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1997

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Case Developments in Consumer Bankruptcy Highlight Need for Statutory Reform

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I. Introduction

A new record was established for bankruptcy filings in 1996. Through June 30, 1996 there were 1,042,110 bankruptcy filings of which 989,172 were non-business filings, i.e., "consumers." This record has resulted in considerable media attention and provided a spur to the ongoing work of the National Bankruptcy Review Commission (Commission) as well as new interest in Congress. While concern for the record number of filings (unrelated to a major economic recession) continues to challenge the best minds, in terms of the justification for
bankruptcy little advance has been made on the metaphor of the honest but unfortunate debtor so often recalled from Local Land Co. v. Hunt. For example, the summary of the basic bankruptcy concept for consumer debtors as proposed for the Consumer Bankruptcy Working Group of the Committee on a goal the perspective of a "balance between creditors and debtors by making bankruptcy benefits available only to debtors who are legitimately in need of the bankruptcy system to reorganize their financial affairs."

Thus, although numerous voices have been raised against a form of bankruptcy relief, little consensus has been formed beyond the broad yet vague desire to help the honest but unfortunate debtor of Local Land Co. v. Hunt. Your authors believe that little in the way of fundamental reform can be expected unless a further consensus on this issue is achieved at least in Congress. A complex and efficient Bankruptcy Code that significantly reduces personal agreements must be based on getting principles to the courts in applying the statutory language to the specifics of the numerous and diverse cases. Courts and litigants need to know more about what our society expects debtors to do when repayment of the creditor entitlement becomes difficult. The increasing need for courts to reflect division in that regard with consequent lack of uniformity and resulting "quasi-independent judicial districts, in which individual judges may pursue their own agendas." Your authors also share the concerns noted by the Commission's Bankruptcy Working Group, particularly the "possibility of abuse, complexity and expense and nonuniformity." But we urge the Commission to observe the recommendation of John Frank long ago that law reform should be guided by the desire to "reduce and simplify decision points." Often well-meaning reform goes astray because the decisions called for by the courts to implement legislative policy require both superior judgment and such a wide breadth of factual considerations that neither consistency nor reasonable costs are achieved. Asking courts to reduce "substantial abuse" or only to approve that which is done in "good faith" simply parses the back with out any real guidance as to the goal to be achieved and provides no means to reduce litigation costs.

II. Substantial Abuse

This area continues to grow in tandem with the increasing number of bankruptcy filings. It necessarily involves the judge in the "day-to-day financial life of the debtor." This intrusive but currently essential inquiry is apparent from any reading of the cases. As two of us noted last year the factually intensive nature of the inquiry is "cumbersome and expensive" and essentially escapes effective appellate review. Two cases will be used merely to illustrate the on-going difficulties.

In In re Vareaze displays some of what is often hidden in the reported cases. The court reported the time delay occasioned by the section 707(b) proceeding. The debtors filed their Chapter 7 petition on January 6, 1995. The U.S. Trustee's motion to dismiss was filed June 9, 1995, orally argued on July 18 and August 8, 1995, evidently heard on September 27 and October 13, 1995, and briefs were submitted and the matter submitted November 22, 1995. The decision was rendered and the case dismissed January 19, 1996. Thus a year's time of the debtors, their creditors, the U.S. Trustee, and court personnel was consumed in finding that relief under Chapter 7 would constitute a substantial abuse. The debtors' assets totaled about $177,000 which included a residence valued at $170,000. Secured debts were about $153,000 and unsecured debts totaled about $20,000. The unsecured debt of $193,000 was a personal guarantee on a corporate promissory note on which no demand had been made, and $86,500 were gambling debts at least $70,000 of which had been incurred within 120 days before bankruptcy. The debtors also estimated that $150,000 in gambling losses had occurred during the last year before bankruptcy. There was also a debt for funds borrowed from one of the debtors' tax exempt annuity, a nondoctrined student loan, and various credit card debts on which payment had ceased in October 1994. Despite ceasing credit card payments the debtors leased a new car and purchased a used car in October 1994. While the debtors' schedules filed in January 1995 reported monthly income of $6,700 after deductions, one debtor had lost her job at the time of the hearing and testified that she had not sought full-time employment since being terminated. This resulted in total monthly income at the time of trial of $4,307. Although in their mid-50s both debtors were entitled to retirement plans in the near future. The debtors' monthly expenses varied from $8,420 in their schedules to $4,659 in a debtors' trial exhibit. The U.S. Trustee proposed a further reduction to $3,380.

