Selected Bankruptcy Cases of Note

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By George J. Wallace, Gary D. Hammond, Jeffrey E. Tate, and Alvin C. Harrell

I. Treatment of "Unsecured" Second Mortgages and Judicial Liens (for the Section 522(f) Issue)

A. The "Unsecured" Mortgage

The Second and Sixth Circuit U.S. Courts of Appeals have joined the majority of lower courts in finding that an unsecured mortgage can be crammed down in a Chapter 13 case, despite the language of 11 U.S.C. section 1322(b)(2). In In re Lane, the Sixth Circuit concluded that the extent to which a "completely unsecured" second mortgage lien must be treated as "secured" for Chapter 13 plan purposes is determined by the ordinary valuation process of "crum-down" under 11 U.S.C. section 506. There are certainly strong arguments to the contrary, particularly considering United States Supreme Court precedent on the issue, so it will be interesting to see how this issue is handled by other courts. Several cases are presented for appellate review.

B. The "Short-Term" Unsecured Mortgage

11 U.S.C. section 1322(c)(2) creates an exception to the cramdown prohibition on cramming down a mortgage on the debtor's principal residence. If the last payment due date on the original payment schedule for the mortgage is due before the date on which the final payment is due, the "plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5) of this title." In In re War, the Fourth Circuit Court of Appeals concluded that the phrase "payment of the claim as modified" is ambiguous because "it cannot be determined, merely from the nature of the test, whether the words 'as modified' should apply to 'payment' or 'claim.'" Upon further analysis, the Fourth Circuit concluded that section 1322(c)(2) does not provide a clear-cut rule of cramdowns of short-term mortgages, but rather is limited to modification of the payment schedule. But in American Gen. Finance Inc. v. Pachon (In re Pachon), the Eleventh Circuit U.S. Court of Appeals held that section 1322(c)(2) "literally" and concluded that short-term mortgages could be crammed down. The Pachon court's reasoning was based on an interpretation that the phrase "as modified" modifies, as a matter of grammar, the term "claim" rather than the full phrase "payment of the claim." Since "as modified" immediately follows "claim," the Eleventh Circuit saw no need to look further. The Wint decision suggests that other courts may find the view less than compelling.

C. The Section 522(f) Attack on the "Unsecured" Judicial Lien in the Joint Case

For section 522(f) to apply, it is necessary that the Third Circuit Court of Appeals join the other circuits in finding that a judicial lien held by the debtor for a mortgage held by the creditor who filed the suit is entitled to absolute protection. But, in a Joint Case the Bankruptcy Code provides for a court to consider whether the pre-reaffirmation discussions were "conceivable," but concluded that merely linking reaffirmation of secured debt to reaffirmation of unsecured debt did not violate that standard. The First Circuit court held that "anyone deal in a series of tradeoffs." It concluded that a debtor who files for Chapter 7 should anticipate that creditors will seek reaffirmation of the secured debt in order to maintain the right to foreclose. The court clearly left open the possibility that improper threats could cross the line and become coercive under some circumstances. Moreover, the general approach of the First Circuit leads to a case-by-case analysis of whether particular creditor conduct has crossed that line. On the other hand, this approach has always been a part of automatic stay violation litigation. And the First Circuit seemed to make clear that a statement of the creditor's legal rights, and the probable consequences, is not coercive. Overall, the First Circuit clearly has taken

