

BANKRUPTCY QUARTERLY UPDATE, JULY 14, 2004
Judge Howard R. Tallman and Deanna L. Westfall¹

US SUPREME COURT CASES

Till v. SCS Credit Corp., 124 S.Ct. 1951 (2004). The Supreme Court wrestled with the appropriate rate of interest to be allowed in Chapter 13 cram downs. Pre-petition, Debtor had purchased a vehicle from Instant Auto Finance (later assigned to SCS). At the time Debtor's filed bankruptcy, the vehicle was valued at \$4,000.00 and the debt on the vehicle was \$4984.00. The contract rate of interest was 21%. The issue before the Court was the appropriate rate of interest due the creditor during the period of the plan.

The Seventh Circuit had held that the presumptive contract rate should be the starting point for analysis. The presumptive contract rate is the rate agreed in the contract between the parties, adjusted as necessary by the evidence presented. This is a modified version of the coerced loan rate described by the Seventh Circuit as the "interest rate the creditor in question would obtain in making a new loan in the same industry to a debtor who is similarly situated, although not in bankruptcy." *Id. at 1957, citing, In re Till*, 301 F.3d 583, 591-592 (7th Cir. 2002).

The Supreme Court, after considering various formula for determining the correct rate, determined to follow the "prime rate plus" formula, which allows for a variable to be applied to the prime lending rate, based upon the risk of payment associated with the specific debtor at issue. The Court noted that a Chapter 13 case should reduce certain risks of payment as the Debtor is in a court-supervised repayment plan. However, the Court also noted that anytime a lender must wait for payments over time rather than receiving immediate payment in full, the payment amount must be adjusted to account for the time value of money and the risk of non-payment.

The Court selected the prime plus formula for several reasons including its simplicity and its placement of the burden of proof on the creditor, not the debtor. The Court indicated that the prime plus formula is "a straightforward, familiar, and objective inquiry, and minimizes the need for costly evidentiary proceedings." *Id.*, at 1961.

In his concurrence, Justice Thomas noted that Section 1325(a)(5)(B)(ii) does not expressly indicate a need for payment of any additional interest beyond the time value of money, and therefore, he would not allow an increase in interest rate to adjust for the risk to the lender of non-payment.

Tennessee Student Assistance Corp. v. Hood, 124 S.Ct. 1905 (2004). The Supreme Court addressed the issue of whether service of a non-dischargeability complaint upon a state pursuant to Section 523(a)(8) violates sovereign immunity and is an unauthorized

¹ A substantial portion of the materials were prepared by Thomas Lane, Esq., law clerk to the Honorable Howard R. Tallman.

suit against a state pursuant to the Eleventh Amendment. The State of Tennessee and the Debtor agreed that, absent Section 523(a)(8)'s special protection to the states regarding guaranteed student loans, the issue would not be before the Court, as the debt would be discharged without the necessity of service of a Complaint. However, because objections to dischargeability must be filed as an adversary proceeding pursuant to Rule 7001(6), a Complaint must be served and the Eleventh Amendment is implicated.

The Court determined that the jurisdiction of the Court to decide dischargeability is based upon its personal jurisdiction over the debtor and its *in rem* jurisdiction over all the assets and liabilities of the bankruptcy estate. The bankruptcy court does not need personal jurisdiction over the state in order to determine the dischargeability of the debt. The bankruptcy court cannot award damages against the State, rather it simply determines whether an existing debt of the debtor is dischargeable. The State can choose to participate or not. The Court compared the jurisdiction to that exercised in Maritime cases. The Court held that the service of the Complaint cannot change the essential nature of the action, which is to determine the dischargeability of the debt, an *in rem* proceeding as to the State.

March v. I.R.S., 335 F.3d 1186 (10th Cir. 2003), cert den. 124 S.Ct. 2110 (2004). The Supreme Court denied certiorari to consider the Tenth Circuit's determination that the IRS could substitute a new computer generated Form 4340 for their previously used Form 23C, as long as the IRS agent personally reviewed and signed the assessment and provided a date of assessment. The Debtor in this case tried to argue that the change in forms used by the IRS invalidated an IRS assessment.

