

BANKRUPTCY LAW UPDATE

by

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DISCHARGEABILITY

Student Loans

A student loan is non-dischargeable even though the debtor obtained the loan for someone else's education. In In re Norris, 239 B.R. 247 (M.D. Ala. 1999), the debtor obtained a \$4000, government-backed loan to help finance his son's college education. The issue was whether such a loan, taken out by a non-student, constituted an "educational loan" within the meaning of § 523(a)(8) of the Bankruptcy Code, thereby excepting the loan from discharge. In reversing the Bankruptcy Court, the District Court stated that the plain meaning of the statute did not require that the debtor be the beneficiary of the loan and that the focus of the analysis should be on the nature of the debt and the lender.

The Court found that the debtor was an individual, the debt was of the nature and character of an educational loan, it was guaranteed by the government, and neither of the statute's exceptions applied. Therefore, it held that the loan was an "educational loan" within the meaning of § 523(a)(8), excepting it from discharge.

Student Loans – Accrual of Interest on a Nondischargeable Debt

Student loan lenders are entitled to post-petition interest notwithstanding the Chapter 13 debtor's discharge where the debtor's plan did not provide for the payment of post-petition interest. In In re Girard, 243 B.R. 894 (Bankr. M.D. Ala. 1999), the Court called for a hearing on an order to show cause directed to the debtor's student loan creditors regarding a student loan obligation paid through a discharged Chapter 13 plan. The issue was whether interest continues to accrue on a nondischargeable debt during the pendency of a Chapter 13 case. The debtors paid the student loan debt in full in the Chapter 13 plan, with the exception of post-petition interest. The Court stated that the unpaid portion of a student loan, in this case the post-petition interest and interest accrued since the Chapter 13 discharge, is nondischargeable and survives bankruptcy.

Student Loans – Hardship Discharge

When considering whether a debtor is entitled to a student loan hardship discharge, it is proper for the court to consider the debtor's spouse's income. In In re White, 243 B.R. 498 (Bankr. N.D. Ala. 1999), the debtor contended that his student loan debts should be discharged in his Chapter 7 bankruptcy case because excepting them from discharge would impose an undue hardship. The debtor, who suffered from narcolepsy, was dismissed from medical school and denied reinstatement. He then obtained a job as a graphic designer, which paid approximately \$20,000 a year. His wife, who made a comfortable living as an optometrist, allowed the couple to maintain a fairly comfortable lifestyle.

The issue for purposes of the motion for summary judgment brought by his creditors was whether the debts presented an undue hardship within the meaning of § 523(a)(8) of the Bankruptcy Code, and therefore was dischargeable. The Court applied the Brunner test, formulated by the Court of Appeals for the Second Circuit, to make this determination. Under Brunner, the debtor essentially must prove that he cannot pay his student loans and maintain a minimal lifestyle.

Applying the Brunner test to the facts of the case, the Court first concluded that debtor's wife's income should be included in making the determination because § 523(a)(8)(B) requires consideration of the debtor's actual, not theoretical, circumstances. Taking into account his wife's salary, the Court found his standard of living to be good. Therefore, the Court granted the creditors' motion for summary judgment and held that the debts were nondischargeable.

Thereafter, White filed a motion to alter, amend or vacate, contending that, between the date of the evidentiary hearing on the matter and the date of the court's opinion and order, his family's financial situation had changed. In re White, 243 B.R. 515 (Bankr. N.D. Ala. 1999). The issue was whether the debtor's changed circumstances should be considered in determining the dischargeability of his student loan debt. The Court, in a separate opinion denying the motion, stated that it must select a particular time to evaluate the debtor's "current" financial condition in order to finalize the matter. The debtor failed to demonstrate any manifest errors of law or fact or that the Court needed to consider new evidence.

Divorce-Related Debt

In In re Cameron, 243 B.R. 117 (M.D. Ala. 1999), the debtor's former spouse brought an action to determine whether the debtor's obligation to pay a marital debt was nondischargeable as divorce-related debt not in the nature of support. Under the terms of the property settlement agreement with his former spouse, the debtor agreed to assume and pay an outstanding debt to GMAC resulting from the purchase of a car during their marriage. The issue was whether the Bankruptcy Court erred in finding that the judgment against the debtor was not excepted from discharge under § 523(a)(15)(A) of the Bankruptcy Code, which states, in pertinent part, that an individual debtor is not discharged from any marital debt that is not in the nature of alimony, maintenance or support unless (a) the debtor does not have the ability to pay, or (b) the benefit to the debtor in discharging the debt outweighs the detriment to the debtor's former spouse or child.