II. Reaffirmations

In 2001, a First Circuit BAP concluded, in Katsidin Federal Credit Union v. Jono (In re Jono), that a creditor which had a security interest in the debtors' home violated the automatic stay by threatening to repossess the mortgaged property if the debtor did not reaffirm. The BAP's rationale was that, while there is no implied exception to the automatic stay for collection action when a creditor is seeking to negotiate a reaffirmation agreement from a "willing" debtor, the creditor could not "coerce" the debtor. The crucial step in the BAP's analysis was its view that conditioning the reaffirmation of one debt upon the reaffirmation of other debts was coercive. The First Circuit Court of Appeals, however, reversed the BAP. It agreed that in deciding whether there was an automatic stay violation, the court should consider whether the pre-reaffirmation discussions were "conceivable," but concluded that merely linking reaffirmation of secured debt to reaffirmation of unsecured debt did not violate that standard. The First Circuit court held that "anyone deal in a series of tradeoffs." It concluded that a debtor who files for Chapter 7 should anticipate that creditors will seek reaffirmation of the secured debt in order to maintain the right to foreclose. The court clearly left open the possibility that improper threats could cross the line and become coercive under some circumstances. Moreover, the general approach of the First Circuit leads to a case-by-case analysis of whether particular creditor conduct has crossed that line. On the other hand, this approach has always been a part of automatic stay violation litigation. And the First Circuit seemed to make clear that a statement of the creditor's legal rights, and the probable consequences, is not coercive. Overall, the First Circuit clearly has taken
a step back from the super-protective stance toward the debtor that the bankrupt court and BAP took in Jome. As a result, it is clear that secured and unsecured creditors can act reasonably in protecting their position to debtors as part of reaffirmation negotiations, including linkage of court and unsecured debt and an accurate description of the creditor’s foreclosure rights.

III. Other Circuit and BAP Cases of Interest

A. The Pitfalls of Litigation: When Is a Settlement a Bad Thing?

In Zucker v. Werner (In re Werner),14 the Fourth Circuit U.S. Court of Appeals decided that a settlement of a fraud claim was a settlement that converted the non-dischargeable fraud claim into a dischargeable contract claim. In re Werner, presented the United States Supreme Court has accepted certiorari for review.

There is a split in the Circuits on this point. In Werner, the Fourth Circuit joined the Ninth and Seventh circuits.15 The District of Columbia Circuit and Eleventh Circuit have taken the opposite view, focusing on the nature of the underlying basis for the contract. 16 A Sixth Circuit BAP agreed with the latter approach.

This issue can arise when settling pre-petition, non-dischargeable debt. Careful drafting of the settlement agreement is important. The rationale of Werner’s statute by reason of the settlement agreement containing a general release, a novation occurred. The problem can therefore be avoided by drafting a settlement agreement that does not release the underlying claim, but merely liquidates it in a certain amount. Or, if in fact the parties intend the agreement to result in a novation and a change in the non-dischargeable character of the obligation they should say so and include a specific release in the agreement.

B. Who Can Sue a Creditor to Assert Avoiding Powers

Can the debtor assert an avoiding power against a creditor? This has been an issue for some time, both in commercial and consumer cases. Recently, in a commercial case, the Third Circuit U.S. Court of Appeals concluded that only the case trustee or a debtor in possession (DIP) (in Chapter 11)17 could use to assert the avoiding action. Such a case is a question of the nature of the underlying case for the contract. A Sixth Circuit BAP agreed with the latter approach.

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During the pendency of this case, no interest, penalties, late charges, or costs of collection, including attorney's fees, have been incurred upon his discharge. Debtor...shall be liable for only the unpaid balance of his prepetition debt.

The debtor obtained an order confirming the plan. The student loan agency agreed to the received notice of the debtor's plan as well as the confirmation order, and did not object to the plan or appeal the confirmation order.

After the debtor received his discharge, the student loan agency notified the debtor that it had applied his plan payments to his prepetition debt. The debtor then reopened his bankruptcy case seeking a determination that his plan discharged all postpetition interest that accrued during the pendency of his case. The student loan agency argued that the debtor could not discharge postpetition interest without proving undue hardship in an adversary proceeding. Relying in part on Anderson v. Unipac Nebrieh (In re Anderson),[3] the bankruptcy court ruled that the appealed confirmation order was ex vacuo, and that postpetition interest had been allowed. The district court reversed, and the decision was appealed to the Fourth Circuit.

