ Loans in default – \$63.2 billion; 3.9 million borrowers
- ▶ Loans in grace period – \$42.6 billion; 1.7 million borrowers

STUDENT DEBT STATISTICS BY LOAN STATUS (DIRECT LOAN PROGRAM)

- ▶ Level Repayment Plan, 10 years or less – \$197.8 billion; 11.26 million borrowers
- ▶ Level Repayment Plan, greater than 10 years – \$72.6 billion; 1.65 million borrowers
- ▶ Graduated repayment plan, 10 years or less – \$69.2 billion; 2.68 million borrowers
- ▶ Graduated repayment plan, greater than 10 years – \$12.8 billion; 0.28 million borrowers
- ▶ Income-Contingent (ICR) – \$23.5 billion; 0.60 million borrowers
- ▶ Income-Based (IBR) – \$174.3 billion; 3.10 million borrowers
- ▶ Pay As You Earn (PAYE) – \$44.3 billion; 1.00 million borrowers
- ▶ Revised Pay As You Earn (REPAYE) – \$26.9 billion; 0.57 million borrowers

STUDENT LOAN STATISTICS BY REPAYMENT PLAN (DIRECT LOAN PROGRAM)

▶ Public Service Loan Forgiveness

(As of Q2, 2016)

▶ PSLF Borrowers: 431,853*

- ▶ * – Total number of borrowers who have one or more approved PSLF Employment Certification Forms (ECF)
- ▶ Note that borrowers are self-identified based on submission of an ECF
- ▶ (<https://studentloanhero.com/student-loan-debt-statistics-2016/>; Source: FedLoan Servicing via studentaid.ed.gov)

FORGIVENESS

- ▶ About 40 percent of the \$1 trillion student loan debt was used to finance graduate and professional degrees.
- ▶ Combined undergraduate and graduate debt by degree:
 - ▶ •MBA = \$42,000 (11% of graduate degrees)
 - ▶ •Master of Education = \$50,879 (16%)
 - ▶ •Master of Science = \$50,400 (18%)
 - ▶ •Master of Arts = \$58,539 (8%)
 - ▶ •Law = \$140,616 (4%)
 - ▶ •Medicine and health sciences = \$161,772 (5%)
- ▶ (<https://studentloanhero.com/student-loan-debt-statistics-2016/>; Data via 2012 Newamerica.org study)

GRADUATE STUDENT LOAN DEBT

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

The Essential Resource for Today's Busy Insolvency Professional

Trustee Talk

BY DEBORAH B. LANGEHENNIG AND DANIEL A. HATOUM

Is 13 the Lucky Number for Student Loan Debtors?



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Debbie Langehennig is a chapter 13 trustee for the Western District of Texas and serves on the board of directors for the National Association of Chapter 13 Trustees. Daniel Hatoum recently graduated from the University of Texas School of Law with honors and participated in the Texas Law Review, Bankruptcy Moot Court Team and Bankruptcy Pro Bono Project.

Current law makes it very difficult to either discharge any amount of student loan debt or make any meaningful repayment toward student loan debt in a bankruptcy reorganization case. With the high default rate on this debt and the need to preserve this important resource for future students, it is time to explore options for dealing successfully with student loan debt in bankruptcy proceedings.

Under § 523, to discharge student loans a debtor must show that “excepting such debt from discharge ... would impose an undue hardship.”¹ As a result of a circuit split, there are two tests utilized by the circuit courts to determine whether a debtor is suffering from an undue hardship: the *Brunner* test² and the totality-of-the-circumstances test.³ The first test is more widely adopted, with nine circuit courts applying *Brunner*,⁴ which requires the debtor to demonstrate

(1) that 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; (2) 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 (3) that the debtor has made good-faith efforts to repay the loans.⁵

Each of these is a “prong,” meaning that instead of a factor test where failing to meet one factor is not

necessarily dispositive, to receive a discharge under *Brunner* a debtor *must* meet each prong.⁶

The second test, created and applied by the Eighth Circuit, is the totality-of-the-circumstances test,⁷ which requires examination of a list of *non-exhaustive* factors:

1) the debtor’s past and present financial resources and those the debtor can reasonably rely on in the future, 2) the reasonable necessary living expenses of the debtor and the debtor’s dependents, and 3) any other relevant facts and circumstances surrounding each particular bankruptcy case.⁸

Due to the fact that this test allows courts to consider additional circumstances, does not require debtors to show additional circumstances and does not require debtors to show good-faith efforts to repay loans, the totality-of-the-circumstances test is generally considered a more lenient test.⁹ However, with the majority of circuits applying the *Brunner* test, and some of those circuits indicating that debtors must show a “certainty of hopelessness”¹⁰ in order to discharge a debt, student debtors across the nation face considerable obstacles in discharging this debt.

Congress sought to limit the discharge of student loans because of “rising incidences of consumer bankruptcies of former students motivated primarily to avoid payment of educational loan debts”¹¹ — indicating a need to “[r]escu[e] the student loan pro-

1 11 U.S.C. § 523(a)(8) (2016).

2 *Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395, 396 (2d Cir. 1987).

3 *Long v. Educ. Credit Mgmt. (In re Long)*, 322 F.3d 549, 554-55 (8th Cir. 2003).

4 See *Brunner*, 831 F.2d at 396; *Oyler v. Educ. Credit Mgmt. Corp. (In re Oyler)*, 397 F.3d 382, 385 (6th Cir. 2005); *Educational Credit Mgmt. Corp. v. Polleys*, 356 F.3d 1302, 1307 (10th Cir. 2004); *United States Dep’t of Educ. v. Gerhardt (In re Gerhardt)*, 348 F.3d 89, 91 (5th Cir. 2003); *Hemar Ins. Corp. v. Cox (In re Cox)*, 338 F.3d 1238, 1241 (11th Cir. 2003); *Ekenasi v. Educ. Res. Inst. (In re Ekenasi)*, 325 F.3d 541, 546 (4th Cir. 2003); *Brightful v. PHEAA (In re Brightful)*, 267 F.3d 324, 327 (3d Cir. 2001); *Rifino v. United States (In re Rifino)*, 245 F.3d 1083, 1087 (9th Cir. 2001); *Matter of Roberson*, 999 F.2d 1132, 1135 (7th Cir. 1993).

5 *Brunner*, 831 F.2d at 396.

6 *In re Frushour*, 433 F.3d 393, 404 (4th Cir. 2005) (recognizing that court cannot discharge student loans under *Brunner* without proving all three prongs).

7 *Long v. Educ. Credit Mgmt. (In re Long)*, 322 F.3d 549, 554-55 (8th Cir. 2003).

8 *Id.*

9 See Sarah Edstrom Smith, “Should the Eighth Circuit Continue to Be the Loan Ranger? A Look at the Totality-of-the-Circumstances Test for Discharging Student Loans under the Undue-Hardship Exception in Bankruptcy,” 29 *Hamline L. Rev.* 601, 633 (2006) (describing totality-of-circumstances test as more-lenient test).

10 *Oyler v. Educ. Credit Mgmt. Corp. (In re Oyler)*, 397 F.3d 382, 386 (6th Cir. 2005) (requiring that there be “certainty of hopelessness” in showing that additional circumstances exist indicating that this state of affairs is likely to persist for significant portion of repayment period of student loans).

11 *Brunner*, 46 B.R. at 754 (citing Comm’n Report (Pt. I) at 140-41, n.17).

gram from fiscal doom.”¹² The concern was that more easily allowing discharge — permitting borrowers to have their cake and eat it, too — was so appetizing that it “would lead to the ultimate and speedy bankruptcy of the government-backed student loan program.”¹³

Student Loan Repayment under Chapter 13

Likewise, debtors who propose a repayment plan under chapter 13 find it very difficult to repay meaningful distributions to student loan creditors during the course of a chapter 13 plan. Section 1322(b)(1) of the Bankruptcy Code provides that a plan “may designate a class or classes of unsecured claims, as provided in section 1122 of this title.” However, that designation may lead to unfair discrimination between the classes of claims so designated.¹⁴ Unless the chapter 13 debtor can show that discriminatory treatment between similarly situated creditors is necessary for the debtor to successfully complete his/her chapter 13 plan, a separate classification of student loans and other general unsecured claims is seldom permitted.¹⁵

In many cases, however, a maintenance payment on the student loan debt has very little impact on creditors of the same class. For debtors with a large student loan balance, adding the balance of the debt to the unsecured pool to be paid might actually have a more negative impact on the amount to be repaid to all unsecured creditors. The calculation often favors a small separate maintenance payment on the student loan, rather than inclusion in the class for receipt of *pro rata* distributions, thereby driving down the dividend to general unsecured creditors.

Public Service Loan Forgiveness and Income-Based Repayment

Although it is difficult to discharge or repay loans in bankruptcy, a federal student loan borrower may nevertheless qualify for a “fresh start” — all of their federal loans forgiven — under the Public Service Loan Forgiveness (PSLF) program.¹⁶ This is the closest a borrower can get to a fresh start because loans forgiven under PSLF are not considered income for tax purposes.¹⁷ In order to qualify, federal loans must be *federal* direct student loans.¹⁸ However, if a borrower has nondirect federal loans, he/she may be able to consolidate the nondirect loans into direct loans.¹⁹ The borrower must then make 120 payments toward their student loans, which would be 10 years’ worth of payments.²⁰ While making these payments, the borrower must be employed by a public service organization,²¹ which includes government entities and nonprofit organizations.²²

12 *Pennsylvania Higher Educ. Assistance Agency v. Faish (In re Faish)*, 72 F.3d 298, 299-300 and n.1 (3d Cir. 1995).

13 Jonathan L. Marsh, “Bankruptcy Law-Discharging Student Loans under 11 U.S.C. § 523(a)(8)(b): Find Some Dependents, Make a Few Payments and Disconnect the Cable Television (A Discussion of *Pennsylvania Higher Education Assistance Agency v. Faish*),” 41 *Vill. L. Rev.* 1087, 1135 (1996) (citing *Brunner*, 46 B.R. at 756).

14 11 U.S.C. § 1322(b)(1).

15 *Groves v. LaBarge (In re Groves)*, 39 F.3d 212, 215 (8th Cir. 1994).

16 “Public Service Loan Forgiveness Program,” Federal Student Aid Website at 1 (December 2015), available at studentaid.ed.gov/sa/sites/default/files/public-service-loan-forgiveness.pdf.

17 “Public Service Loan Forgiveness: Questions and Answers for Federal Student Loan Borrowers,” Federal Student Aid Website at 2 (December 2015), available at studentaid.ed.gov/sa/sites/default/files/public-service-loan-forgiveness-common-questions.pdf.

18 Public Service Loan Forgiveness Program, *supra* n.16, at 1.

19 *Id.* at 1-2.

20 *Id.* at 2.

21 *Id.*

22 *Id.*

There are several different income-based repayment plans, each of which caps the amount that a student loan borrower has to repay to the federal government at a fixed rate based on the borrower’s discretionary income.²³ Furthermore, these plans drive up the borrower’s standard repayment plan from 10 years to 20 or 25 years.²⁴ Different programs include the following: Income-Based Repayment (IBR), Pay-As-You-Earn (PAYE), Revised Pay-As-You-Earn (REPAYE) and Income-Contingent Repayment.²⁵

Under the IBR plan and depending on when the borrower first started taking out the loans, the loan repayment will either be capped at 10 or 15 percent of the borrower’s discretionary income.²⁶ However, the qualifying borrower must suffer from a partial financial hardship, meaning that his/her monthly payments on the standard 10-year plan could not be under the amount that IBR caps their income.²⁷ Finally, after a 20- or 25-year term of repaying loans, any remaining debt is forgiven — even if the borrower is working for a private for-profit company.²⁸ Unfortunately, all the additional debt forgiven is taxable income, so forgiveness under this option can create a substantial tax burden.²⁹

The PAYE program caps a borrower’s payment at 10 percent of their discretionary income and extends the term to 20 years,³⁰ after which the debt is forgiven in a similar way to the IBR program.³¹ A small number of borrowers will qualify for this program:³²

In order to qualify for PAYE, [a borrower] need[s] to have borrowed [their] first federal student loan after October 1, 2007, and [they] need to have borrowed a Direct Loan or a Direct Consolidation Loan after October 1, 2011. [They] also need to demonstrate partial financial hardship.³³

For borrowers who do not qualify for PAYE, there is REPAYE. Like PAYE, REPAYE caps the amount that a borrower owes at 10 percent of their discretionary monthly income.³⁴ Also, “REPAYE will forgive remaining debt after 20 years for those who borrowed only for undergraduate study and 25 years for those who borrowed for graduate study.”³⁵ REPAYE was implemented to increase the number of people who could qualify to have their monthly payments reduced.³⁶ Under this program, anyone with federal direct loans can have their monthly debt payments reduced to 10 percent of their discretionary income.³⁷ Borrowers should note that there are subtle

23 Brianna McGurran and Teddy Nykiel, “Find the Best Student Loan Repayment Plan for You,” Nerdwallet (April 8, 2016), available at nerdwallet.com/blog/loans/student-loans/student-loan-repayment-plans.

24 *Id.* However, if a borrower qualifies for PSLF, then the loans will be forgiven after the 10 years of payments that were made while working for a public-service entity.

25 *Id.*

26 See “Income-Driven Repayment Plans for Federal Student Loans,” Federal Student Aid Website 1 (February 2016), available at studentaid.ed.gov/sa/sites/default/files/income-driven-repayment.pdf (indicating that new borrowers after July 2014 would have amount capped at 10 percent of their monthly income).

27 Brianna McGurran, “Income-Based Repayment: How It Works and Whom It’s Best For,” Nerdwallet (March 8, 2016), available at nerdwallet.com/blog/loans/student-loans/what-is-income-based-repayment.

28 *Id.*

29 “Taxability of Student Loan Forgiveness,” FinAid, available at finaid.org/loans/forgivenessstaxability.phtml.

30 McGurran and Nykiel, *supra* n.23.

31 *Id.*

32 *Id.*

33 “What Is Pay As You Earn (PAYE)? How Do I Know if I Qualify?,” Consumer Financial Protection Bureau, available at consumerfinance.gov/askcftp/1555/what-pay-you-earn-pay-how-do-i-know-if-i-qualify.html.

