Consumer Bankruptcy Law Update

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These materials are not intended to be a comprehensive case law update but rather a highlight of some of the major themes/issues from the consumer bankruptcy case perspective. A comprehensive overview can be found at volo.abi.org.

After-Acquired Assets from National Settlements in Chapter 7 Cases

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11 U.S.C. §541 defines what constitutes "property of the bankruptcy estate." 11 U.S.C. §541(a)(7) includes as property of the estate "[a]ny interest in property that the *estate* acquires after the commencement of the case.[1] When a debtor receives or becomes eligible to receive settlement proceeds as the result of a national settlement (class action or otherwise) after a case has been filed (and in some cases even closed), the question becomes whether the settlement proceeds are property of the bankruptcy estate. Generally speaking, pre-petition causes of action belong to the bankruptcy estate and post-petition causes of action belong to the debtor.[2] The U.S. Supreme Court Case *Segal v. Rochelle*[3] established that the mere passage of time between the filing of the bankruptcy petition and the receipt of the asset is not enough to exclude the asset from the estate.[4] While *Segal* did not expand the definition of property of the estate to include legal or equitable interests acquired by the debtor after the filing of the case, it did clarify that where the asset is sufficiently rooted in the pre-bankruptcy past, it becomes property of the bankruptcy estate even if it is not realized until a later point in time.[5] Pursuant to the U.S. Supreme Court's holding in *Butner v. United States,* courts look to state law to determine whether a cause of action existed as of the petition date.[6] Recent developments in class actions and multi-district litigation have brought the issue of after-acquired assets and whether they are property of the bankruptcy estate once again to the forefront in consumer cases across the nation.

1 11 U.S.C. §541(a)(7) (*Emphasis added*).
2 *See e.g. Witko v. Menotte (In re Witko)*, 374 F.3d 1040 (11th Cir. 2004).
3 382 U.S. 375 (1966).
4 *Id.*
5 *See In re Ross, infra.*
6 *Butner v. United States* 440. U.S. 48 (1979).

The National Mortgage Settlement

The National Mortgage Settlement, a settlement agreement with the nation's five largest mortgage servicers, was announced by the U.S. Attorney General on February 9, 2012.[7] This settlement established a fund to provide payments to borrowers who lost their homes to foreclosure during a certain period of time.[8] The settlement specifically extends the relief available under its terms to eligible homeowners in bankruptcy.[9] In *Mackenzie v. Neidorf*[10], the Ninth Circuit Bankruptcy Appellate Panel ("9th Cir. BAP") examined the issue of whether the payment received by the debtor pursuant to the National Mortgage Settlement ("NMS") is property of the bankruptcy estate.[11] The facts in the case were undisputed[12]: The Chapter 7 debtor, at the time of filing the case, owned real property. The debtor duly scheduled her real property on Schedule A, claimed the homestead exemption on Schedule C, and showed that the property was encumbered by three liens on Schedule D including a first position deed of trust in favor of Countrywide Home Loans. Countrywide filed a motion for relief from the stay and stay relief was granted without objection from either the debtor or the trustee. Countrywide foreclosed on the property in 2009. Years later, the debtor received $31,250.00 pursuant to the NMS and disclosed receipt of this payment to the trustee. The trustee filed a motion for turnover contending that the $31,250.00 is property of the bankruptcy estate. The Bankruptcy Court denied the trustee's turnover motion and the trustee appealed.

The 9th Cir. BAP agreed with the Bankruptcy Court's decision and held that the payment the debtor received pursuant to the NMS is *not* an after-acquired interest of the estate.[13] 11 U.S.C. §541(a)(7) makes "property of the estate any interest that the estate (not the debtor) acquires after the

7 https://www.justice.gov/ust/national-mortgage-settlement
8 *Id.*
9 https://www.justice.gov/sites/default/files/ust/legacy/2012/04/24/341_One_Pager.pdf
10 *Mackenzie v. Neidorf (In re Neidorf),* 534 B.R. 369 (B.A.P. 9th Cir., 2015).
11 *Id.* at 371.
12 *Id.* (The facts of the case are outlined in full on page 371. Internal citations omitted.)
13 *Id.* at 372 (*Emphasis added*).

petition date."[14] The Court restated the ways after-acquired property becomes property of the bankruptcy estate as follows:

> [F]or the after-acquired interest to be considered property of the estate under §541(a)(7), the interest (1) must be created with or by property of the estate; (2) acquired in the estate's normal course of business; or (3) otherwise be traceable to or arise out of any prepetition interest included in the bankruptcy estate. The party seeking to include property in the estate bears the burden of showing that the item is property of the estate.[15]

The Court found that the payment received by the debtor pursuant to the NMS was "neither created with or by property of the estate nor [is it] traceable to or arose out of any pre-petition interest included in the bankruptcy estate."[16] Specifically, the Court found that the debtor's legal right to the NMS payment was grounded in events that occurred after the bankruptcy was filed.[17]

The District Court for the District of Idaho is considering a similar case at the moment in *In re Porrett*.[18] There, the Bankruptcy Court ruled in favor of the trustee on the issue of whether NMS funds are property of the bankruptcy estate.[19] The debtors appealed, and the Bankruptcy Court has granted a stay pending appeal pursuant to Federal Rule of Bankruptcy Procedure 8007(a).[20] It is notable that the Bankruptcy Court specifically references the *Neidorf* decision, indicating that while the Court believes it to be distinguishable, the debtors have raised a serious question of law, noting that "arguments exist to justify both possible outcomes."[21]

Other Class Action Settlements

As reported by Bloomberg, there exist upward of 45,000 claims against Johnson & Johnson by women who were injured as a result of the company's vaginal-mesh inserts.[22] Thousands of these cases have settled, resulting in damages in the tens of thousands of dollars recovered by those injured by the

14 *Id.* at 371-72.
15 *Id.* (*Internal citations omitted*).
16 *Id.* at 372.
17 *Id.*
18 *In re Gary Alan Porrett and Jennifer Sue Porrett*, Bankruptcy Case No. 09-03881-JDP.
19 *Id.*
20 *Id.*
21 *Id.*
22 http://www.bloomberg.com/news/articles/2016-01-27/j-j-said-to-pay-120-million-in-its-first-big-mesh-settlement

inserts.[23] This in turn has given rise to the question of whether these damage payouts constitute property of the bankruptcy estate where the faulty device was implanted prior to the petition date but neither the debtor nor the medical community had knowledge that the device could or would cause the debtor harm at the time of the bankruptcy filing.