The Bankruptcy Court found that the debtor was unable to pay the debt. In reversing and remanding the case to the Bankruptcy Court, the District Court directed the Bankruptcy Court to determine the debtor's ability to pay based on the debtor's financial circumstances as of the date of trial and based on debtor's actual expenses rather than debtor's expenses based on published standards for determining reasonable living expenses.

The Court held that the Bankruptcy Court clearly erred in relying on "Collection Financial Standards" as opposed to the more subjective "reasonably necessary" standard for determining the debtor's allowed expenses under the "disposable income test." It also held that the Bankruptcy Court erred in measuring the debtor's ability to pay as of the date he filed his petition, as opposed to the date of the trial. On remand, the District Court also directed the Bankruptcy Court to consider the merits of granting the debtor a partial discharge after determining his ability to pay based on his disposable income.

Guardian Ad Litem Fees

Fees owed by a debtor to a court appointed guardian ad litem to represent debtor's children in a pre-bankruptcy child support litigation constitute a debt owed for the support of a child and are thus non-dischargeable under Bankruptcy Code § 523(a)(5). In *In re Joffrion*, 240 B.R. 630 (M.D. Ala. 1999), the debtor incurred guardian ad litem fees resulting from a post-divorce child custody dispute. The Bankruptcy Court held that these fees were nondischargeable. The issue was whether the fees fell within the exception to discharge in § 523(a)(5) for debts owed for the maintenance or support of a child or spouse, and therefore were nondischargeable in bankruptcy.

The District Court held that the Bankruptcy Court's finding that the debtor's obligation to pay guardian ad litem fees was intended as support for his children was not clearly erroneous given that the state court appointed the guardian ad litem to "represent the interests of the minor children." It then turned to the question of whether the debt fell within the exception to § 523(a)(5), and held that the debt was generally in the nature of support and that the identity of the payee (not the former spouse or child) was unimportant. The Court held that the fees owed did constitute support, and therefore were not dischargeable in bankruptcy.

Debts Paid through Chapter 13 Bankruptcy

A debtor who converts from Chapter 13 to Chapter 7 may redeem personal property under Bankruptcy Code § 722 by paying the secured creditor the difference between the allowed secured claim, as determined in the Chapter 13 case, less the amount paid toward such claim in the Chapter 13 case. In *In re Archie*, 240 B.R. 425 (Bankr. S.D. Ala. 1999), the debtors brought a motion to reopen their bankruptcy case and for an order requiring a creditor to turn over title to their car. The debtors originally filed for Chapter 13 relief, but later converted their case to a Chapter 7 liquidation. The debtors paid in full the allowed secured claim and 60% of the unsecured claim relating to the car during their Chapter 13 case.

The creditor opposed the debtors' request to redeem unless the debtors paid the lesser of the amount of the secured claim determined at the time of the conversion on the amount of the claim. The Bankruptcy Court held that upon conversion from Chapter 13 to Chapter 7 bankruptcy, the original valuation governs the amount of the secured claim, and that the amount necessary to

pay the allowed secured claim for purposes of redemption must be reduced by the amount paid on the claim prior to conversion. Because the debtors had paid the full amount of the creditor's secured claim, the debtors were allowed to redeem the car for \$0.00.

DISMISSAL OF A VOLUNTARY CHAPTER 7 CASE

In In re Simmons, 200 F.3d 738 (11th Cir. 2000), the debtor, in her sixth filing for bankruptcy since March 1988, moved to dismiss her voluntary Chapter 7 case. Her repeated filings were an attempt to delay or avoid eviction from her home. The Bankruptcy Court denied debtor's motion to dismiss after the Trustee became aware of various assets possessed by the debtor. The debtor refused to cooperate with the Court's temporary restraining order and preliminary injunction ordering her to turn over her car, monies, and accounts to the Trustee. After the debtor refused to be deposed and was generally uncooperative, the Court submitted a report and recommendation that she be held in contempt of court. When a debtor seeks to dismiss his or her Chapter 7 case under Bankruptcy Code 707(a), the debtor has the burden of establishing the "cause" for granting the dismissal.

The Bankruptcy Court's recommendation and report was assigned to a District Court judge, who immediately withdrew the reference of the case to the Bankruptcy Court and dismissed the entire case, refusing to hold the debtor in contempt. The District Court judge maintained that, because no claims had been filed against the bankruptcy estate, the sole beneficiary of the case would be the Trustee's attorney. He maintained that there was no evidence that the debtor was willingly uncooperative regarding her deposition testimony.