In beginning its discussion of section 707(b), the Vareaze court noted that "[o]ne of the main purposes of bankruptcy law historically has been to relieve honestly indebted debtors from the weight of oppressive indebtedness, thereby allowing them to start afresh." The court tied this principle to the totality of the circumstances, set forth by the Fourth Circuit in In re Green. The court noted Green's citation to an earlier decision of the bankruptcy court quoted the relevant factors to include:

1. Whether the debtors have a likelihood of sufficient future income to fund a Chapter 13 plan which would pay a substantial portion of the unsecured claims;
2. Whether the debtor's (sic) property per capita is below the $12,000 threshold set by the U.S. Trustee, the court found enough disposable income to pay $927 per month which would pay 19% of the $75,000 owed. The court noted that 50% had been suggested as a test for substantial abuse in some cases and that the debtors here could not approach 50%. The court in response said: "If the facts that the debtors are unable to repay more than 50% of the funds borrowed from their discharge under Chapter 13 plan does not stand lying preclude the Court (sic) granting the UST's motion, nonetheless," the court then turned to certain aggravating factors in its analysis.

The court noted that the bankruptcy was not precipitated by any lack of funds in fact the debtors' testimony concerning retirement plans in the near future. In applying these factors the court first reduced the unsecured debt to $175,000 by eliminating the contingent debt of $193,000, apparently because it had not been called. Also eliminated from consideration was the $30,234 in student loans because they were nondoctrined and $42,570 owed to one debtor's former spouse. It was his own money. It is unclear why the student loans should not be considered in the totality of the circumstances. The court could not be said to be a finding that could not or might not be paid or because of disposable income or otherwise. Nevertheless, the issue thus became whether the debtors' net worth was such that it could not be paid for more than remaining $175,000. This goal was accomplished by determining what was necessary for 'the reasonable maintenance and support of the debtors, i.e. not to deprive item of adequate food, clothing, shelter and other necessities." Adopting in large part the analysis in In re Green the court noted that the U.S. Trustee, the court found enough disposable income to pay $927 per month which would pay 19% of the $75,000 owed. The court noted that 50% had been suggested as a test for substantial abuse in some cases and that the debtors here could not approach 50%. The court in response said: "If the facts that the debtors are unable to repay more than 50% of the funds borrowed from their discharge under Chapter 13 plan does not stand lying preclude the Court (sic) granting the UST's motion, nonetheless," the court then turned to certain aggravating factors in its analysis.

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unsecured debt over a three-year period, although there is a presumption in favor of the debtor under section 707(b), the debtors were denied the Chapter 7 "opt-out" exception because the ethical quality of their behavior—behavior which is arguably not morally different from that of thousands, if not tens of thousands, of other debtors. The moral quality of the debtors' behavior is reflected in the passage:

"According to one debtor's written statement, as well as his testimony, it is obvious that the debtors are being treated in a manner that is not for the next few years, essentially debt free. However, debtors' financial planning for the future should not be at the expense of their creditors, even if debt repayment will be less than significant. As this Court [sic] noted in Pellici, "It is morally and legally unconscionable that a person should be able to extinguish his obligations without first making a reasonable effort to fulfill them."

Your authors agree that there are moral issues in bankruptcy that can inform the legal text—especially where the statutory language is so vague and is based on an equitable tradition. But where it does seem that the bankruptcy court is in a plodding sense of its nearly impossible for the standards to require a

common law cohesiveness in the absence of other effective appellate control (unlike where as here the cases are so numerous and the issues are treated as factual or specific guidance from Congress). A consensus seems to be struggling to emerge that a "reasonable" or "best" effort to repay creditors ought somehow to work in ways to bring back bankruptcy practice on the basis of legal traditions and cultural expectations. This reflects to some claim by unsecured creditors to some portion of the debtor's future income. But to principally impose such a standard through the medium of the bankruptcy court is difficult and wholly short of better guidance from Congress. The resulting nonuniformity of substantial abuse litigation is clear from any perusal of the cases. More than one bankruptcy judge has noted unsure "with passing judgment on expenditures which represents a debtor's choice of lifestyle." But [10] make determinations as to whether the debtor's expenditures are "reasonably necessary" to perform an unfortunate but essential task in the absence of more specific standards. Your authors applaud the bankruptcy judges who undertake this inquiry seriously and unemotionally. The point is not that the inquiry is unwarranted, but that better guidance is deserved.