34 Announcement of New REPAYE Plan, Federal Student Aid, available at studentaid.ed.gov/sa/about/announcements/repaye.

35 *Id.*

36 *Id.*

37 Brianna McGurran, “5 Facts About REPAYE, the New Student Loan Repayment Plan,” Nerdwallet (Dec. 17, 2015), available at nerdwallet.com/blog/loans/student-loans/repaye-student-loan-repayment-plan.

differences between these two programs. For example, REPAYE considers a person's spousal income in determining where to cap payments, while PAYE only considers the borrower's income.³⁸

PSLF is the most broadly applicable form of forgiveness, but debtors' attorneys should keep in mind that there are other programs available for specific fields, such as teaching.³⁹ In addition, Perkins Loans — a form of federal student loans — may also qualify for loan forgiveness, but the criteria for determining who qualifies is much more stringent than PSLF. Borrowers apply for this program through their school or their school's student loan servicer rather than the borrower's own loan servicer.⁴⁰ Lastly, many law schools have programs in place that help their public service alumni pay off student loans with monthly payments, known as loan assistance repayment programs (LRAPs).⁴¹

Debtors should apply for one of the repayment plans before or as they enter bankruptcy, and a reasonable monthly repayment amount should be continued while the debtor completes a chapter 13 plan. Maintaining a forgiveness repayment program during bankruptcy effectuates a true fresh start, as well as balances the policy objectives of the bankruptcy system and expressed governmental interest in maintaining a viable student loan program. It is advisable to have the student loan repayment made through the trustee to ensure that the payment is kept current and to ensure complete accounting records.

The U.S. Bankruptcy Court for the Middle District of North Carolina has signaled that student loan debt should be paid during the course of a chapter 13 plan, subject to certain parameters to ensure fairness to the student loan creditor and other unsecured creditors.⁴² For example, a debtor should apply for and enroll in an income-driven repayment plan. The bankruptcy plan should not provide for the discharge of any portion of the student loan debt and should avoid unfair discrimination in favor of the student loan creditor (*i.e.*, a disproportionate advantage to the student loan creditor). The debtor must also notify the trustee of any changes in repayment of the student loan or any default under the repayment plan. The court's approval of such a chapter 13 plan ensures transparency while allowing a debtor to participate in a favorable repayment program.

Other Proposals for Chapter 13 Plans

Debtors, creditors and trustees should consider creative solutions for maintaining student loan repayment during a plan. For below-median debtors, a proposal to extend the plan term beyond the required 36-month repayment period in order to maintain student loan debt should be viewed favorably.

If student loan debt is to be paid along with general, unsecured claims on a *pro rata* basis, the plan should provide for commencement of distributions early in the plan (if possible), along with secured and priority claims, so that the interest accrual is minimized. Until Congress acts to amend

³⁸ McGurran and Nykiel, *supra* n.23.

³⁹ In certain situations, you can have your federal student loan forgiven, canceled or discharged.

See Federal Student Aid Website, available at studentaid.ed.gov/sa/repay-loans/forgiveness-cancellation#perkins.

⁴⁰ *Id.*

⁴¹ List of Law School LRAPs, Equal Justice Works (2016), available at equaljusticeworks.org/resources/student-debt-relief/law-school-lrap/list-law-school-lrap.

⁴² *In re Buchanan (Order Confirming Chapter 13 Plan)*, Case No. B-14-51161 (Bankr. M.D.N.C. June 12, 2015).

the bankruptcy laws to balance the competing interests of good faith and equal treatment in bankruptcy and a policy to promote repayment of student loan debt, the bankruptcy community should review options to allow maintenance of the debt repayment that does not greatly impact other similarly situated creditors. **abi**

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SO ORDERED.

SIGNED this 23rd day of December, 2015.

Dale L. Somers

Dale L. Somers
United States Bankruptcy Judge

**Opinion Designated for Electronic Use, But Not for Print Publication
IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

In re:

ELISA SALAZAR,

DEBTOR.

**CASE NO. 15-21309-13
CHAPTER 13**

**OPINION DENYING CONFIRMATION OF THE DEBTOR'S CHAPTER 13
PLAN BECAUSE IT UNFAIRLY DISCRIMINATES IN FAVOR OF
HER STUDENT LOAN CREDITOR**

In this case, the Court must determine whether the Debtor's proposed Chapter 13 plan can be confirmed. The plan places the Debtor's unsecured student loan creditors in a special class that will receive distributions while her other unsecured creditors will receive nothing. The Debtor appears by counsel David A. Reed. Chapter 13 Trustee William H. Griffin objects to the plan, and he appears by counsel Karie L. Fahrenholz.

The Court has reviewed the relevant materials and is now ready to rule.

This case concerns a rather strange intersection in Chapter 13 practice. Congress has been sufficiently concerned about student loan debts to make them usually not dischargeable in Chapter 13, but not concerned enough to give them payment priority over other unsecured debts. Because interest on nondischargeable debts continues to accrue while a debtor is performing under a Chapter 13 plan but cannot be paid unless the debtor is paying all the unsecured claims in full, a debtor with student loan debts runs a very real risk of paying into a plan for three to five years only to find that she finishes her plan owing more on those debts than she did when she filed for bankruptcy. In this case, the Debtor hopes to reduce that risk by creating one class for student loan creditor and another class for all her other unsecured creditors, and directing to the student loan class alone all the money she pays into her plan that would otherwise be divided pro rata among all her unsecured creditors. Whether she can do that depends on whether the Court can find that her proposal does not discriminate unfairly against her non-student-loan unsecured creditors.

Facts

The Debtor filed her Chapter 13 bankruptcy petition on June 20, 2015. She reported owing no secured debts and no unsecured priority debts. She listed a total of \$31,394.78 in general unsecured debts, including two student loan debts totaling \$6,119 that she owes to the same creditor. The deadline for non-governmental creditors to file proof of their claims was October 13, 2015, but governmental creditors have until

December 21, 2015, to file theirs. By October 13, the Debtor's student loan creditor had filed a claim for \$6,136.66, and four other claims (all unsecured) were filed, one for \$3,845.07, one for \$99.34, one for \$881.19, and one for \$22.03. The sum of the non-student-loan debts is \$4,847.63, and the sum of all the filed claims is \$10,984.29. The Court notes that none of the creditors the Debtor listed appear to be governmental units, except perhaps the student loan creditor. The Debtor reports that she owns no real property and the personal property she owns is worth \$3,728. She claims exemptions for \$3,606 worth of that personal property.

The Debtor reported that she is single, has no dependents, and has gross income of \$2,891 per month from her work as a machine operator. As shown on the Official Form 22C-1 she filed, her average monthly income during the 6 full months before she filed bankruptcy (her "Current Monthly Income") was also \$2,891, making her annualized Current Monthly Income for the year before she filed \$34,692. At the time she filed, the applicable median family income for a household of one in her home state, Kansas, was \$45,980. Since the Debtor is a below-median-income debtor, her disposable income is not controlled by the Chapter 7 means test as incorporated by § 1325(b)(3).

Along with her bankruptcy petition, the Debtor filed a proposed Chapter 13 plan. In it, she reported that she is a below-median debtor and her Applicable Commitment Period under the Bankruptcy Code is three years. She proposed that she would pay \$185 per month into her plan for 36 months, providing a total of \$6,660. The plan provided for distributions to pay the Debtor's attorney fee of \$3,000, the Chapter 13 filing fee of \$310,

and the Chapter 13 Trustee's fee of 5.25%, or \$349.65 (a total of \$3,659.65). Since she listed no secured or unsecured priority creditors, the Debtor expected \$3,000.35 to be available for paying her unsecured creditors. But the Debtor did not propose to have that money distributed pro rata among all her unsecured creditors. Instead, she wanted to place her student loan creditor in a special class and have all the \$3,000.35 distributed to it. The Trustee objected to this part of the Debtor's plan, contending it was not a permissible proposal, so the plan could not be confirmed.

In their briefs, the parties have asserted certain additional facts, mainly about the Debtor's past and present circumstances, that they contend should affect the Court's analysis here. According to the Trustee, assuming the Debtor makes all her payments timely and she incurs no additional attorney fees, her attorney's fees will not be paid until 17 months into her plan, and the first distribution to her student loan creditor will therefore not be made until the month after that. The Trustee added that the Debtor previously filed a Chapter 13 case in February 2007 and received a discharge, so she was eligible to receive a Chapter 7 discharge when she filed her current case.¹ The Trustee also asserted that during 2015, the Debtor's attorney had filed five Chapter 7 cases by the end of September and had charged a fee of \$1,200 in each, as opposed to the \$3,000 fee he is charging in this case. In Chapter 7 then, the Trustee concludes, the Debtor would have paid \$1,200 in attorney fees plus a filing fee, and her case would likely have been

¹See § 727(a)(9) (debtor not eligible for Chapter 7 discharge in case filed within six years of commencement of Chapter 13 case in which debtor received discharge).

completed in 90 to 120 days. Immediately after filing under Chapter 7, the Debtor could have devoted the same monthly amount she proposed to pay into her plan to paying the student loan creditor alone, and that creditor could therefore have begun to receive payments almost immediately and could be paid in full in approximately 36 months. Under the Debtor's Chapter 13 plan, by contrast, the creditor must wait for 18 months to receive its first distribution and would ultimately receive only a 48% dividend, while interest would continue to accrue, and possibly fees and late charges. Finally, the Trustee pointed out that the Debtor's student loans totaled over \$10,000 in her prior case but had been reduced by approximately 40% by the time she filed this case.

In response, the Debtor does not dispute any of the Trustee's asserted facts, but contends other facts show Chapter 13 was an appropriate choice for her bankruptcy filing. She noted that fifty-nine days before she filed bankruptcy, she refinanced a loan with a creditor her attorney suspected might file a § 523 or § 727 complaint if she filed a Chapter 7 case. Her attorney suggested his effective hourly rate of compensation typically turns out to be lower for a \$3,000 flat-fee Chapter 13 than it does for a \$1,200 flat-fee Chapter 7 case. The Debtor's choice of Chapter 13 was also influenced by the fact she experiences recurring medical expenses she is unable to pay for in full, so she is likely to need bankruptcy again in the future, probably sooner than the eight-year delay that must pass between Chapter 7 discharges. A successful Chapter 13 now, rather than a Chapter 7, will also leave Chapter 7 available to her sooner if she should suffer a catastrophic reversal of fortune in the future. The Debtor said the reduction in her student

loan debts since her prior case occurred because her son (who had been the primary beneficiary of at least one of the loans) made some payments on them, and she acted as the caretaker for her son's son during 2014 and became entitled to large tax refunds that were taken by government intercepts and applied to the debts. Now, though, her grandson has resumed living with her son, and her son has stopped making payments on her student loans, so the principal is not likely to be further reduced anytime soon. The Chapter 13 automatic stay will protect her from the student loan creditor's collection efforts for the duration of her case. The Debtor added that being in Chapter 13 will provide a structure that improves her chances of sticking to her tight budget. The Debtor pointed out how difficult it would have been for her to come up with the money to pay a Chapter 7 attorney fee because she has no savings, no anticipated tax refunds, and no help from her family, and *Lamie v. United States Trustee*, 540 U.S. 526 (2004), requires the fee to be paid in full before filing bankruptcy.

Discussion

As the proponent of her plan, the Debtor has the burden to prove the plan may be confirmed. Because the Trustee objected, the plan may not be confirmed unless “the plan provides that all of the debtor’s projected disposable income to be received in the applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.”² Under

²§ 1325(b)(1)(B)

§ 1325(b)(2), “disposable income” means “current monthly income received by the debtor less amounts reasonably necessary to be expended — (A)(i) for the maintenance or support of the debtor.” The Debtor’s Current Monthly Income during the six months before she filed bankruptcy was the same as her actual monthly income as of the date she filed, so her Current Monthly Income minus her reasonably necessary expenses is no different than her actual income minus those expenses. Because her Current Monthly Income is less than the median income for a one-person household in Kansas, her reasonably necessary expenses are not explicitly specified by the Chapter 7 means test. While some debtors (usually above-median-income debtors) turn out to have actual discretionary income that exceeds the “disposable income” the Code declares them to have, the Debtor in this case does not.

Section 1322 of the Bankruptcy Code specifies various provisions that a Chapter 13 plan may contain. Subsection (b)(1) allows a plan to designate one or more classes of unsecured claims, but says the plan “may not discriminate unfairly against any class so designated.” The Code contains no express guidance about what makes discrimination “unfair,” and bankruptcy courts have broad discretion to determine whether proposed discrimination is permissible.³ The Debtor contends it is not unfair for her plan to pay her student loan creditor all the money that is available for her unsecured creditors, but the Trustee contends it is unfair.

³*In re Knowles*, 501 B.R. 409, 415 (Bankr. D. Kan. 2013).

Courts have adopted two main tests for determining whether proposed discrimination in a Chapter 13 plan is unfair. One test, adopted by the Eighth Circuit in *Leser* and by the Ninth Circuit Bankruptcy Appellate Panel in *Wolff*, asks:

(1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination.⁴

This test was roundly criticized by the First Circuit Bankruptcy Appellate Panel in *Bentley*, where the court said (among other things), “[I]nsofar as the test relies upon abstract, undefined notions of ‘reasonableness,’ ‘legitimacy,’ and ‘good faith,’ it fails to direct a court’s analysis and instead creates a vacuum that the court itself must fill.”⁵ This Court must agree that the test does not appear to supply any firm guidance for determining when discrimination proposed by a Chapter 13 plan crosses the line between fairness and unfairness.

In a case that dealt specifically with a debtor-couples’ effort to pay more through their Chapter 13 plan to their student loan creditors than to their other unsecured creditors, the *Bentley* court adopted the second main test for determining whether a plan discriminates unfairly. This test is not quite as simple to summarize as the *Leser-Wolff* test is.⁶ Another bankruptcy judge in this District, Judge Karlin, explained the test this

⁴*Mickelson v. Leser (In re Leser)*, 939 F.2d 669, 672 (8th Cir. 1991); *AMFAC Distribution Corp. v. Wolff (In re Wolff)*, 22 B.R. 510, 512 (9th Cir. BAP 1982).

⁵*Inre Bentley*, 266 B.R. 229, 238 (1st Cir. 2001).

⁶*In re Bentley*, 266 B.R. 229 (1st Cir. 2001).

way:

[*Bentley*] directed courts to look to “the principles and structure of Chapter 13 itself” for “the baseline against which to evaluate discriminatory provisions for fairness.” Specifically, the *Bentley* court looked at (1) equality of distribution; (2) nonpriority of student loans; (3) mandatory versus optional contributions (a comparison of what the dischargeable unsecured creditors would receive in a pro rata distribution of the mandatory contribution under chapter 13); and (4) the debtor’s fresh start. Under this analysis:

When a plan prescribes different treatment for two classes but, despite the differences, offers to each class benefits and burdens that are equivalent to those it would receive at the [statutory] baseline, then the discrimination is fair. On the other hand, when the discrimination alters the allocation of benefits and burdens to the detriment of one class, the discrimination is unfair and prohibited.⁷

In 2003, in *Mason*, Chief Judge Nugent considered these tests and concluded the *Bentley* test was the better one.⁸ More recently, in *Stull*, he determined that even after the passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which made significant changes to Chapter 13, the *Bentley* test remained the one that best reflected the aims of the Bankruptcy Code.⁹ In *Stull*, the debtor had what Judge Nugent called “discretionary income” in addition to the “projected disposable income” the Code required him to pay into his plan, and the debtor proposed to use that discretionary income to pay his student loan debt in full while paying his other unsecured creditors only

⁷*In re Knowles*, 501 B.R. 409, 415-16 (Bankr. D. Kan. 2013) (Karlin, J.) (*quoting Bentley*, 266 B.R. at 240).