Pre-Petition Events – Post-Petition Settlement

In the case of *In re Ross,* the Eastern District of New York recently had the occasion to examine whether the post-petition settlement offered to a debtor in exchange for a release of all of her claims related to the pre-petition implant and removal of transvaginal surgical mesh ("the Device") is sufficiently rooted in the pre-bankruptcy past to render the settlement proceeds property of the bankruptcy estate.[24] In 1998, the debtor in this case underwent a procedure to implant the Device; in 1999, the debtor underwent another procedure to remove the Device.[25] At the time the debtor's bankruptcy petition was filed, neither the debtor, nor the medical community as a whole, were aware of the possible medical complications related to the Device.[26] In 2012, long after the case was closed, the debtor learned from a television commercial that the Device may be defective and retained mass tort counsel.[27] The debtor was found ineligible to join the class, but was offered settlement proceeds of more than $105,000.00 in exchange for a full release of all present or future claims related to the Device.[28] In 2015 after being notified of the settlement by the debtor's tort counsel, the trustee moved to reopen the case to administer the settlement for the benefit of the estate.[29] While, the Court was asked to determine only whether there is sufficient cause to reopen the case, the Court recognized that it could do so only after it determines whether the settlement proceeds were in fact property of the

23 *Id.*
24 *In re Ross* (Bankr. E.D.N.Y. 2016) at 1.
25 *Id.* at 4.
26 *Id.*
27 *Id.*
28 *Id.*
29 *Id.*

estate.[30] In denying the trustee's motion to reopen the case, the Court held that the settlement proceeds do not constitute property of the bankruptcy estate because no cause of action had accrued as of the date the case was commenced.[31] Pursuant to New York law, a "tort claim does not accrue until the debtor sustains an injury as a result of the complained act or omission."[32] The debtor here suffered no injury even though she was exposed to the Device; however, mere exposure to a defective product, without actual injury, is not sufficient to create an interest in a tort cause of action under New York law.[33] The Court reasoned that since the debtor did not have a cause of action as defined by applicable state law at the time the bankruptcy was commenced, the settlement proceeds do not constitute property of the bankruptcy estate. The Chapter 7 trustee, standing in the shoes of the debtor, can maintain only those actions that the debtor could have brought at the time the case was filed. Here, no such cause of action existed and the motion to reopen was denied.[34]

Pre-Petition Implant – Post-Petition Injury and Settlement

In *In re Segura*, as in *Ross*, the Court again was asked to rule on a motion to reopen a Chapter 7 case and it too had to conduct an analysis of whether the debtor's claims in connection with a pelvic mesh implant ("the Device") constitute property of the bankruptcy estate in order to rule on the motion.[35] Here, the debtor had the Device implanted in 2006.[36] The Chapter 7 was commenced in 2007.[37] Unlike the debtor in *Ross*, here the Device was still in place as of the petition date.[38] Following the petition date, the debtor started experiencing pain and ultimately had to undergo multiple surgeries to address issues caused by the Device.[39] In 2012, the debtor retained counsel to pursue a claim for

30 *Id.*
31 *Id.* at 15.
32 *Id.* at 7.
33 *Id.* at 11.
34 *Id* at 9-10.
35 *In re Segura* (Bankr. N.D. Ohio, 2016) at 2.
36 *Id.* at 1-2.
37 *Id.* at 2.
38 *Id.*
39 *Id.*

damages against the makers of the device.[40]

In analyzing whether a claim is sufficiently rooted in the pre-bankruptcy past, the Sixth Circuit has established three principles to consider:[41]:

1. "Is there a pre-petition violation? Pre-bankruptcy conduct or facts alone are not sufficient to root a claim in the past."[42]
2. "If the cause of action could have been brought pre-petition, it is sufficiently rooted in the past even if the debtor was not aware of it at the time."[43]
3. "The entire cause of action is property of the estate, even if post-petition damages were incurred."[44]

Sixth Circuit precedent further holds that "a cause of action qualifies as bankruptcy estate property only if the claimant suffered a pre-petition injury."[45] Since the debtor was not injured prior to filing the case, the Court found that a "critical predicate for the debtor's cause of action" did not exist pre-petition. In light of this, the Court held that the cause of action was not sufficiently rooted in the pre-bankruptcy past and therefore did not constitute property of the bankruptcy estate.[46]

Issues in Chapter 20 Cases

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Lien Avoidance

Even though the Bankruptcy Code does not actually contain a Chapter 20, its existence is well

40 *Id.*
41 *See, Tyler v. DH Capital Mgmt., Inc.*, 736 F.3d 455 (6th Cir. 2013).
42 *In re Segura* at 4.
43 *Id.*
44 *Id.*
45 *Id.* at 4 citing *Underhill v. Huntington National Bank (In re Underhill)*, 579 Fed. Appx. 480 (6th Cir. 2014).
46 *Id.* at 5.