The issue regarding ability to pay a significant amount of the unsecured debt in a Chapter 13 plan is often seen as either a per se rule or one of the totality of the circumstances. This oversimplifies the issue. As suggested above, there is no agreement on what is a significant portion of the unsecured debt. Moreover, some cases apparently following the per se rule contain heavy overtones of a moral aggravating circumstances test. For example, re 

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Dierow involved debtor with net monthly income of $2,691 and monthly expenditures of $5,876. The U.S. Trustee questioned $1,266 of the monthly expenses but the court found them "not inordinate." Total debt was shown as $83,600 secured and $93,978 unsecured. Although adopting a per se rule, and thus purporting to ignore what we have called the moral factors, the court early noted (as favoring the debtor) two related factors: Mrs. Dierow had undergone a number of surgeries until just before bankruptcy and as a result, had to reduce her employments to part-time. Despite this, medical bills shown as only $459, although more could be credited in the credit card debt of $15,256. It would seem that in a per se jurisdiction uncontrollable expenses having some moral overtones in the absence of a rule does little to enable the courts to form a meaningful code. Form the case, it necessarily involves the courts in the daily lives of debtors. It also involves the courts in predicting the economic future—hopefully better than the failed predictions of the debtors and their creditors.

Dischargeability of Student Loans for Undue Hardship

Under 11 U.S.C. section 523(a)(8) certain student loans are nondischargeable unless "excepting such debt from discharge...will impose an undue hardship on the debtor or the debtor's dependents." As with other issues this involves the bankruptcy courts in detailed and intimate examination of the debtor's past, present, and future life.

Another circuit court has adopted the "Bruener test" of 

Bruener v. New York State Higher Education Serv. Corp. The Third Circuit in Pennsylvania Higher Education Assist. Agency v. Fatih (In re Fatih) felt that Bruener was "the most consistent with the scheme Congress established in 1978." The Bruener test requires a prerequisite to dischargeability:

"(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 for student loans; and (3) that the debtor has made good faith efforts to repay the loans.

The Bruener standard certainly seems to respond to Congressional concerns as every other court to consider the issue has done. The test does little to enable the courts to form a meaningful code. As noted, it necessarily involves the courts in the daily lives of debtors. It also involves the courts in predicting the economic future—hopefully better than the failed predictions of the debtors and their creditors.

Undue hardship is intended to be a harsh standard. One court last year adopted the "certainty of hopeless" standard as a dischargeability test in the absence of more specific standards. Your authors applaud the bankruptcy judges who undertake this inquiry seriously and unemotionally. The point is not that the inquiry is unwarranted, but that better guidance is deserved.

The issue regarding ability to pay a significant amount of the unsecured debt in a Chapter 13 plan is often seen as either a per se rule or one of the totality of the circumstances. This oversimplifies the issue. As suggested above, there is no agreement on what is a significant portion of the unsecured debt. Moreover, some cases apparently following the per se rule contain heavy overtones of a moral aggravating circumstances test. For example, in re 

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IV. Dischargeability of Nonsupport Obligations—Section 523(a)(15)

The 1994 Bankruptcy Reform Act greatly expanded the nondischargeability of divorce decree obligations. Now, nonsupport divorce obligations of a debtor may be excepted from discharge unless (1) the debtor does not have the ability to pay such debt from income or property of the debtor that is not reasonably necessary for the maintenance or support of the debtor or a dependent, and if the debtor is engaged in a business, for the payment of dividends or income to that business; or (2) discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to the spouse, former spouse, or child of the debtor. This "nonsupport" exception to dischargeability was enacted to be effective in bankruptcy cases filed after October 22, 1998. The two exceptions to nondischargeability under section 523(a)(15) (A) and section 523(a)(15) (B) are relatively permissive and a debtor need only prove on one of them in order to discharge a non-support obligation.

However, language in section 523(a)(15) suggests that the bankruptcy court must first determine whether the obligation in question is one for support. Since section 523(a)(15) is applicable only to divorce decree obligations "not of the kind described in section 523(a)(5)." However, the court found that nondischargeability was clear under section 523(a)(15), "an exhaustive determination of nondischargeability under section 523(a)(15) was unnecessary."
Section 523(a)(15) is a plethora of challenging conceptual and factual considerations, and courts have approached application of the provision with understandable trepidation.

