SELECTED CONSUMER BANKRUPTCY ISSUES

Panel for the
22nd Annual University of Texas Bankruptcy Conference
Austin, Texas
November, 2003

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The Pro Tanto Invalidity of Protective Trusts: Partial Self-Settlement and Beneficiary Control, 78 MARQ. L. REV. 807 (1995).

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I.

PRE-BANKRUPTCY COUNSELING

Joe and Sally Client consult with their attorney concerning their financial problems. What factors should the attorney consider in counseling with them? Should the attorney suggest a course of action? If the attorney does so, should he or she mention only one?

Judicial discussions of what factors should be considered in planning for bankruptcy or potential bankruptcy have arisen frequently in cases involving the unauthorized practice of law. The practice of law includes advising clients on financial matters related to bankruptcy or on steps that might be taken as an alternative to a bankruptcy filing. Such advice requires a knowledge of both federal law and state property law and the application of the law to a particular situation. Thus, rendering such advice is something that a layperson may not do and that an attorney may not delegate to a non-lawyer. *In re ICLNDS Notes Acquisition, LLC*, 259 B.R. 289 (Bankr. N.D. Ohio 2001); *see In re Guttierez*, 248 B.R. 287 (Bankr. W.D. Tex. 2000) (Leif M. Clark, J.).

Initially, Joe and Sally's attorney would have to determine whether they would benefit from a bankruptcy filing, what the effect of bankruptcy on their credit might be, and what alternatives might be available. *ICLNDS Notes Acquisition*, 259 B.R. at 289; *Columbus Bar Ass'n v. Flanagan*, 674 N.E.2d 681 (Ohio 1997) (attorney was subject to bar discipline for delegating the responsibility for advising clients on such matters to a non-attorney employee). It is possible that some sort of workout or compromise with creditors, or with one or two major creditors, might, in some cases, offer as much as a full-scale bankruptcy proceeding. In this respect, it should be noted that legislation that Congress is considering would deny any individual the right to file a bankruptcy petition unless, with certain exceptions, the individual had consulted with an approved agency during the previous six months about the opportunities for budget and credit counseling.

If bankruptcy does appear to be the best option, the attorney should advise Joe and Sally on the comparative advantages and disadvantages of Chapter 7 and Chapter 13. *Guttierez*, 248 B.R. at 287. Notably, the Clients should be informed of the "super discharge" of 11 U.S.C. § 1328 and the completion of a plan as the price of that discharge. If Chapter 7 is selected, the attorney should discuss which secured debts should be reaffirmed and what personal property might be redeemed or surrendered under 11 U.S.C. § 521(2). *Flanagan*, 674 N.E.2d at 681. In addition, the lawyer should make the Clients aware of whether the relevant jurisdiction permits a "reinstatement" or "ride through" as an additional option. *Cf. In re Canady-Houston*, 281 B.R. 286 (Bankr. W.D. Mo. 2002) (noting that the Eighth Circuit has not spoken to the issue and that bankruptcy judges in the Western District of Missouri have been divided on this question). If Chapter 13 is selected, the attorney should discuss the contents of a plan, at least in general terms. *Guttierez*, 248 B.R. at 287.

Regardless of what chapter may appear best suited to Joe and Sally's needs, the attorney would have to advise them as to what property to claim as exempt and what new exempt property they might acquire. *See* Barbara J. Houser & Robert Taylor, *Pre-Bankruptcy Planning Using State Law Exemptions*, 389 PLI/REAL 153 (1993); Elizabeth R. Turner & Kathryn G.

Henkel, *Asset Protection Techniques*, C992 ALI-ABA 1 (1995); *see also In re Farness*, 244 B.R. 464 (Bankr. D. Idaho 2000) (petition preparer engaged in unauthorized practice of law and violated 11 U.S.C. § 110(f) by advising debtors as to what property to claim as exempt). In addition, the attorney should discuss reaffirmation, which otherwise dischargeable debts Joe and Sally might wish to reaffirm, and what the requirements for reaffirmation are. *Flanagan*, 674 N.E.2d at 681.

Even a relatively straightforward situation presents many choices. The attorney should be prepared to discuss the options and the likely consequences and help Joe and Sally reach an informed decision.

II.

PRE-BANKRUPTCY PLANNING AND POTENTIAL DISCHARGE PROBLEMS

If there is a potential objection to the dischargeability of a particular debt under 11 U.S.C. § 523(a), or a potential blanket objection to discharge under 11 U.S.C. § 727(a), should Joe and Sally Client's attorney advise them to file for bankruptcy?

An attorney owes a duty to offer a potential debtor honest and competent advice as to whether certain debts are dischargeable and what objections may be raised. Failure to do so may lead to liability for legal malpractice. *Swanson v. Sheppard*, 445 N.W.2d 654 (N.D. 1989) (failure to tell client about how student loans would be treated in Chapter 13); *see also Guillot v. Smith*, 998 S.W.2d 630 (Tex. App. — Houston [1st Dist.] 1999, no pet.) (failure to give accurate advice as to the nondischargeability of certain tax liabilities). Likewise, if an attorney himself or herself will have to testify as a witness in order to establish that a debt is dischargeable, the attorney should withdraw, at least from the discharge proceeding. *In re Seivers*, 74 B.R. 981 (Bankr. D. Colo. 1987).

That said, the mere fact that someone may file a complaint to determine dischargeability or an objection to discharge should not, without more, require an attorney to advise his or her client not to file a bankruptcy petition. In the first place, the exceptions to discharge for particular debts under 11 U.S.C. § 523(a) cut against the basic bankruptcy policy of giving the debtor a fresh start. Therefore, the various subsections of that statute are strictly construed against the objecting party and in favor of debtor. *In re Miller*, 156 F.3d 598 (5th Cir. 1998), *cert. denied*, 526 U.S. 1016 (1999); *accord, e.g., In re Baylis*, 313 F.3d 9 (1st Cir. 2002). The same policy of strict construction applies to the grounds for a general denial of a discharge set forth in 11 U.S.C. § 727(a). *In re Womble*, 289 B.R. 836 (Bankr. N.D. Tex. 2003) (Robert L. Jones, J.); *accord, e.g., In re Juzwiak*, 89 F.3d 424 (7th Cir. 1996); *In re Sendecky*, 283 B.R. 760 (8th Cir. B.A.P. 2002).

In addition, 11 U.S.C. § 523(d) provides that, if a complaint brought under section 523(a)(2) (obtaining credit, property, or services through false pretenses or false representations) is not "substantially justified," the debtor may recover reasonable costs and attorney's fees. This does not mean that the complaint must be outright frivolous before it is sanctionable; it does mean that a creditor risks sanctions if the complaint under section 523(a)(2) is not reasonably grounded in law or fact. *In re Shurbier*, 134 B.R. 922 (Bankr. W.D. Mo. 1991) (Koger, C.J.).

Section 523(d) was designed to deter questionable litigation designed to coerce the debtor into reaffirmation agreements. *In re Way*, 260 B.R. 291 (Bankr. M.D. Fla. 2000).

While section 523(d) only applies to complaints to determine dischargeability brought under section 523(a)(2), a complaint brought under any subsection of 11 U.S.C. § 523(a), or any objection to discharge under 11 U.S.C. § 727(a), may be subject to sanctions under Rule 9011. Thus, creditors have every incentive not to seek to deny a discharge on a whim. *In re Burse*, 120 B.R. 833 (Bankr. E.D. Va. 1990).

Other factors militate against refraining from filing a bankruptcy petition only because of potential discharge litigation. Section 523(a) applies only to deny the discharge of particular debts, and simply because one debt is not dischargeable does not mean that all debts must be denied a discharge. Furthermore, a debtor who successfully completes a Chapter 13 plan may obtain a the discharge of many sorts of debts that otherwise would be nondischargeable under section 523(a). *See* 11 U.S.C. § 1328(a)(2). The grounds for denying a discharge section 727(a) pertain to various sorts of abuse of the bankruptcy system itself, and truly egregious misconduct by the potential debtor might be grounds for counseling against a bankruptcy filing, at least if the potential debtor is unwilling or unable to cure the acts that would lead to a denial of a discharge. Nonetheless, no matter how reprehensible the debtor's misconduct may have been, a discharge may not be denied unless the relevant conduct falls into one of the categories specified in section 727(a). *In re Cutignola*, 87 B.R. 702 (Bankr. M.D. Fla. 1988); *In re Ksenzowski*, 56 B.R. 819 (Bankr. E.D.N.Y. 1985).

Even if a particular debt is declared nondischargeable, or if a discharge is denied altogether, the debtor is scarcely in a worse position than if no bankruptcy petition had been filed in the first instance. The debtor has simply not obtained the full potential benefits of a bankruptcy proceeding. In light of this consideration and of the strong presumption in favor of dischargeability, the possibility of objections, standing alone, should not deter an attorney from counseling the filing of a bankruptcy petition, provided that the attorney fully apprises the client of the potential risks concerning these matters.

If a bankruptcy petition is filed, a debtor's attorney should be honest and straightforward in dealing with a nondischargeable debt. For example, some Chapter 13 plans have included provisions to the effect that, upon completion of the plan, student loans will be discharged under the "undue hardship" provision of 11 U.S.C. § 523(a)(8). Often such provisions have been inserted in the plan in the hope that they will slip past the student loan creditor, who will then be bound by the res judicata effect of the confirmation order. Such a step deprives the creditor of the right to litigate the matter in an adversary proceeding. Moreover, the undue hardship question may be premature or unripe at the time of confirmation. *See* Kevin C. Driscoll, Jr., Note, *Eradicating the "Discharge by Declaration" for Student Loan Debt in Chapter 13*, 2000 U. ILL. L. REV. 1311 (2000). A number of courts have held that inserting such a provision in a plan may be sanctionable, particularly if the attorney had no good faith basis for including a term purporting to discharge a section 523(a)(8) debt. *In re Gardner*, 287 B.R. 822 (D. Kan. 2002); *In re Patton*, 261 B.R. 44 (Bankr. E.D. Wash. 2001); *In re Evans*, 242 B.R. 407 (Bankr. S.D. Ohio 1999).

III.

NONDISCHARGEABLE DEBTS AND UNFAIR DISCRIMINATION IN A CHAPTER 13 PLAN: 11 U.S.C. § 1322(b)(1)

May a debtor treat nondischargeable debts in a Chapter 13 plan differently than other classes of unsecured claims?