On the trustee's appeal, the Court of Appeals, held that, given the debtor's history of grossly abusing the bankruptcy process, the Bankruptcy Court's actions were not cause for withdrawing the reference to the bankruptcy court, and that denial of debtor's motion to dismiss was warranted. As to the civil contempt charges, the Court of Appeals agreed with the District Court that they should not have been imposed because the Trustee located the assets soon after the recommendation was filed. The Court of Appeals reversed the District Court's dismissal of the bankruptcy case on the basis that the District Court incorrectly determined that the Bankruptcy Court had the burden of showing "cause" why the case should not be dismissed, when the law imposed the burden on the moving party to show cause for dismissal.

The case was then remanded to the District and Bankruptcy Courts for further proceedings. On remand, the District Court judge recused himself, stating that he could not obey the mandate of the Court of Appeals. In re Simmons, 2000 WL 913859 (N.D. Ala.). He adhered to the reasoning in his initial opinion, stating that there was no foundation for the Court of Appeals to assert that he did not review the record before issuing his decision.

LIEN STRIPPING

According to the District Court for the Middle District of Alabama, a debtor may not strip off a junior mortgage lien from property having a value less than the first mortgage. In In re Cater, 240 B.R. 420 (M.D. Ala. 1999), the issue was whether a debtor is allowed to have a consensual junior lien on her property voided under Bankruptcy Code § 506(d) when the property's senior mortgage

lien exceeds its market value. At the time the debtor filed the petition, her property value was approximately \$19,000 less than the amount of the lien securing the first mortgage. She maintained that the second mortgage lien was void under § 506(d) of the Bankruptcy Code which provides, in part, that “to the extent that a lien secures a claim against the debtor is not an allowed secured claim, such a lien is void, unless...”

The debtor argued that an “allowed secured claim,” when interpreted in light of § 506(a), which basically states that a claim is secured to the extent of the value of the collateral, would exclude liens that are wholly unsecured. The District Court rejected this argument, relying on the Supreme Court’s reasoning in Dewsnup v. Timm, 112 S.Ct. 773 (1992). According to Dewsnup, an “allowed secured claim” under § 506(d) is not to be interpreted in conjunction with the extent of a secured claim as defined in § 506(a). Instead, an “allowed secured claim” is an “allowed” claim, under § 502, that is “secured” (i.e. backed up by a security interest in the property – regardless of whether the value of the property covers the claim). The District Court rejected the debtor’s reasoning that subsections (a) and (d) should be read together, so that creditors would have an “allowed secured claim” only to the extent of the judicially determined value of collateral under subsection (a), with the remaining portion of the claim being void under subsection (d) because it was not an “allowed secured claim” within the meaning of subsection (a). The Court held that the debtor could not void the lien because the claim was “allowed” and “secured” by a valid lien.

EXEMPTIONS

Garnishment

The practice of “stacking” constitutional, federal and state exemptions regarding garnishment limitations is permissible according to the Bankruptcy Code in In re Robinson, 240 B.R. 70 (Bankr. N.D. Ala. 1999). That opinion involved the determination of what portion of the Chapter 7 debtor’s wages were subject to garnishment to satisfy judgment debt previously declared nondischargeable in bankruptcy. The debtor alleged that the Alabama Constitutional exemption allowed him to shield another one thousand dollars of his wages above and beyond what is already protected by federal and state limits on garnishment.

Although, lower and intermediate Alabama courts had ruled against the practice of “stacking” the exemptions, the Bankruptcy Court ruled that “stacking” was permissible. It held that the legislature’s attempt to restrict when a debtor may use the constitutional exemption was unconstitutional because a statute may not determine when one receives a constitutional benefit. It held that a debtor may assert the constitutional exemption multiple times to maintain at all times a level of \$1000 of exempt personal property. If the amount of the personal property exempt falls below \$1000 for any reason (except fraud, fault of the debtor, etc.), the debtor may reassert it for the amount necessary to restore the \$1000 exemption.

Homestead Exemptions

In In re Lehman, 205 F.3d 1255 (11th Cir. 2000), the debtor sought complete avoidance of a judicial lien on his home. Under § 522(f) of the Bankruptcy Code, a debtor may avoid certain liens on property to the extent that they impair an exemption. A precise reading of the statute

would have shielded debtor's entire equity of \$30,000 from the lien of approximately \$54,000, even though he was only entitled to an exemption of approximately \$5,000. A precise calculation would have produced the following result:

\$ 53,878.19 (amount of the lien)
\$165,000.00 (amount of mortgage)
+ 5,312.00 (debtor's claimed exemption)
\$224,190.19

\$224,190.19 > \$112,500 (debtor's 50% interest in the property)
Therefore, the lien would have impaired debtor's exemption by \$111,690,
Making all of the lien (\$53,878.19) avoidable.

