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Abundant Splits and Other Significant Bankruptcy Decisions

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If a creditor objects to chapter 13 eligibility in good faith, the court may look behind the debtor's schedules to decide whether the debt exceeds the cap.

Claims Subject to *Bona Fide* Dispute Are Included in Deciding Eligibility for Chapter 13

Even if a claim is subject to a *bona fide* dispute, the claim is still included in the calculation to determine whether the debtor has too much debt to be eligible for chapter 13.

The facts would make a nifty final exam question in an introductory bankruptcy course, because the outcome revolves around the definitions of "unliquidated" and "contingent" claims.

The March 16 opinion by the Ninth Circuit Bankruptcy Appellate Panel is useful authority for involuntary petitioners when the debtor claims that the petitioners' claims are contingent or unliquidated.

Disputed Liability on an Unsecured Note

The debtor admitted she had signed a $1 million note to purchase a home. The lender never recorded the mortgage, however. The debtor sold the home without paying the lender.

The lender sued the debtor on the note in state court and filed a motion for summary judgment. The debtor raised several defenses to the motion, including the statute of limitations. The debtor also argued that the lender did not have possession of the note or standing to sue.

Before the state court ruled on the summary judgment motion, the debtor filed a chapter 13 petition.

In her schedules, the debtor listed $30,000 in other unsecured debt. She scheduled the lender as having a disputed, unliquidated, contingent claim of $1,000. The lender filed a proof of claim for $1.75 million, representing the original principal plus accrued interest.

The lender filed a motion to dismiss the chapter 13 case, alleging that the debtor had more unsecured debt than the cap at the time of about $395,000 under Section 109(e). Bankruptcy Judge Robert J. Faris of Honolulu granted the motion and dismissed the case.

The debtor appealed to the BAP, which affirmed in an opinion by Bankruptcy Judge Scott H. Gan.

In calculating eligibility for chapter 13, Judge Nevins in Connecticut differs from some other bankruptcy judges in the Second Circuit.

Debt Discharged in Prior Chapter 7 Isn't Counted in Later Chapter 13 Eligibility

On an issue where the courts are divided, Bankruptcy Judge Ann M. Nevins of New Haven, Conn., ruled that personal liability on a secured debt that was eliminated in a prior chapter 7 discharge is not counted toward the debt limits in a subsequent chapter 13 case.

The decision by Judge Nevins was informed in part by a decision from the Ninth Circuit Bankruptcy Appellate Panel on July 30. *Washington v. Real Time Resolution Inc. (In re Washington)*, 18-1206, 2019 BL 284935, 2019 Bankr. Lexis 2389, 2019 WL 345052 (B.A.P. 9th Cir. July 30, 2019).

In a so-called chapter 20 case, the BAP held in *Washington* that personal liability extinguished in a prior chapter 7 discharge is not resurrected and is not a claim to be paid in the debtor's subsequent chapter 13 case. To read ABI's discussion of *Washington*, click here.

The Extinguished (?) Personal Liability

Judge Nevins was ruling on motions by the trustee to dismiss two chapter 13 cases. Together, the debtors in both cases had owned a business that went belly up. They had both personally guaranteed about $3 million in business debts and secured those debts with subordinate mortgages on their homes.

They had both filed chapter 7 petitions and received discharges in April 2013. The chapter 7 discharges standing alone meant that the debtors' personal liabilities on the $3 million subordinate mortgages were no longer personal liabilities, although the chapter 7 discharges did not strip the mortgages from the homes. In legal parlance, the mortgages remained *in rem* liabilities encumbering the homes but not personal liabilities of the debtors themselves.

To strip down or strip off the subordinate mortgages from their homes, the debtors employed the so-called chapter 20 strategy by filing chapter 13 petitions in August 2018. Because the new filings were entered more than four years after their chapter 7 discharges, they were both theoretically eligible for discharges in the new chapter 13 cases.

Michigan judges disagree about the court's ability to consider Social Security benefits in deciding whether a chapter plan was proposed in good faith.

Courts Deeply Split on Social Security Benefits in the Chapter 13 'Abuse' Test

Addressing several issues where the courts are deeply split, Bankruptcy Judge Thomas J. Tucker of Detroit concluded that Social Security benefits can be considered in deciding whether a chapter 7 petition should be dismissed for "abuse" under the "totality of the circumstances" test.

