PCBA CLE SEMINAR November 22, 2013

BANKRUPTCY UPDATE

Anita L. Shodeen, U.S. Bankruptcy Judge

LIEN AVOIDANCE

***J&M Sec., LLC v. Moore (In re Moore)*, 2013 Bankr. LEXIS 2729 (B.A.P. 8th Cir. July 8, 2013).**

Creditor appealed from the bankruptcy court's order granting chapter 13 debtor's motion to avoid the creditor's judicial lien on her homestead. The B.A.P. affirmed, holding that the debtor was entitled to claim her homestead exempt and that the creditor's judicial lien impaired her exemption.

According to 11 U.S.C. § 522(f)(1), "the debtor may avoid the fixing of a lien on an interest of the debtor in property to the extent that such lien impairs an exemption to which the debtor would have been entitled under subsection (b) of this section." The creditor argued that the existing cause of action exception under the Missouri Annotated Statute § 513.510 prevented the debtor from exempting her homestead from property of the estate because the judicial lien was rooted in a cause of action that existed prior to the debtor's acquisition of her homestead. The court disagreed and held that to the extent § 513.510 would except the debtor's homestead from exemption as to the creditor specifically, it is preempted by the specific exceptions listed in § 522(c) of the Code. The court also held that to the extent § 513.510 would except the debtor's homestead from exemption from property of the estate, that the result was at odds with the Code's exemption scheme, and therefore preempted. Concluding that § 522(f) was available to the debtor, *Kolich v. Antioch Laurel Veterinary Hospital (In re Kolich)*, 328 F.3d 406 (8th Cir. 2003) governs the calculation of the amount to which the lien impaired the debtor's exemption.

CLAIMS AND DISCHARGE ISSUES

***Hernandez v. Neb. HHS*, 2013 Bankr. LEXIS 3228 (B.A.P. 8th Cir. July 25, 2013).**

The debtor appealed the bankruptcy court's order allowing a claim filed by the creditor as a priority debt in the nature of a domestic support obligation. The B.A.P. affirmed that the debt owed to the creditor was child support debt under 11 U.S.C. section 101(14A)(B). The debtor had two children, one of which was committed to the care, custody, and control of the creditor. When the debtor filed her chapter 13 petition, the creditor objected because the debtor failed to identify her debt to the creditor as a priority domestic support obligation and failed to provide for full payment of the debt as required under 11 U.S.C. section 1322(a)(2). The bankruptcy court denied the debtor's plan and the debtor appealed.

According to 11 U.S.C. 101 (14A), the elements for determining whether a debt is a domestic support obligation are that the debt is: (1) owed to a governmental unit; (2) in the nature of support of a child of the debtor; (3) established before the date of the order for relief by a determination made in accordance with applicable non-bankruptcy law by a governmental unit; and (4) not assignable to a nongovernmental entity. Here, the only issue is whether the debt the debtor owes the creditor is in the nature of support for her child. The court concluded that since the creditor was only seeking 50% of the total paid to the debtor, it implies that had both of the debtor's children been residing at home, the creditor would not have sought to recoup any of the funds.

***Samuel J. Temperato Revocable Trust v. Unterreiner (In re Unterreiner)*, 699 F.3d 1022 (8th Cir. 2012).**

King William Management Company (King William) operated Dairy Queen of Greater of St. Louis (DQSTL) and the debtors were shareholders of DQSTL. A trust, creditor, owns DQSTL. Cass Bank made a loan to King William and to secure the loan, the debtors signed personal guarantees and a security agreement. Four years before this loan was made, the creditor had signed a separate agreement with Cass Bank under which the creditor guaranteed all of DQSTL's obligations to Cass Bank. One year after the loan was distributed to King William, the debtors informed Cass Bank that King William did not actually own most of the collateral, thereby making the security agreement contain a misrepresentation. King William then defaulted on the loan and Cass Bank pursued the debtors on the guaranty. The debtors were released from further liability after payment of $20,000. Cass Bank then made a demand on the creditor for payment of the outstanding balance on the loan. The creditor claimed the debtors, as co-guarantors of the loan, owed a debt to the creditor that was non-dischargeable under § 523, claiming: 1) it had reasonably relied on the misrepresentation in the security agreement when it guaranteed DQSTL's obligations and when it allowed DQSTL to guaranty the loan and 2) that the debtors knew the security agreement contained a misrepresentation at the time the debtors signed the security agreement. The bankruptcy court found that DQSTL had reasonably relied on the debtors' misrepresentation and the debtors' obligation to the creditor was non-dischargeable. The bankruptcy court entered judgment in favor of the plaintiff and the defendant appealed.