11 U.S.C. § 1322(b)(1) prohibits a chapter 13 plan from discriminating "unfairly" against any class of unsecured claims. The extent to which a debtor may classify nondischargeable debts separately and treat them more favorably than other unsecured debts has been subject to a great deal of controversy. Stephen L. Sepinuck, *Rethinking Unfair Discrimination in Chapter 13*, 74 AM. BANKR. L.J. 341 (2000).

Debts exempted from the sweeping Chapter 13 discharge fall into four broad categories. First, there is liability for death or personal injury resulting from operating a motor vehicle while intoxicated. 11 U.S.C. § 1328(a)(2). Second, liability for a criminal fine or restitution is not dischargeable. *Id.* § 1328(a)(3). Courts have been hostile to giving favored treatment to such debts on the ground that it is simply wrong for the debtor to shift the cost of punishment, deterrence, and/or restitution to other creditors. *In re Bennett*, 237 B.R. 918 (Bankr. N.D. Tex. 1999); *In re Williams*, 231 B.R. 280 (Bankr. S.D. Ohio 1999); *In re Ponce*, 218 B.R. 571 (Bankr. E.D. Wash. 1998). Third, matured support obligations are nondischargeable. 11 U.S.C. § 1328(a)(2). If such obligations have not been assigned to someone other than the debtor's spouse, former spouse, or child, they are entitled to priority status, *id.* § 507(a)(7), so a plan *must* discriminate in favor of such claims. If such obligations have been assigned to a governmental unit, however, they lose their priority status while remaining nondischargeable, and thus questions of unfair discrimination may arise. *In re Crawford*, 324 F.3d 539 (7th Cir. 2003). Fourth, student loans are nondischargeable. 11 U.S.C. § 1328(a)(2). Student loans have spawned the most discussion and devising of formulae to determine whether the discrimination is unfair.

Courts have used at least five tests to determine whether a plan that classifies a nondischargeable debt separately and treats it more favorably than other unsecured debt discriminates unfairly. First, a few courts have held that discrimination is acceptable so long as it has a "legitimate" or "rational" basis. *In re Willis*, 189 B.R. 203 (Bankr. N.D. Okla. 1995) (ensuring a fresh start was a reasonable basis for discriminating in favor of student loan debt), *rev'd*, 197 B.R. 912 (N.D. Okla. 1996); *In re Brown*, 152 B.R. 232 (Bankr. N.D. Ill.), *rev'd*, 162 B.R. 506 (N.D. Ill. 1993). This test has been generally rejected. The mere fact that a debt is nondischargeable, and that paying it will aid the debtor's fresh start, does not, without more, justify foisting the burden onto other creditors. *In re Chandler*, 210 B.R. 898 (Bankr. D.N.H. 1997). The debtor's interests are not paramount in determining whether the discrimination is unfair. *In re Scheiber*, 129 B.R. 604 (Bankr. D. Minn. 1991). By statute, a nondischargeable debt receives preferential treatment after a plan is completed. There is no obvious reason why the debtor, solely for his or her own benefit, should give it preferential treatment during the life of the plan. *In re Coonce*, 213 B.R. 344 (Bankr. S.D. Ill. 1997).

Second, many courts have followed the four-part test expounded in *In re Leser*, 939 F.2d 669 (8th Cir. 1991): (1) whether there is a reasonable basis for the discrimination; (2) whether the debtor can carry out the plan without the discrimination; (3) whether the discrimination is proposed in good faith; and (4) whether the degree of discrimination is directly related to the rationale for it. This test has been criticized as hopelessly ad hoc, if not circular, and for failing to give adequate attention to the interests of creditors. *Crawford*, 324 F.2d at 539; *In re Simmons*, 288 B.R. 2003 (Bankr. N.D. Tex. 2003) (Lynn, J.); *In re Colley*, 260 B.R. 532 (Bankr. M.D. Fla. 2000).

Third, one court has held that discrimination in favor of a nondischargeable claim is at least presumptively fair if disfavored creditors receive 80% or more of what they would receive without the disparate treatment, and at least presumptively unfair if they receive less than 80%. *In re Sullivan*, 195 B.R. 649 (Bankr. W.D. Tex. 1996) (Clark, J.). This test is open to the charge that it is arbitrary. *Crawford*, 324 F.3d at 439. Fourth, some courts add the *Sullivan* test, or something like it, to the four-part *Leser* test. *See In re Chacon*, 223 B.R. 917 (Bankr. W.D. Tex. 1998) (Kelly, C.J.); *In re Strausser*, 206 B.R. 58 (Bankr. W.D.N.Y. 1997); *In re Koble*, 199 B.R. 569 (Bankr. D. Md. 1996). This fourth position is subject to all the criticisms that could be leveled at both *Leser* and *Sullivan*. In addition, such a five-pronged analysis could be unwieldy.

Fifth, some courts, stressing that Chapter 13 is designed for creditors at least as much as debtors, have propounded what might be called a "win-win" test. Discrimination is fair and acceptable if the discrimination is essential to enable the debtor to carry out the plan and if creditors as a whole are better off if the favored creditor receives preferential treatment. For example, if the debtor is a small proprietor, and if the favored creditor is an essential supplier who will not do any more business with the debtor unless he or she is paid in full, then it might be fair to discriminate in that creditor's favor. If the supplier ceased to do business with the debtor, the debtor might have to close up shop, and, if the debtor were unable to fund a plan, creditors as a group could be in a worse position. *Crawford*, 324 F.2d at 539; *see Simmons*, 288 B.R. at 737 (Lynn, J.); *see also Colley*, 260 B.R. at 532. The difficulty is that nondischargeable debts will seldom satisfy such a test. *See Crawford*, 324 F.3d at 539 (matured support obligations that had been assigned to a government agency); *Simmons*, 288 B.R. at 737 (student loans). If any nondischargeable debt could meet this criterion, it would be a criminal fine. If the debtor is likely to be incarcerated if the fine is not paid, creditors as a group may be in a better position if there is discrimination in favor of that debt so that the debtor may work to fund the plan. Discrimination in favor of criminal penalties, however, has been the sort of disparate treatment that courts are least likely to accept. *See* Sepinuck, *Rethinking Unfair Discrimination*, 74 AM. BANKR. L. J. at 341.

Some courts have either held or suggested in dicta that any unfair discrimination problem may be solved by extending the plan beyond three years, treating all unsecured claims alike for the first three years, and then giving disproportionately favorable treatment to nondischargeable claims after the third year. The rationale for these decisions is that, under 11 U.S.C. § 1325(b)(1), unsecured creditors as a group are entitled to all of the debtor's disposable income for only three years, and thus section 1325(b)(1) somehow creates an exception to the unfair discrimination limitation of section 1322(b)(1) after the third year of the plan. *In re Thibodeau*, 248 B.R. 699 (Bankr. D. Mass. 2000); *Ponce*, 218 B.R. at 571; *see Williams*, 231 B.R. at 280 (suggesting, without holding, that a criminal restitutionary claim could be given more favorable

treatment after three years). There is, however, not a syllable in any relevant statute that says that the unfair discrimination requirement ceases at the end of three years. *Sullivan*, 195 B.R. at 649; *see In re Cristophe*, 151 B.R. 475 (Bankr. N.D. Ill. 1993). Furthermore, a plan may be extended beyond three years only for cause, 11 U.S.C. § 1322(d), and it is anything but clear that allowing the debtor to indulge in what otherwise would be unfair discrimination constitutes cause for taking this step. *In re Taylor*, 137 B.R. 60 (Bankr. N.D. Okla. 1992).

Other courts have held that any unfair discrimination may be avoided by treating the nondischargeable debt as a long-term obligation under 11 U.S.C. § 1322(b)(5), curing any arrearages in the plan, and remaining current on the debt, typically outside the plan, if the last payment on the debt would otherwise come due after the completion of the plan. In the view of these courts, section 1322(b)(5) provides an exception to section 1322(b)(1), the unfair discrimination statute. *In re Groves*, 39 F.3d 212 (8th Cir. 1994); *Chandler*, 210 B.R. at 898; *Sullivan*, 195 B.R. at 649; *In re Cox*, 186 B.R. 744 (Bankr. N.D. Fla. 1995). This view has been subject to severe criticism. First, by its plain terms, section 1322(b)(5) is an exception to section 1322(b)(2), not to section 1322(b)(1). Section 1322(b)(5) does not even address the disparate treatment of classes of claims, and thus it cannot be an exception to the unfair discrimination requirement. *Simmons*, 288 B.R. at 737; *accord Thibodeau*, 248 B.R. at 699. Second, there is no basis for permitting discrimination in favor of a claim simply because its original term extended beyond the life of the plan. There is no reason for allowing the debtor to pay some, but not all, long-term debts in full while similarly situated creditors receive a pittance. *Simmons*, 288 B.R. at 737; *accord Colley*, 260 B.R. at 532. Thus, although the debtor may treat a long-term nondischargeable debt under section 1322(b)(5), cure arrearages through the plan, and make substantial current payments outside the plan, the debtor may not unfairly discriminate against other classes of unsecured creditors in the process. *In re Labib-Kiyarash*, 271 B.R. 189 (9th Cir. B.A.P. 2001).

The issue of giving disparate treatment to nondischargeable debts in a Chapter 13 plan is fraught with problems. The policy of fostering a fresh start must be balanced against the need to treat all creditors fairly and the rationale for making the debt nondischargeable in the first instance. A definitive solution to the question of unfair discrimination in favor of nondischargeable debts does not appear likely in the near future.

IV.

REPOSSESSION, THE AUTOMATIC STAY, AND THE RIGHTS OF A GOOD FAITH PURCHASER

Ace Auto Finance repossessed Joe Client's car about a week before he filed his bankruptcy petition because he had not been able to make a payment in two months. About a week after the petition was filed, Joe tells his attorney that his friends are tired of taking him to work, so he needs the car back. He went by the car lot yesterday, and the manager told him that the repossessed car had already been sold to someone else. Can the bankruptcy court order the return of Joe's car?