⁸300 B.R. 379, 387 (Bankr. D. Kan. 2003).

⁹489 B.R. 217, 220-21 (Bankr. D. Kan. 2013).

about one-half of their claims.¹⁰ It appears the debtor's discretionary income came about because his actual expenses were not as high as those specified in the means test that applies to above-median debtors, although the opinion did not make that completely clear. Judge Nugent noted that a below-median debtor can only have discretionary income if his or her actual monthly income is greater than the historical Current Monthly Income the Code normally requires courts to use to determine a Chapter 13 debtor's projected disposable income.¹¹ The discrimination was not unfair because the debtor was paying his non-student-loan creditors all of his projected disposable income, as required by the Code, and paying more to his student loan creditor only out of additional income he had.¹²

In *Knowles*, Judge Karlin similarly concluded the *Bentley* test, rather than the *Leser-Wolff* test, more accurately reflected the statutory scheme established by Chapter 13 and the spirit of the Bankruptcy Code.¹³ Like *Stull*, *Knowles* involved above-median debtors who proposed to discriminate in favor of their student loan creditors by making direct payments from discretionary income the Bankruptcy Code did not require them to pay into their plan.¹⁴ Because student loans are nondischargeable and making direct

¹⁰*Id.* at 218-23.

¹¹*Id.* at 222, n. 24. An above-median Chapter 13 debtor can also have discretionary income because his or her actual monthly income exceeds his or her historical Current Monthly Income.

¹²The debtor's plan could not be confirmed, however, because it violated § 1322(b)(10) by proposing to pay interest on the student loan debt even though the other unsecured claims were not to be paid in full.

¹³501 B.R. at 415-17.

¹⁴*Id.* at 413-14.

payments to them would reduce the chances the debtors would owe more on them after completing their plan than they did when they filed bankruptcy, and the debtors were paying the student loan creditors only from money they were not required to pay into their plan, Judge Karlin ruled the discrimination the plan called for in favor of the student loan creditors was not unfair.¹⁵ However, she ruled the debtors could not pay more on a claim to reimburse a state agency for an overpayment of unemployment compensation benefits because that claim was not entitled to priority status, it was not nondischargeable, and the debtors presented no evidence to show they needed to pay the claim in full to further their fresh start.¹⁶

Under the circumstances of this case, the Court concludes the Debtor's plan unfairly discriminates against her non-student-loan creditors and therefore cannot be confirmed. Unlike the debtors in *Stull* and *Knowles*, the Debtor has no discretionary income but only the projected disposable income that § 1325(b)(1)(B) requires her to pay into her plan. The Debtor's plan fails each step of the *Bentley* test. It does not honor the Code's requirement of equality of distribution among her unsecured creditors. She does not suggest her student loans are entitled to priority under § 507(a), or that equitable subordination should be applied to her other unsecured claims under § 510(c). Her student loans are most likely excepted from discharge, but that fact does not mean they have priority over her other unsecured claims and nothing else in the Bankruptcy Code

¹⁵*Id.* at 418-21.

¹⁶*Id.* at 422.

justifies treating them more favorably than those other claims. The Debtor proposes to pay her student loans out of her projected disposable income, the money that § 1325(b)(1)(B) fixes as the minimum she must devote to a plan before the plan can be confirmed, and she has not suggested she has any additional income beyond her projected disposable income that she can voluntarily pay on her student loans. Although the Debtor's potential fresh start would be improved if she were allowed to direct all the unsecured creditors' share of her projected disposable income to her student loan creditor alone, a Chapter 13 fresh start does not guarantee that a debtor will emerge from Chapter 13 free from all debts, but only from those that are not entitled to priority and are not excepted from discharge.

The Debtor concedes her plan does not satisfy the Code's principle of equality of distribution among unsecured creditors of equal priority, but suggests this is okay because her student loans comprise the majority of the claims, almost 56% by the Court's calculation. She cites *In re Jackson*,¹⁷ saying the student loan percentage here "is close to the same percentage" involved there. But as the student loans there were nearly 90% of the unsecured debts and the debtor was going to pay them as long-term debts under § 1322(b)(5), the case is distinguishable from the one before this Court. The Debtor also concedes her student loans are not entitled to priority under § 507(a). With regard to mandatory versus optional contributions, the Debtor suggests *Bentley* requires comparing

¹⁷2006 Bankr. LEXIS 4327 at *4-12 (Bankr. N.D. Ga. 2006).

what her plan would give her non-student-loan creditors to what they would receive in a Chapter 7 liquidation. This is wrong. *Bentley* directs the Court to consider what the unsecured creditors would receive if the Debtor's mandatory contributions to her Chapter 13 plan were distributed pro rata among all of them, not what they would receive in a Chapter 7 liquidation. A plan like the Debtor's will probably always fail this part of the test because the plan tries to impose a distribution scheme for the mandatory contributions that is different than the scheme imposed by the Bankruptcy Code. It tries to rearrange the priorities Congress established in Chapter 13, and that is simply not permissible. The Debtor argues that her proposed discrimination is not unfair because without it, she will owe a larger student loan debt when she completes her plan than she did when she filed bankruptcy. While it is true that the requirement for the Debtor's other nonpriority unsecured creditors to share pro rata with her student loan creditor in any distributions that may be available from the contributions Chapter 13 requires her to make to her plan will leave her owing a larger student loan debt if she completes her plan than she would owe if her proposal were accepted, this is a consequence of Congress's clear decision to make student loans nondischargeable, but to not make them priority claims. Finally, the Debtor argues it is bad policy not to permit the discrimination she proposes in her plan. While the Court feels sympathy for the points she makes, this is an argument that must be directed to Congress, which makes the laws, and not to a bankruptcy court, which can only interpret and enforce the law as Congress has made it.

Conclusion

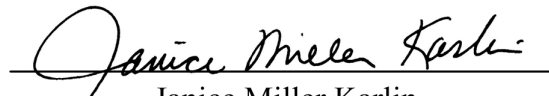
For these reasons, the Court concludes that the discrimination proposed by the Debtor's plan is unfair, and that her plan therefore cannot be confirmed. The Court appreciates the effort the Debtor's attorney made here to cleanly present and forcefully argue the question whether a debtor in this Debtor's predicament can deal with the nondischargeable student loan problem in the manner proposed. Unfortunately, the Court is convinced that Congress has barred the relief the Debtor seeks. The Debtor is hereby given twenty-eight days to file an amended plan that removes the unfair discrimination, or to ask to have her case dismissed or converted to Chapter 7.

###

SO ORDERED.

SIGNED this 4th day of November, 2013.




Janice Miller Karlin
United States Bankruptcy Judge

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

In re:

**Daniel Lee Knowles
Tiffany Ann Knowles,**

**Case No. 13-40602
Chapter 13**

Debtors.

**Memorandum Opinion and Order Overruling in Part and Sustaining in
Part the Trustee's Objection to Plan Confirmation**

Debtors seek confirmation of a Chapter 13 plan¹ that treats debts owed to two unsecured creditors—a student loan creditor and the Kansas Department of Labor (KDOL)—dramatically more favorably than the debts they owe to their many other general unsecured creditors. Debtors' plan also calls for them to retain and fully pay for a third, non-exempt vehicle for their two-person household, while also paying for the two vehicles they elected to exempt. The chapter 13 trustee (the Trustee) objects to all of these proposals.

¹ Doc. 2.

The Court overrules in part and sustains in part the Trustee's objection to plan confirmation. The Code, since being amended in 2005, only prohibits above-median income debtors from voluntarily paying nondischargeable student loan debt using discretionary income outside of a plan when all projected disposable income, as defined by the Code, is paid into a plan when *unfair* discrimination results from such treatment. The treatment of the student loan creditor in this case does not create unfair discrimination under 11 U.S.C. § 1322(b)(1) if Debtors are not accelerating the repayment of the student loan. Debtors' treatment of the KDOL claim, however, does unfairly discriminate against similarly situated creditors, and the Trustee's objection to this part of the plan is therefore sustained. The Trustee's objection to Debtors' planned retention of a third vehicle is also sustained, as Debtors did not carry their burden to show that this plan provision was filed in good faith under 11 U.S.C. § 1325(a)(3).

Because of these rulings, Debtors' plan cannot be confirmed. Debtors must file an amended plan consistent with this decision within 21 days of the entry of this Memorandum Opinion if they wish to remain in a Chapter 13 proceeding.

I. Factual and Procedural History

The parties stipulate to the following facts,² which are supplemented by record

² Doc. 28 (Stipulations of Fact). On July 24, 2013, I set a deadline for the parties to stipulate to all facts they could stipulate to by August 14 (rejecting Debtors' counsel's preferred procedure that required the Trustee to file a summary judgment motion). On August 14, the Trustee filed a Motion to Extend the deadline to file stipulations (Doc. 27), noting that while the Trustee had tried, in good faith, to meet the August 14 deadline by sending proposed stipulations to Debtors' counsel 6 days earlier, and soliciting similar stipulations from him, Debtors' counsel had refused to stipulate to the Trustee's facts or to

evidence. Debtors filed this Chapter 13 bankruptcy in May 2013 and scheduled a total of \$65,075 in unsecured claims, \$40,598 in secured claims, and \$268 in priority unsecured claims. While Debtors' plan will pay no dividend to general unsecured creditors, it will pay for three vehicles, with the Trustee's discount rate of interest, as follows:

- Creditor Capital One – collateral 2010 Nissan, with debt of \$11,100 and value of \$11,000, proposing to pay the full debt at \$208.20 a month;
- Creditor Chase Auto – collateral 2006 Ford F-150, with debt of \$15,698 and value of \$10,866, proposing to pay the full debt at \$294.45 a month because Chase Auto is a “910” creditor; and
- Creditor HD Credit – collateral 2011 motorcycle, with debt of \$13,800 and value of \$11,375, proposing to pay full debt at \$258.85 a month because HD Credit is a “910” creditor.

The plan also provides full payment of the anticipated \$4,793 KDOL claim as a special class.³ Debtors' schedules list student loan debt owed to Direct Loan Servicing System

offer any of his own. Counsel's main basis for refusing to stipulate, originally, was that most of the facts the Trustee sought to stipulate could be found if I simply combed through the pleadings on file for the information. I conducted a status conference on August 15, 2013, and confirmed that while Debtors' counsel still disagreed with my order to stipulate to the relevant facts (and if the parties disputed any material facts, we'd have an evidentiary hearing solely on the limited disputed facts), he did not actually dispute any of the Trustee's offered facts, and did not need any additional facts of his own. As a result, Debtors' counsel ultimately agreed to sign the Stipulation of Facts that the Trustee had originally presented to him. This is fairly summarized in an Order I signed on August 16, 2013 (Doc. 29, noting “The parties have indicated agreement to the facts circulated.”). At no time since (other than to present additional evidence about retention of the third, non-exempt vehicle, as the parties agreed) have Debtors indicated a desire to present additional evidence.

³ Although KDOL has not yet filed a claim (the government bar date doesn't expire until November 13, 2013), this opinion will refer to its “claim” as opposed to its “debt” for consistency.

for \$33,975 and to U.S. Department of Education for \$1028.⁴ The plan provides to pay those student loans pro rata with other general unsecured creditors, but Debtors do not expect that any portion of the payments they promise to make to the Trustee will ever reach any unsecured creditor except for KDOL.

Debtors' plan payment is \$980 per month. Debtors are above-median income and thus their applicable commitment period is 60 months.⁵ Debtors' budget reflects \$1051.25 in monthly net income, although Mr. Knowles admitted at trial that his Schedule J overstates his true motorcycle insurance costs by close to \$100 each month.⁶ Debtors' monthly expenses include, but are not limited to: \$300 for transportation (not including car payments); \$250 for auto insurance; \$56.56 for motorcycle insurance; \$75 for auto tags and taxes; and \$500 for "student loan repayments to Fed Loan, UNL." Over the life of Debtors' plan, they will thus spend \$18,000 for transportation (not including the note payments, which total approximately \$42,000), \$15,000 for auto insurance, \$3393.60 for motorcycle insurance, \$4500 for auto tags and taxes, and \$30,000 for student loan debt repayment.

The Trustee generally objects to confirmation of Debtors' plan on the basis that

⁴ Of these two student loan creditors, only the U.S. Department of Education has filed a claim, for \$35,058.61 (Claim number 13).

⁵ See 11 U.S.C. § 1325(b)(4) (requiring payments of projected disposable income for not less than five years if the current monthly income of the debtors is above the median family income for that state).

⁶ At the time of filing, Debtors were paying \$150/mo for motorcycle insurance. They have since switched insurers and now pay \$56.56/month, but have not amended their Schedule J to reflect this savings.

it does not comply with 11 U.S.C. § 1322(b)(1) because the plan unfairly discriminates against classes within the plan. The Trustee then stated three bases for his objection to confirmation: (1) Debtors' direct payment of \$500 per month for student loan debt results in unfair discrimination against other unsecured creditors; (2) there is no legal basis for separate classification of the KDOL claim as a special class; and (3) Debtors are unnecessarily retaining the 2011 motorcycle when they are already paying to retain two other vehicles.⁷ Debtors' response, filed by their retained counsel, contains only one sentence: "COME NOW debtors and object to the motion to dismiss and show that the Trustee is dead wrong in the position he has taken and debtors will soon show same."⁸

I have fully considered the parties' briefs, the Stipulation of Facts, and the evidence received at trial on the issue of the motorcycle retention.⁹ As a preliminary

⁷ Doc. 18.