In a 32-page opinion, Judge Tucker even disagreed with another bankruptcy judge in his district.

No-Asset Chapter 7 vs. Full-Payment Chapter 13

The husband and wife debtors had two sources of income: combined Social Security benefits of about $4,000 and a monthly pension of some $1,800, for total monthly income of approximately $5,800. They had no priority claims. Their unsecured debt aggregated about $40,000. It was a no-asset chapter 7 case.

If the debtors were to remain in chapter 7, creditors would receive nothing while the pension income and Social Security benefits would be insulated from creditors' claims.

If Social Security benefits were considered, however, Judge Tucker calculated that the debtors would have about $1,250 left over every month after paying living expenses, including their $900 monthly mortgage and lease payments on two almost-new automobiles. Taking Social Security benefits into consideration, he deduced that the debtors could pay their creditors in full over the course of a 41-month chapter 13 plan.

The Statutes and the Motion to Dismiss for 'Abuse'

The U.S. Trustee moved to dismiss the case for "abuse" under Section 707(b)(3). In his opinion on January 27, Judge Tucker granted the motion but gave the debtors the option of converting the case to chapter 13.

The outcome of the motion to dismiss turned the question of whether Social Security benefits, otherwise an exempt asset, can be included in the "abuse" determination. The courts are divided.

The debtors had several statutory provisions on their side.

Social Security benefits are explicitly excluded from the definition of "current monthly income" under Section 101(10A)(B)(ii)(I). Consequently, Social Security benefits are not considered in the calculation to determine whether there is a presumption of abuse under the means test in Section 707(b)(2).

As a result, there was no presumption of abuse that could result in dismissal or importuning the debtors to convert to chapter 13.

Social Security benefits are not taken into consideration in the chapter 13 confirmation requirement that the debtors commit all of their "projected disposable income" to creditor payments under the plan. Were the debtors in chapter 13, a plan paying nothing to creditors would be presumptively confirmable under Section 1325(b)(1)(B), because "disposable income" includes only "current monthly income," which does not include Social Security benefits.

The debtors also relied on 42 U.S.C. § 407, barring the garnishment or attachment of Social Security benefits.

Finally, of course, Social Security benefits are exempt assets under state law and under Section 522(d)(10)(A).

For whatever it could be worth, the debtors might not have been able to argue successfully that Social Security benefits were not estate assets, because exemptions only apply to property of the estate, thus possibly implying that Social Security benefits are estate property.

The Debtors Lose on Every Count

Judge Tucker knocked down the debtors' theories, one by one.

Lower courts are split on whether Social Security benefits can be considered in deciding whether there is "abuse" under Section 707(b)(3). Judge Tucker cited a Virginia bankruptcy judge who said it made no sense for Congress to exclude benefits from the presumption-of-abuse test while allowing a judge to use the same benefits and find abuse under the "totality" test.

Judge Tucker decided to consider Social Security benefits because the statute has no "clear and explicit" exclusion of the benefits under the "totality" test. Indeed, he said, Congress knew how to exclude the benefits and did so in several Code provisions. Thus, the lack of a specific exclusion suggested to him that Congress intended to include the benefits under the "totality" test.

Judge Tucker also rejected the debtor's contention that it would be pointless to compel them to convert to chapter 13 because they could confirm a plan paying nothing to unsecured creditors.

The case in the appeals court apparently did not involve a student account structured to prevent the college from being the initial recipient of a fraudulent transfer.

First Circuit Starkly Holds that Tuition for an Adult Child Is a Fraudulent Transfer

The First Circuit starkly held – without any ifs, ands, or buts – that college tuition paid by an insolvent parent for an adult child is a constructive fraudulent transfer.

The lower courts are divided on the issue, but the First Circuit is the first court of appeals to decide the question.

The debtor was a fraudster sentenced to 10 years in prison for perpetrating a Ponzi scheme and was slapped with a $9.7 million judgment by the Securities and Exchange Commission for securities law violations. As usual, the college was an innocent bystander.

Insolvent at the time, the fraudster-parent had paid almost $65,000 in college tuition for an adult child over two years. The last payment was some two months before the father copped a guilty plea. Two months after the plea, he filed a chapter 7 petition.

The chapter 7 trustee sued the college on theories of actual and constructive fraudulent transfer. On cross motions for summary judgment, the college contended that the debtor-father received equivalent value because an educated child will not be an economic burden on the parents.