The first issue is whether the postpetition sale of the car violated the automatic stay. If the debtor has lost all rights in repossessed property before the petition was filed, a postpetition

disposition of the property could not violate the stay, and the sale would be valid and final. *See In re Lamar*, 249 B.R. 822 (Bankr. S.D. Ga. 2000). In a very strained interpretation of the interplay between Article 9 of the UCC and the relevant states' certificate of title acts, the Eleventh Circuit has held that the debtor loses "title" to a vehicle upon repossession, and that a repossessing creditor, therefore, does not violate the stay by retaining the vehicle postpetition and refusing to surrender it if the debtor has not redeemed the collateral. *In re Kalter*, 293 F.3d 1350 (11th Cir. 2002) (Florida law); *In re Lewis*, 137 F.3d 1280 (11th Cir. 1998) (Alabama law). These decisions have been almost universally rejected by other courts. Furthermore, an outright sale of the vehicle, as opposed to merely retaining it, would cut off the right of redemption, which is indisputably an asset of the debtor or the estate. Thus, there can be little question that the postpetition sale of Joe's car violated the stay. *Nissan Motors Acceptance Corp. v. Baker*, 239 B.R. 484 (N.D. Tex. 1999); *In re Patterson*, 263 B.R. 82 (Bankr. E.D. Pa. 2001); *In re Cepero*, 226 B.R. 595 (Bankr. S.D. Ohio 1998).

The second issue is the proper remedy. It would appear that the best analysis is that the postpetition sale must first be avoided under 11 U.S.C. § 549(a). After that, recovery would be governed by section 550. 11 U.S.C. § 550(b)(1) provides in the clearest terms that, if a transaction is avoided under section 549, the property or its value may not be recovered from a subsequent transferee who took for value, in good faith, and without knowledge of the voidability of the transfer. Here, one could argue that the purchaser of Joe's car was a subsequent transferee and that either Ace Auto Finance or the car lot was the initial transferee. Assuming that the purchaser gave value in good faith and without knowledge of the voidability of the transfer, the purchaser would be shielded by section 550(b)(1). Thus, 11 U.S.C. § 550(b)(1) provides protection for a good faith purchaser when property has been sold in violation of the stay. *In re Hill*, 156 B.R. 998 (Bankr. N.D. Ill. 1993).

On similar facts, however, one court held the debtor could recover the car from the buyer even though the buyer was a subsequent good faith purchaser. *In re Barbour*, 96 B.R. 97 (Bankr. W.D. Ky. 1988). The *Barbour* court started from the settled principle that any action taken in violation of the stay is void unless the bankruptcy court grants retrospective relief by way of annulment. Thus, the court held, the postpetition sale could be avoided under 11 U.S.C. § 362(a). Because the sale was void under the automatic stay statute, section 550 did not apply; section 550, by its terms, does not apply to transactions avoided under section 362(a). The court concluded that 11 U.S.C. 550(b)(1) did not shield the buyer, even though the buyer was a secondary good faith purchaser. The purchaser was required to return the vehicle, subject to a refund of the purchase price.

There are several things wrong with the *Barbour* court's decision. First, it is highly doubtful that section 362(a), by its own force, allows for the avoidance of a transfer of the debtor's property. On the contrary, while section 549(a)(1) clearly provides for the avoidance of any postpetition transfer that is not authorized by the Bankruptcy Code or by court order, section 362(a) says nothing about avoiding any transfer. Even if 11 U.S.C. § 362(a) were an avoidance statute, avoiding a transfer and recovering the property transferred are very distinct concepts. *E.g.*, *In re H&S Transp. Co.*, 939 F.2d 355 (6th Cir. 1991); *In re Richmond Produce Co.*, 195 B.R. 455 (N.D. Cal. 1996); *In re Glanz*, 205 B.R. 750 (Bankr. D. Md. 1997). If 11 U.S.C. § 362(a) could be used as an avoidance statute *ex proprio vigore*, that would mean that Congress provided no means for recovering property transferred in violation of the stay. Section 362 itself

says nothing about recovery. This is all the more reason for concluding that Congress meant for postpetition transfers in violation of the stay to be avoided under section 549(a). In that case, recovery would be governed by section 550, and 11 U.S.C. § 550(b)(1) would protect any secondary good faith purchaser.

If the buyer were deemed the *initial* transferee, however, section 550(b)(1) would not apply. There is no general good faith purchaser defense for an initial transferee of the debtor's property that has been sold in violation of the stay. *In re Fjeldsted*, 293 B.R. 12 (9th Cir. B.A.P. 2003); *In re Pierce*, 272 B.R. 198 (Bankr. S.D. Tex. 2001). Section 549(c) does provide protection for an initial good faith purchaser, but that statute applies only to transfers of the debtor's real property, and then only if the debtor was a willing participant in the transaction. *In re Mitchell*, 279 B.R. 839 (9th Cir. B.A.P. 2002).

Nonetheless, even if the buyer is the initial transferee, ordering the return of the vehicle would present problems. Clearly, a good faith purchaser would be entitled to recover the purchase price if he or she had to give up the property. This would mean that the burden of pursuing the wrongdoer would be shifted to an innocent third party, the purchaser, who would normally be a complete stranger to the bankruptcy case. Alternatively, the innocent debtor would have to refund the purchase price and then pursue the wrongdoer. Neither alternative should have much appeal for a court of equity. Without examining whether the postpetition buyer of the debtor's repossessed property was an initial or a subsequent transferee, several courts have agreed that it would simply be impracticable or inequitable to compel that person to surrender the property, even if the sale violated the stay. *In re Koreskvo*, 91 B.R. 689 (Bankr. E.D. Pa. 1988) (Scholl, J.); *accord In re Patterson*, 263 B.R. 82 (Bankr. E.D. Pa. 2001) (Sigmund, J.); *see In re Wills*, 34 B.R. 451 (Bankr. M.D.N.C. 1983).

Here, Joe Client's attorney would have a strong argument for sanctions against Ace Auto Finance under 11 U.S.C. § 362(h) and for avoiding the sale under 11 U.S.C. § 549(a). If the purchaser is deemed a subsequent bona fide transferee for value, then the only remedy, apart from sanctions, would be to recover the value of the vehicle from Ace Auto Finance (or, conceivably, the car lot) as the party for whose benefit the transfer was made. 11 U.S.C. § 550(a). If the buyer is considered the initial transferee, it might be theoretically possible to recover the car, but the more likely and practicable remedy still would be to recover its value from Ace as the party for whose benefit the transfer was made.

V.

VALUING THE COLLATERAL UNDER 11 U.S.C. § 506(a) FOR PURPOSES OF RELIEF FROM THE STAY AND ADEQUATE PROTECTION: THE APPLICATION OF *RASH*

Sally Client likes her Big Gasguzzler vehicle. She paid $34,000 for the Big Gasguzzler when she bought it about a year ago. A week or two ago, she saw one just like it offered for sale at a dealership for $25,000. The "Blue Book" wholesale value for the vehicle is $19,000. Sally still owes $27,500 to Big G Auto Finance on the installment sale contract. Joe and Sally have filed a Chapter 13 petition. Big G Auto Finance promptly files a motion to lift the automatic stay because Sally is one month behind in her payments. What value should be used at the lift stay hearing? Would the same value be used at plan confirmation?

Clearly Big G Auto Finance is undersecured. The plain language of 11 U.S.C. § 506(a) mandates that the value of the collateral securing an undersecured claim must be determined in light of the purpose of the valuation and the proposed use or disposition of the collateral. The Supreme Court stressed this point in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997). If Sally proposed to surrender the Big Gasguzzler pursuant to 11 U.S.C. § 521(2), then the reasoning of *Rash* demands that foreclosure or wholesale value should be used. The vehicle would be valued at $19,000 — the net amount that Big G would receive if it foreclosed — and the surrender of the Big Gasguzzler would fully satisfy the secured claim. Big G would then have an allowed unsecured claim of $8,500. *See In re TennOhio Transp. Co.*, 247 B.R. 714 (Bankr. S.D. Ohio 2000).

It appears, however, that Sally does not wish to surrender the vehicle. In these circumstances, a creditor establishes a prima facie case for lifting the stay for cause under 11 U.S.C. § 362(d)(1) by showing: (a) the debtor is in default; (b) the lender is undersecured — *i.e.*, there is no equity cushion to provide adequate protection; and (c) the collateral is depreciating. *In re Zeoli*, 249 B.R. 61 (Bankr. S.D.N.Y. 2000). All three of those conditions would appear to be satisfied here. The debtor, however, may modify the rights of a secured creditor and provide for the cure of any default under the plan. 11 U.S.C. § 1322(b)(2), (3). The debtor may retain the property pending plan confirmation and defeat the secured creditor's request for relief from the stay by providing adequate protection for the secured portion of the claim. *In re Farmer*, 257 B.R. 556 (Bankr. D. Mont. 2000); *TennOhio*, 247 B.R. at 715. Adequate protection payments are designed to compensate the creditor for the depreciation of the collateral up until the time that a plan is confirmed. *In re Weinstein*, 227 B.R. 284 (9th Cir. B.A.P. 1998); *In re Cook*, 205 B.R. 437 (Bankr. M.D. Fla. 1997). Thus, to ask what value should be used at the lift stay hearing is equivalent to asking what value should be used to determine the value of the secured portion of Big G's claim for adequate protection purposes. *Farmer*, 257 B.R. at 556; *TennOhio*, 247 B.R. at 715. Such payments normally would be made to the Chapter 13 trustee. The real question comes down to what portion of the payments made prior to confirmation should be allocated to adequate protection.

In *Rash*, 520 U.S. at 953, the Supreme Court made clear that, if the debtor retains the collateral, then the collateral should be valued at its replacement cost to the debtor, not at its liquidation value. In footnote 6 of the opinion, however, the *Rash* Court pointed out that replacement value would not necessarily mean the retail value that a merchant or dealer would charge for property of comparable age and condition. The creditor's secured claim should not include items that the debtor does not receive by simply retaining the collateral. Such items would include a dealer's cleanup, inspection, and reconditioning costs, storage charges, or advertising costs. Thus, in this case, Big G Auto Finance would not be able to claim the retail cost (presumably $25,000) as the value of the secured portion of its claim on the basis of which adequate protection payments should be computed.