⁸ Doc. 21. This response is wholly unacceptable. It does not provide the Trustee or me with a single factual or legal basis for Debtors' position, and, in fact, does all parties a disservice by delaying the proceedings. The response shows a lack of preparation and indicates that there was no inquiry into, or true analysis of, the factual and legal elements of the issues by Debtors' counsel. Furthermore, Debtors' counsel's refusal to enter into good faith stipulations of fact by the August 14 deadline, until I had to intervene and conduct a hearing, is similarly unprofessional and cannot be tolerated. Counsel for Debtors is warned to not file any similar pleadings in this Court, or to again refuse to cooperate when ordered to provide a Court with reasonable stipulated facts, without risk of a referral to the Kansas Board for Discipline of Attorneys for violations of the Kansas Rules of Professional Conduct. Counsel can (and must) be both professional and courteous while also protecting his clients' rights. *See* In the Matter of the Kansas Bar Association's Pillars of Professionalism Memorandum and Order, adopted by both the District and Bankruptcy Courts in this District on October 19, 2012.

⁹ Doc. 31 (Brief in Support of the Chapter 13 Trustee's Objection to Confirmation); Doc. 32 (Debtors' Response); Doc. 33 (Chapter 13 Trustee's Reply Brief).

matter, I find this Court has jurisdiction to decide this matter,¹⁰ as it is a core proceeding.¹¹

II. Analysis

Debtors, as the proponents of the plan, bear the burden of proof to show that their plan is confirmable.¹²

A. Unfair Discrimination — Payment of Student Loans and the Kansas Department of Labor as Special Classes

Section 1322(b)(1) of Title 11 permits a chapter 13 plan to “designate a class or classes of unsecured claims;” the plan, however, “may not discriminate unfairly against any class so designated.” Generally stated, § 1322(b)(1) permits the designation of separate classes of unsecured claims and different treatment of the separate classes, as long as the classification does not cause “unfair” discrimination.¹³ The Court has

¹⁰ This Court has jurisdiction pursuant to 28 U.S.C. § 157(a) and 11 U.S.C. § 1334(a) and (b) and by operation of a Standing Order dated August 1, 1984, effective July 10, 1984, referenced in D. Kan. Rule 83.8.5, wherein the District Court for the District of Kansas referred all cases and proceedings in, under, or related to Title 11 to the Districts’ bankruptcy judges.

¹¹ See 28 U.S.C. § 157(b)(2)(A) and (L) (stating that “matters concerning the administration of the estate” and the “confirmation of plans” are core proceedings that a bankruptcy judge has jurisdiction to hear and determine).

¹² See *Alexander v. Hardeman (In re Alexander)*, 363 B.R. 917, 921–22 (10th Cir. BAP 2007) (generally assigning burden of proof for confirmation to plan proponent).

¹³ Although not clear, Debtors may be arguing that § 1322(b)(1) does not apply to their preferred treatment of the student loan creditors via direct payment, because the plan itself does not directly classify the student loan creditor separately. I find that the direct payment to the student loan creditor outside of Debtors’ plan is the equivalent of a separate classification for purposes of § 1322(b)(1). See, e.g., *In re Sharp*, 415 B.R. 803, 807 (Bankr. D. Colo. 2009) (stating that “classifications are not always explicit” and that “[c]ourts have recognized that a payment to a creditor ‘outside the plan’ can amount to an implicit classification, even though not specifically referenced in the plan”); *In re Renteria*, Case No.

wide discretion in determining whether proposed discrimination is unfair discrimination.¹⁴

The Bankruptcy Code does not define when a plan classification causes unfair discrimination, and courts have struggled to define the limits of unfair discrimination under § 1322(b)(1). The D.C. Circuit, the first Circuit to address unfair discrimination under § 1322(b)(1), simply stated:

[A]n inquiry into fairness plainly involves more than the rationality of the debtor's classifications or some minimum amount creditors must receive. What constitutes fair discrimination will vary from case to case, and we cannot offer a generally applicable definition. The court must examine the amounts proposed for each class in light of the debtor's reasons for classification, and exercise sound discretion.¹⁵

Other appellate courts, however, have attempted to offer a “generally applicable definition” through the use of multi-factor tests.

For example, the First Circuit BAP, in *Bentley v. Boyajian (In re Bentley)*,¹⁶ directed courts to look to “the principles and structure of Chapter 13 itself” for “the baseline against which to evaluate discriminatory provisions for fairness.”¹⁷

11-25510 MER, 2012 WL 1439104, at *1 (Bankr. D. Colo. Apr. 26, 2012) (stating that “payment to . . . a student loan creditor, ‘outside the plan,’ *i.e.*, as a recurring expense not covered by the plan provisions or paid through the Chapter 13 trustee, can constitute an implicit classification”).

¹⁴ *Labib-Kiyarash v. McDonald (In re Labib-Kiyarash)*, 271 B.R. 189, 196 (9th Cir. BAP 2001).

¹⁵ *Barnes v. Whelan (In re Barnes)*, 689 F.2d 193, 201–02 (D.C. Cir. 1982).

¹⁶ 266 B.R. 229 (1st Cir. BAP 2001).

¹⁷ *Id.* at 240.

Specifically, the *Bentley* court looked at (1) equality of distribution; (2) nonpriority of student loans; (3) mandatory versus optional contributions (a comparison of what the dischargeable unsecured creditors would receive in a pro rata distribution of the mandatory contribution under chapter 13); and (4) the debtor's fresh start.¹⁸ Under this analysis:

When a plan prescribes different treatment for two classes but, despite the differences, offers to each class benefits and burdens that are equivalent to those it would receive at the [statutory] baseline, then the discrimination is fair. On the other hand, when the discrimination alters the allocation of benefits and burdens to the detriment of one class, the discrimination is unfair and prohibited.¹⁹

The Seventh Circuit also appears to favor the *Bentley* approach. In *In re Crawford*,²⁰ the Seventh Circuit cited the *Bentley* opinion and then stated:

[T]his is one of those areas of the law in which it is not possible to do better than to instruct the first-line decision maker, the bankruptcy judge, to seek a result that is reasonable in light of the purposes of the relevant law, which in this case is Chapter 13 of the Bankruptcy Code; and to uphold his determination unless it is unreasonable (an abuse of discretion).²¹

The Eighth Circuit and Ninth Circuit BAP use a different four-part test, referred to as the *Leser/Wolff* test,²² to determine whether separate classification results in

¹⁸ *Id.* at 240–42.

¹⁹ *Id.* at 240.

²⁰ 324 F.3d 539 (7th Cir. 2003).

²¹ *Id.* at 542.

²² *Mickelson v. Leser (In re Leser)*, 939 F.2d 669 (8th Cir. 1991); *AMFAC Distribution Corp. v. Wolff (In re Wolff)*, 22 B.R. 510 (9th Cir. BAP 1982).

unfair discrimination. Under this test, the court is directed to ask: “(1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination.”²³

The Tenth Circuit has not considered this issue,²⁴ and bankruptcy courts in this Circuit have used both the *Bentley* test²⁵ and the *Leser/Wolff* test.²⁶ Although it seems that the *Leser/Wolff* test may be followed by a majority of courts,²⁷ this Court believes that the *Bentley* test more accurately reflects the statutory scheme established by

²³ *In re Leser*, 939 F.2d at 672; *In re Wolff*, 22 B.R. at 512. More recent cases from the Eighth and Ninth Circuit BAP applying the *Leser/Wolff* tests are *Groves v. LaBarge (In re Groves)*, 39 F.3d 212 (8th Cir. 1994); *Copeland v. Fink (In re Copeland)*, 483 B.R. 534 (8th Cir. BAP 2012); *In re Labib-Kiyarash*, 271 B.R. at 194–96.

²⁴ Even if the Tenth Circuit had specified the use of a particular test, the existing multi-factor tests are not without criticism. Some courts have noted that the multi-factor tests that have been developed to define unfair discrimination are not entirely satisfactory because they are essentially totality of circumstances tests, “running the risk of being depicted as an ad hoc, potentially purely subjective determination.” *See, e.g., In re Sharp*, 415 B.R. 803, 807–08 (Bankr. D. Colo. 2009) (discussing criticism of tests for determining unfair discrimination). And as noted by one commentator, “numerous authorities have suggested that the multi-factor tests boil down to nothing more than a test of reasonableness.” Stephen L. Sepinuck, *Rethinking Unfair Discrimination in Chapter 13*, 74 Am. Bankr. L.J. 341, 360 n.113 (2000).

²⁵ *See, e.g., In re Stull*, 489 B.R. 217, 220 (Bankr. D. Kan. 2013) (applying *Bentley* test); *In re Mason*, 300 B.R. 379, 387 (Bankr. D. Kan. 2003) (concluding that the *Bentley* test “is most loyal to the objective goals and motivations of Chapter 13 and the Bankruptcy Code”).

²⁶ *See, e.g., In re Anderson*, 173 B.R. 226, 229 (Bankr. D. Colo. 1993) (applying four-part *Leser* test); *In re Perkins*, 55 B.R. 422, 425–26 (Bankr. D. Okla. 1985) (same).

²⁷ *See In re Towler*, 493 B.R. 239, 244 (Bankr. D. Colo. 2013) (calling the *Leser/Wolff* test the “most prominent” of the multi-factor tests for unfair discrimination under § 1322(b)(1)).

chapter 13 and the spirit of the Code. As a result, I will use it to help determine whether Debtors' plan results in unfair discrimination.

Here, Debtors have discriminated in favor of two unsecured creditors—a student loan creditor and the KDOL. With regard to the student loan creditor, Debtors propose pro rata distribution along with other unsecured creditors (which admittedly is predicted to result in the Trustee paying zero dollars to *any* unsecured creditor), plus an additional \$500 per month Debtors will pay directly to the student loan creditor out of the income not devoted to the plan payment. With regard to Creditor KDOL, Debtors propose a special class to fully pay the anticipated \$4,793 claim, which arose from overpayment of unemployment compensation to one of the Debtors.

The Trustee argues that Debtors' treatment of these creditors unfairly discriminates against other unsecured creditors, because the student loan creditor would be paid almost in full and the KDOL claim would be paid in full, while the remaining unsecured creditors would receive nothing. And while the Trustee acknowledges that Debtors' student loan debt is nondischargeable, he argues that this fact, alone, is insufficient to justify separate treatment. He argues that if payments were instead shared pro rata among all unsecured creditors, the dividend to all unsecured creditors would be 51% (rather than zero, as currently proposed). Finally, the Trustee argues that pro rata payment to the student loan creditor in addition to direct payment is doubly unfair because if pro rata distribution to unsecured creditors would occur, perhaps due to non-filing of claims, earlier payment of secured claims, an inheritance, or the like, the student loan creditor would receive dual favorable

treatment.

With regard to the treatment of the student loan creditor, Debtors respond that the superior treatment of the student loan creditor is not unfair because that debt is nondischargeable. They argue that paying nearly all of the debt during the plan would enhance their ability to obtain a fresh start after they exit bankruptcy,²⁸ because if they are prevented from paying this debt for 60 months, they will face not only the \$35,000 presently owed, but five years of additional nondischargeable interest when they finally exit bankruptcy with their discharge.

With regard to the treatment of the KDOL claim, Debtors argue that Kansas law allows the Department of Labor to reduce future unemployment payments by the amount of a past overpayment under K.S.A. § 44-719(d)(1), and that, *if* Debtors are laid off and *if* they apply for unemployment in the future, future benefits *might* be denied based on the outstanding overpayment. They further argue that *if* this happened during the life of this plan, there *might* be insufficient income to make plan payments.

Using the *Bentley* court's test, I consider the following factors to aid in the

²⁸ The plan will result in approximately 85% of the student loan being paid in five years when many student loans are paid out over a much longer period of time. If the actual promissory note(s) for these loans called for payment, for example, of only \$300 per month, it might not be in good faith (or fair) to in essence pre-pay the student loan at the expense of other unsecured creditors. *See In re Freeman*, Case No. 06-10651-WHD, 2006 WL 6589023, at *2, n.1 (Bankr. N.D. Ga. Dec. 22, 2006) (curing and maintaining student loan debt does not unfairly discriminate; however, payment on an accelerated basis may constitute unfair discrimination); *see also In re Brown*, __ B.R. __, 2013 WL 4806392, at *11 (Bankr. S.D. Ga. 2013) (noting that the bankruptcy court would continue to approve plans that provide for regular monthly payments to a creditor equal to that required pre-petition under the loan documents, with the balance at the end of the five-year period to be excepted from discharge under § 1328(a)(1)). This precise objection is not before me with this plan, and no evidence was presented as to the amount of the contractually agreed payment.

determination whether Debtors' proposed treatment of these "preferred" creditors creates unfair discrimination: (1) equality of distribution; (2) nonpriority of student loans or the KDOL debt; (3) mandatory versus optional contributions (a comparison of what the unsecured creditors holding dischargeable claims would receive in a pro rata distribution of the mandatory contribution under chapter 13); and (4) the Debtors' fresh start.²⁹

Regarding the equality of distribution, the *Bentley* court noted that the Code's focus is to treat all equally situated creditors equally, unless specifically stated otherwise in the Bankruptcy Code. Debtors do not claim that the Code has accorded either "preferred" unsecured creditor priority status under 11 U.S.C. § 507(a).³⁰ As a result, these "preferred" unsecured creditors would normally share in pro rata distributions with the other approximately \$25,000 in unsecured claims, receiving 51% of their claims instead of 85-100%.³¹ Debtors must thus justify this widely differing treatment using some alternate argument.³²

Admittedly, student loan debts are nondischargeable, but, as stated in *Bentley*,

²⁹ *In re Bentley*, 266 B.R. at 240–42.

³⁰ I note that while the plan expressly states they have no priority creditors, Debtors have since stipulated that their schedules showed \$268 in priority claims. I can also take judicial notice that the IRS has filed a priority claim for \$1,383, and that Debtors have not objected to that claim.

³¹ Doc. 28, Stipulation No. 11.

³² *See Bentley*, 266 B.R. at 240 ("As a general rule, then, fairness in Chapter 13 requires equality of distribution among nonpriority unsecured creditors, and the burden on justification is on those who propose plans to the contrary.").

“nondischargeability is not, and does not entail, priority as to any distribution in or through bankruptcy; it merely permits the holder to continue to enforce the debt after bankruptcy. . . . Accordingly, as far as the Code is concerned, nothing in the nature of the claims at issue here warrants or justifies treating the student loans more favorably than the others.”³³ Chapter 13 expressly excepts many debts from discharge, and thus the Code does not necessarily contemplate that a debtor will emerge from Chapter 13 entirely free of all prepetition debt. The “choice here is not between a fresh start and no fresh start, but between fresh starts of different extent.”³⁴

That said, however, I agree with one commentator who has opined that the real reason educational loans are nondischargeable has little to do with the debtor at all; they are more likely nondischargeable because Congress wishes to protect the government’s fiscal health as a guarantor (or lender) of these loans, and because “if these debts were dischargeable, the availability of educational loans might drastically decline.”³⁵ So we cannot forget that Congress, while not according student loans priority status, most certainly gave them favored status.³⁶ This is important when

³³ *Id.* at 241; *see also Towler*, 493 B.R. at 246 n.5 (collecting cases stating that nondischargeability of debt is not a sufficient basis, by itself, to justify more favorable treatment of the debt).