In its Bankruptcy decision, the Fourth Circuit first noted that the Bankruptcy Code and Rules require debtors to file an adversary proceeding in order to discharge student loans and postpetition interest on student loans.[4] Further, the court noted that the Bankruptcy Rules require heightened notice requirements for adversary proceedings. In fact, the Fourth Circuit expressly rejected the Tenth Circuit's Anderson decision precisely because the Tenth Circuit did not address the due process requirements of an adversary proceeding. Moreover, an adversary proceeding requires the debtor to show the burden of proof to establish an undue hardship.[5]

The Fourth Circuit then held that the debtor's attempt to establish undue hardship in the plan was no more than "discharge by delay."[6] The Fourth Circuit broadly held that the due process requirements that accompany an adversary proceeding will bar debtors from discharging student loan debts by merely inserting language in a Chapter 13 plan. [7]

More recently, Judge Niles Jackson of the Bankruptcy Court for the Western District of Oklahoma published an interesting and somewhat similar opinion regarding what the court termed improper "gameness" by debtors' counsel. [8]

In Lembay, the debtors' counsel inserted language in a Chapter 13 plan that called for abatement of interest on student loan debt during the term of the Chapter 13 plan. Furthermore, the plan directed that all collection expenses and penalties associated with the student loan would be paid as unsecured debt and thus discharged. At the Lembay confirmation hearing, the student loan creditors argued that both a student loan and the interest accruing postpetition on the student loan are non-dischargeable in bankruptcy. The creditors further noted that the same debtor's counsel had unsuccessfully tried to insert similar language in a Chapter 13 plan submitted to Judge Jackson's predecessor, Judge John T. Seiselle, in a prior case, and that Judge Seiselle had specifically rejected that practice.

Judge Jackson used the Lembay case as an opportunity to discuss the Tenth Circuit's holding in Anderson, in light of subsequent case law such as the Fourth Circuit's Bankruptcy Court decision discussed above. Judge Jackson noted that both the Bankruptcy Code and Rules require debtors to initiate adversary proceedings to discharge student loan debts upon a requisite showing of undue hardship. He also noted that the rights to be determined in adversary proceedings involve heightened notice requirements under Bankruptcy Rule 7004.

Judge Jackson observed that the Anderson court did not address the issue of the heightened due process notice requirements for adversary proceedings. Therefore, in the absence of guidance from the Tenth Circuit on the matter, Judge Jackson reviewed the reasoning and result of the Fourth Circuit's Bankruptcy Court decision, declaring that he would enforce compliance with the due process requirements as set forth in the Bankruptcy Code and Rules. Judge Jackson also used the Lembay opinion as an opportunity to caution the bankruptcy bar about his dim view of the "gameness" by the debtor's counsel. Included within the ambit of such gameness would be: (1) attempts to discharge otherwise nondischargeable debt through plan language; (2) assertion of exemptions as to property that is clearly not exempt under state law; (3) plan provisions characterizing, as unsecured, claims that are clearly secured; (4) plan provisions that unilaterally lower a contract rate of interest; (5) attempts to cram-down junior mortgages without proper notice; and (6) any other attempt to bypass clear and unequivocal language of the Bankruptcy Code and controlling case law.

C. Debtors No Longer Routinely Excluded From Attending Their Meeting of Creditors

Under 11 U.S.C. section 343, the Bankruptcy Code requires debtors to appear at their section 341 meeting of creditors. A debtor who is not in mandatory language, debtors periodically seek to be excused from attending the section 341 meeting. A recent bankruptcy court decision examined the circumstances under which debtors may be excused from their obligation to attend the meeting of creditors.[26]

In concluding that the debtor is required to attend the section 341 meeting, the court stated that there is one departure from the mandatory requirement imposed by section 343. Individuals who file bankruptcy and are in the military service may have some relief. The Soldiers' and Sailors' Relief Act may apply. But, according to Judge Bohan in Agnew, "[m]ilitary debtors are not excused from appearing at the meeting of creditors but, upon a proper showing, it may be stayed until they are able to appear."[27]

Federal Reserve Adopts Regulations...

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38. Agnew, 38 B.R. at 54.