The bankruptcy court ruled in favor of the college, finding that the debtor received reasonably equivalent value. The bankruptcy court certified a direct appeal to the circuit.

In an eight-page opinion on November 12, Chief Circuit Judge Jeffrey R. Howard reversed, ruling *de novo* on a question of law that the payments were constructively fraudulent transfers under Section 548(a)(1)(B).

Judge Howard explained that courts "evaluate transfers from the creditors' perspective . . . , measuring value at the time of transfer." He conceded that lower courts are divided on the issue, "although the recent cases have mostly ruled for trustees."

Despite the high court's ban on nunc pro tunc orders, may bankruptcy courts make their orders retroactive?

Supreme Court Bans *Nunc Pro Tunc* Orders

The Supreme Court has banned the term "*nunc pro tunc*" from the bankruptcy lexicon.

In a *per curiam* opinion on February 24, the Court also ruled that a state court altogether lacks jurisdiction in a removed action until the case has been formally remanded. Merely terminating the basis for federal jurisdiction does not restore the state court's jurisdiction and power to act.

The Catholic Church in Puerto Rico filed a petition for *certiorari* in January 2019, contending that rulings by the Puerto Rico Supreme Court violated the Free Exercise and Establishment Clauses of the First Amendment. The Solicitor General filed a brief in December 2019 recommending that the Court grant *certiorari* and reverse the Puerto Rico Supreme Court.

Without holding argument, the Court granted the petition, reversed and remanded, but not on First Amendment grounds. Instead, the Supreme Court ruled that the Puerto Rico courts were without jurisdiction to enter orders at the critical time.

The Complex Facts

The facts and procedural history are complex, but they boil down to this: The Catholic Church in Puerto Rico terminated a pension plan for workers in the island's parochial schools. The workers sued in an island court. Reversing the intermediate appellate court, the Puerto Rico Supreme Court reinstated the orders of the trial court in favor of the workers by directing the church to deposit $4.7 million with the court. Another order directed the sheriff to seize church assets.

Based on the Treaty of Paris of 1898, the Puerto Rico Supreme Court believed that all church entities in Puerto Rico — including schools and parishes — are liable for the debts of their brother and sister Catholic institutions. Because the high court in Puerto Rico had disregarded the corporate separateness of Catholic entities, the church filed a petition for *certiorari*, raising complex questions under the First Amendment.

For the courts in Puerto Rico, there was a jurisdiction problem that had been overlooked. Before the trial court entered its orders to deposit money and seize assets, the church had removed the suit to federal court, contending that it was related to a bankruptcy case that had been filed by the schools' pension trust.

Disagreeing with the Tenth and D.C. Circuits and siding with four other circuits, the Seventh Circuit rules that passively holding estate property violates the automatic stay.

Seventh Circuit Solidifies a Circuit Split on the Automatic Stay

Solidifying a split of circuits, the Seventh Circuit ruled that the City of Chicago must comply with the automatic stay by returning impounded cars immediately after being notified of a chapter 13 filing.

The decision lays the foundation for the Supreme Court to grant *certiorari* and decide whether violation of the automatic stay requires an affirmative action or whether inaction amounts to control over estate property and thus violates the stay.

The Second, Seventh, Eighth, Ninth and Eleventh Circuits hold that a secured creditor or owner must turn over repossessed property immediately or face a contempt citation. The Tenth and the District of Columbia Circuits have ruled that passively holding an asset of the estate in the face of a demand for turnover does not violate the automatic stay in Section 362(a)(3), which prohibits "any act . . . to exercise control over property of the estate."

The same issue was argued on May 23 in the Third Circuit, where the lower courts were siding with the minority. *See Denby-Peterson v. NU2U Auto World*, 18-3562 (3d Cir.). For ABI's report on *Denby*, click here.

The Impounded Cars in Chicago

Four cases went to the circuit together. The facts were functionally identical.

The chapter 13 debtors owed between $4,000 and $20,000 on unpaid parking fines. Before bankruptcy, the city had impounded their cars. Absent bankruptcy, the city will not release impounded cars unless the fines are paid. If the cars are not redeemed by their owners, most of them are scrapped.

In 2016, Chicago passed an ordinance giving the city a possessory lien on impounded cars.

After filing their chapter 13 petitions, the debtors demanded the return of their autos. The city refused to release the cars unless the fines and other charges were paid in full.