Courts have been divided on how the replacement value should be calculated. Some courts have used the midpoint between the wholesale value (here, $19,000) and the retail value (presumably $25,000) as a starting point for determining what the replacement value should be, or to establish a rebuttable presumption as to what the replacement value is. The rationale is that the debtor has access to private or non-dealer sources, and that individual-to-individual sales typically fall between wholesale and retail value. Either side, however, may introduce evidence

to show that the actual replacement value should be higher or lower than this midpoint. *In re Getz*, 242 B.R. 916 (6th Cir. B.A.P. 2000); *In re Marquez*, 270 B.R. 761 (Bankr. D. Ariz. 2001). Here, if the court followed this method, the replacement value of the Big Gasguzzler presumptively would be $22,000.

Other courts have held that a split-the-difference approach is no more proper as a starting point than as an end point. The court should begin with the value of the secured claim that the creditor itself has given as presumptively valid and leave to the debtor the burden of showing that replacement value is less than what the creditor claims. *Evabank v. Baxter*, 278 B.R. 867 (N.D. Ala. 2002); *see also In re Longbein*, 256 B.R. 470 (Bankr. S.D. Tex. 2000). Ultimately, however, the final result may well be the same.

When the collateral is valued for lift stay or adequate protection purposes, decisions appear to be split as to the time that the value should be assigned. Some courts have suggested that the collateral should be valued as of the petition date because adequate protection is meant to protect the creditor between the petition date and confirmation. *Farmer*, 257 B.R. at 556; *see Marquez*, 270 B.R. at 761. Some say that the value should be determined as of the date that relief from the stay or adequate protection was requested. *In re TennOhio Transp. Co.*, 269 B.R. 775 (Bankr. S.D. Ohio 2001). Unless there has been some unusual delay, the choice between these dates is unlikely to make much practical difference.

For plan confirmation purposes, the replacement value of the collateral must be determined as of the confirmation date. *In re Townshend*, 256 B.R. 881 (Bankr. N.D. Ill. 2001); *see Farmer*, 257 B.R. at 556. Thus, the value of Big G's secured claim at the Clients' confirmation hearing will be less than at the lift stay or adequate protection hearing. A second valuation may not be needed at confirmation time, however. If the adequate protection payments were properly calculated, then these payments may simply be deducted from the value of the secured claim established at the lift stay hearing. After all, adequate protection is meant to compensate for depreciation, and, presumably, the value at confirmation would equal the value established previously minus the subsequent adequate protection payments. *Marquez*, 270 B.R. at 761. On the other hand, if there are grounds to believe that the adequate protection payments were too great or too small, either side might request a new valuation at confirmation. *See Farmer*, 257 B.R. at 556. If it turned out that the collateral had depreciated more or less rapidly than originally anticipated, an adjustment to the value of the secured claim could be made accordingly. *See TennOhio*, 269 B.R. at 775.

In the present case, it appears likely that, at the lift stay hearing, Sally's Big Gasguzzler would be valued at roughly $22,000. Big G would then be entitled to adequate protection on the basis of this figure and the rate of depreciation that the court determines. At the confirmation hearing, the adequate protection payments could be deducted from the value of the secured claim to determine the amount of Big G's allowed secured claim under the plan. Alternatively, if a new valuation hearing is held at confirmation, the amount of Big G's secured claim under the plan could be adjusted if it turned out that the adequate protection payments had been excessive or inadequate.

Legislation that Congress is now considering would abrogate footnote 6 in *Rash*. The legislation would amend section 506(a) to provide that if the debtor is an individual in Chapter 7

or 13, and if the collateral is personal property, then the property shall be valued at the price that a retail merchant would charge without any deduction for costs of sale or marketing. The valuation shall be made as of the petition date. If that legislation is enacted, Sally's Big Gasguzzler would be valued at $25,000. The same value, minus appropriate deductions for adequate protection payments, would form the basis for the amount of the allowed secured claim under the plan.

VI.

SURRENDERING THE COLLATERAL POST-CONFIRMATION IN FULL SATISFACTION OF A SECURED CLAIM: WHAT ARE THE LIMITS ON 11 U.S.C. § 1329?

Nine months after the bankruptcy court confirmed Joe and Sally Clients' Chapter 13 plan, Sally's boss tells her that, because of a drop in business, she will no longer be able to work overtime as she has been doing for the past two years. Without the additional overtime income, the Clients will no longer be able to afford the payments to Big G Auto Finance on Sally's Big Gasguzzler car. Sally wants to surrender the car to Big G in satisfaction of the secured claim under the plan. May she do this?

Whether a debtor may modify a confirmed Chapter 13 plan by a post-confirmation surrender of the collateral to the secured creditor has generated a split of authority. *See* David S. Cartee, Comment, *Surrendering Collateral Under Section 1329: Can the Debtor Have Her Cake and Eat It Too?*, 12 BANKR. DEV. J. 501 (1996). There is no question that 11 U.S.C. § 1329(a)(3) permits the debtor to surrender the collateral as a payment, and the creditor must apply the wholesale value of the vehicle as a credit against the allowed secured claim. *In re Meeks*, 237 B.R. 856 (Bankr. M.D. Fla. 1999). The real question is whether the debtor may then reclassify the post-confirmation deficiency (the difference between the surrender value and the unpaid amount of the allowed secured claim under the plan) as part of the unsecured claims and, for the remainder of the plan, treat the leftover balance of the secured claim as though it were simply unsecured debt entitled only to the ratable distribution allocated to other unsecured claims. *In re Barclay*, 276 B.R. 276 (Bankr. N.D. Ala. 2001) (giving an excellent formulation of the issue).

One point on which all courts agree is that the debtor may not surrender the collateral and reclassify the deficiency if the debtor is not acting in good faith. *In re Taylor*, 243 B.R. 226 (Bankr. W.D.N.Y. 2000). Under 11 U.S.C. § 1329(b)(1), any plan modification must meet the section 1325(a) requirements for confirming a plan in the first place, and that includes the good faith requirement. 11 U.S.C. § 1325(a)(3). If the debtor has wantonly failed to maintain the vehicle, for example, or if the debtor has wrecked the vehicle and failed to maintain insurance coverage, the debtor can scarcely demand that the creditor receive only salvage value and then treat the remaining secured claim as an unsecured debt. This would not be a good faith plan modification. *In re Butler*, 174 B.R. 44 (Bankr. M.D.N.C. 1994); *In re Cooper*, 167 B.R. 889 (Bankr. E.D. Ark. 1994).

Assuming the debtor is acting in good faith, however, courts and commentators are divided as to whether section 1329 permits a post-confirmation lien stripping as a legitimate form of plan modification. Two major treatises take the position that a post-confirmation

surrender of the collateral and a reclassification of the deficiency is a permissible step. COLLIER ON BANKRUPTCY ¶ 1329.02 (15th rev. ed. 2003); HON. KEITH M. LUNDIN, CHAPTER 13 BANKRUPTCY § 264.1 (3d ed. 2000). This view was well expounded by Judge Wesley W. Steen in *In re Hernandez*, 282 B.R. 200 (Bankr. S.D. Tex. 2002).

According to this reasoning, the plan modification statute, 11 U.S.C. § 1329, Is a broad exception to the res judicata effect that section 1327(a) normally bestows upon a confirmed plan. For plan modification purposes, section 1329(b)(1) incorporates 11 U.S.C. § 1322(b)(2), which provides that a plan may modify the rights of secured creditors, and 11 U.S.C. § 1325(a)(5)(C), which allows the debtor to satisfy a secured claim by surrendering the collateral. By its plain terms, 11 U.S.C. § 1329(a)(1) permits the debtor to increase or decrease the amount of payments on claims in a particular class, while section 1329(a)(3) allows the debtor to alter the amount distributed to a particular creditor in light of any payment (such as the surrender of the collateral) not provided for in the plan. In addition, 11 U.S.C. § 502(j) permits any claim that has been allowed or disallowed to be reconsidered for cause. Taken together, these provisions provide ample statutory justification for surrendering the collateral and reclassifying the post-confirmation deficiency together with other unsecured claims.

Furthermore, a Chapter 13 debtor may convert the case or dismiss at any time. In a new Chapter 7 bankruptcy proceeding or a state law foreclosure, the debtor could surrender the collateral, and any deficiency would be an unsecured debt. Thus, allowing lien-stripping as a modification to a Chapter 13 plan will not really prejudice the creditor. A number of courts have followed the same statutory analysis, looked to the same practical considerations, and reached the same result as Judge Steen in *Hernandez*. *E.g., In re Knappen*, 281 B.R. 714 (Bankr. D.N.M. 2002); *In re Day*, 247 B.R. 898 (Bankr. M.D. Ga. 2000).

On the other hand, one major treatise has rejected this reasoning, NORTON BANKRUPTCY LAW AND PRACTICE § 124:3 (2d ed. 2001), and, significantly, so has the only court of appeals that has considered the question. *In re Nolan*, 232 F.3d 528 (6th Cir. 2000). The view that the debtor may not surrender the collateral and reclassify the post-confirmation deficiency as unsecured debt was argued cogently by Judge Robert L. Jones in *In re Coffman*, 271 B.R. 492 (Bankr. N.D. Tex. 2002) and by Judge Barbara J. Houser in *In re Cameron*, 274 B.R. 457 (Bankr. N.D. Tex. 2002).

This reasoning starts from the premise that 11 U.S.C. § 1327(a) means that a confirmed plan is a new contract binding upon the debtor and the creditor, and the plan can only be modified as section 1329 expressly permits. 11 U.S.C. § 1329(a)(1) does not allow the reclassification or modification of claims; it only allows changes in the timing or amount of payments. "Payment" and "claim" are not synonymous. Similarly, 11 U.S.C. § 502(j) allows a court, for cause, to reconsider the allowance or disallowance of claims, but it does not permit a court to reclassify an allowed claim. Significantly, the plan modification statute, 11 U.S.C. § 1329(b)(1), incorporates section 1325(a)(5)(B), which mandates that, once a secured claim is allowed, it is fixed in amount and status and must be paid in full under the plan.