³⁴ *Bentley*, 266 B.R. at 242 n.25.

³⁵ Sepinuck, *supra* note 24, at 382.

³⁶ *Id.* at 383. The Sepinuck article also makes the interesting point that Congress may have elected to not grant priority status to student loans since the Code requires priority claims to be paid in full during a three to five year plan, which many debtors could not afford to do. Priority treatment would actually foreclose many debtors from seeking Chapter 13 relief. *Id.* at 385–86.

trying to construe how Congress wished its “fair discrimination” language to be interpreted.

I also acknowledge that the nondischargeability rule effectively forbids student loan claimants from pursuing collection from a debtor’s post discharge earnings for upwards of 5 years. As a result, if the nondiscrimination rule does not allow favorable treatment of student loan claims during the life of the plan, those claimants may, in fact, be worse off than if the debtor had liquidated under Chapter 7, since they may not pursue collection for a long time. And the result for debtors is even worse—owing more on their student loans after completion of their plan than before filing for Chapter 13 relief because of accumulation of equally nondischargeable interest that will accrue.³⁷ Further, since it is clear that Congress intended for the means test to result in more debtors filing chapter 13 petitions rather than chapter 7 petitions, a decision that encourages a Chapter 7 filing (an outcome that could occur by denying Debtors the opportunity to maintain their student loan payment during the life of their mandatory 5-year plan) does not further the purposes or spirit of the Code.

Regarding distributions, Debtors show a negative projected disposable income on their B22C means test, so there is no projected disposable income to devote to

³⁷ *Id.* at 387-88; *In re Delbecq*, 368 B.R. 754, 759 (Bankr. S.D. Ind. 2007) (concluding that paying credit card debt instead of making student loan payments was not a reasonable alternative for a debtor as she would end up owing substantially more in nondischargeable student loans than she did upon the date of filing).

payment of unsecured creditors.³⁸ It is only Debtors' excess discretionary income that is devoted to the extra \$500 per month payment of student loans. As a result, this prong of the *Bentley* test—the comparison of what the unsecured creditors would receive in a pro rata distribution of the mandatory contribution—is satisfied: *Bentley* notes that, “after student loan claims have shared on a *pro rata* basis with other general unsecured claims in the distribution funded by the Chapter 13 plan,” the student loans may be “paid by debtors out of assets that they need not contribute to the plan.”³⁹ This is exactly what Debtors have proposed here—it is Debtors' discretionary income, above their Code-computed projected disposable income, that they are voluntarily contributing to payment of student loans.⁴⁰ As Judge Nugent noted in *In*

³⁸ Obviously, because below I herein deny confirmation of a plan that retains a third vehicle (as discussed below), the means test would now show at least an additional \$229.52 (the amount deducted for the motorcycle), thus showing a positive \$198 as monthly disposable income potentially payable to unsecured creditors. As Debtors admit in their brief, the Supreme Court's recent decision in *Ransom v. FIA Card Servs., N.A.*, ___ U.S. ___, 131 S. Ct. 716, 722 (2011) would not allow them to deduct the costs of the associated loan for a vehicle they cannot keep. Because this would be known with certainty at the time of plan confirmation, this decision is without prejudice to any objection the Trustee or other parties in interest might make if Debtors opt to amend their plan in lieu of dismissal.

³⁹ *Bentley*, 266 B.R. at 243.

⁴⁰ For the plan at issue here, the Trustee did not dispute Debtors' calculation of projected disposable income. For this reason, the Trustee's argument based on *Hamilton v. Lanning (In re Lanning)*, 560 U.S. 505, 130 S. Ct. 2464 (2010), is misplaced. The Supreme Court in *Lanning* held that “when a bankruptcy court calculates a debtor's projected disposable income, the court may account for changes in the debtor's income or expenses that are known or virtually certain at the time of confirmation.” *Id.* at 2478. The Trustee cites this case and then argues that the Supreme Court requires chapter 13 debtors to satisfy a forward-looking approach to income (rather than a mechanical approach), and that this somehow requires debtors to make equal payments to all similarly situated creditors. But the *Lanning* opinion does not reach this far—in fact, although the opinion gives lower courts permission to consider changes in income or expenses when computing projected disposable income, it says nothing about the treatment of discretionary income above that

re Stull, after assessment of the *Bentley* test in that case: “Because student loans are not accorded statutory priority, anything they receive over what they would take in a pro rata distribution without the discrimination, should come from assets not required to be contributed to the plan and thus not detract from the unsecured creditors’ take.”⁴¹

Application of this factor to the KDOL claim, however, is less clear. As a result of Debtors’ special treatment of this claim, other unsecured creditors essentially bear the burden of paying this similarly situated dischargeable debt, although the difference in pro rata distribution would be admittedly small. And while Debtors argue that they must separately classify this debt because they may need unemployment compensation in the future, and they presume that if they do not repay this claim in full they may be denied future benefits, there are no facts in evidence to support this argument. There is nothing in the Stipulation of Facts that provides evidence about the likelihood either Debtor might be laid off during the life of the plan, or, if they were, whether they could defer payment of other expenses until re-employment without the need for unemployment benefits. In addition, Debtors fail to acknowledge that the very statute upon which they rely for this argument—K.S.A. § 44-719(d)(1)—also allows the secretary of the agency to totally waive repayment under certain conditions, making the certainty they would face consequences for nonpayment even more speculative. Debtors are now currently gainfully employed, qualifying as above-median income

number, and certainly does not define unfair discrimination under § 1322(b)(1).

⁴¹ 489 B.R. 217, 220 (Bankr. D. Kan. 2013).

debtors. Accordingly, any potential future impact on Debtors' fresh start is pure speculation. For that reason, I have no evidence upon which I can find this discrimination is "fair."⁴²

Finally, under the *Bentley* test, I consider Debtors' fresh start. Admittedly, as the *Bentley* court notes, "affording debtors a fresh start is one of the fundamental purposes of Chapter 13 and of the Bankruptcy Code in general."⁴³ But the Code places many limitations on this fresh start, including its express exclusion of most student loans from discharge under § 523(a)(8). And fair distribution to creditors is equally an important goal of the Code as is a fresh start. The Code contemplates that student loans will remain after debtors receive their discharge. Debtors will presumably be better situated to repay those student loans, having received a discharge of all their other unsecured debt. Yet, as *Bentley* notes, nothing in the Code prevents debtors from facing this debt earlier, using their discretionary income to pay student loan debt throughout the life of the plan.

Based on the consideration of the *Bentley* factors, and a weighing of the burdens and benefits established by the Code as a baseline, this Court concludes that the direct payment to the student loan creditor of ongoing contractual payments does not constitute unfair discrimination under § 1322(b)(1). Although student loans are not

⁴² Unlike the student loan claim, where the Trustee has admitted its nondischargeability, there is no similar admission regarding the KDOL debt, and Debtors have not claimed the KDOL debt is nondischargeable.

⁴³ 266 B.R. at 242.

accorded priority by the Code, Debtors are contributing this excess amount to the student loan debt only from funds not required by the Code to be committed to the plan. As stated by *Bentley*, “[w]hen a plan prescribes different treatment for two classes but, despite the differences, offers to each class benefits and burdens that are equivalent to those it would receive at the baseline, then the discrimination is fair.”⁴⁴ If payment of \$500 per month to student loan creditors is what is required by Debtors’ contract, then the treatment of the student loan creditors in this case is no different than that contemplated by the Code, and Debtors do not unfairly discriminate by devoting their discretionary income to repayment of those loans.

For these reasons, the facts of this case are distinguishable from the case upon which the Trustee relies, *In re Kubeczko*.⁴⁵ The bankruptcy court in *Kubeczko* analyzed whether a below-median income debtor could pay monthly payments to student loan creditors as a long-term debt under § 1322(b)(5), thereby causing a significant decrease in plan payments to other unsecured creditors.⁴⁶ The *Kubeczko* court concluded that the proposed treatment resulted in unfair discrimination under § 1322(b)(1).⁴⁷ But the difference from the facts at hand is critical. The debtor in *Kubeczko* earned below median income and thus, pursuant to the Bankruptcy Code, had no disposable income. Here, Debtors are above-median, and propose to commit their *discretionary* income to

⁴⁴ *Id.* at 240.

⁴⁵ Case No. 12-13766 HRT, 2012 WL 2685115 (Bankr. D. Colo. July 6, 2012).

⁴⁶ *Id.* at *1–2.

⁴⁷ *Id.* at *5.

their student loan payments. Utilizing the baseline test, this is permissible, because the “principles and structure of chapter 13 itself” do not indicate the procedure is unfair.⁴⁸

For similar reasons, the Court rejects the Trustee’s argument that payment to the student loan creditor via both direct payment and pro rata through the plan is unfair. The Trustee contends that if pro rata distribution to unsecured creditors occurs under the plan, the student loan creditor will receive dual favorable treatment. But grouping of unsecured creditors for equal plan payment is exactly what the Code contemplates, and I cannot determine that equal distribution of any plan payments, as directly required by the Code, is unfair discrimination.⁴⁹ In this case,

“Debtors’ student loan and non-student loan creditors are receiving

⁴⁸ *Bentley*, 266 B.R. at 240. The Trustee argues that it is absurd for Congress to permit a more wealthy, above-median debtor to pay a student loan through the plan but then deny the same benefit to a below-median debtor. While I express no opinion on how this case would be decided if Debtors were below-median, I do note that the entire exercise of determining *unfair* discrimination (which is not permitted) versus discrimination (which is permitted) necessarily requires a weighing of factors. And although from where I sit the result of permitting wealthier debtors (who will presumably have more income after bankruptcy) to pay student loans during bankruptcy but to deny that same benefit to poorer debtors may not seem well-guided, Congress did not ask for my advice when it wrote the current version of the Code, and that current version appears to require this result. So while the result may be misguided, I cannot find the result is necessarily absurd. First, this interpretation does still allow some (wealthier) debtors a “fresher” start, a fresh start being a stated goal of the Code. Second, an interpretation that repays government-backed debt more quickly also furthers the government’s interest in replenishing the Treasury and potentially having more funds available to make more student loans.

⁴⁹ *See, e.g., In re Sharp*, 415 B.R. 803, 813 (Bankr. D. Colo. 2009) (citing *Bentley* and concluding that the debtors’ pro rata payment to student loan creditors in addition to a monthly discretionary payment to student loan creditors was not unfair discrimination because equal distribution of plan payments, by definition, did not discriminate). I also note that no party expects this double recovery to actual occur, because the plan anticipates no payments to the student loan creditors under the plan.

exactly what the Code requires Debtors to pay them—a pro rata payment of PDI [projected disposable income]. The fact that the student loan creditors are also receiving a discretionary payment from Debtors does not entitle the remaining unsecured creditors to additional moneys, nor ‘dis-entitle’ student loan creditors from receiving a pro rata payment.”⁵⁰

The Court finds that the treatment of the debt owed KDOL as a special class, however, is unfairly discriminatory. Debtors do not assert that the KDOL debt commands either priority status or that it is a nondischargeable debt. As a result, and in contrast to the analysis of the student loan debt, the proposed treatment of the KDOL debt does unfairly discriminate against similarly situated creditors. Debtors presented no evidence whatsoever on this issue, and thus failed to demonstrate it was more likely than not that failure to pay 100% of that debt would impair their fresh start. Accordingly, the Court finds that the proposed discrimination merely “alters the allocation of benefits and burdens to the detriment of one class,”⁵¹ and the discrimination is, therefore, unfair under § 1322(b)(1).

B. Good Faith — Retention of Third Vehicle

The Trustee also challenges Debtors’ plan to retain and pay for three vehicles through their plan. Debtors propose to retain and pay for a 2010 Nissan Sentra, a 2006 Ford F-150 pickup, and a 2011 Harley Davidson motorcycle. Debtors claimed the Nissan and Ford as exempt, and do not dispute that the Harley motorcycle is not exempt. Debtors’ plan will also pay more for both the Ford and the Harley motorcycle

⁵⁰ *Id.*

⁵¹ *Bentley*, 266 B.R. at 240.

than they are worth, because they were both purchased within 910 days of filing bankruptcy.⁵²

Section 1325(a)(3) requires that a chapter 13 plan be “proposed in good faith and not by any means forbidden by law.” Whether a plan has been proposed in good faith is a question of fact based on the totality of the circumstances.⁵³ In *Flygare v. Boulden*,⁵⁴ the Tenth Circuit expressed the following non-exclusive factors for determining a debtor’s good faith:

(1) the amount of the proposed payments and the amount of the debtor’s surplus; (2) the debtor’s employment history, ability to earn and likelihood of future increases in income; (3) the probable or expected duration of the plan; (4) the accuracy of the plan’s statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court; (5) the extent of preferential treatment between classes of creditors; (6) the extent to which secured claims are modified; (7) the type of debt sought to be discharged and whether any such debt is non-dischargeable in Chapter 7; (8) the existence of special circumstances such as inordinate medical expenses; (9) the frequency with which the debtor has sought relief under the Bankruptcy Reform Act; (10) the motivation and sincerity of the debtor in seeking Chapter 13 relief; and (11) the burden which the plan’s administration would place upon the trustee.⁵⁵

The continued viability of the *Flygare* factors for all cases, however, has been questioned by a subsequent Tenth Circuit case as a result of the 2005 amendments to

⁵² See Doc. 28, Stipulation No. 2 and 11 U.S.C. § 1325(a) (requiring full payment of vehicles purchased within 910 days of bankruptcy, with interest, in chapter 13 plans).

⁵³ *Robinson v. Tenantry (In re Robinson)*, 87 F.2d 665, 668 (10th Cir. 1993).

⁵⁴ 709 F.2d 1344 (10th Cir. 1993).

⁵⁵ *Id.* at 1347–48 (quoting *United States v. Estus (In re Estus)*, 695 F.2d 311, 316–17 (8th Cir. 1982)).

the Bankruptcy Code.