One bankruptcy court stated:

Section 523(a)(15) is a pernicious creature. Using it is equivalent to applying acupuncture without a license because it does not heal the emotional wounds from a divorce. Indeed, section (a)(15) is an intrusive invasion into the private lives of a former couple who had agreed in their divorce to separate forever. Section (a)(15) can be described as an impediment to the emotional fresh start in life that divorce may bring. It also can impede the fresh start of bankruptcy. The section, presumably, was enacted by Congress to fill in the gaps in sections (a)(6) by protecting ex-spouses who pass through that section and are harmed.

B. Burden of Proof and Statutory Construction Under Section 523(a)(15)

Generally, an objecting creditor must establish nondischargeability by a preponderance of the evidence. However, as to section 523(a)(15), the courts have split on various issues as to the parties' respective burdens of proof. There appears to be agreement that the creditor has the initial burden of proof under section 523(a)(15). The majority view appears to be that this initial burden is limited to establishing a valid claim under a separation agreement, divorce decree, or other order of a court relating to such familial obligations.

Some courts have held that the creditor's initial burden includes proof that the obligation in question is not for alimentary or support under section 523(a)(5).

A. The rationale for this requirement is not clear. It is true that section 523(a)(5) relates only to familial obligations "not of the kind" provided for under section 523(a)(6). Nonetheless, it is obviously not the defense to nondischargeability to assert that an obligation pled under section 523(a)(15) is actually one under section 523(a)(5), since section 523(a)(5) obligations are nondischargeable also. Perhaps the practical solution for a creditor is to plead the two sections in the alternative. Interestingly, it has been held that where a dischargeability complaint only raises section 523(a)(15), the court can still find obligations nondischargeable under section 523(a)(5).

Beyond the creditor's initial, limited burden of proof, there is considerable disagreement among the courts. Fundamentally, the cases divide into three different approaches.

The majority approach appears to be that the creditor's satisfaction of its initial burden gives rise to a "rebuttable presumption of nondischargeability" by which places upon the debtor the burden to prove either the debtor's inability to pay the obligation or that discharging the debt would confer a benefit upon which would outweigh the detriment anticipated by the intended beneficiary of the obligation.

Under this approach, it has been held that the exceptions to nondischargeability under section 523(a)(15) should be pled as affirmative defense.

On the other hand, some bankruptcy courts have held that the objecting creditor has the burden of persuasion on all material issues under section 523(a)(15). Practically, what section 523(a)(15) calls for is a creditor showing that the debtor can pay for his or her obligations despite the bankruptcy petition or plan.

A third approach is that "the burden of going forward...shifts to, varying degrees, to the objector upon the creditor's plaintiff's satisfaction of their initial burden, but that the ultimate burden of proof remains upon the debtor/plaintiff to establish the elements of section 523(a)(15)." Under this approach, upon satisfaction of the creditor's initial burden of proof, "the burden of going forward and the burden of proof is bifurcated."

If the debtor can show the inability to pay the [section 523(a)(15)] debt then the examination stops. There is no motivation for plaintiff to restate that burden. However, if the debtor can afford to make the payment, then the plaintiff has the burden, as is the norm in dischargeability actions, to show that the detrimental consequences outweigh the benefit to the debtor. This bifurcation results in placing the burden upon the party to more easily present evidence. Thus the debtor must plead the affirmative defense of section 523(a)(15) or waive it. In that event, the court goes immediately to the issues of section 523(a)(15)(B) where plaintiff has the burden of proof.

As with exceptions to discharge generally, courts have held that the objecting creditor has the burden of persuasion on all material issues under section 523(a)(15).

C. Debtor's Ability to Pay

A non-support divorce decree obligation is dischargeable "if paying the debt reduces the debtor's current income below what necessary for the support of the debtor and the debtor's dependents." Thus, the Court finds a similar analysis is appropriate.

To be confirmable over the objection of the non-support divorce, a Charette 13 plan must provide that all of the debtor's projected "disposable income" for a three year period will be applied to plan payments. "Disposable income" references income received by the debtor "which is not reasonably necessary to be expended..." for the maintenance or support of the debtor or a dependent of the debtor.

Thus, a creditor engaged in a bankruptcy case is not to receive funds reasonably necessary for the maintenance or support of the debtor or a dependent of the debtor, or to receive funds necessary for the continuation, preservation, and operation of such business.

The disposable income test analyzes whether the debtor's budgeted expenses are reasonably necessary.