In order to except a debt from discharge under 11 U.S.C. § 523(a)(2)(B), all of the elements must be satisfied. The court concluded that the creditor cannot establish all of the elements, specifically that the debtors obtained money, property, services, or credit from the creditor, nor can the creditor establish that it relied on the debtors' misrepresentation. First, the debtor did not receive any money or property from the creditor concurrent with the representation because the representations in the security agreement were made to Cass Bank, not to the creditor, and the loan was made by Cass Bank, not by the creditor. Second, the creditor cannot prove it reasonably relied on the debtors' misrepresentation because the creditor's liability for the loan arose from the creditor's blanket guaranty of DQSTL's obligations to Cass, not from the loan agreement. The creditor's blanket guaranty occurred four years before the loan

agreement. Therefore, the creditor could not have relied on the misrepresentations in the security agreement. Since the creditor cannot meet at least two of the elements of § 523(a)(2)(B), it fails the requirements and the other elements do not need to be addressed. The court affirmed the B.A.P. ruling and directed judgment for the debtors.

***Hathorn v. Petty (In re Petty)*, 491 B.R. 554 (B.A.P. 8th Cir. 2013).**

Creditors commenced suit against the debtor in state court prior to the bankruptcy filing. No notice of the bankruptcy case was sent to these creditors because the bankruptcy schedules failed to include these creditors. After the deadline for filing dischargeability complaints, the debtors amended their schedules and listed the creditors. However, prior to the deadline for filing objections to discharge, the creditors attorney did receive an email containing the bankruptcy notice and the attorney gave the creditors actual notice. This was six days prior to filing objections to discharge. The creditors argued that the debtors' failure to properly schedule them until after the deadline to object to dischargeability deemed their debt non-dischargeable, or alternatively, that the creditors be allowed to proceed on the allegation that the debtors debt is of the kind that is non-dischargeable under § 523(a)(6). The bankruptcy court dismissed the creditors' complaint as untimely and the creditors appealed.

There are three exceptions to discharge which are not self-effectuating. These include the debts listed in § 523(a)(2), (4), and (6). According to Federal Rule of Bankruptcy Procedure 4007(c), creditors holding these types of debts must file a complaint to determine dischargeability no later than 60 days after the first date set for the meeting of creditors. If a creditor fails to file the complaint within those 60 days, the debt will be discharged. Here, the creditors' complaint relies, in part, on § 523(a)(6), which is one of the exceptions from discharge. The creditors' complaint was not filed within the 60 days required by Rule 4007(c) and is therefore considered untimely. The rule does permit the court to extend the deadline for cause though, but the motion for extension must be filed before the time has expired. Here, the request for extension was not properly filed before the deadline, so the court did not have the authority to grant the request.

Creditors do have an alternate remedy among the self-effectuating exceptions to discharge - § 523(a)(3). This section protects creditors who missed the deadline for filing complaints because they were not properly scheduled. Also, there is no time limitation on filing a complaint under § 523(a)(3), so the complaint may be filed at any time. To determine the adequacy of notice under § 523(a)(3), courts must decide at least four issues: (1) Is the debt of a kind described in § 523(a)(2), (4), or (6)? (2) Was the debt listed or scheduled (as that term has been interpreted) under § 521(a)(1) of the Bankruptcy Code with the name of the creditor? (3) Did the creditor have actual knowledge of the case in time to timely file an adversary proceeding in the bankruptcy court under § 523(a)(2), (4), or (6)? (4) Does the creditor's case have merit? Here, the debt is of a kind in § 523(a)(6). The debt was not listed or scheduled with the creditors' names until after the deadline for objecting had passed. The bankruptcy court has not yet reached a decision on the merits. Therefore, the main issue is whether the creditors had actual

knowledge of the case in time to timely file an adversary proceeding. If a creditor with a debt of the kind in § 523(a)(2), (4), or (6) did not receive actual knowledge of the bankruptcy case in time for timely filing of a request for determination of dischargeability, the debt is non-dischargeable. The only issue here was whether six days was sufficient notice to timely file an adversary proceeding. The bankruptcy court concluded that it was not sufficient notice. Yhe creditors have the right to proceed with their complaint to try to prove that they hold a debt of a kind described in § 523(a)(6).

PROPERTY OF THE ESTATE

***Longaker v. Boston Sci. Corp.*, 715 F.3d 658 (8th Cir. 2013).**

The debtor entered into a three-year employment agreement with his employer and the agreement guaranteed the debtor payments unless he quit or was terminated for certain reasons. The debtor filed for bankruptcy and then was terminated from his employment. He asserted claims for breach of contract in state court; however, the district court found that the debtor lacked standing to assert a breach of contract claim because his interest in the guaranteed payments was part of the bankruptcy estate.

A debtor's contingent interests under a pre-petition contract are included in § 541. A post-petition payment on a pre-petition contractual interest belongs to the bankruptcy estate if the payment is neither attributable to nor conditioned on the debtor's post-petition services. Here, the debtor did not perform any post-petition services; therefore, if the employer must pay guaranteed payments, they are neither attributable nor conditioned on debtor's post-petition services. Consequently, the payment(s) are part of the bankruptcy estate and the debtor lacks standing to assert the breach of contract claim.