In *Anderson v. Cranmer (In re Cranmer)*,⁵⁶ the Tenth Circuit noted that the Bankruptcy Code has been amended since *Flygare* was decided to include § 1325(b), and that “[s]ection 1325(b)’s ‘ability to pay’ criteria subsumes most” of the *Flygare* factors such that the “good faith inquiry now has a more narrow focus.”⁵⁷ Regardless, the Tenth Circuit stated in *Cranmer* that bankruptcy courts still need to consider “factors such as whether the debtor has stated his debts and expenses accurately; whether he has made any fraudulent misrepresentation to mislead the bankruptcy court; or whether he has unfairly manipulated the Bankruptcy Code.”⁵⁸

The Trustee argues that Debtors’ retention of a third vehicle is unreasonable and unnecessary. He notes that by claiming two other functioning vehicles as exempt, Debtors have essentially admitted that it is the Nissan and Ford that they regularly use for transportation to and from work.⁵⁹ The Trustee contends, then, that retaining and paying for a third vehicle (the motorcycle) for a two-adult household must necessarily be a luxury expense, and that diverting income from unsecured creditors so they can retain a spare vehicle would create an absurd result. The Trustee argues that retention of the motorcycle, along with associated increased insurance, tax, and

⁵⁶ 697 F.3d 1314 (10th Cir. 2012).

⁵⁷ *Id.* at 1319 n.5 (internal quotations omitted).

⁵⁸ *Id.* (internal quotations omitted).

⁵⁹ See K.S.A. §60-2304(c) (granting exemption for “one means of conveyance regularly used for the transportation of the person or for transportation to and from the person’s regular place of work”).

maintenance costs, when Debtors propose no dividend to unsecured creditors, would hinder the spirit and purpose of the Code.

Debtors respond that retaining the motorcycle is not only necessary—because Mr. Knowles rides the motorcycle to work in warm weather—but financially wise, because if required to surrender the motorcycle, Debtors’ transportation expenses would actually *increase* due to higher costs associated with the Ford’s poor gas mileage. Debtors presented evidence that Mr. Knowles rides the Harley motorcycle to work about 32 weeks a year, from mid-March to late-September or October. Debtors live about 18 miles from Mr. Knowles’ job, and Mr. Knowles testified that he could make two weeks’ worth of trips to work on one tank of gas in the motorcycle, but it cost an additional \$60 a week for gas when he drives the truck to work. Mr. Knowles ultimately claimed that riding the motorcycle saves him about \$1920 a year in gas.⁶⁰

In reaching that conclusion, however, Mr. Knowles failed to consider the other costs associated with retaining this spare vehicle. Mr. Knowles testified that the motorcycle’s tags and taxes cost about \$200 a year, insurance (at \$56.56 per month) \$678.72 a year, and the annual note payment totaled \$3096 (at \$258 each month). The actual comparison is, therefore, a questionable \$1920 per year gas savings versus a certain \$3,974.72 per year expense of ownership of the motorcycle. And this does not

⁶⁰ This claimed savings did not compute. Mr. Knowles testified he rode the motorcycle to work approximately 32 weeks a year, and that round trip mileage was 180 per week. So over a year, to reach the claimed savings, he would need to drive the cycle to work 5,760 miles. He testified, however, that he purchased the cycle with 3,000 miles 13 months ago, and that it now has 6,000 miles. It is thus clear that he is not driving the cycle nearly as much as his “savings” claim, further buttressing my conclusion that not only is this a luxury item, but that the claimed gas savings are not as significant as claimed.

account for any additional maintenance costs (or new tires) that Debtors would likely encounter over a 60 month plan, so the difference is probably even greater.

Debtors' brief additionally contends that, regardless of whether retention of the motorcycle is necessary for their maintenance and support, as long as they comply with the Code's provisions for retention of secured debt, they have filed their plan in good faith, citing Judge Berger's decision in *In re Roberts*⁶¹ and contrasting it to Judge Nugent's decision in *In re Sandberg*.⁶² In *Sandberg*, the above-median debtors proposed a chapter 13 plan that paid unsecured creditors only a 2.3 per cent dividend, but proposed to retain and pay for a 36-foot boat.⁶³ Judge Nugent concluded that the boat was indisputably a luxury item, and that the debtors' motivation and sincerity with respect to rehabilitation through their chapter 13 plan weighed in favor of a finding that the plan was *not* proposed in good faith.⁶⁴ Judge Nugent concluded that it was fundamentally inappropriate to "discharge so much unsecured debt while still retaining and enjoying a luxury item" and that "[h]olding otherwise would defy the letter and spirit of chapter 13."⁶⁵

In *Roberts*, the above-median debtors proposed a chapter 13 plan that retained their expensive home (valued somewhere between \$530,000 and \$665,000) while

⁶¹ 493 B.R. 584 (Bankr. D. Kan. 2013).

⁶² 433 B.R. 837 (Bankr. D. Kan. 2010).

⁶³ *Id.* at 839–41.

⁶⁴ *Id.* at 844–45.

⁶⁵ *Id.* at 848.

paying nothing to general unsecured creditors.⁶⁶ In analyzing whether the debtors' plan was proposed in good faith, and citing the good faith factors cited by the Tenth Circuit in *Cranmer*, Judge Berger specifically found that the debtors' documents and schedules were accurate, and that there were no attempts to mislead the bankruptcy court.⁶⁷ More importantly, Judge Berger then noted:

Here, the Debtors have attempted to follow the Bankruptcy Code; they have *pared their expenses and share a single car*, they have amended their schedules to more accurately reflect their financial situation, and they ask to keep their house *in which they have lived for eight years*.⁶⁸

As a result of these findings of fact, Judge Berger found no unfair manipulation of the Bankruptcy Code, and concluded that the totality of the circumstances indicated that the debtors filed their chapter 13 plan in good faith in accordance with § 1325(a)(3).⁶⁹

In contrast, Mr. Knowles testified that his wife drives the Nissan to work, and that their work shifts do not allow them to ride together. He also testified, however, that he makes no attempt to utilize the far more fuel efficient/30 mpg Nissan for his work transportation on days Ms. Knowles does not work (which, most weeks, is four days, as she is a registered nurse most often working three 12-hour shifts). The facts also showed that both the Ford F150 and the Harley motorcycle were purchased within about 15 months of filing bankruptcy—the Ford F150 was purchased in February 2012,

⁶⁶ 493 B.R at 587.

⁶⁷ *Id.* at 594–95.

⁶⁸ *Id.* at 596 (emphasis added).

⁶⁹ *Id.*

the Harley motorcycle was purchased in August 2012, and Debtors filed their bankruptcy petition in May 2013. Further, the debt on the Harley—which Debtors propose to pay in full through the plan—is \$14,272.59, but the motorcycle is worth only \$11,375.

As a result of this evidence, I find the totality of the facts in this case are much more similar to those in *Sandberg* than to the facts in *Roberts*. First, by exempting the Nissan and the Ford F150, Debtors necessarily claim those were the two vehicles necessary for their transportation to work. For them to now fudge on which vehicle they actually use most places Mr. Knowles' testimony in conflict with their sworn schedules. Second, state law allows the exemption of one vehicle, not 1.5 each as they essentially want. Third, the Harley motorcycle is indisputably a luxury item. While they may save some money on gas when Mr. Knowles elects to ride it to work, they spend far more than they save when considering the overall costs of insurance, tags and taxes, maintenance and debt payments. Fourth, Debtors admit that they seek to retain this motorcycle even though retention will require them to pay \$3000 more than it is worth; this makes no financial sense. Fifth, unlike in *Roberts* where the debtors hoped to retain their one exempt homestead allowed under Kansas law, instead of two, these Debtors think they should be able to retain more than state law exemptions allow. Finally, the debtors in *Roberts* had pared expenses, contrary to the evidence here, where in spite of having incurred upwards of \$65,000 in unsecured debt, Debtors purchased not one, but two, vehicles within 15 months of bankruptcy (and the motorcycle less than 9 months before filing). There is simply no financially responsible

reason to retain an expensive Harley motorcycle under these facts other than simply because Debtors like to have it—and this is not enough, especially where Debtors propose *zero* dividend to their non-preferred unsecured creditors.

As stated by Judge Nugent in *Sandberg*, a “primary purpose of the good faith inquiry is to determine under the totality of the circumstances of a case whether there has been an abuse of the provisions, purpose, or spirit of Chapter 13.”⁷⁰ The Court finds here that permitting Debtors to retain and pay for their third vehicle, a Harley Davidson motorcycle, at the expense of any dividend to their unsecured creditors, is not in good faith, but would instead be an unfair manipulation of the Bankruptcy Code. Debtors have failed to carry their burden under § 1325(a)(3). Like Judge Nugent did in *Sandberg*, I question these Debtors’ motivation and sincerity with respect to rehabilitation through their chapter 13 plan, and find the plan was *not* proposed in good faith.⁷¹

III. Conclusion

The Trustee’s objection to confirmation is overruled in part and sustained in part, as indicated more fully herein. Because of these rulings, Debtors’ plan, as proposed, cannot be confirmed. Debtors must file an amended plan, tailored to reflect the rulings contained herein, within 21 days of the entry of this Memorandum Opinion, if they wish to remain in this Chapter 13 proceeding. Failure to do so will result in the

⁷⁰ 433 B.R. at 845.

⁷¹ *Id.* at 844–45.

dismissal of their case for undue delay prejudicial to creditors pursuant to 11 U.S.C.
1307(c)(1).

It is so ordered.

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Chronology of Student Loan Discharge	
Date	Event
1978	Under the Bankruptcy Code, all student loans were dischargeable in Chapter 7 five years after first due and always dischargeable in Chapter 13
May 1982	Bruner receives Masters degree in Social Work.
December 1982	Bruner files Chapter 7, seeking discharge of \$9,000 of student loans.
1987	<i>Bruner</i> decided.
1990	Crime Control Act of 1990 extended period for discharge in Chapter 7 from five to seven years, with dischargeability of all government student loan subject to the "undue hardship" standard in Chapter 13 also.
1991	Higher Education Act amended to permit administrative wage garnishment of 10% of income and intercept tax refunds for student loans.
1996	Debt Collection Improvement Act of 1996 amended to allow offset of Social Security benefits and 6-year statute of limitations for collection of student loans was repealed.
1998	Higher Education Amendments eliminated the waiting period, making dischargeability of all government student loan subject to the "undue hardship" standard.
2005	BAPCPA makes dischargeability of all private student loan subject to the "undue hardship" standard.
2006	Deficit Reduction Act of 2005 increase administrative wage garnishment from 10% to 15% of income.

11 U.S.C. § 524(m)(1):

Until 60 days after an agreement of the kind specified in subsection (c) is filed with the court (or such additional period as the court, after notice and a hearing and for cause, orders before the expiration of such period), **it shall be presumed that such agreement is an undue hardship on the debtor if the debtor's monthly income less the debtor's monthly expenses as shown on the debtor's completed and signed statement in support of such agreement required under subsection (k)(6)(A) is less than the scheduled payments on the reaffirmed debt.** This presumption shall be reviewed by the court. The presumption may be rebutted in writing by the debtor if the statement includes an explanation that identifies additional sources of funds to make the payments as agreed upon under the terms of such agreement. If the presumption is not rebutted to the satisfaction of the court, the court may disapprove such agreement. No agreement shall be disapproved without notice and a hearing to the debtor and creditor, and such hearing shall be concluded before the entry of the debtor's discharge.

United States Bankruptcy Appellate Panel
For the Eighth Circuit

No. 15-6009

In re: Kevin D. Jordahl, Jr.; Sarah J. Jordahl, formerly known as Sarah J. Davis

Debtors

Kevin D. Jordahl, Jr.; Sarah J. Jordahl

Debtors - Appellants

v.

Gregory A. Burrell

Trustee - Appellee

Appeal from United States Bankruptcy Court
for the District of Minnesota - Minneapolis

Submitted: October 9, 2015

Filed: November 2, 2015

Before SCHERMER, SALADINO and NAIL, Bankruptcy Judges.

SCHERMER, Bankruptcy Judge

The Debtors, Kevin D. Jordahl, Jr. and Sarah J. Jordahl (Debtors), appeal from the order of the bankruptcy court¹ confirming their amended Chapter 13 plan. We have jurisdiction over this appeal from the final order of the bankruptcy court. *See* 28 U.S.C. § 158(b). For the reasons set forth below, we affirm.

ISSUE

The issue in this appeal is whether a Chapter 13 debtor is permitted to pick and choose the subsections of 11 U.S.C. § 1322(b) with which he will comply to the exclusion of other subsections, or whether when the debtor's treatment under one subsection of § 1322(b) falls within the ambit of another subsection, the debtor must meet all standards of that other subsection. We hold that when a Chapter 13 debtor's treatment of a creditor under one subsection of § 1322(b) falls within the contours of another subsection of that statute, all standards of both subsections must be satisfied. Specifically, we examine whether the maintenance of regular payments for unsecured non-priority student loan debt by the Debtors in this case, while they paid substantially less to other unsecured non-priority debt, satisfied the requirements of Bankruptcy Code §§ 1322(b)(1) and (b)(10). We hold that those requirements were not met.

BACKGROUND

On September 30, 2013, the Debtors filed a petition for relief under Chapter 7 of Title 11 of the United States Code (Bankruptcy Code), and the Debtors' case was later converted to a case under Chapter 13.

The two Debtors had a total of three student loans, each of which had a final payment that would come due after the completion of the Debtors' Chapter 13 plan. The Debtors were current on their student loan payments at all relevant times.

¹ The Honorable Kathleen H. Sanberg, United States Bankruptcy Judge for the District of Minnesota.

Following the conversion of the Debtors' case to Chapter 13, the Debtors filed their Chapter 13 plan (Original Plan). The Original Plan bifurcated the Debtors' non-priority unsecured debt into student loan debt (which was non-dischargeable) and all other unsecured non-priority debt (which was dischargeable). Taking into account the calculations by the Debtor and Chapter 13 trustee, Gregory A. Burrell (Trustee), the bankruptcy court found that the proposed dividend to unsecured creditors would be between 6% and 11.5% under the Original Plan. The Original Plan provided that the Debtors would maintain their full student loan payments under Bankruptcy Code §1322(b)(5), making those payments directly to the lenders. The bankruptcy court found that the dividend to the Debtors' student loan creditors over the life of the plan was projected to be 52%.

The Trustee objected to confirmation of the Original Plan because the Debtors' proposed treatment of the student loans, while meeting the standards of § 1322(b)(5), failed to meet the requirements of Bankruptcy Code §§ 1322(b)(1) and (b)(10). In its opinion, the bankruptcy court denied confirmation of the Original Plan because the Debtors' separate classification of the student loan debt constituted unfair discrimination under Bankruptcy Code § 1322(b)(1). The court did not address the Trustee's arguments that the Original Plan failed to meet the requirements of Bankruptcy Code § 1322(b)(10) because the student loan debt payments included interest, while all other allowed claims were not paid in full.