Courts interpreting "reasonably necessary" have arrived at several standards. Many courts are resistant to impose more on the values on the debtor to the exclusion of luxury items and obvious indulgences. Other courts find that only those expenses for basic needs not related to the debtor's former status in society or accustomed lifestyle should be allowed.

D. Balancing Test

Even if a debtor is able to pay the obligation in question, it is dischargeable if discharge is more beneficial to the debtor than detrimental to the complaining party. Thus, the Court finds a similar analysis is appropriate.

The debtor is able to pay the [section 523(a)(15)] debt. The use of the phrase "ability to pay" in section 523(a)(15)(A) directs the Court to Section 1325(b)(2)'s "dischargeable income" test. The Language of Section 523(a)(15)(A) essentially mirrors the language of Section 1325(b)(2). Thus, the Court finds a similar analysis is appropriate.

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discharge, but efforts to convince the debtor in reafrm may violate the automatic stay.

For example, in In re Walker,127 letters suggesting that two Chapter 7 debtors reaffirm certain credit card debts were held to violate the automatic stay. The letters allowed 3 days to reaffirm, included proposed reaffirmation agreements that did not disclose the right to rescind the agreement, and were deemed contrary to what a reasonable person would consider fair.128

Conversely, in In re Epestrimmer129 the court concluded that a department store's letter suggesting reaffirmation was not threatening or burlesque and did not violate the automatic stay. This letter acknowledged the bankruptcy, noted the creditor’s “whoopie money security interest and the debtor’s options, proposed a reaffirmation that would preserve the debtor’s line of credit, and asked the debtor for a statement of his intentions.130

The letter was sent to the debtor’s attorney with a copy to the debtor (marked “for information only”). In a similar case,131 the Seventh Circuit held that sending in the debtor a copy of a nonthreatening letter to the debtor’s attorney (offering to continue a line of credit upon reaffirmation) did not violate the automatic stay. This appears to represent the majority rule,132 and a notable textbook of some bankruptcy and appellate courts to develop consistent legal standards in the complex law tradition, without specific statutory guidance.

C. Other Stay Issues

Both the broad scope and the limits of the stay were illustrated in a series of recent cases. In In re McVillen133 the creditor argued that a postpetition deed of trust executed by the debtor was a conveyance of real property to a good faith purchaser for value without knowledge of the bankruptcy case, as to be protected from the automatic stay under Bankruptcy Code section 541(c)(3).134 However, the Ninth Circuit held section 541(c)(3) protects only a transfer of property and not the creation of a lien (as created by a deed of trust).135 This may be an unduly restrictive interpretation, as the “lien” is defined in the Bankruptcy Code as (among other things) “an interest in property.”136 "Purchaser" is interpreted generally in commercial law to include acquisition of a consensual lien.137

In re Leavelle138 serves as a reminder that upon confirmation of a Chapter 13 plan only that portion of the debtor’s earnings necessary to make the plan payments is property of the estate. The remainder of the debtor’s earnings is not estate property and is not protected by the automatic stay.139

Finally, the division continues between these courts concerning violations of the automatic stay voidable, and those that consider them void. In one case, for example, an unauthorized postponement foreclosure sale (and purchase of the collateral by the creditor at that sale), conducted without knowledge of the bankruptcy case, was not void.140 Of course, an automatic stay may not replace a lien superior to the transferor for purposes of section 547(c)(1).141

In the case at bar, however, a number of courts have been unable to distinguish between analysis of the date of perfection for purposes of section 547(c)(1) and analysis of the date of perfection for purposes of section 547(c)(3).142 Therefore, in determining the effective date of perfection for purposes of section 547(c)(3), one recent example is Fitzgerald v. First Security Bank of Alabama,143 which held that the Ninth Circuit created a false conflict between state and federal law by incorrectly using the transfer date as section 547(c)(2)(A) to define perfection for purposes of section 547(c)(3). Thus, it concluded that the under a rule at section 547(c)(2)(A) as defined by section 547(c)(3) for perfection for purposes of section 547(c)(3), and then concluded that the ten day rule at section 547(c)(2)(A) cannot apply to establish state law grace period for perfection.144

Since the Bankruptcy Code preempts inconsistent state laws, the result of this false conflict was to override the applicable state law grace period for perfection (which the secured creditor had complied with) and apply the applicable 90 day grace period for transfers at section 547(c)(2)(A). As the security interest was not perfected within the 90 day carry over period, the collateral had to be avoided. Had the court recognized that the effective date of perfection for purposes of section 547(c)(3)(B) is determined under section 547(c)(1)(B), incorporating the state law grace period, it would have been apparent that the effective date of perfection for the state law was within the Bankruptcy Code purchase money grace period at section 547(c)(3)(B), and the security interest would not have had to be avoided.