At a more practical level, only the debtor, the trustee, or an unsecured creditor may seek to modify a plan. 11 U.S.C. § 1329(a). The view that the debtor may surrender the collateral and reclassify the deficiency would allow the debtor to shift to the creditor all the risk of the

collateral's depreciation, whereas an undersecured creditor would have no right to ask for an increase in the secured portion of its claim if the collateral appreciated following confirmation. Furthermore, the argument that the debtor may dismiss or convert, thus leaving the creditor with only the depreciated collateral to satisfy its secured claim, is not as strong as it may appear. There are significant burdens and risks to the debtor in dismissing or converting. There is no reason to allow the debtor to have the benefits of dismissal or conversion without the risks or burdens by engaging in post-confirmation lien stripping in Chapter 13.

Under this line of authority, the debtor may certainly surrender the collateral and receive credit for it, but the debtor must pay the remainder of the allowed secured claim in full. This was the basis on which the plan was confirmed. Many courts have accepted this analysis. *E.g.*, *Barclay*, 276 B.R. at 276; *In re Smith*, 259 B.R. 323 (Bankr. S.D. Ill. 2001); *In re Dunlap*, 215 B.R. 867 (Bankr. E.D. Ark. 1997).

On the facts given above, Sally could surrender the car and receive credit for its value. Whether she could then reclassify the balance of Big G's allowed secured claim as unsecured debt depends on the court where the bankruptcy is pending. Certainly there could be no reclassification in the Sixth Circuit. Apart from that, the outcome would depend on which line of authority the bankruptcy court found more persuasive and whether the particular judge had spoken to the issue.

The pending bankruptcy reform legislation would resolve this dispute in favor of Big G. The legislation would amend 11 U.S.C. § 1325(a) to provide that section 506 would not apply — *i.e.*, there could be no lien stripping — if the collateral is a motor vehicle for the Chapter 13 debtor's personal use, if the creditor holds a purchase money security interest, and if the vehicle was acquired with 910 days (2½ years) of the petition date. Furthermore, 11 U.S.C. § 1325(a)(5)(B) would be amended to provide that the lien would be retained until the entire underlying debt had been fully paid or a discharge had been granted. In other words, the debt would be deemed secured throughout the term of the plan. Taken together, these provisions would prevent any return of the vehicle and a reclassification of the remaining debt.

VII.

RELEASE OF A LIEN BEFORE THE COMPLETION OF A CHAPTER 13 PLAN: THE INTERPLAY OF 11 U.S.C. §§ 349, 506(a), (d), 1325(a)(5), AND 1327

Joe Client's attorney managed to unwind the postpetition sale of Joe's car to a good faith purchaser, and the status quo ante was restored. Ace Auto Finance held a lien on the car securing a debt of $10,500. For purposes of confirming the Chapter 13 plan, the car was valued at $8,000. The plan was extended to five years. Because of large monthly car payments, the $8,000 secured debt was paid in full at the end of three years, and payments to unsecured creditors were just beginning to be meaningful. Joe now wants to obtain title to the car so that he can trade it in for something better. He believes that he can afford a small additional car payment because his salary has increased since the plan was confirmed. May Joe obtain the release of the lien and compel Ace Auto Finance to give him the certificate of title showing that the lien has been discharged?

Whether a Chapter 13 debtor may obtain the release of a lien before the completion of the plan when the lien has been stripped down has been a subject of controversy for several years. *See* Craig A. Gargotta, *The § 1325(a)(5)(B)(i) Paradox: Lien Stripping in Chapter 13 and the Need for Congressional Clarity*, 17-May AM. BANKR. INST. J. 10 (1998). The dispute shows no sign of abating. *See In re Castro*, 285 B.R. 703 (Bankr. D. Ariz. 2002). Frequently, the argument has centered on plan confirmation and whether the plan may contain an early release provision requiring the release of the lien, typically on a vehicle, once the secured debt has been paid but before the completion of the plan and the debtor's discharge. One court has tried to sidestep the problem by holding that the issue is unripe until the secured debt actually is paid under the plan. *In re Parker*, 285 B.R. 394 (Bankr. E.D. Tenn. 2002). Because Joe is seeking the release of the lien after the secured claim has been paid as a form of plan modification, any ripeness question is not at issue here.

A number of cases have concluded that a debtor may obtain the release of a lien after having paid the secured portion of the overall debt, and that a plan may provide for an early release. Almost always, the collateral in question is a car or truck. *E.g.*, *Castro*, 285 B.R. at 703; *In re Johnson*, 213 B.R. 552 (Bankr. N.D. Ill. 1997); *see also Parker*, 285 B.R. at 394. In Texas, the leading decision espousing this view is *In re Gray*, 285 B.R. 176 (Bankr. N.D. Tex. 2002) (Dennis Michael Lynn, J.)

The argument that the debtor may compel the release of a lien or security interest begins with 11 U.S.C. § 506(a), which divides undersecured claims into a secured and an unsecured component. 11 U.S.C. § 506(d) then voids the lien in any amount in excess of the value of the collateral. Under 11 U.S.C. § 1325(a)(5)(B), all that a secured creditor is entitled to have under the plan is the retention of the lien and the receipt of the value of the allowed secured claim over the life of the plan. Section 1322(b)(2) allows the debtor to modify the rights of secured creditors, while section 1322(b)(10) allows a plan to include any provision that is not inconsistent with the Bankruptcy Code. Section 1327(b) provides for the revesting of estate property in the debtor upon confirmation, while section 1327(c) calls for such revesting free and clear of any claim or interest that is not provided for in the plan. Taken together, these provisions appear to establish a strong statutory basis for allowing the debtor to demand the release of the lien and the surrender of the certificate of title prior to the completion of the plan.

It is true that 11 U.S.C. § 1307(b) allows the debtor to dismiss at any time before the plan has been completed and the debtor has received a discharge. In such an event, section 349 attempts to restore the *status quo ante concursus* by, among other things, reinstating any lien that has been stripped. 11 U.S.C. § 349(b)(1)(C). Although it is conceivable that the debtor might already have sold the car, thus leaving the creditor unsecured, or refuse to surrender the certificate of title, thus leaving the creditor unperfected, the mere possibility for abuse in some cases should not defeat a statutory right. The debtor will still be personally liable for the balance of the debt if the case is dismissed. Moreover, if the secured debt has been paid in full under the plan, the creditor will already have received what it would have gotten if it had repossessed and sold the car as of the confirmation date, which is all that the creditor could demand in Chapter 13. Thus, the secured claimant will be in at least as strong a position as though the plan had run to completion, and an early release of the lien and the certificate of title may help the debtor without doing any real harm to the creditor.

Other cases, perhaps a majority, have taken the position that the debtor is not entitled to a release of the lien or a return of the certificate of title until the plan has been completed and the debtor has earned a discharge. *E.g., In re Zakowski*, 213 B.R. 1003 (Bankr. E.D. Wis. 1997); *In re Scheierl*, 176 B.R. 498 (Bankr. D. Minn. 1995). In Texas, at least four bankruptcy judges have adopted this position: Judge Abramson in *In re Thompson*, 224 B.R. 360 (Bankr. N.D. Tex. 1998), Judges King and Clark in a joint opinion in *In re Smith*, 287 B.R. 882 (Bankr. W.D. Tex. 2002), and, most recently, Judge Jones in *In re Day*, 292 B.R. 133 (Bankr. N.D. Tex. 2003).

Although these cases differ slightly in their reasoning, all start with the premise that a Chapter 13 plan is a new contract between the debtor and creditors in a collective proceeding. Unlike a Chapter 11 case where property rights are permanently fixed and a discharge is granted upon confirmation, a Chapter 13 debtor must fully perform his or her end of the bargain before receiving the most sweeping discharge that the Bankruptcy Code offers, 11 U.S.C. § 1328(a), unless the debtor obtains a hardship discharge. *See id.* § 1328(b)(1). Full performance by the debtor is a precondition to obtaining the benefits of the new contract.

It follows that, in a Chapter 13 case, the effects of lien stripping should not become permanent unless the debtor has completely fulfilled his or her end of the bargain. For example, a Chapter 13 debtor may convert the case to Chapter 7 at any time. 11 U.S.C. § 1307(a). The debtor then would have to comply with the requirements of Chapter 7, and lien stripping is not permitted in Chapter 7. *Dewsnup v. Timm*, 502 U.S. 410 (1992). If the debtor had obtained the certificate of title before conversion, however, the lien already would have been stripped permanently. At best, the creditor would hold an unperfected security interest that the Chapter 7 trustee could avoid. Again, 11 U.S.C. § 1307(b) allows a Chapter 13 debtor to dismiss at any time, and, if the debtor does so, section 349 attempts to restore the *status quo ante concursus*, including the reinstatement of liens for the benefit of an undersecured creditor. If the debtor has obtained the certificate of title, however, section 349 would be nullified. The debtor might sell the car to a purchaser who would take free and clear of any lien. On the facts above, the debtor would have traded the car in, and thus the creditor would have no collateral if the case were dismissed; section 349 would be rendered meaningless.

In sum, on this view, where and how the property vests when a plan is confirmed is immaterial. What matters is that the debtor should not be rewarded until the plan is completed, and an undersecured creditor should not lose its lien permanently until the debtor has earned a discharge.

On the facts above, both Joe and Ace Auto Finance would have strong arguments that the lien should be released and the certificate of title surrendered once the allowed secured claim has been paid in full, and, to the contrary, that such a step should await the completion of the five-year plan. The outcome will depend on which line of reasoning the court finds more persuasive and whether the particular judge has already spoken to the issue.

If the current bankruptcy reform legislation is enacted, Ace Auto Finance would certainly prevail. 11 U.S.C. § 1325(a)(5)(B)(i) would be amended to mandate that a secured creditor would retain its lien until the entire debt owed to that creditor had been paid in full or until the plan had been completed and the debtor had received a discharge. Furthermore, if the case were converted or dismissed, the creditor would retain its lien to the extent permitted by

nonbankruptcy law. In addition, section 1325(a) would be amended to provide that there could be no lien stripping in the first instance (section 506 would not apply) if the creditor holds a purchase money security interest, if the collateral is a motor vehicle for the debtor's personal use, and if the vehicle was acquired within 910 days (2½ years) of the petition date.

VIII.