***Mehlhaff v. Allred (In re Mehlhaff)*, 491 B.R. 898 (B.A.P. 8th Cir. 2013).**

Chapter 7 debtor appealed the bankruptcy court's order finding that her prepetition claim against her former spouse for alimony is property of her bankruptcy estate, and ordering her to turn that over to the trustee. The B.A.P. affirmed.

Under § 541, certain types of property are expressly excluded from the bankruptcy estate. The issue here is whether the debtor's alimony award was property of the estate under § 541 at the commencement of the case. When a debtor has obtained a prepetition judgment against another party, the estate succeeds to all rights under that judgment. Here, the debtor had an interest in a prepetition judgment awarding her alimony, and the trustee had a right to take whatever interest the debtor had in the alimony award.

***Seaver v. Klein-Swanson (In re Klein-Swanson)*, 488 B.R. 628 (B.A.P. 8th Cir. 2013).**

The issue in this appeal was whether bonus payments received post-petition by the debtor from her employer were property of the debtor's bankruptcy estate pursuant to 11 U.S.C. section 541. The debtor was employed by IBM on the petition date and continued to be employed by them. Post-petition, she received two bonuses, an Excellence Award and a GDP Award. These awards were given to employees based on the complete discretion of IBM and the debtor was not notified she would receive either award until after she filed her petition. The bankruptcy court revoked the debtor's discharge, avoided the transfer of bonuses and entered judgment for recovery of those funds by the trustee, and granted a motion for costs filed by the trustee. The B.A.P. reversed the bankruptcy court's order.

The party seeking to include property in the estate bears the burden of proof. The debtor in this case had no interest in the bonuses as of the petition date because IBM had complete discretion to decide that it would not make an award to the debtor under either of its award programs. The trustee argued that the debtor was eligible for the bonuses pre-petition and that the estate has a contingent interest in the bonuses because the debtor's receipt of the bonuses came from the debtor's prepetition services and the IBM bonus programs that were in place pre-petition. The BAP disagreed stating that the bonuses were made post-petition and belong post-petition, and therefore were never property of the estate. IBM did not exercise its discretion to award the bonuses until post-petition, and, on the petition date, the debtor had only the hope or expectation that she would receive the bonuses.

***Leitch v. Christians (In re Leitch)*, 2013 Bankr. LEXIS 2829 (B.A.P. 8th Cir. July 16, 2013).**

The debtor appealed an order of the bankruptcy court holding that the funds of his health savings account (HSA) were not excluded from the bankruptcy estate and were not exempt. The B.A.P. affirmed.

Under § 541(b)(7)(A)(ii), "property of the estate does not include any amount withheld by an employer from wages of employees for payment as contributions to a health insurance plan regulated by state law." An HSA is a trust account in which the account beneficiary uses the funds for medical expenses. The court held, however, that the beneficial taxation does not make the account a health insurance plan regulated by state law. Also, Congress added § 541(b)(7) to the Code as part of the 2005 BAPCPA amendments and the HSAs were created in 2003. If Congress intended for HSAs to be excluded, it would have specifically said so.

The debtor also attempted to claim the HSA as exempt through the federal exemptions. The court concluded he could not claim the exemption because the HSA could be used for purposes other than "disability, illness, or unemployment." Also, the federal exemptions apply only to a debtor's "right to receive," and here, the debtor has *already* received the money from his employer. Therefore, he no longer has a "right to receive" the money that is already in his HSA.

CONVERSION/ABUSE

***Schlehuber v. Fremont Nat'l Bank (In re Schlehuber)*, 489 B.R. 570 (B.A.P. 8t Cir. 2013).**

The debtor appealed from the bankruptcy court's order converting the debtor's chapter 7 case to a chapter 11 case, pursuant to 11 U.S.C. section 706(b). The main issue was whether the bankruptcy court abused its discretion when it converted the debtor's chapter 7 case to a chapter 11 case without the debtor's consent.

According to section 706(b), "on request of a party in interest and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 of this title at any time." The court has discretion as to whether to convert the case and it is based on the best interests of the parties. Section 706(b) does not provide guidance as to factors a court should consider; therefore, a court should consider anything relevant that would further the goals of the Bankruptcy Code. In this case, the bankruptcy court determined that the ability to pay is an important factor. The debtor's ability to fund a chapter 11 plan if he chooses to do so was an important consideration.

The debtor argued that since ability to pay is considered under section 707(b), the case of an individual debtor with primarily business debt should not be converted to chapter 11 based on his ability to pay. Section 706(b) does not state that a court cannot focus on ability to pay where the debtor is an individual with primarily business debts.