The propriety of some courts to create a false conflict between federal and state law (resulting in preemption of the federal and lack of important interest preemected in accordance with recognized state commercial law standards), when the Bankruptcy Code specifically recogines and incorporates that state law, remains puzzling, particularly in view of the case law properly analyzing these issues.

VI. Other Preference and Avoidance Issues

Bankruptcy Code section 547(c)(3)145 protects from avoidance de minimis transfers by a consumer debtor of less than $600. In In re Djerf146 the court held that multiple transfers to the same creditor should be aggregated and avoided if the total exceeds $600. The creditor argued that use of the term “transfer” (rather than “transactions”) in section 547(c)(3) means that each individual transaction must be measured individually, but the court emphasized that the section also refers to “the aggregate value of all property that constitutes or is affected by such transfer.”147

Subsequently the issue came before the Fifth Circuit in Matter of Hailers.148 The Fifth Circuit agreed with the court in Djerf, on grounds that under Bankruptcy Code section 102(2) ("the singular includes the plural.").149 The court also noted that in attempting to prevent creditors from structuring large transfers in $599 increments as a means to contumace section 547.

The risk that such abuses would otherwise go unpunished seems somewhat overstated; indeed, the countering risk is that individual creditors, such as Hailers, small transactions intended to be protected under section 547(c)(8) may now be subject to avoidance because the court should have a continuous relationship that involved a number of small transactions. The result may be that an entire range of ordinary course of business payments will be jeopardized by rules designed to combat abusive preferences.
Among the other recent preference cases of interest, a bankruptcy court in Virginia rejected the Seventh Circuit's view that a payment made during the preference period satisfies an excusable omission. In re Avery 187 held that a lien could not be avoided under Bankruptcy Code section 522(f)(1) even though it was a judicial lien on an exempt homestead because the first mortgage loan on the homestead exceeded the value of the property and thus there was no homestead equity to be impaired.188

VIII. Valuation and Crum-Down of Liens

A. Method of Valuation

In 1996 a significant split developed among the circuits as to whether retail or wholesale value is the appropriate measure for the value of collateral when the debtor is seeking to "crum down" a lien to its market value. Creditors typically argue that retail value (or "replacement cost") represents the fair market value as that term is commonly understood, and this seemed to represent a solid majority position prior to 1996.189 Subsequently, however, the Fifth Circuit reversed its prior position in Reinhart and adopted a "case by case" approach that allowed the use of wholesale value.190

In the meantime, the 11th Circuit held in a Chapter 11 case that the fair market value of real estate (essentially the "replacement cost") rather than the liquidation value (the equivalent of wholesale value) should be used in valuing the collateral.191 This case is consistent with Whipple and the Fifth Circuit's earlier decision in Reinhart, as well as other recent U.S. Court of Appeals decisions supporting a retail valuation standard.192 But then the Seventh Circuit affirmed a holding that a value midway between retail and wholesale value should be used on the basis that it represented a theoretical compromise between the positions of the two parties that was appropriate in the absence of more specific statutory guidance.193 This left the majority rule favoring a retail valuation apparently intact, though subject to differing decisions in the Fifth and Seventh Circuits, until the U.S. Supreme Court resolved the issue in an eight-to-one decision authored by Justice Ginsburg.

Quotable Report

The majority rule would have been that "replacement cost" should be used. The reported opinions are of the opinion that a middle ground was more appropriate when the value of property was not in dispute and the collateral was closely related to the nature of the transactions involved, unless the court found that an "objective, reasonable, and generally accepted method of valuation is available to the court other than the generally accepted methods of valuation under this subpart," which was not the case here. In Whipple, 905 F.2d 1361, 1367 (5th Cir. 1990), the court held that the "replacement cost" method was "appropriate for valuing property which is not subject to a lien," and that "the method of valuation shall be determined by the nature of the transaction involved," not the type of collateral or property involved. See 11 U.S.C. § 522(f)(2)(A). The Fifth Circuit, however, has held that the court should determine the value of the collateral in the marketplace, which is more consistent with the Ninth Circuit's approach. In Whipple, 905 F.2d 1361, 1367 (5th Cir. 1990), the court held that the "replacement cost" method was "appropriate for valuing property which is not subject to a lien," and that "the method of valuation shall be determined by the nature of the transaction involved," not the type of collateral or property involved. See 11 U.S.C. § 522(f)(2)(A). The Fifth Circuit, however, has held that the court should determine the value of the collateral in the marketplace, which is more consistent with the Ninth Circuit's approach.