known among consumer practitioners.[47] Essentially, it represents a short hand way of indicating that a debtor in a current Chapter 13 already filed for relief pursuant to Chapter 7 at some point prior to the Chapter 13 filing. In a Chapter 13 case filed less than 4 years following a Chapter 7 case, the debtor is not eligible for a discharge in the Chapter 13 case.[48]

Often times, the second case – the Chapter 13 case – is filed to deal with, at least in part, a wholly unsecured junior lien on the debtor's residence. The 9th Cir. BAP recently examined the issue of whether a Chapter 20 debtor can utilize a Chapter 13 for purposes of avoiding a junior lien, despite the lack of a discharge at the end of the case in *Boukatch v. Midfirst Bank.*[49] Acknowledging the split authority among courts, the Court carefully reviewed the three approaches other courts have utilized in determining this issue before holding that the debtor is in fact able to avoid the junior lien ("Lien Strip").[50] The Court rejected the argument that allowing the Lien Strip would somehow result in a *de facto* discharge of the underlying debt.[51] The *Boukatch* Court further rejected another approach, which precludes the Chapter 20 debtor from obtaining a permanent Lien Strip unless the junior lien is paid in full during the plan period.[52] Instead, the Court held that a Lien Strip is not dependent upon a discharge, finding that there is nothing in the Bankruptcy Code to prevent or preclude that result.[53]

HSBC Bank United States v. Blendheim presented the Ninth Circuit Court of Appeals set of issues related to a Chapter 20 case.[54] Here, the Court arrived at the same conclusion regarding the debtor's ability to obtain a permanent Lien Strip as the *Boukatch* Court.[55] In this case, the Chapter 13 case was commenced after the debtors obtained their Chapter 7 discharge in the prior case, but while

47 *See Johnson v. Home State Bank*, 501 U.S. 78, 87 (1991).
48 11 U.S.C. §1328(f)(1).
49 *Boukatch v. Midfirst Bank (In re Boukatch)*, 533 B.R. 292 (9th Cir. BAP July 9, 2015).
50 *Id.* at 297.
51 *Id.*
52 *Id.* at 298 (...[B]because the debtor is ineligible for a chapter 13 discharge, the only way to make the lien avoidance "permanent" is by paying the debt in full during the course of the chapter 13 plan. *See* §1325(a)(5)(B)(i)(I)(aa), (bb). Thus, without discharge, the only way to conclude the case is dismissal or conversion, either of which reinstates the avoided lien. *See* §§1325(a)(5)(B)(i)(II), 348(f)(1)(C)(I).)
53 *Id.* at 299.
54 *HSBC Bank United States v. Blendheim (In re Blendheim)* (9th Cir., 2015).
55 *Id.* at 37.

the case remained open and pending.[56] This did not constitute a fatal flaw for the debtors' case, however, as the Court rejected a per se rule prohibiting a debtor from commencing a Chapter 13 case while the debtor's prior Chapter 7 case is pending.[57]

What makes the *Blendheim* case unusual is the fact that here the debtors sought to avoid the first position mortgage lien on the grounds that the creditor did not have an allowed secured claim.[58] The creditor holding the first mortgage ("HSBC") filed a proof of claim in the case but failed to attach a copy of the promissory note.[59] The debtors objected pursuant to Rule 3001 of the Federal Rules of Bankruptcy Procedure and the Court – hearing absolutely no objection from HSBC – disallowed the claim.[60] The debtors subsequently brought an adversary proceeding to void the first position lien arguing that the HSBC's claim, having been disallowed by the Court, is not an allowed secured claim and could therefore be avoided pursuant to 11 U.S.C. §506(d).[61] 11 U.S.C. §506(d) states that "[t]o the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void." Finding for the debtors, the Court held that "[t]he most straightforward reading of the text suggests that if a creditor's claim has not been "allowed" in the bankruptcy proceeding, then "such lien is void." "Void" means "[o]f no legal effect" or "null." Black's Law Dictionary (10th ed. 2014). Accordingly, Congress's language appears unequivocal: §506(d)'s clear and manifest purpose is to nullify a creditor's legal rights in a debtor's property if the creditor's claim is "not allowed," or disallowed."[62]

Debt Limits

Debtors seeking relief under Chapter 13 of the Bankruptcy Code are eligible to do so only if their debts do not exceed the limits set forth in 11 U.S.C. §109(e). Specifically, §109(e) provides, in

56 *Id* at 5.
57 *Id* at 42-3 citing *In re Saylors*, 869 F.2d 1434 (11th Cir. 1989).
58 *Id.* at 5-6.
59 *Id.*
60 *Id.* at n1.
61 *Id.*
62 *Id.* at 22.

pertinent part, that "[o]nly an individual with regular income that owes, on the date of the filing of the petition, noncontingent, liquidated, unsecured debts of less than […] may be a debtor under Chapter 123 of this title."[63] The question in the Chapter 20 context then becomes whether the amount owed to a wholly unsecured junior lien holder, who at this point is prohibited from collecting from the debtor personally, constitutes an unsecured debt for purposes of the debt limit analysis.

The 9th Cir. BAP addressed this question in *Free v. Malaie*r where the Chapter 13 trustee moved for the dismissal of the debtors' case arguing that their unsecured debt, including a wholly unsecured junior lien as an "unsecured debt," exceeds the debt limit.[64] The Court started with definitions provided by the Bankruptcy Code.[65] The Bankruptcy Code defines "debt" as liability on a claim and "claim" as a right to payment.[66] Therefore, if a creditor does not have a right to payment on an unsecured basis, there is no unsecured debt.[67] The Court then turned to 11 U.S.C. §524(a)(2) to analyze how the discharge injunction impacts the application of these definitions.[68] The Court pointed out that the reference to "personal liability" in 11 U.S.C. §524 preserves any *in rem* rights a creditor may have even though the discharge bars any claims that are not secured.[69] After conducting a thorough review of applicable case law, the 9th Cir. BAP concluded that "[n]either the Code, nor case law compel inclusion of the discharged *in personam* liability" in the eligibility calculation under 11 U.S.C. §109(e).