THE REMEDIES FOR A MATERIAL DEFAULT IN PLAN PAYMENTS: 11 U.S.C. §§ 362(d)(1), 1307(c), AND OTHER POSSIBILITIES

During the fourth year of their five-year Chapter 13 plan, Joe and Sally Client decide that they are tired of making payments and stop sending payments to the trustee. Because of a computer error, the trustee does not notice that they are no longer paying. What remedies, if any, do the creditors have? Are the remedies different for secured and unsecured creditors? Are the remedies for Ace Auto Finance different from the remedies for other creditors? Does it make any difference if title to Joe's car has been released or not?

By its plain terms, 11 U.S.C. § 1307(c)(6) permits any creditor, secured or unsecured, to seek conversion or dismissal if a Chapter 13 debtor is in material default under the terms of a confirmed plan. Overlapping with this statute, 11 U.S.C. § 1307(c)(4) permits any creditor, secured or unsecured, to seek conversion or dismissal for failure to commence making timely payments, although some courts apparently have read this statute as referring to a failure to make timely payments at any point rather than a failure to begin making them at the outset of a plan. *See In re Haugland*, 199 B.R. 125 (Bankr. D.N.H. 1996); *see also In re Tornheim*, 239 B.R. 677 (Bankr. E.D.N.Y. 1999).

Whether to convert or dismiss lies in the court's discretion. The court may consider the reasons for the default, the magnitude of the default, and the period of nonpayment. *In re Green*, 64 B.R. 530 (9th Cir. B.A.P. 1986). Furthermore, a plan may be amended to cure post-confirmation defaults. *In re Mendoza*, 111 F.3d 1264 (5th Cir. 1997); *In re Hoggle*, 12 F.3d 1008 (11th Cir. 1994). Thus, whether such a modification is appropriate or feasible may be taken into account. If the debtor's conduct has been truly egregious, dismissal or conversion should be granted, *In re White*, 126 B.R. 542 (Bankr. N.D. Ill. 1991), or the court may give the debtor a short time to cure and then convert or dismiss if the debtor fails to do so. *See In re Hubbard*, 259 B.R. 186 (Bankr. N.D. Ala. 2000).

One early case held that secured creditors who were provided for under the plan, like unsecured creditors, were limited to seeking conversion or dismissal if the debtor committed a material default under the plan's terms. *In re Brock*, 6 B.R. 105 (Bankr. N.D. Ill. 1980). That position has since been universally rejected. After *Brock,* courts have held that a default under a plan's terms may be grounds for granting a secured creditor relief from the stay so that it may foreclose on its collateral. *E.g., In re Ellis*, 60 B.R. 432 (9th Cir. B.A.P. 1985); *In re Smith*, 104 B.R. 695 (Bankr. E.D. Pa. 1989).

At the other extreme, a few courts have held that, because estate property revests in the debtor upon plan confirmation unless the plan or the confirmation order provides otherwise, 11 U.S.C. § 1327(b), secured creditors are no longer bound by the stay after confirmation and may

simply foreclose if they are entitled to do so under nonbankruptcy law. *Laughlin v. U.S. I.R.S.*, 98 B.R. 494 (D. Neb. 1989), *aff'd on other grounds*, 912 F.2d 197 (8th Cir. 1990), *cert. denied*, 498 U.S. 1120 (1991); *In re Nicholson*, 70 B.R. 398 (Bankr. D. Colo. 1987). This view is erroneous. While confirmation might arguably eliminate the stay provisions protecting estate property, 11 U.S.C. § 362(a)(2), (3), (4), confirmation does not eliminate the prohibition against foreclosing prepetition liens on the debtor's property or on collecting a prepetition debt from the debtor. *Id.* § 362(a)(5), (6). Thus, a secured creditor must seek relief from the stay. *In re Broman*, 82 B.R. 581 (Bankr. D. Colo. 1988); *accord In re Carona*, 254 B.R. 364 (Bankr. S.D. Tex. 2000) (Wesley W. Steen, J.).

Courts are in almost universal agreement that a material default under a confirmed plan may be "cause" for lifting the stay under 11 U.S.C. § 362(d)(1), and that a secured creditor may seek this form of relief as an alternative to asking for conversion or dismissal under section 1307(c). The plan is a new contract, and, if the debtor materially breaches it, the debtor is no longer entitled to the benefits of the Bankruptcy Code. *E.g., In re Owens*, 132 B.R. 293 (Bankr. E.D. Pa. 1991); *In re Elmore*, 94 B.R. 670 (Bankr. C.D. Cal. 1988); *In re Davis*, 64 B.R. 358 (Bankr. S.D.N.Y. 1986). As with conversion or dismissal, a court should consider the reasons for the default and its magnitude before granting relief from the stay. *In re Matthews*, 229 B.R. 324 (Bankr. E.D. Pa. 1999). A court should also consider whether it would be appropriate or feasible to cure the default. If a cure would not be feasible or appropriate, or if the debtor has made no attempt to propose or effectuate a cure, then the stay should be lifted if the default is material. *Carona*, 254 B.R. at 364 (Steen, J.).

Here, Joe and Sally's conduct appears to be rather egregious. Any creditor, secured or unsecured, could ask for conversion or dismissal under section 1307(c). In addition, any secured creditor could ask for relief from the stay in order to foreclose on its collateral. Before granting any form of relief, a court might consider how long Joe and Sally have ceased making payments and whether they are willing or able to effectuate a cure. In addition, a court might consider whether it would be appropriate to allow a cure in light of their intentional misconduct.

If Ace Auto Finance's allowed secured claim had already been paid in full by the end of the third year, Ace would no longer be a secured creditor under the plan in the fourth year when payments ceased. If that is the case, then Ace would have no standing to ask that the stay be lifted to permit foreclosure because Joe and Sally would not be in default with respect to the allowed secured claim. Ace would still hold an unsecured claim, but Ace could not gain the full benefits of dismissal if the certificate of title had been surrendered. The value of its stripped down lien would be difficult, if not impossible, to restore. Thus, Ace would be hard-put to gain the benefits of section 349, which is meant to put the parties in the *status quo ante concursus* if a case is dismissed. Similarly, if the case were converted to Chapter 7, lien stripping would not be permitted, *Dewsnup v. Timm*, 502 U.S. 410 (1992), but Ace's lien already would have been stripped, and, as a practical matter, Ace's lien would be gone altogether if Ace had released its security interest in the car prior to the default.

The bottom line would appear to be that if Ace Auto Finance had surrendered the certificate of title, it would have no truly efficacious remedy on these facts. Thus, this hypothetical lends force to the argument that the holder of an allowed secured claim should not be compelled to surrender its lien until the debtor has fully performed under the Chapter 13 plan

and received a discharge. *See In re Day*, 292 B.R. 133 (Bankr. N.D. Tex. 2003) (Jones, J.); *In re Smith*, 287 B.R. 882 (Bankr. W.D. Tex. 2002) (King and Clark, J.J.). The pending bankruptcy legislation would help Ace Auto Finance by providing that there would be no lien stripping under the plan and that the lien would secure the entire debt until it was paid in full or until a discharge was granted.

IX.

THE GAPS IN 11 U.S.C. § 521(2)

In their Chapter 7 case, Don and Doris Debtor state in their schedules that they will reaffirm their debt to Friendly Finance. The debt is secured by a big screen TV that they recently purchased. Friendly's friendly attorney sends them a reaffirmation agreement. Don and Doris decide not to sign it, choosing instead just to keep their payments current. Can Friendly insist on a reaffirmation agreement? Can Friendly repossess if they do not sign the reaffirmation agreement?

The problem illustrates the ambiguities in 11 U.S.C. § 521(2). The first issue is whether the options mentioned in section 521(2)(A) — reaffirming the secured debt, surrendering the collateral, or redeeming it — are exclusive. Four courts of appeals have held that these options are not exclusive, and that there may be a "reinstatement" of the debt or a "ride through." Provided that the debtor is not in default, the debtor may retain the property and continue to make payments without reaffirmation. *In re Parker*, 139 F.3d 668 (9th Cir.), *cert. denied*, 525 U.S. 1041 (1998); *In re Boodrow*, 126 F.3d 43 (2d Cir. 1997); *In re Belander*, 962 F.2d 345 (4th Cir. 1992); *Lowry Fed. Credit Union v. West*, 882 F.2d 1543 (10th Cir. 1989). The Fifth Circuit and three other courts of appeals, however, have held that reaffirmation, redemption, or surrender are the only options, and that a consumer debtor may not unilaterally transform recourse debt into nonrecourse debt in a Chapter 7 case. *In re Johnson*, 89 F.3d 249 (5th Cir. 1996); *accord In re Burr*, 160 F.3d 843 (1st Cir. 1998); *In re Taylor*, 3 F.3d 1512 (11th Cir. 1993); *In re Edwards*, 901 F.2d 1383 (7th Cir. 1990). Thus, Don and Doris could not have a reinstatement or ride through in Texas or Massachusetts, but they could in California or New York.

The National Bankruptcy Review Commission endorsed the Fifth Circuit's view and recommended that reinstatement or ride through should be prohibited. National Bankruptcy Review Commission, *Bankruptcy: The Next Twenty Years: Final Report*, Rec. 1.3.3 (1997). Legislation that Congress has been considering would specify that the choices currently listed in section 521(2)(A) — redemption, reaffirmation, or surrender — are the only options that a debtor has. Legislation now under consideration would codify that recommendation.

The second level of analysis is what the appropriate remedy should be if the Chapter 7 debtor fails to perform his or her stated intention within 45 days as 11 U.S.C. § 521(2)(B) requires. The statute specifies no penalty if the debtor fails to do so. This is similar to the question what should be done if the debtor fails to comply with section 521(2)(A) and does not declare any intention within 30 days of the petition date. As with section 521(2)(B), section 521(2)(A) itself provides no sanction for noncompliance.

Many courts have concluded that, at least if the debtor is in default, the most appropriate remedy is to lift the stay with respect to the collateral. If the debtor is dealing honestly with other creditors and otherwise complying with the Bankruptcy Code, outright dismissal would be too harsh, as would declaring the entire debt nondischargeable. The secured creditor would have adequate relief by exercising its state law rights and foreclosing on the collateral. A number of decisions have held that lifting the stay for cause is the proper way to proceed if the debtor fails to declare any intention as 11 U.S.C. § 521(2)(A) requires, *American Nat'l Bank & Trust Co. v. DeJournette*, 222 B.R. 86 (W.D. Va. 1998); *In re Claflin*, 249 B.R. 840 (1st Cir. B.A.P. 2000), or if the debtor fails to carry out his or her stated intention as mandated by 11 U.S.C. § 521(2)(B). *In re Rodgers*, 273 B.R. 186 (Bankr. D.R.I. 2002); *In re Donnell*, 234 B.R. 567 (Bankr. D.N.H. 1999); *see In re Jones*, 261 B.R. 479 (Bankr. N.D. Ala. 2001). Furthermore, legislation that Congress is considering would establish that, if a Chapter 7 consumer debtor failed to comply with either section 521(2)(A) or section 521(2)(B) in a timely manner, then the stay would automatically terminate with respect to the property in question.