The Court, agreeing with the Bankruptcy Court that this was an absurd result, took a more common sense approach. The Court stated that where applying the Bankruptcy Code according to its plain language produces an absurd result, a court can disregard the plain language and interpret the Code in the manner it believes Congress intended. The Court adopted the approach taken in Brantz, basing the calculation on the value of the property, not on the value of debtor's interest in the property. Using the Brantz method, the Court came to the following result:

\$ 225,000.00 (value of property)
- 165,000.00 (amount of mortgage)
\$ 60,000.00 (equity in property)

\$ 30,000.00 (debtor's 50% equity interest in property)
- 5,312.00 (debtor's claimed exemption)
\$ 24,688.00

\$53,878.19 (amount of lien) > \$24,688.00
Therefore, creditor may maintain its lien for \$24,688.00,
the nonexempt value of debtor's property.

The Court found that this deviation from the literal language of the statute was consistent with the legislative intent.

PREFERENCE/GARNISHMENT

A transfer under 11 U.S.C. § 547 is not made until the debtor has acquired rights in the property transferred. In In re Johnson, 239 B.R. 416 (Bankr. M.D. Ala. 1999), a proceeding was brought to recover sums withheld from a Chapter 13 debtor's wages during the 90-day preference period in connection with a writ of garnishment issued more than 90 days before the petition. The debtor filed his Chapter 13 case approximately ten months after his creditor issued a garnishment to collect its judgment and served it upon the garnishee. The debtor and the trustee moved to have the funds withheld during the ninety days before bankruptcy declared a preferential transfer under Title 11 U.S.C. § 547.

The issue was when a transfer occurs under Title 11 U.S.C. § 547. The Court stated that, while garnishment is a state right, if it results in a transfer under Federal law within the reach back period, it is subject to attack as a preference. Because the transfers sought to be recovered were earned and payable to the debtor and occurred within the 90-day period before bankruptcy was filed, they were recoverable.

DISMISSAL/CONVERSION OF CHAPTER 11 CASE

Where a debtor fails to abide by orders of the Bankruptcy Court and demonstrates an inability to show any reasonable likelihood of reorganizing, a court may find that cause exists to convert or dismiss the case. In In re Robino, 243 B.R. 472 (Bankr. N.D. Ala. 1999), the bankruptcy administrator filed a motion to convert or, in the alternative, dismiss debtor's Chapter 11 case under Title 11 U.S.C. § 1112(b) based on debtor's failure to comply with court orders. The debtor failed in many respects, including failing to file the required reports for a Chapter 11 case, failing to act as a fiduciary for his creditors through improper management of his properties, and other actions of bad faith which disintitiled him to the protections of the Bankruptcy Code.

The Court stated that it would order dismissal, not conversion, as being in the best interests of creditors. It found that the state court had the ability to enforce immediate compliance through the threat of incarceration, and that it was the best forum for assuring long-term solutions because it would likely be the site used to resolve future disputes (Robino was involved in continuing litigation). Finally, the Court stated that it would dismiss the case because probate matters are inherently within the province of state courts.

MISCELLANEOUS

In In re Golden Mane Acquisitions, 243 B.R. 773 (Bankr. N.D. Ala. 1999), plaintiff, a mortgage company, sought reimbursement for property taxes paid which accrued during the period of ownership by defendants. Plaintiff contended that it was entitled to reimbursement by the terms of the mortgage instrument, because of covenants contained in the deed defendant delivered to its successor, and because payment of the tax debt created an implied contract which required reimbursement from the defendant.

The Court granted defendant's motion for summary judgment on all three contentions. It held that since the defendant was not a party to the mortgage and did not agree to become personally liable for the mortgage debt, it could not be made personally liable through any provision of the mortgage instrument. It also held that because there was no privity of estate between the parties, the plaintiff was not entitled to recovery based on the covenants of quiet enjoyment and warranty contained in the deed from the defendant to its successor. Finally, the Court held that plaintiff was not entitled to restitution or reimbursement under a theory of implied contract because the assessment constituted only an in rem claim against the property and, therefore, plaintiff had no legal obligation to pay the taxes.