Claims and the Discharge Injunction

In *Green Point Credit, LLC v. McLean* a creditor filed a proof of claim in the debtors' Chapter 13 case based on a debt that was discharged in the debtors' prior Chapter 7.[70] The Bankruptcy Court ruled that the creditor ("Green Tree") violated the discharge injunction and awarded the debtors both

63 11 U.S.C. §109(e).
64 *Free v. Malaier (In re Free), 542 B.R. 492, 494-5 (9th Cir. BAP 2015).*
65 *Id.* at 496.
66 11 U.S.C. §101(12).
67 11 U.S.C. §109(e).
68 *Free*, 542 B.R. at 496.
69 *Id.*
70 *Green Point Credit, LLC v. McLean (In re Mclean)*, 794 F.3d 1313, 1320 (11th Cir. 2015).

compensatory and non-compensatory damages.[71] The District Court affirmed the Bankruptcy Court and upheld the compensatory damages as well as the non-compensatory damages, finding them to be punitive in nature.[72]

The Court of Appeals agreed with the lower Courts and found that Green Tree's filing of a proof of claim in the Chapter 13 case was in fact a violation of the discharge injunction.[73] In doing so, the Court articulated the test for whether a violation of the discharge injunction has occurred as "whether the objective effect of the creditor's action is to pressure a debtor to repay a discharged debt, regardless of the legal entity against which the creditor files its claim."[74]

The Court did not uphold the non-compensatory sanctions imposed on Green Tree, finding them to be punitive in nature as Green Tree did not have the opportunity to lift the sanctions through compliance.[75] Since punitive sanctions require a certain level of due process related procedural protections that were not met in this case, the Court remanded this issue to the Bankruptcy Court to determine how to properly address the debtors' request for non-compensatory sanctions.[76] Finally, the Court remanded the issue of compensatory damages to the Bankruptcy Court to allow for a thorough analysis as to whether compensatory damages are appropriate in light of a recent decision articulating a test for calculating compensatory damages by the Court of Appeals in the Eleventh Circuit.[77]

71 *Id.* at 1318.
72 *Id.*
73 *Id.* at 1322.
74 *Id.*
75 *Id.* at 1323-4.
76 *Id.*
77 *Id.* at 1325-26 referring to *Lodge v. Kondaur Capital Corp.*, 750 F.3d 1263 (11th Cir. 2014).

The Intersection of the Bankruptcy Code and the Fair Debt Collection Practices Act

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Does Filing a Proof of Claim on Time-Barred Debt Subject a Creditor to FDCPA Claims?

There are two recent Circuit Court decisions addressing the issue of whether a creditor can be sued for violating the Fair Debt Collection Practices Act (the "FDCPA") based on its filing of a proof of claim on debt that is time-barred.

Yes, the creditor can be sued for FDCPA violations:

Johnson v. Midland Funding, LLC, 26 U.S. App. LEXIS 9478, 62 Bankr. Ct. Dec. 169 (11th Cir. May 24, 2016). In *Johnson*, the 11th Circuit considered the consolidated appeal of two District Court decisions dismissing debtors' lawsuits for alleged FDCPA violations. In both cases, the fact that gave rise to the FDCPA claims was the creditor's filing of a proof of claim on debt for which the applicable statute of limitations had run. Specifically, the debtors argued that because the proofs of claim on their face were barred by statutes of limitations, the claims were "false, deceptive, or misleading" under the FDCPA. 15 U.S.C. § 1692.

The District Court invoked the doctrine of implied repeal to hold that a creditor's right to file time-barred claims under the Bankruptcy Code precluded debtors from challenging that right

as a violation of the FDCPA. On appeal, the 11th Circuit first looked to its recent decision of *Crawford v. LVNV Funding, LLC*, 758 F.3d 1254 (11th Cir. 2014), which held that "a debt collector violates the FDCPA when it files a proof of claim in a bankruptcy case on a debt it knows to be time-barred." *Johnson*, 2016 U.S. App. LEXIS 9478, *2.

Then, the *Johnson* court rejected the District Courts' reliance on the implied repeal doctrine, holding that the Code and FDCPA are not in "irreconcilable conflict," but instead create two "different tiers of sanctions for creditor misbehavior in bankruptcy." *Id.* at *13 & *15. Thus, while "[t]here is no blanket prohibition on filing a time-barred claim in bankruptcy," a debt collector that files a time-barred claim "is simply opening himself up to a potential lawsuit for an FDCPA violation." *Id.* at *17.

No, the creditor cannot be sued for FDCPA violations:

Nelson v. Midland Credit Mgmt., Inc., 2016 U.S. App. LEXIS 12683 (8th Cir. July 11, 2016). The *Nelson* court declined to follow *Johnson* and *Crawford*, and focused on the differences between the acts of filing a bankruptcy claim and actual or threatened litigation. Specifically, the *Nelson* court relied on Eighth Circuit precedent holding that "the FDCPA bars a debt collector from filing or threatening a lawsuit to collect a time-barred debt," and that a debt collector's liability turned on "whether an unsophisticated consumer would be harassed, misled or deceived by the debt collector's acts." *Id.* at *4-5 (internal quotations and citations omitted).