If the debtor is not in default, however, then lifting the stay would do little good. The creditor could foreclose without violating any provision of bankruptcy law, but it would have no grounds for doing so under state law. In that event, it would be entirely appropriate to render an order directing the debtor to declare his or her intention, or to carry out the intention that he or she has declared, within a specified time. *In re Waters*, 248 B.R. 916 (Bankr. M.D. Fla. 2000). The penalty for failing to do so could be to deny a discharge with respect to the entire debt in question, both the secured and the unsecured portion, or even a blanket denial of a discharge under section 727(a)(6)(A). *See In re Waters*, 248 B.R. 916 (Bankr. M.D. Fla. 2000). Alternatively, failure to declare any intention, or to carry out an intention that has been declared, could be grounds for dismissal under section 707(a). *In re Green*, 119 B.R. 72 (Bankr. D. Md. 1990). The Fifth Circuit has approved an order directing the debtor to select one of the options specified in section 521(2)(A) within a certain time on pain of dismissal, *Johnson*, 89 F.3d at 249, and there is no reason to suppose that a similar remedy would be considered inappropriate for failing to comply with section 521(2)(B).

In this case, if Don and Doris are in default, the overwhelming consensus is that Friendly Finance should be granted relief from the stay for cause, or else the court could order that the stay will lift on a certain date if Don and Doris do not sign the reaffirmation agreement by then. If Don and Doris have kept all of their payments current, however, lifting the stay would do Friendly Finance little good. In that event, Friendly Finance could ask that the case be dismissed or the debt declared nondischargeable, or else request an order that the case will be dismissed or the debt will be declared nondischargeable, unless Don and Doris sign the reaffirmation agreement by a certain date.

X.

WHAT IS AN EDUCATIONAL LOAN UNDER 11 U.S.C. § 523(a)(8)?

Doris Debtor applied for and received a loan when she went to cosmetology school. She did not use the money for tuition, books, or classroom supplies, but rather used it for living expenses while she was in school. Is the loan nondischargeable?

There is a split of authority as to whether the purpose of a loan or the actual use of the proceeds determines whether the debt is a nondischargeable educational loan within the purview of 11 U.S.C. § 523(a)(8). *See In re Joyner*, 171 B.R. 762 (Bankr. E.D. Pa. 1994) (giving a thorough discussion of the competing lines of cases). Some lower courts have held that the actual use of the monies advanced is controlling, and that a debt is not a nondischargeable student loan if, or to the extent that, the debtor did not use the loan proceeds for educational purposes in a strict sense. *In re Shipman*, 33 B.R. 80 (Bankr. W.D. Mo. 1983) (one of the first cases espousing this view); *accord, e.g., In re Ealy*, 78 B.R. 897 (Bankr. C.D. Ill. 1987); *In re Brown*, 59 B.R. 40 (Bankr. W.D. La. 1986), *abrogated by In re Murphy*, 282 F.3d 868 (5th Cir. 2002). Explicitly or implicitly, these courts have reasoned that exceptions to discharge should be strictly construed, and hence that section 523(a)(8) should be read narrowly.

Other lower courts have held that the purpose of the loan is controlling. The bankruptcy statute says nothing about how the loan proceeds are actually used, and the debtor receives an educational benefit from monies used to pay for living expenses while attending school. *E.g.*, *In re Flint*, 238 B.R. 676 (E.D. Mich. 1999); *In re Roberts*, 149 B.R. 547 (C.D. Ill. 1993); *In re Vretis*, 56 B.R. 156 (Bankr. M.D. Fla. 1985).

In March, 2002, the Fifth Circuit sided with the latter line of cases and held that the purpose of the loan is dispositive, not how the proceeds are actually used. *In re Murphy*, 282 F.3d 868 (5th Cir. 2002). Section 523(a)(8) itself makes no reference to the specific use of the loan proceeds. It would be absurd to hold that a student who took out a student loan and then spent the funds on drugs or alcohol could receive a discharge, whereas a borrower who spent the funds on books and tuition could not. Furthermore, 11 U.S.C. § 523(a)(8) is designed to protect the public fisc and not-for-profit organizations by exempting federally guaranteed student loans and loans made by nonprofit organizations from discharge. That policy should not be undermined by a crimped reading of the statute. Finally, bankruptcy statutes should be construed in harmony with other federal legislation, and section 472 the Higher Education Act of 1965 specifically includes room, board, child care, and miscellaneous personal expenses among a student's "costs of attendance." *See* 20 U.S.C. § 1087ll(2), (3), (8).

Certainly within the Fifth Circuit, and in many other jurisdictions as well, Doris's cosmetology school loan would be an educational loan under section 523(a)(8). Doris could obtain a discharge only if she could show that repaying the loan would cause "undue hardship" to her or her dependents. In order to establish undue hardship, she would have to demonstrate: (a) that, based on current income and expenses, she could not maintain a minimal standard of living for herself and her dependents if she were forced to repay the loan; (b) that this state of affairs is likely to persist throughout the repayment period; and (c) that she has made a good faith effort to repay the loan. *See Brunner v. New York State Higher Educ. Servs. Corp.*, 831 F.2d 395 (2d Cir. 1987); *In re Hollins*, 286 B.R. 310 (N.D. Tex. 2002) (Felsenthal, J.); *In re Barron*, 264 B.R. 833 (Bankr. E.D. Tex. 2001) (Parker, J.).

XI.

THE AUTOMATIC STAY AND THE *ROOKER-FELDMAN* DOCTRINE

At the time Don and Doris filed a Chapter 7 petition, a personal injury lawsuit was pending against them in state court. Their potential liability was fully covered by insurance. The state court was informed of the bankruptcy filing, and Don and Doris asked that the lawsuit be abated because of the automatic stay. The plaintiff argued, however, that the stay did not apply because the plaintiff was not seeking to recover from Don and Doris personally. The state court accepted the plaintiff's argument, held that the stay did not apply, and directed that the lawsuit proceed. May the bankruptcy court sanction the creditor for violating the automatic stay?

This hypothetical is loosely based on *In re Benalcazar*, 283 B.R. 514 (Bankr. N.D. Ill. 2002). The question is whether, under the *Rooker-Feldman* doctrine, the bankruptcy court has jurisdiction to collaterally review the state court decision. *See Rooker v. Fidelity Trust*, 263 U.S. 413 (1923); *District of Columbia Court of Appeals v. Feldman*, 460 U.S. 462 (1983). Under the *Rooker-Feldman* doctrine, no lower federal court has any jurisdiction to collaterally review a state court order. Because *Rooker-Feldman* is a doctrine of jurisdiction rather than preclusion, there is no requirement that the state court judgment must be final in order for the doctrine to apply. *E.g., Cruz v. Melecio*, 204 F.3d 14 (1st Cir. 2000); *Charchenko v. City of Stillwater*, 47 F.3d 981 (8th Cir. 1995).

The Ninth Circuit has held that bankruptcy courts have the ultimate authority to determine whether the stay applies, and that state courts may decide this question only if they decide it correctly. An erroneous state court determination that the stay does not apply is void *ab initio* and is subject to collateral attack. The rationale is that such a decision is a usurpation of jurisdiction and thus beyond the protection of *Rooker-Feldman*. *In re Gruntz*, 202 F.3d 1074 (9th Cir. 2000) (en banc); *accord In re Dunbar*, 245 F.3d 1058 (9th Cir. 2001). This view has support in the Third Circuit, *Raymark Indus., Inc. v. Lai*, 973 F.2d 1125 (3d Cir. 1992), and in some lower courts. *Benalcazar*, 283 B.R. at 514; *In re Rainwater*, 233 B.R. 126 (Bankr. N.D. Ala. 1999), *vacated*, 254 B.R. 273 (N.D. Ala. 2000). Other courts have rejected this position, either expressly, *In re Singleton*, 230 B.R. 533 (6th Cir. B.A.P. 1999); *In re Siskin*, 258 B.R. 554 (Bankr. E.D.N.Y. 2001), or implicitly. *In re Ferren*, 203 B.R. 559 (8th Cir. 2000); *see Pico v. Global Marine Drilling Co.*, 900 F.2d 845 (5th Cir. 1990).

There are several problems with the view that the bankruptcy court in the hypothetical could collaterally review the state court determination that the stay does not apply. First, the relevant jurisdictional statute, 11 U.S.C. § 1334, gives bankruptcy courts exclusive jurisdiction only over the underlying bankruptcy case, not over civil proceedings arising under the Bankruptcy Code. There is no statutory basis for saying that a bankruptcy court has primary, let alone exclusive, jurisdiction over deciding whether the stay applies. *See In re Power Equip. & Marine, Inc.*, 292 F.3d 61 (1st Cir. 2002).

Second, there is no principled reason for distinguishing between state and federal courts in this respect. If bankruptcy courts truly had exclusive or primary jurisdiction to decide the applicability of the stay, there is no reason why a bankruptcy court in Texas could not collaterally attack a decision by a federal district court in Ohio, or even by the Sixth Circuit,

holding that the stay does not apply. Clearly this is not the law. *N.L.R.B. v. Edward Cooper Painting, Inc.*, 804 F.2d 934 (6th Cir. 1986); *In re Baldwin-United Corp. Litig.*, 765 F.2d 343 (2d Cir. 1985).