Reinhart v. Whipple, 471 F.2d 721 (5th Cir. 1973), reh. en banc denied, 473 F.2d 1294 (5th Cir. 1973), is the leading case in this area. In Reinhart, the court held that the "replacement cost" method was more appropriate for valuing property which is not subject to a lien, and that the method of valuation should be determined by the nature of the transaction involved, not the type of collateral or property involved. See 11 U.S.C. § 522(f)(2)(A). The Fifth Circuit, however, has held that the court should determine the value of the collateral in the marketplace, which is more consistent with the Ninth Circuit's approach.

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In re Richards, the court recognized use of the credit card as a representation of intent to repay but rejected the creditor’s argument that drawing $3,800 of a $4,000 credit limit in cash advances while owing other unpaid debts was evidence of fraudulent intent. In Master of America, the court held that the bank’s claim of inability to repay was not evidence of fraudulent intent because the debtor expected to repay the debt from profits of the business venture financed by the bank. In re Griffin, the debtor’s sale of household goods collateral was held to be a willful and malicious conversion, resulting in nondischargeability under section 523(a)(4).

XI. Equitable Subordination

In an important case that reflects the limits of Bankruptcy Code section 510(c), the United States Supreme Court held in United States v. Noland that bankruptcy courts may not use their equitable subordination authority under section 510(c) to alter the Bankruptcy priority system. The court established two bases for this conclusion. The court rejected the argument that the credit card finance charge was excessive. The court concluded that use of a credit card does not constitute any representation, express or implied, and that the debtor did not misrepresent his ability to repay. In re Christmas, the court held that the debtor was not required to repay the debt. The court determined that the debtor’s ability to repay was not evidence of intent to repay. The court held that use of the credit card as a representation of intent to repay but rejected the creditor’s argument that drawing $3,800 of a $4,000 credit limit in cash advances while owing other unpaid debts was evidence of fraudulent intent. In Master of America, the court held that the bank’s claim of inability to repay was not evidence of fraudulent intent because the debtor expected to repay the debt from profits of the business venture financed by the bank. In re Griffin, the debtor’s sale of household goods collateral was held to be a willful and malicious conversion, resulting in nondischargeability under section 523(a)(4).

D. Failure to Provide/Preserve Collateral

In In re Weisberg, the debtor obtained a loan to purchase an automobile, to be secured by a security interest in the vehicle. The loan proceeds were in part used by the debtor to purchase a new car. The debtor failed to provide or preserve collateral to secure the debt. The court held that the debtor was not able to provide or preserve collateral to secure the debt. The court held that the debtor was not able to provide or preserve collateral to secure the debt.
against lenders seeking to help rehabilitate urban areas (where multi-family properties are common), while protecting upper income suburban lenders (where single-family dwellings predominate). But the court concluded that this is appropriate because to do otherwise would create difficult "line-drawing" problems.240

Aside from these policy issues, the First Circuit's decision in Looman can be criticized on grounds of statutory language. While section 1322(b)(2) clearly does not protect a loan secured by properties other than the debtor's principal residence, the statutory language seemed to protect any secured loan exclusively by real property that is the debtor's residence. The only questions under this test should be whether the loan is secured exclusively by real property and whether that property is the principal residence of the debtor.241 It should be irrelevant whether the debtor rents out part of the property to others, uses the property partly as an office, or conducts other business in the garage or on the premises. The First Circuit's concern that this might allow the modification of a mortgage on a 100 unit apartment complex is perhaps understandable,242 although it is not clear why any debtor sophisticated enough to invest in such a property would want to create this problem by occupying the premises during his or her bankruptcy. But in any event the statutory language supports a broad view, and the inclination of some courts to de-emphasize the statutory language (in the face of Supreme Court precedent) seems to be correct.