Thereafter, the Debtors filed a first modified plan (Modified Plan), under which the Debtors proposed to maintain and make payment directly to the lender for one student loan (principal and interest), which the Debtors stated was a loan that was co-signed by a grandmother of one of the Debtors. The Debtors proposed to pay the remaining two student loans the same *pro rata* distribution that would be paid to other unsecured non-priority creditors. The Trustee objected to confirmation of the Modified Plan because it proposed payment of post-petition interest on non-dischargeable student loan debt, while the Debtors were not making full payment of

all allowed claims. The Debtors objected to confirmation of the Modified Plan because it did not provide for treatment of the three student loans as the Debtors had proposed in the Original Plan. The bankruptcy court denied confirmation of the Modified Plan.

The Debtors filed a second modified plan, which the Debtors did not pursue after the Trustee objected to it. The Debtors then filed their third modified plan (Final Plan). The Final Plan separately treats one student loan for which the payment of the principal amount (but not interest) of the loan is maintained. With respect to this loan, the Final Plan states “Codebtor is liable on claim. All amounts paid to this creditor during the plan term shall be applied only to principal and not to interest.” Under the Final Plan, the remaining student loans are to be paid *pro rata* with other unsecured non-priority claims. Against the Debtors’ objection, the Final Plan was confirmed. The Debtors timely appealed.

STANDARD OF REVIEW

We review findings of fact for clear error and conclusions of law *de novo*. *Venture Bank v. Lapidis*, 800 F.3d 442, 443 (8th Cir. 2015). Statutory interpretation is a legal question that we review *de novo*. *Hardy v. Fink*, 787 F.3d 1189, 1192 (8th Cir. 2015). The standard of review for whether a debtor’s classification discriminates unfairly is unclear. In *Groves v. LaBarge (In re Groves)*, 39 F.3d 212 (8th Cir. 1994), the Eighth Circuit “treated the issue of classification as ‘primarily one of statutory construction.’” *Copeland v. Fink (In re Copeland)*, 742 F.3d 811, 813 (8th Cir. 2014) (quoting *Groves*, 39 F.3d at 214). However, the *Groves* court stated that “application of the ‘discriminate unfairly’ standard in other cases may involve little more than exercise of the bankruptcy court's broad discretion.” *Id.* (quoting *Groves*, 39 F.3d at 214). Our conclusion is the same regardless of which standard is used.

DISCUSSION

The Debtors' appeal of the order confirming their Final Plan was proper. *See Bullard v. Blue Hills Bank*, 135 S.Ct. 1686 (2015) (order denying confirmation of Chapter 13 plan was not final for appeal when the debtor could propose an alternate plan); *Zahn v. Fink (In re Zahn)*, 526 F.3d 1140, 1141 (8th Cir. 2008) (Debtor had standing to appeal confirmation of her own plan). The Debtors seek reversal of confirmation of their Final Plan and approval of their Original Plan.²

A. 11 U.S.C. § 1322(b)

Bankruptcy Code § 1322(b) sets forth eleven subsections pertaining to a Chapter 13 plan. It provides, in pertinent part, that:

(b) . . . the plan may –

(1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims;

. . .

(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;

. . .

(10) provide for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are nondischargeable under section 1328(a), except that such interest may

² In their brief, the Debtors request that we “reverse the bankruptcy court’s confirmation of the debtors [*sic*] third modified plan and remand the case so that the debtors may propose a plan substantially similar to their original plan for confirmation.”

be paid only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims;

11 U.S.C. §§ 1322(b)(1), (b)(5) and (b)(10). Section 1122(a) states that “a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class.” 11 U.S.C. §1122(a).

The Debtors argue that the word “may” in § 1322(b) signifies that they are permitted to choose one subsection of the statute (§ 1322(b)(5)) for treatment of their student loan debt, to the exclusion of all other subsections. The Trustee submits that the subsections of § 1322(b) are not eleven independent choices; instead, they set forth eleven standards that must be met in a Chapter 13 plan.

We agree with neither the Debtors nor the Trustee. Instead, we hold that when a Chapter 13 Debtor’s treatment of a creditor under one subsection of § 1322(b) falls within the contours of another subsection of that statute, all standards of both subsections must be satisfied. This is clear from the face of § 1322(b) and a common sense reading of the statute. To allow a debtor to comply with the requirements of only one of the eleven subsections of § 1322(b) when the facts of his case fall within another subsection of the statute would be nonsensical. Congress chose to set forth all eleven subsections. A debtor cannot ignore those that he does not like.

The Debtors cite to *dicta* in the Eighth Circuit’s *Groves* decision, which they believe supports their argument that they need only comply with § 1322(b)(5), to the exclusion of the other subsections of § 1322(b). 39 F.3d at 215. However, the sentence to which the Debtors cite, “[a]lternatively, the debtor may treat the student loan obligation as a long term indebtedness under § 1322(b)(5), curing arrearages within a reasonable time and thereafter maintaining regular payments,” is just that, *dicta*. *Id.* The interplay between § 1322(b)(5) and the other subsections of § 1322(b)

was not at issue in *Groves*, and the language cited by the Debtors does not impact our ruling.

The Trustee does not dispute the application of § 1322(b)(5) to the student loan debt, provided that the Debtors also comply with the requirements of §§ 1322(b)(1) and (b)(10). The Trustee argues that the Debtors failed to comply with the requirements of §§1322(b)(1) and (b)(10). We address each subsection in turn.

(1) 11 U.S.C. § 1322(b)(1)

Under §1322(b)(1), “[a] Chapter 13 debtor's plan of reorganization may place unsecured claims in separate classes ‘as long as the classification 1) complies with section 1122 of the Code and 2) does not result in unfair discrimination between the claims grouped separately.’” *Groves*, 39 F.3d at 214 (quoting *Mickelson v. Leser (In re Leser)*, 939 F.2d 669, 671 (8th Cir. 1991)); 11 U.S.C. § 1322(b)(1).

The Debtors believe that under their Original Plan, § 1322(b)(1) does not apply, because the Debtors did not create a separate class for the student loan debt under §1122. The Debtors argue that they instead elected to treat their student loan debt separately under § 1322(b)(5). However, § 1122(a) simply states that a claim must be substantially similar to the other claims in the same class. By paying the student loan debt directly, and not through the plan, the effect of what the Debtors did was to separately classify and treat the student loan debt. Therefore, § 1322(b)(1)³

³ Section 1322(b)(1) also states that the plan “may treat claims for a consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims.” 11 U.S.C. §1322(b)(1). The confirmed Final Plan separately classified and provided for the maintenance of payment of the principal (but not interest) of one student loan that was co-signed by a third party. The Trustee did not contested the payment of principal on the co-signed loan and no issue regarding such payment was raised in this appeal.

does apply and the Debtors must comply with the bar on unfair discrimination in that statute.

The Eighth Circuit has “adopted a four-part test for unfair discrimination” under § 1322(b)(1). *Copeland*, 742 F.3d at 813. Under the test, we examine:

(1) whether the discrimination has a reasonable basis; (2) whether the debtor can carry out a plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the basis or rationale for the discrimination.

Leser, 939 F.2d at 672 (citations omitted). The Debtors bear the burden of proving that the classification of the student loan debt does not discriminate unfairly. *Groves*, 39 F.3d 212, 214 (8th Cir. 1994).

The Debtors argue that we should not look to the Eighth Circuit’s four-part analysis for unfair discrimination because § 1322(b)(1)’s fairness requirement is satisfied as a matter of law by the statutory authority granted under § 1322(b)(5). *See In re Jordahl*, 516 B.R. 573, 576 (Bankr. D. Minn. 2014) (bankruptcy court noting a split of authority regarding “whether the classification of an unsecured debt under §1322(b)(5) is subject to the unfair discrimination test found in § 1322(b)(1),” and the majority view that treatment under § 1332(b)(5) must satisfy the unfair discrimination analysis.) We disagree with the Debtors. This argument by the Debtors is an end run around § 1322(b)(1) and is, in substance, the same as the argument that we already rejected; that each subsection of § 1322(b) operates independently. As we stated above, the requirements of all applicable subsections of § 1322(b) must be satisfied.

We agree with the bankruptcy court’s holding that the Debtors’ plan was unfairly discriminatory under the four-part test. The bankruptcy court stated that the

Debtors failed to establish that the discrimination was reasonable, the Debtors and the Trustee had agreed before that court that the Debtors could not satisfy the second part of the test, the Debtors satisfied the good faith requirement, and the last part of the test was inapplicable.

The only reason for the discrimination that the Debtors set forth in this appeal is the one that we just rejected; that Congress's authorization for debtors to make the student loan payment under § 1322(b)(5) renders such treatment fair under §1322(b)(1). In addition, special classification is not justified by the non-dischargeability of the debt standing alone, which appears to be the real reason for the Debtors' separate treatment of the student loan debt. *See Copeland*, 742 F.3d at 814 (citing *Groves*, 39 F.3d at 216). The Debtors make no argument in this appeal to support the last three parts of the four-part test. Moreover, without a basis for the discrimination, we do not examine the last part of the test; the relationship between the degree of discrimination and the rationale for such treatment. *Copeland*, 742 F.3d at 815 ("Having rejected the [Debtors'] proffered rationale for the discrimination, we see no need to consider whether the degree of discrimination is reasonably related to the rationale.").

(2) 11 U.S.C. § 1322(b)(10)

The facts of the Debtors' case also show that § 1322(b)(10) applies to and bars the Debtors' proposed treatment of their student loan debt. Section 1322(b)(10) provides that the payment of post-petition interest on a non-dischargeable unsecured claim is permitted only if the debtor's plan provides for full payment of all allowed claims. *See* 11 U.S.C. § 1322(b)(10). The Debtors admit that each maintenance payment that they seek make to their student loan lenders would include a component of post-petition interest. However, the Debtors did not provide for full payment of all allowed claims.


CONCLUSION

For the reasons stated, we affirm the decision of the bankruptcy court.



SO ORDERED.

SIGNED this 27th day of March, 2013.


Robert E. Nugent
United States Chief Bankruptcy Judge

PUBLISHED

**IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF KANSAS**

IN RE:)
)
QUINCY RAY STULL) **Case No. 12-11696**
) **Chapter 13**
)
 Debtor.)
_____)

ORDER DENYING CONFIRMATION OF CHAPTER 13 PLAN

Chapter 13 allows debtors to propose plans that discriminate between holders of unsecured claims so long as the discrimination is not “unfair.”¹ This means that for appropriate reasons, debtors may propose to pay one unsecured claim on more favorable terms than another. The Code expressly forbids the payment of interest on an unsecured nondischargeable claim unless all of the other

¹ 11 U.S.C. § 1322(b)(1). Unless otherwise indicated, all statutory references are to the Bankruptcy Code, as amended, Title 11 U.S.C. § 101 *et seq.*

allowed claims are paid in full.² Quincy Stull proposes to treat his nondischargeable student loan more favorably than his other unsecured creditors by paying it in full with interest over the plan's duration. While this proposed discrimination may be "fair," his proposal to pay interest on the student loan claim without paying the other unsecured creditors in full violates § 1322(b)(10) and cannot be approved. Accordingly, confirmation of his plan must be DENIED.³

Facts⁴

Quincy Stull filed this chapter 13 case on June 22, 2012. He is an above-median debtor. He proposed to pay the Trustee 60 payments of \$385 per month.⁵ His monthly disposable income as calculated on Form B22C, Line 59 is \$129.01.⁶ He owes \$3,722 to the U.S. Department of Education on a student loan that the parties agree would be excepted from his discharge under § 1328(a)(2) and § 523(a)(8). The parties stipulated that unsecured claims in the case, including the student loan claim, total \$20,861.⁷ Stull proposes that he will pay his projected disposable income

² § 1322(b)(10).

³ The chapter 13 trustee Laurie B. Williams appears by her staff attorney Karin N. Tollefson. The debtor appears by his counsel, David P. Eron.

⁴ The Trustee and the debtor stipulated to the facts that govern this decision and these findings, except as noted, are based on that stipulation. *See* Dkt. 25.

⁵ Dkt. 25-2 (Stipulation Ex. B)

⁶ This monthly amount multiplied by 60 equals an unsecured pot of \$7,740.60 as set forth in the debtor's plan, paragraph 1.c. The stipulations provide that non-student loan general unsecured creditors will receive \$8,440.90, a difference of some \$700 that is unexplained. The Court's calculations herein will utilize the stipulated \$8,440.90 figure.

⁷ Subtracting the amount of the secured claim filed in the case from the total amount of the claims shown on the Claims Register yields a remainder that is \$10 less than what the stipulation provides. This difference appears to be attributable to the varying amount of the student loan debt. The proof of claim shows a student loan debt of \$3,722 while the plan and Schedule F list the student loan debt at \$3,732. For purposes of the calculations in this opinion,

into the plan for the benefit of the unsecured creditors, but that the student loan claim will be paid separately from additional funds. The student loan will be paid in full, plus interest at 4.75 per cent.⁸ According to the stipulations, the non-student loan unsecured creditors will receive \$8,440 or a dividend of 40.462 percent if the debtor is permitted to separately pay the student loan as proposed.⁹ The stipulations do not reflect what the remaining terms of the two student loans are, nor is there any information in the record concerning the amount of the scheduled payments due on the loans. The absence of this information makes it unclear whether the plan treatment of the student loan debt is proposed under § 1322(b)(5) as a cure and maintenance of long term debt.

The stipulated dividend calculation seems to be incorrect. If the non-student loan creditors whose claims total \$17,139 (\$20,861 - \$3,722) receive \$8,440, their dividend will be 49.24 percent while the student loan creditor's dividend will be 100 percent plus interest. On the other hand, if the student loan creditor were to participate in the unsecured distribution, the total dividend would be 40.46 percent,¹⁰ yielding the non-student loan creditors \$6,934 and the student loan creditor

the Court accepts the figure of \$20,861 for total general unsecured claims and will utilize \$3,722 as the amount of the student loan debt.

⁸ The U.S. Department of Education's proof of claim in the amount of \$3,722.27 states that the contract rate on this claim is only 2.39%. *See* Claim No. 6-1 at Dkt. 25-3 (Stipulation Ex. C). Nothing in the briefs explains the difference between that and what the debtor proposes to pay.

⁹ The parties stipulate the admissibility of Exhibit D, the Trustee's "Plancalc" table showing what claimants may expect to receive on their claims. *See* Dkt. 25-4. (What is unclear here is that the Plancalc refers to the student loan claim being paid separately and the unsecured claims being paid based on a total amount of \$20,861 while the body of the stipulation (and the claims register) reflect that the whole unsecured pool, including the student loan, only totals \$20,861. For the purposes of this order, I will assume that \$20,861 represents all of the allowed unsecured claims including the student loan claim.

¹⁰ $\$8,440 \div \$20,861 = 40.46\%$.