Third, whenever a statute permits a federal court to collaterally review a state court decision, an exhaustion of state court remedies is a jurisdictional prerequisite. *Engel v. Carpenter*, 456 U.S. 107 (1982) (habeas corpus); *San Diego Gas & Elec. Co. v. City of San Diego*, 450 U.S. 621 (1981) (certiorari). If a bankruptcy court may collaterally review a state court decision as to the applicability of the stay, the same rule should apply. State appellate courts are quite capable of correcting erroneous lower court holdings concerning the automatic stay. *In re Sensitive Care, Inc.*, 28 S.W.3d 35 (Tex. App. — Fort Worth 2000, orig. proceeding); *Sanchez v. Hester*, 911 S.W.2d 173 (Tex. App. — Corpus Christi 1995, orig. proceeding). If the bankruptcy court awaited a state appellate decision, there would be no need for collateral review.

Fourth, the wrongheaded decisions mentioned above do not discuss whether a bankruptcy court may collaterally review a mistaken state court determination that the stay *does* apply. If a state court closed its doors in the mistaken belief that the stay applied, this would not be a "violation" of the stay, but, under the reasoning of *Gruntz*, it would be a usurpation of bankruptcy court jurisdiction. It would be tantamount to *extending* the stay under 11 U.S.C. § 105(a), which is something that only a bankruptcy court may do. If a bankruptcy court has jurisdiction to vacate a state court judgment if the state court has made an erroneous decision that the stay does not apply, *Raymark Indus.*, 973 F.2d at 1125, there is no principled reason why a bankruptcy court should not be able to issue a writ of mandamus or its equivalent if a state court has erroneously held that the stay does apply. Looking at matters from this perspective shows how absurd it is to say that a state court has jurisdiction to decide the applicability of the stay only if it resolves the question correctly.

Fifth, if a state court mistakenly holds that the stay does not bar an action before it, a bankruptcy court may enjoin the action under 11 U.S.C. § 105(a). This would not be a collateral attack on the state court's ruling. On the contrary, the use of section 105(a) in this manner is appropriate only if the automatic stay does not apply. *In re Martin Explor. Co.*, 731 F.2d 1210 (5th Cir. 1984); *In re Sprint Corp. Sec. Litig.*, 232 F. Supp. 2d 1193 (D. Kan. 2002); *see In re Commerce Oil Co.*, 847 F.2d 291 (6th Cir. 1988). Thus, enjoining the further prosecution of the lawsuit in the state court would amount to giving full faith and credit to the state court's decision, not to a violation of the *Rooker-Feldman* doctrine.

On the facts above, the bankruptcy court should await a state appellate court ruling, most appropriately in a mandamus action, that the stay does apply, and then consider sanctioning the plaintiff. Alternatively, the bankruptcy court should enjoin the action under section 105(a) and then hold the plaintiff in contempt if the plaintiff tried to press forward.

XII.

LIMITS ON PUNITIVE SANCTIONS IMPOSED UNDER A BANKRUPTCY STATUTE

About a year ago, Don and Doris Debtor applied for and received a loan from Turkey Finance Company. The loan was secured by all of their furniture, appliances, and household goods.

Shortly after receiving notice of the Debtors' bankruptcy filing, Tom Turkey, the president and sole shareholder of Turkey Finance Company, was heard to say, "They ain't goin' to get away with this theft!" One night when Don and Doris were away from home, Tom had his employees break into their house and haul away all of the furniture, appliances and household goods, including bedding and cooking utensils. The Debtors' lawyer has brought a motion for sanctions under 11 U.S.C. § 362(h). Are there any limits on the punitive sanctions that Don and Doris may recover?

The Supreme Court has repeatedly held that the Due Process Clause of the Fourteenth Amendment sets both procedural and substantive limits on the imposition of punitive damages by the states. *State Farm Mut. Auto. Ins. Co. v. Campbell*, 123 S. Ct. 1513 (2003); *TXO Production Corp. v. Alliance Resources Corp.*, 509 U.S. 443 (1993). Due process does not permit the imposition of grossly excessive or arbitrary civil penalties on a wrongdoer. *Cooper Indus., Inc. v. Leatherman Tool Group, Inc.*, 532 U.S. 424 (2001). Hence, procedurally, the defendant must have fair notice of the sort of conduct that will subject him or her to punitive damages and of what the range of exemplary awards may be. *BMW of N. Am., Inc. v. Gore*, 517 U.S. 559 (1996). Likewise at the procedural level, an award of exemplary damages must be subject to meaningful review. A trial court or a jury may not have unbridled discretion in awarding punitive damages. *Honda Motor Co., Ltd. v. Oberg*, 512 U.S. 415 (1994).

Substantively, the Supreme Court has laid down several guidelines for awarding and reviewing an award of punitive damages. The most important consideration is the defendant's culpable mental state or the egregiousness of the offending conduct. *Gore*, 517 U.S. at 559. Blatantly outrageous and deliberate wrongdoing may justify substantial punitive damages, *TXO*, 509 U.S. at 443, whereas misconduct that is scarcely more than negligent will support only a small exemplary award, if any. *Gore*, 517 U.S. at 559.

Second, punitive damages must bear a reasonable relationship to the actual or compensatory damages. *Id.* Single digit ratios will seldom arouse great concern, although even a small punitive award may be set aside if the defendant appears to have acted without *malo animo*. *See id.* Conversely, punitive awards more than 10 times the compensatory damages will usually call for careful due process scrutiny, *Campbell*, 123 S. Ct. at 1513 (overturning a punitive award 145 times the compensatory damages), although a high ratio may be upheld if the defendant's wrongdoing was truly outrageous and if the low amount of actual damages was due to happenstance rather than the defendant's restraint. *TXO*, 509 U.S. at 443 (upholding punitive damages of $10 million when the actual damages were only $19,000).

Third, if a statute establishes enhanced civil penalties for similar misconduct, these may be used as a point of comparison to determine if exemplary damages are excessive. *Gore*, 517 U.S. at 559. In addition, because punitive damages are meant to punish and deter, the defendant's wealth may be taken into account. *TXO*, 509 U.S. at 443. On the other hand, supposed misconduct totally unrelated to the harm that the plaintiff has suffered, and that may have been lawful when or where it occurred, may not be considered. *See Campbell*, 123 S. Ct. at 1513.

The Fourteenth Amendment, by its own force, has no application to sanctions imposed by a bankruptcy court, but the Due Process Clause of the Fifth Amendment means that all of the

Supreme Court's holdings on exemplary damages are applicable in a proceeding under a bankruptcy statute. *In re Diviney*, 225 B.R. 762 (10th Cir. B.A.P. 1998). This includes punitive damages for violating the automatic stay under 11 U.S.C. § 362(h), *Progressive Motors, Inc. v. Frazier*, 220 B.R. 476 (D. Utah 1998), or for the bad faith filing of an involuntary bankruptcy petition under section 303(i). *In re John Richards Homes Bldg. Co., L.L.C.*, 291 B.R. 727 (Bankr. E.D. Mich. 2003).

Seldom have the procedural limits on punitive awards arisen in bankruptcy. Bankruptcy statutes themselves provide fair notice of the proscribed conduct, and a wealth of decisions give fair notice of the potential magnitude of punitive awards. *See In re Cepero*, 226 B.R. 595 (Bankr. S.D. Ohio 1998). Of course, any bankruptcy court decision imposing an exemplary award under section 362(h) (or section 303(i)) is subject to meaningful review, and a bankruptcy court scarcely has unbridled discretion. *See In re Ocasio*, 272 B.R. 815 (1st Cir. B.A.P. 2002).

Substantively, the due process guidelines established by the Supreme Court are simply guidelines; there is no rigid formula as to when punitive damages are excessive. *Cepero*, 226 B.R. at 595. The outrageousness of the defendant's conduct is the most important consideration. Threats of bodily harm will justify substantial punitive damages. *Ocasio*, 272 B.R. at 515 (upholding actual damages of $1,000 for emotional distress and a $9,000 punitive sanction under section 362(h) when the creditor had threatened to get his money "from [the debtor's] face."). Direct defiance of the bankruptcy process is an important consideration. Willfully repossessing a car when the creditor knows the stay is in effect certainly merits punitive damages. *Diviney*, 225 B.R. at 762; *accord In re Smith*, 296 B.R. 46 (Bankr. M.D. Ala. 2003) (willful repossession of debtor's mobile home in a particularly brutal manner with full knowledge of bankruptcy filing warranted actual damages of $1,400 for damage to debtor's belongings, $25,000 for lost wages and emotional distress, and $25,000 in exemplary damages).

A reasonable proportion between the actual award and punitive damages should also be taken into account. Section 362(h), like section 303(i), contains a fee-shifting provision and makes the debtor's reasonable costs and attorney's fees part of the actual damages in computing the ratio between compensation and the exemplary award. *Progressive Motors*, 220 B.R. at 476 (nominal damages of $1.00, coupled with attorney's fees of $1,500, meant that $20,000 punitive award was high, but not disproportionately excessive under the circumstances); *Diviney*, 225 B.R. at 762 ($2,850 in actual damages and $15,000 in attorney's fees justified an exemplary award of $40,000; ratio of punitive to compensatory damages was an acceptable 2.25-to-1); *see In re Cadillac by De Lorean & De Lorean Cadillac, Inc.*, 265 B.R. 574 (Bankr. N.D. Ohio 2001) (imposing punitive sanctions under section 303(i) when there was no compensatory award other than attorney's fees). When costs and fees are taken into account, the ratio between punitive and compensatory sanctions in section 362(h) cases has exceeded a 10-to-1 ratio only in a few very egregious cases. *See Progressive Motors*, 220 B.R. at 476 (ratio of roughly 13.3-to-1).

Finally, courts have considered an offending creditor's wealth and sophistication. All else being equal, a wealthy corporate creditor with substantial bankruptcy knowledge and experience is more deserving of punitive sanctions than an unsophisticated individual creditor of modest means. *Diviney*, 225 B.R. at 762; *see also In re Vazquez*, 221 B.R. 222 (Bankr. N.D. Ill. 1998) (punitive sanctions against Sears pursuant to section 105(a) for violating the discharge injunction).

On the facts given above, it seems that punitive damages are certainly warranted because of the blatant nature of Turkey's conduct. *See Smith*, 296 B.R. at 46. It appears that Dan and Doris would have substantial actual damages in addition to attorney's fees, and the punitive damages could rise accordingly. A ratio of 10-to-1 or more might be justified. On the other hand, a higher ratio would probably attract close scrutiny, and the award might be reduced if Mr. Turkey was new to the financing business and relatively unsophisticated, or if Turkey Finance itself was in poor financial condition.

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