240. The court should have treated the "plain meaning" approach to be analogous to the "premises" clause of 11 U.S.C. § 1322(a)(5) only if the plan payments are sufficient to preserve the present value of the creditor's secured claim. The court also rejected the debtor's "use the "cure" provision at section 1322(b)(5) to reduce the contract interest rate to section 1322(b)(2)." Secured claims other than home mortgage loans are not protected from modification under section 1322(c)(2), the primary protection for such liens lies in the plan confirmation requirement at section 1325(a)(5)(B), requiring preservation of the present value of the creditor's secured claim. This issue is commonly confronted in the context of efforts by the debtor to reduce the contract interest rate, typically from a very high to a very low rate.

241. For an excellent discussion highlighting these issues, see In re Smith, where the court rejected confirmation of three Chapter 13 plans because of proposed significant reductions in the contract interest rates.243 The court reasoned that: 244


244. 870 F.2d 1319, 1320 (2d Cir. 1989).
Chapter 13 equivalent also allows dis- 

missa for "cause." 271 In addition, a court 

court order of dismissal of sequential bank- 

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term of section 109(g) did not apply, so 

that a subsequent filing was not barred. 

In contrast, in the case in re Studer 274 the 

court denied the debtor's four prior bankruptcy cases evidenced an intent to manipulate and abuse the 

system. The court cited several violations of 

court orders and bankruptcy law that were 

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under section 109(g). In re Teel 275 a creditor objected to the confirmation of a plan filed by the debtor. It included a charitable contribution of 

$100 per month to the debtor's church. 

The court denied confirmation on the grounds that the plan did not commit all of the 

creditors' disposable income to the plan. "The court also held that the Religious Freedom Restoration Act, as applied in this case, constitutional violation of the separation of 

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wage garnishment is not a transfer for purposes of section 547(b) until the debtor performs the work and earns the wages subject to the garnishment. The court concluded that prior to that time the debtor has only an expectation of earnings but has no interest in those future wages to transfer. Although an equitable lien could be recognized based on service of the garnishment summons, the court reasoned that there were no funds to which the lien could attach until the earnings were payable. Therefore the wage garnishment was avoidable.

D. Fraudulent Transfers

Christians v. Christal Evangelical Free Church (In re Young) held that the debtors’ $13,450 prepetition contribution to their church was a fraudulent transfer, but that it could not be recovered due to a statutory conflict with the Religious Freedom Restoration Act (RFRA).

In Jobin v. McKay (In re M&L Business Machine Co.), the court considered the standard to be applied in determining whether a transferee receives a fraudulent transfer “in good faith” as a defense to avoidance under Bankruptcy Code section 548(c). The transferee received $43,500 from the debtor as part of a “ponzi” scheme operated by the debtor. In determining whether the transferee received the payments in good faith, the court applied an objective test, concluding that the transferee does not take in good faith if the circumstances would place a reasonable person on notice of a need to inquire and such an inquiry would have discovered the debtor’s fraudulent purpose. The court also concluded that the transferee had an offsetting fraud claim for restitution against the transferor/debtor.

XIV. Conclusion

Almost any review of recent consumer bankruptcy cases will reveal the extent to which moral, social, and philosophical factors are implicated in a bankruptcy system that broadly contemplates rearing private economic bargaining on the Religion of vague statutory standards. Without clear and specific guidance from Congress these cases will continue to reflect the widely divergent views of bankruptcy judges imposed on the basis of an unpredictable case-by-case analysis that poses significant litigation costs and delays on society. Even when the statutory language seems clear, some courts continue to read the statute to suit their own preferences, creating unnecessary inconsistencies.

Yet these deficiencies in the current Bankruptcy Code do not mean that the system is fundamentally flawed. With all of its faults, the bankruptcy system overall has performed remarkably well in recent years, and continuing ad hoc reform in a small number of areas where there are obvious weaknesses could result in significant further improvements. Hopefully, the system of Bankruptcy Appellate Panels will help reduce the incidence of judicial inconsistencies. Beyond this, what is needed is more specific statutory guidance for judges being forced to make difficult moral judgments regarding, for example, the choice between Chapters 7 and 13 and vague concepts involving substantial abuse, good faith, misrepresentation, and undue hardship. It does not seem too much to ask that Congress make these essentially political decisions rather than shifting the burden to a judiciary that is ill-equipped to do so on a consistent basis.

These statutory deficiencies appear apparent and easily remedied. They do not require fundamental, structural revision of the Bankruptcy Code, merely that Congress do what it is supposed to do by specifically confronting and resolving statutory ambiguities. If Congress undertakes this task, no doubt the result will be a series of political compromises, as it should be, but at least this would offer the prospect of solutions that would be applied more consistently, more predictably, and at lower cost than is presently the case.