Then, the *Nelson* court reasoned that filing a proof of claim is not an act of "filing or threatening a lawsuit" and that the bankruptcy process protects debtors against such harassment and deception because debtors are "aided by trustees who owe fiduciary duties to all parties and have a statutory obligation to object to unenforceable claims." *Id.* at *5. In addition, the court

stated that the claims resolution process in bankruptcy is less burdensome than objecting to a time-barred proof of claim, which provides additional protections to debtors. *Id.* at *6 (citing *Simmons v. Roundup Funding, LLC*, 622 F.3d 93, 96 (2d Cir. 2010)).

POST *ZACHARY* [1] REALITIES IN THE 9TH CIRCUIT AND BEYOND

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I. ABSOLUTE PRIORITY RULE IN INDIVIDUAL CHAPTER 11 CASES

11 U.S.C. §1129(b) in part, states as follows:

> "(b)(1) Notwithstanding section 510(a) of this title, if all of the applicable requirements of subsection (a) of this section other than paragraph (8) are met with respect to a plan, the court, on request of the proponent of the plan, shall confirm the plan notwithstanding the requirements of such paragraph if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan.
>
> (2) For the purpose of this subsection, the condition that a plan be fair and equitable with respect to a class includes the following requirements:. . .
>
> (B) With respect to a class of unsecured claims -
> (i) the plan provides that each holder of a claim of such class receive or retain on account of such claim property of a value, as of the effective date of the plan, equal to the allowed amount of such claim; or
> (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property, except that in a case in which the debtor is an individual, the debtor may retain property included in the estate under section 1115, subject to the requirements of subsection (a)(14)[2] of this section."

This judicially interpreted and created "absolute priority rule" requires that "A dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain any property under a reorganization plan". *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 202 (1988). For this rule to apply the impaired classes must refuse to accept the Chapter 11 Plan as

[1] *Zachary v. California Bank & Trust*, 811 F.3d 1191(9th Cir. 2016)

[2] The reference to (a)(14) appears to be in error. It is more logical that the scriveners meant (a)(15).

required by §1129(a)(8) but all other requirements of §1129(a) have been met.

The rule requires that a Chapter 11 Plan be "fair and equitable". It must either pay 100% of all unsecured claims or provide that the debtor does not retain any property except that which is provided for under §1115. The split in authority questions what property is included under §1115 and is broken into two views, the minority held "broad" view and the majority held "narrow" view.

Under the minority view, the rule does not apply in individual Chapter 11 cases because property included under §1115 includes all pre and post petition property. In other words, by cross-referencing §1115 Congress meant to allow a debtor to keep all property and, as a result, the rule has been abrogated. There are no binding Circuit Court of Appeal decisions following this broad view. For those practicing in jurisdictions that still subscribe to the broad view, an individual debtor gets to keep all pre and post petition property similar to a Chapter 13. As a result, Chapter 11 is a viable alternative to Chapter 13 as the debtor retains control over all property without the over-sight of a Chapter 13 Trustee.

Under the majority view the individual debtor does not get to keep all pre petition property unless unsecured creditors are paid in full. Section 1115 is read narrowly and thus allows a debtor to only keep post petition property and earnings despite those assets becoming property of the estate. The question may then become whether or not a debtor who does not propose paying 100% of all unsecured claims can keep pre petition property that was claimed as exempt under State or Federal exemptions. A recent unpublished decision out of the Southern District of Georgia leads one to conclude "yes"[3] and conforms with the reasoning of the pre BAPCPA case of *In re Henderson*, 321 B.R. 550 (Bankr. M.D. Fla., 2005) *aff'd* 341 B.R. 783 B.R. 783 (M.D. Fla. 2006) which states, "it

[3]"In this case, the Debtors' Plan proposes to allow the Debtors to retain their non-exempt, pre-petition property upon confirmation. . . Therefore, the Debtors' Plan violates the absolute priority rule because it proposes to allow the Debtors to retain property of the estate that is not included in § 1115 without paying unsecured creditors in full." *In re Rodgers* 14-40219 EJC (Bankr. S.D. Ga. 2016)

is clear that the Debtor's interest in exempt property can never be junior to the interest of creditor's including the claim of dissenting unsecured creditors". *Id.* at 560.

II. IMPACT ON THE 9TH CIRCUIT - NOW MUST FALL IN LINE WITH THE MAJORITY

Up until a few months ago, those practicing in the Ninth Circuit were doing so under the broad view pursuant to *In re Friedman* [4]. With the 2012 holding in *Friedman* most bankruptcy practitioners enjoyed life under the broad view. Confirming a Chapter 11 Plan was relatively easy - find an impaired creditor who would vote in favor of the Plan and you were good to go. *Friedman*, following the reasoning of several bankruptcy court decisions, held that Section 1115 was all encompassing and that an individual debtor could keep all pre and post petition property without the need to pay unsecured creditors in full. On January 28, 2016 the good life ended - or did it?

With the decision in *Zachary v. California Bank & Trust* (*Fn. 1*) the Ninth Circuit Court of Appeals overruled the good life and brought the Ninth Circuit in line with all other Circuit Courts that have ruled on the application of the absolute priority rule in individual cases.[5] The Ninth Circuit now subscribes to the majority position that individual Chapter 11 debtors must meet the absolute priority rule if §1129(b)(2)(B)(ii) applies.