\$1,506.¹¹ If the debtor were somehow prohibited from paying “discretionary” income toward the student loan, at discharge, he would still owe the U.S. Department of Education about \$2,216 plus accrued interest.¹² Thus, the effect of the proposed discriminatory treatment is to direct \$2,216 of the debtor’s disposable income toward a nondischargeable claim and to reduce the unsecured creditors’ dividend by about 9 percent.¹³

The Trustee argues that this treatment amounts to unfair discrimination that is barred by § 1322(b)(1) and § 1325(a)(1). She also notes that as the debtor is not paying his claims in full, the student loan claim should not receive interest under § 1322(b)(10). The debtor suggests that his interest in receiving a fresh start, combined with the fact that he is paying exactly what the Code requires him to pay the unsecured creditors, makes the discrimination permissible. His brief makes no mention of the § 1322(b)(10) problem.

Analysis

Unfair Discrimination under § 1322(b)(1).

The Trustee’s principal objection to the plan is that it unfairly discriminates among unsecured claims by paying the nondischargeable claim in full while paying the rest of the unsecured creditors pro rata. The debtor essentially argues that because he proposes to pay the unsecured creditors all that they are required to be repaid under the Bankruptcy Code – his projected disposable income – he should be permitted to pay the student loan in full. He suggests that the adoption of

¹¹ The non-student loan debt comprises 82.16% of total general unsecured claims (\$17,139 ÷ 20,861) and 82.16% of an \$8,440 distribution equals \$6,934. The student loan debt comprises 17.84% of the general unsecured claims (\$3,722 ÷ \$20,861) and 17.84% of the \$8,440 distribution equals \$1,506.

¹² \$3,722 - \$1,506 = \$2,216.

¹³ 49.24% - 40.46% = 8.78%

BAPCPA displaces the courts' prior formulations for determining whether unfair discrimination has occurred. The Trustee says that any dividend differential that favors a nondischargeable debt unfairly discriminates against the unsecured creditors and should be barred.

Before BAPCPA was enacted, many courts weighed in on whether discriminatory treatment favoring a nondischargeable student loan was fair and passed muster under § 1322(b)(1). As both parties note, "unfair discrimination" is not defined in the Code, leaving courts to divine or devise tests to determine whether the discriminatory treatment is indeed unfair. This Court visited that topic in 2003 in *In re Mason*.¹⁴ There I reviewed the different tests advanced by various courts and applied the "Baseline Test" found in *In re Bentley* as the one that best reflected the aims of the Code as it existed then.¹⁵ The baseline test assesses whether, despite the differences in treatment, the plan offers each class benefits and burdens that are equivalent to what it would receive at the baseline, the discrimination can be permitted.¹⁶ The baseline is defined by the treatment the creditors in the disadvantaged class would receive without the separate classification. This requires determining whether the plan honors the four Code-based principles of (i) equality of distribution; (ii) the non-priority of student loans; (iii) whether the contributions to those loans are mandatory or optional; and (iv) whether the debtor's interest in gaining a fresh start justifies the discrimination. Because student loans are not accorded statutory priority, anything they receive over what they would take in a pro rata distribution without the discrimination, should come from assets not required to be

¹⁴ 300 B.R. 379 (Bankr. D. Kan. 2003).

¹⁵ *Id.* at 384 (describing the baseline test) and 387 (finding the baseline test "most loyal to the objective goals and motivations of Chapter 13 and the Bankruptcy Code.")

¹⁶ *In re Bentley*, 266 B.R. 229, 240 (1st Cir. BAP 2001).

contributed to the plan and thus not detract from the unsecured creditors' take.¹⁷ Otherwise, the unsecured creditors would bear the burden of paying the nondischargeable claim.

Nothing in the enactment of BAPCPA renders the *Bentley* test obsolete. BAPCPA significantly altered the discretion that judges once wielded when determining whether a debtor was devoting his or her disposable income to a plan by defining what above-median debtors pay their unsecured creditors as their projected disposable income (PDI). Congress decreed that, for above-median debtors, PDI is determined by a mechanical test found in § 707(b)(2) and (3) and applied to chapter 13 by § 1325(b)(2) and (3). But the 2005 amendments did not displace the equal distribution concept, nor did they prioritize student loans. And by imposing mechanically-determined projected disposable income requirements on above-median debtors, § 1325(b) actually makes it easier to determine whether these debtors are committing disposable or discretionary income to their nondischargeable obligations by liquidating the amount of disposable income the debtors must pay to the unsecured creditors.

As it must, Stull's plan proposes committing all of his PDI to his unsecured creditors. The stipulated total amount proposed to be paid to the unsecured creditors is \$8,440, yielding the non-student loan creditors a dividend of 49 percent. But Stull generates more income than the disposable income calculation yields. So, using funds other than his PDI, Stull proposes to pay the \$3,722 student loan claim in full with interest, yielding a 100 percent dividend to that creditor. Because he is not using PDI, the non-student loan creditors will receive not a dime less than they would at the baseline while the student loan will be paid in full.

A summary comparison of the effect on unsecured creditors under the proposed plan

¹⁷ *Id.* at 243.

treatment and the treatment without separately classifying the student loan claim, is set forth below:

Proposed Plan Treatment:

Total student loan debt	\$3,722
Total non-student loan unsecured debt:	\$17,139
Proposed distribution to non-student loan unsecured debt:	\$8,440
% Dividend to non-student loan unsecured creditors	49.24%
% Dividend to student loan creditor (paid separately)	100.00%

Baseline Treatment Without Separate Classification:

Total student loan debt:	\$3,722
Total non-student loan unsecured debt	\$17,139
Total unsecured debt	\$20,861
Proposed distribution to total unsecured debt	\$8,440
% Dividend to unsecured creditors	40.46%

As this comparison demonstrates, the non-student loan unsecured creditors are better off under the proposed plan treatment than at the baseline.

Several courts have approved this outcome in above-median debtor cases. In *In re Sharp*, a case in the District of Colorado, several sets of debtors proposed to pay their student loans pro-rata with the other unsecured creditors and to make additional payments outside their plans from income other than the disposable income they had committed to the plan.¹⁸

That these Debtors have excess income for student loan payments is a function of the historical PDI calculation imposed by BAPCPA, rather than any attempt to evade the

¹⁸ 415 B.R. 803 (Bankr. D. Colo. 2009).

payment of their PDI.¹⁹

In *Sharp*, the Trustee did not complain about the extra-plan payment with discretionary income; rather the complaint concerned forcing the unsecured creditors to share the pro rata distribution with the student loan creditors. The court there held that the pro rata student loan payments were also permissible because the loans were unsecured claims that the debtor could pay under § 1322(b)(1) (allowing a class of unsecured claims to be designated) and long term debt payments that could be made under § 1322(b)(5) (allowing the cure of any default and maintaining of any payments on debts whose last payment will be due after the plan's final payment is due).²⁰

Another bankruptcy judge in the District of Colorado has held to the contrary, albeit on different facts. In *In re Kubeczko*, the below-median debtor proposed to pay current student loan monthly payments as payments on a long-term debt under § 1322(b)(5) while also paying the student loan creditor pro rata with the other unsecured creditors inside the plan.²¹ This debtor had no disposable income. Over the life of the 36-month plan, the student loan creditor would have received a 47% dividend while the other unsecured creditors would only get 0.27%. By comparison, paying the student loan creditor pro rata without discriminating against the unsecured creditors would yield everyone a dividend of 8.06%. The court concluded that even if a student loan is eligible to be treated as a long term debt under § 1322(b)(5), the treatment still has to pass muster under §

¹⁹ *Id.* at 812.

²⁰ *Id.* See also *In re Abaunza*, 452 B.R. 866 (Bankr. S.D. Fla. 2011) (what above median debtors are required to pay under means test is “essentially the pot” that unsecured creditors must receive; as long as they receive it, paying a non-dischargeable claim from funds not in the “pot” is permissible).

²¹ 2012 WL 2685115 (Bankr. D. Colo., July 6, 2012) (Tallman, C.J.).

1322(b)(1) – any discrimination among classes cannot be unfair.²² The hardship to the unsecured class as a whole must be balanced against the harm suffered by the debtor if the proposed treatment were disapproved. In *Kubezcko*, the dividend received by the student loan creditor was 47 times that received by the dischargeable creditors and therefore violated § 1322(b)(1) even though it complied with § 1322(b)(5).²³

In our case, the Trustee suggests that *Kubezcko* supports denying Stull the opportunity to pay his student loan from funds outside the pot. But because *Kubezcko* is a below-median debtor, his case is distinguishable. Because a below median debtor necessarily pays his unsecured creditors his disposable income based upon income and *actual* expenses rather than upon a projection derived from the means test, he may have no “discretionary” income.²⁴ Whatever he pays the student loan will necessarily diminish what he can pay the other unsecured creditors.

The proposed treatment also yields the unsecured creditors funds in excess of the baseline. If the student loans were paid pro rata with the other unsecured claims, all would receive a 40 percent. Under Stull’s proposed plan, the non-student loan creditors would receive a dividend of 49 percent. I hold on these facts that a similarly situated above-median debtor may separately classify

²² See also *In re Boscacny*, 442 B.R. 501 (Bankr. N.D. Miss. 2010) (analyzing three cases where debtor separately classified student loan debt under § 1322(b)(5)’s cure and maintenance of long term debt to determine whether they unfairly discriminated against general unsecured creditors in violation of § 1322(b)(1)).

²³ There is nothing in the record in the present case that indicates what the amount of the contractual payments on the student loan is, nor can I tell that the last payment will come due after the last plan payment. Section 1322(b)(5) may well not even apply here.

²⁴ Cf. § 1325(b)(2)(A)(i) versus § 1325(b)(3). Only to the extent that a below median income debtor’s current monthly income (CMI), a historical figure, differs from a debtor’s actual income on Schedule I would the possibility of discretionary income exist. But in *Kubezcko*, the below median debtor had no “discretionary income.”

and pay a non-dischargeable obligation from income he or she earns in excess of the projected disposable income that must be committed to the unsecured pot. If that were the extent of the treatment proposed for the student loan creditor here, it would be approved.

But it isn't. Stull also proposes to pay the Department of Education interest on its non-dischargeable claim. This § 1322(b)(10) clearly prohibits. Added by BAPCPA in 2005, that subsection provides that a plan may—

. . . provide for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are nondischargeable under section 1328(a), except that such interest may be paid *only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims;*²⁵

This language is plain: in the absence of “full payment of all allowed claims,” an unsecured non-dischargeable claim may not receive interest. In *Kubezcko*, the debtor proposed to pay interest on the student loan claims, arguing that paying interest was a necessary component of curing the default and maintaining the payments on this long-term debt.²⁶ The court there concluded that the later-enacted and very specific terms of (b)(10) trump the earlier and more general provisions of § 1322(b)(5).²⁷

²⁵ § 1322(b)(10). *See generally* Keith M. Lundin & William H. Brown, CHAPTER 13 BANKRUPTCY, 4TH EDITION, § 459.1, SEC. REV. July 26, 2007, www.Ch13online.com.

²⁶ Section 1322(b)(5), the long-term debt provision, permits a debtor to cure any default and maintain original contract payments on any unsecured or secured claim for which the final payment is due after the last plan payment is due.

²⁷ 2012 WL 2685115 at *6 (noting (b)(10)'s “severely limiting” effect of any treatment of a nondischargeable unsecured debt in a chapter 13 plan that involves the payment of interest on the debt). As a matter of statutory interpretation, where two provisions cannot be harmonized, the later enacted, more specific will control over the earlier, more general statute. *Id.*; *In re Edmonds*, 444 B.R. 898, 902 (Bankr. E.D. Wis.) (Stating that (b)(10) is “very clear in its wording.”).

In *In re Freeman*, one bankruptcy court concluded that § 1322(b)(5) and (b)(10) presented an irreconcilable conflict and led that court to conclude that (b)(5) was the more specific provision and controlled over the more general (b)(10).²⁸ But the court appears to reason that applying (b)(10) would render (b)(5) superfluous. It stated:

... the Court concludes that Congress intended to permit the cure and maintenance of long-term unsecured debts, notwithstanding the applicability of section 1322(b)(10). As noted above, prohibiting the payment of interest on nondischargeable debts would make the cure and maintenance of any long-term debt impermissible. Such a result could not have been intended by Congress.²⁹

While it is true that a long-term debt treated under (b)(5) is nondischargeable by virtue of § 1328(a)(1), only *unsecured* nondischargeable debt is subject to (b)(10).³⁰ And (b)(10) is not an outright proscription on payment of post-petition interest on an unsecured nondischargeable debt; payment of interest is *conditioned* upon paying all allowed claims in full. In short, the *Freeman* court's statement that (b)(10) "would make the cure and maintenance of any long-term debt impermissible," simply reads and applies (b)(10) beyond its plain language.³¹ I conclude that (b)(5) and (b)(10) are not irreconcilable and choose to enforce the plain language of (b)(10) where applicable.

²⁸ 2006 WL 6589023 at *2 (Bankr. N.D. Ga. 2006) (Congress intended to permit the cure and maintenance of long-term unsecured debts, notwithstanding § 1322(b)(10)). *See also, In re Webb*, 370 B.R. 418 (Bankr. N.D. Ga. 2007) (following *Freeman*, and concluding that § 1322(b)(5) controlled over less specific provision (b)(10); section 1322(b)(10) "is inapplicable" to proposed treatment of maintaining direct payments on long-term student loan debts).

²⁹ *Freeman* at *2. [Emphasis added]

³⁰ For example, § 1322(b)(10) would not be implicated in the situation where a debtor proposes to cure and maintain a secured home mortgage under § 1322(b)(5).

³¹ *See* Cameron M. Fee, *An Attempt at Post-Mortem Revival*, AM. BANKR. INST. J. (July 2012) questioning the reasoning of *Freeman*.

Stull makes no argument in support of paying interest here. The statute's "full payment" language seems incapable of another interpretation and is in accord with basic bankruptcy distribution principles. It is inequitable to allow a nondischargeable claim interest while refusing to pay the other creditors in full when, unlike the other unsecured creditors, the student loan claim holder will have the means of collection after the plan is complete. Because the Stull plan runs afoul of this provision, it cannot be confirmed.³²

In conclusion, while the plan does not unfairly discriminate by providing for this above median debtor to pay his student loan claim from funds he receives in excess of his projected disposable income, his added offer to pay interest on the student loan while only partially paying the other allowed claims cannot be permitted under § 1322(b)(10). Confirmation is DENIED; the debtor may submit an amended plan consistent with the provisions of this Order within 21 days of its entry.

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³² *In re Edmonds, supra* (payment of post-petition interest on student loan debt not permitted by § 1322(b)(10) when not all unsecured claims will be paid in full).