III. GETTING A PLAN CONFIRMED - COMBATING THE MAJORITY VIEW

The "new value exception" is a judicially created avenue around the detrimental impact of the absolute priority rule.[6] It gives a debtor the ability to propose a Chapter 11 Plan that includes pumping in "new value" for the creditors. New value is a cash infusion into the bankruptcy estate. Generally, new value must be "new, substantial [and] necessary for success of the plan, reasonably

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[4] *In re Friedman*, 466 B.R. 471 (9th Cir. BAP 2012)

[5] *In re Maharaj*, 681 F.3d 558 (4th Cir. 2012); *In re Lively*, 717 F.3d 406 (5th Cir. 2013); *In re Stephens*, 704 F.3d 1279 (10th Cir. 2013); and *Ice House America, LLC v. Cardin*, 751 F.3d 734 (6th Cir. 2014)

[6] *Case v. Los Angeles Lumber Products, Co*. 308 U.S. 106 (1939)

equivalent to the value retained, and in the form of money or money's worth" *In re 203 N. LaSalle St. Partnership*, 126 F.3d 955,963 (7th Cir. 1997). The problem is that this new value cannot come from the debtor. How does an individual contribute new value if it cannot come from him or her? There are several avenues and I am sure we can find others.

Could the debtor propose to sell exempt property and contribute the proceeds to the Plan? Unfortunately, this may not be "new value" as it was pre petition property of the estate.[7] But see the unpublished decision of *In re Rodgers* (*Fn. 3*) where the court determined that the debtor must use an outside source "unless exempt property is contributed for this purpose." What about borrowing funds from a relative or friend? What about a substantial gift?

Contribution of post petition wages are probably not new value due to §1129(a)(15)(B). But what if projected disposable income is committed beyond the 60th month? How much beyond would be necessary to show reasonable equivalent value as it relates to the property to be retained? Is this even possible considering that new value generally needs to be given at the time of plan confirmation[8]?

Another issue is determining what value to use. The contribution must be reasonably equivalent to the value to be retained by the debtor. Is value based upon a liquidation analysis or some other value such as on-going concern value? Either way, such may require an evidentiary hearing as case law tends to support the proposition that new value must be equal to or more than the value of non-exempt pre petition property to be retained.[9] Case law also tends to support that

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[7] *In re Chen*, 482 B.R. 473, 485 (Bankr. P.R. 2012)

[8] See *In re Brown*, 498 B.R. 486, 507 (Bankr. E.D. a, 2013) *aff'd.* 505 B.R. 638 (E.D. Pa, 2014). See also Memorandum Opinion in *In re Tucker*, 10-67281FRA (Bankr. Or. 2011)

[9] *In re Gerard*, 495 B.R. 850,855-856 (Bankr. E.D.Wis., 2013)

value is based upon the debtor's equity position if property is encumbered.[10] A deduction in value based upon the encumbrances on the property could be very beneficial to the debtor. For example, the debtor is a 100% member of a LLC. The debtor values the LLC at $0.00 due to the long term debt of the LLC. If the value of the LLC is based upon the debtor's equity position and that value is $0.00, then keeping the asset might not be impacted by the absolute priority rule.

If the objecting creditor and the debtor wish to avoid the cost of a valuation hearing, the parties certainly could negotiate a resolution. Is it possible to treat the creditor in a separate class and pay more? Would such be an impermissible discrimination? What about offering an overall greater dividend to unsecured creditors?

Of course, there would be no issues if the debtor either paid 100% of all unsecured claims or the debtor agreed not to retain non-exempt assets. In paying all unsecured claims in full, would a Plan that extends into decades be too speculative? In agreeing not to retain assets, the debtor could propose a liquidating plan? Who is going to purchase assets that may only have value to the debtor? What about abandoning assets at the beginning of the case?

Lastly, consideration must be given to the Bankruptcy Court itself. If a debtor cannot produce the votes necessary to meet the requirements of §1129(a)(8) but creditors fail to raise the issue of the absolute priority rule, does the Court have an independent duty to deny confirmation? One would assume that it does as it must find that the Plan is "fair and equitable" and cannot allow a Plan to be confirmed if it fails to comply with the Bankruptcy Code.[11]

IV. IS A CHAPTER 13 A VIABLE ALTERNATIVE?

As we all know, the absolute priority rule is unique to Chapter 11 and therefore does not

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[10] *Ice House America, LLC v. Cardin*, 751 F.3d 734, 737 (6th Cir. 2014)

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

apply in Chapter 13. In a Chapter 13 the debtor keeps everything so long has he/she meets the "best interest of the creditors test" and Chapter 7 reconciliation. Having a Chapter 13 trustee involved may make more sense, assuming the debtor otherwise qualifies for the Chapter 13.

In many instances, debtors are forced into the more complicated and expensive Chapter 11 due to personal guaranties. Adding the amount owed on such guaranties to a debtor's general personal obligations may throw the debtor over the debt limits allowed for Chapter 13 pursuant to 11 U.S.C. §109(e) . One must be cognizant of these limits. The debtor must look at the terms of the underlying personal guaranty contract and state law. It seems settled that the amount owed based upon an unconditional guaranty, regardless of a creditor's efforts to collect from the borrower, will be included in the debt limit calculation.[12] It becomes a bit more complicated if liability under the guaranty is contingent upon the happening of some event. If, at the time the debtor files a Chapter 13, that contingency has not sprung, then the obligation may not count toward the §109(e) limits as one does not include contingent obligations in the calculation. "[T]he rule is clear that a contingent debt is 'one which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event which will trigger the liability of the debtor to the alleged creditor.'" *In re Fostvedt*, 823 F.2d 305, 306 (9th Cir. 1987). One must first ask if the contingency happened prior to the filing of the Chapter 13. Certainly, if the borrower is in default at time the bankruptcy is filed the contingency has sprung and the full obligation must be listed as non-contingent.[13] However, if the borrower is not in default, the debtor/guarantor may be below the debt limits and qualify for the Chapter 13 thus eliminating the complexities of confirming a Chapter 11 Plan.

Another consideration in tweaking the amount of debt for the Chapter 13 is the potential strip

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[12] *In re Glaubitz*, 436 B.R. 99 (Bankr. E.D. Wis., 2010);

[13] *In re Enriquez*, 315 B.R. 112, 121-122 (Bankr. N.C. Cal., 2004)

off of any junior mortgage liens (or even a cram down on rental property). In the Ninth Circuit, an attempt at a strip off will increase the amount of unsecured debt and could throw a debtor over the debt limit and back to the Chapter 11. "Under the holding of *Scovis v. Henrichsen* (*In re Scovis*), 249 F.3d 975 (9th Cir.2001), and *Smith v. Rojas* (*In re Smith*), 435 B.R. 637 (9th Cir. BAP 2010), when determining a debtor's chapter 13 eligibility, the undersecured portion of a secured creditor's claim should be counted as unsecured debt. *In re Scovis*, 249 F.3d at 983. Although *Scovis* was speaking about the unsecured portion of a partially secured obligation, its holding was extended to wholly unsecured junior trust deeds in *Smith*. *In re Smith*, 435 B.R. at 648-49." *In re Free* 2015 WL 9252592 (9th Cir. BAP).

Pigeonholing a debtor into a Chapter 13 certainly looks more and more appetizing. For the consumer bankruptcy practitioner who previously enjoyed relatively unfettered control over Plan confirmation, moving back to the simpler life may just be in the cards.

IV. CONCLUSION

It appears that as more Circuit Court of Appeals rule on the application of the absolute priority rule in individual Chapter 11 cases, more and more practitioners will be seeking ways around it. For those of us in the Ninth Circuit it is too soon to tell where this will all lead. Certainly those of you practicing in other Circuits that follow the majority view, individual Chapter 11 cases have not gone away. You have found ways around the problems and I encourage you to share your experiences with those who are less familiar with navigating the rule.

Exemption Issues After Law v. Siegel

ABI Southwest Consumer Case Law Update

September 9, 2016

Hon. Paul Sala, U.S. Bankruptcy Court, District of Arizona

Leslie R. Hendrix, Law Clerk to the Hon. Paul Sala

***Law v. Siegel*, 134 S.Ct. 1188 (U.S. 2014)**

a. Chapter 7 debtor claimed a $75,000 exemption in his residence and the trustee did not timely object.

b. Debtor claimed Lin's Mortgage & Associates had a lien on the property.

c. Trustee sought to avoid the lien.

d. Bankruptcy court found that the debtor had fabricated the lien to fraudulently preserve equity beyond the debtor's exemption.

e. Trustee incurred over $500,000 in legal fees during the five-year battle investigating the debtor's actions and avoiding the lien.

f. Bankruptcy court surcharged the debtor's entire $75,000 exemption in the property and made them available to defray the trustee's legal fees because of the debtor's fraud on his creditors and the court.

g. The Supreme Court reversed, holding that the bankruptcy court's power under § 105(a) (to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions" of the Bankruptcy Code) "does not allow the bankruptcy court to override explicit mandates of other sections of the Bankruptcy Code." *Law v. Siegel*, 134 S.Ct. 1188, 1194 (U.S. 2014), quoting 2 *Collier on Bankruptcy* ¶ 105.01[2], p. 105–06 (16th ed. 2013).

h. Surcharging the debtor's homestead exemption under § 105(a), or under the bankruptcy court's inherent sanctioning authority, was invalid in light of § 522(k)'s specific directive that exempt property generally "is not liable for payment of any administrative expense." *Law v. Siegel*, 134 S.Ct. at 1195.

i. To support its ruling, the Supreme Court noted that "[t]he Code's meticulous—not to say mind-numbingly detailed—enumeration of exemptions and exceptions to those exemptions confirms that courts are not authorized to create additional exceptions." *Law v. Siegel*, 134 S.Ct. at 1196, citing *Hillman v. Maretta*, —— U.S. ——, 133 S.Ct. 1943, 1953, 186 L.Ed.2d 43 (2013); and *TRW Inc. v. Andrews*, 534 U.S. 19, 28–29, 122 S.Ct. 441, 151 L.Ed.2d 339 (2001).

EXEMPTION OBJECTIONS AFTER LAW V. SIEGEL

A. Do Bad Faith Objections Still Work?

1. No –

a. *Baker v. Baker (In re Baker)*, 791 F.3d 677 (6th Cir. 2015).

a. Finding that *Law v. Siegel* "prohibits [a] bankruptcy court from disallowing the debtor's claimed homestead exemptions because of the alleged bad faith and fraudulent conduct.". *Baker*, 791 F.3d at 682.

b. *In re Elliott*, 523 B.R. 188 (B.A.P. 9th Cir. 2014) [*Elliott I*].

a. Finding that "courts can no longer deny claimed exemptions or bar amendments to exemptions on the ground that the debtor acted in bad faith…."). *Elliot*, 523 B.R. at 194.

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c. *In re Whittick*, 547 B.R. 628 (Bankr. D.N.J. 2016).

d. *In re Coyle*, 2016 WL 828459 (Bankr. C.D. Ill March 2, 2016).

e. *Taylor v. Caillaud*, 2015 WL 7738391 (W.D.N.C. December 1, 2015).

f. *In re Lua*, 529 B.R. 766, 773-74 (Bankr. C.D. Cal 2015)(collecting cases**).**

2. Maybe –

a. *In re Woolner*, 2014 WL 7184042 (Bankr. E.D. Mich. Dec. 15, 2014)

i. Only case that distinguishes *Law v. Siegel* on the bad faith issue. Court found that in *Law v. Siegel* "the validity of the debtor's claim of exemption was not directly contested or challenged, rather, the issue was whether the bankruptcy court had authority

to "surcharge" an already allowed exemption because of the debtor's bad acts." *Woolner*, 2016 WL at *1.

ii. Having distinguished *Law v. Siegel*, the court reasoned that where Fed. R. Bankr. P. 4003(b)(2) allows for a trustee to file an objection to an exemption at any time prior to one year after the closing of the case if the debtor fraudulently asserted the claim of exemption., "[c]ourts should be able to fairly assume that a procedural rule is premised on the existence of authority of the Court involved to decide the substantive issue raised in accordance with the procedure prescribed by that rule." *Woolner*, 2014 WL at *3.

iii. No longer applicable in the Sixth Circuit given the Sixth Circuit's decision in *Baker v. Baker (In re Baker)*, 791 F.3d 677, 682 (6th Cir. 2015).

B. 11 U.S.C. § 522(g)

Section 522(g)(1), in relevant part, provides:

> [T]he debtor may exempt under subsection (b) of this section property that the trustee recovers under section 510(c)(2), 542, 543, 550, 551, or 553 of this title, to the extent that the debtor could have exempted such property under subsection (b) of this section if such property had not been transferred, if—
>
> (1)(A) such transfer was not a voluntary transfer of such property by the debtor;
>
> and
>
> (B) the debtor did not conceal such property....

1. *Elliott v. Weil (In re Elliott),* 544 B.R. 421 (B.A.P. 9th Cir. 2016) [*Elliott III]*

a. After remand in Elliot I, the bankruptcy court denied the debtor's homestead exemption under § 522(g)(1) where the trustee had obtained a judgment for turnover of the property under § 542(a) and where there were no disputes that the debtor (i) failed to list real property in his schedules, (ii) testified at his §341 meeting that he owned no real property and (iii) voluntarily transferred the real property prior to his

bankruptcy filing. The Bankruptcy Appellate Panel affirmed the bankruptcy court.

C. State Law may provide a basis for objection

1. *In re Gray*, 523 B.R. 170 (B.A.P. 9th Cir. 2014)

a. One day before deciding Elliot I, a different panel of the Ninth Circuit BAP (also finding that the holding in Law v. Siegel prevented bankruptcy courts from denying exemptions for bad faith conduct) vacated the Bankruptcy Court's order and remanded the matter for a determination of whether equitable considerations may be used to disallow exemptions under Arizona law. Here debtors amended schedules to list and claim an exemption in previously undisclosed prepaid rent.

2. *In re Liao*, 2016 WL 3961184 (Bankr. S.D. Tex. July 15, 2016)

a. "*Siegel* did leave the door open for an exemption to be denied for bad-faith conduct where applicable state law so allows. In Texas, such law does exist: 'Misrepresentations by a homestead claimant may, under the property circumstances, create an estoppel to claim the homestead exemption.'" *Liao*, 2016 WL at *22. Court applied doctrine of quasi-estoppel to deny debtor's amended exemption where initial schedules listed different property as his homestead.

3. *Taylor v. Caillaud*, 2015 WL 7738391 (W.D.N.C. Dec. 1, 2015)

a. Recognizing that state law could provide basis for denial of exemption but ruling that debtor's change of circumstance in obtaining exemption justified amendment to claim exemption under state law.

4. *In re Lua*, 529 B.R. 766 (Bankr. C.D. Cal. 2015)

a. Denied exemption finding that California law recognizes equitable estoppel as grounds to deny exemption.

5. *In re Gutierrez*, 2014 WL 2712503 (Bankr. E.D. Cal. June 12, 2014)

a. Recognizing that state law creates potential grounds to deny exemptions based on misconduct, citing *Redwood Empire Prod. Credit Asss'n v. Anderson (In re Anderson)*, 824 F2d 754, 756 (9th Cir. 1987). Ultimately, denied trustee's object to exemption.

6. *In re Coyle*, 2016 WL 828459 (Bankr. C.D. Ill. Mar. 2, 2016)

a. Trustee failed to establish that Illinois law supported denying exemption because of the debtor's alleged bad acts. Debtor's exemption upheld.

D. Timeliness Rule 1007(h)

1. *Taylor v. Caillaud*, 2015 WL 7738391 (W.D.N.C. December 1, 2015).

a. Appellant argued that Court should deny exemption where debtor received inheritance and did not amended her schedules within 14 days as mandated by Bankruptcy Rule 1007(h). District Court, finding that argument was not raised to the Bankruptcy Court, refused to hear argument on appeal.

E. Timeliness Rule 1009

1. *In re Baker*, 514 B.R. 860 (E.D. Mich. 2014), *aff'd*, 791 F.3d 677 (6th Cir. 2015)

a. Debtor filed amended exemption in reopened case seeking to exempt previously undisclosed asset. Trustee objected to amended exemption arguing that Bankruptcy Rule 1009(a) limits right to amend to "any time before the case is closed." Bankruptcy Court determined that objection was untimely under Bankruptcy Rule 4003(a)(1) [requiring objections within 30 days of amendment]. District Court affirmed but noted, in *dicta*, that a timely Rule 1009(a) objection would not be barred by *Law v. Siegel*, because the Rule 1009(a) objection focused only on the timeliness of the amendment and not on the debtor's good or bad faith.

F. *11 U.S.C. § 522(o)* – for improper and abusive pre-bankruptcy planning where non-exempt property is converted into exempt property.

1. *In re Van Erem*, 2015 WL 1293525 (Bankr. S.D. Tex. Mar. 18, 2015)

a. Recognizing that Bankruptcy Code §522(o) reduces homestead exemptions by the amount of any funds attributable to a debtor's intent to hinder, delay or defraud creditors, but ruling that the debtor's exemption was proper under the facts of the case.