TENTH CIRCUIT OPINIONS

McKowen v. I.R.S., 370 F. 3d 1023 (10th Cir. 2004). The Tenth Circuit agreed with the District Court (Matsch) in overturning the Bankruptcy Court's (Cordova) decision that transferee tax liability became an unsecured debt and was therefore dischargeable. Debtor's company, New Century Corp., dissolved and its assets were transferred to the Debtor in 1987. In 1995, Debtor filed bankruptcy. In 1996, The I.R.S. audited the corporate taxes and determined that there was a tax liability owing by the company. The IRS determined that the liability of the company followed the assets and became a transferee liability of the Debtor. The issue before the Court was whether the transferee tax was non-dischargeable pursuant to Section 507 and 523(a)(1) or an unsecured obligation. Applying the terms of IRC Section 6901, the Court determined that the essential nature of the debt was not altered by its transfer from one entity to another; accordingly, it was a non-dischargeable tax debt.

In re Lucre Management Group LLC, 365 F.3d 874 (10th Cir. 2004). The Tenth Circuit upheld a bankruptcy court contempt citation against the Debtor, but clarified the District Court decision that had labeled the contempt criminal. The Bankruptcy Court issued an order directing the Debtor that it could only use the rental payments received from property for the purpose of paying the expenses of the property. Debtor used certain of the funds to pay administrative expenses including the US Trustee fees. Upon

motion by the secured creditor (receiver), the bankruptcy court issued a contempt citation requiring the Debtor to repay the secured creditor, with interest, the amount improperly used to pay administrative expenses. The order provided that if the Debtor failed to comply within the time set forth in the order, the Debtor would be liable for an additional \$1000.00 sanction. Citing to *International Union, United Mine Workers of America v. Bagwell*, 512 U.S. 821, 827-28, 114 S. Ct. 2552, 129 L.Ed. 642 (1994), the Tenth Circuit upheld the bankruptcy court order and held that the contempt citation was clearly civil in nature as the Debtor had the ability to avoid the penalty by complying with the order. Thus, the order was for the benefit of a creditor and the punitive component of the sanction was within debtor's control.

BANKRUPTCY APPELLATE PANEL DECISIONS

AC Rentals Inc. v. Hough (In re AC Rentals, Inc.), 2004 WL 1182254 (10th Cir. BAP).

The BAP, in an unpublished opinion restated several key principles of divorce-bankruptcy law. Husband and Wife filed divorce. An oral ruling issued from the divorce court with Wife's counsel charged with submitting a form of order. The order granted Wife alimony in lieu of property division in the amount of \$325,000, secured by a lien on the assets of husband's wholly owned company, AC Rentals, Inc.(AC). Husband refused to sign the proposed order. Wife files a motion for entry of order. AC then filed a Chapter 11 bankruptcy. One day later, Wife recorded a statement of interest in the property in the real property records.

The Debtor, AC, filed a Complaint for violation of the automatic stay and essentially seeking avoidance of the lien using the powers of the Trustee pursuant to Sections 544 and 549. First, the Court determined that pursuant to 11 U.S.C. 544(a)(3), husband is not the same as the debtor in possession and his knowledge is not imputed to the debtor in possession. Second, the Court reiterated the importance of filing a *lis pendens* or other notice in the real property records immediately upon filing a divorce or receiving an oral award. Although this is not new law, it is a good reminder of general principles.

Bank of Cushing v. Vaughan (In re Vaughan), 2004 WL 1532194 (B.A.P. 10th Cir. July 7, 2004).

After the Bank obtained a judgment of nondischargeability against the Debtors under § 523(a)(2), it obtained relief from stay in order to collect the judgment and recorded a lien on the Debtor's residence. This case arises upon the Debtors' motion to avoid the Bank's lien on their homestead under § 522(f). The bankruptcy court granted the Debtors' motion and avoided the lien. The B.A.P. affirmed. The B.A.P. found that § 522(c) is intended to insulate exempt property against pre-petition debts. That section lists some exceptions to its provisions that arise under § 523, but does not except a debt found to be nondischargeable under § 523(a)(2). Thus, the Bank's lien with respect to the pre-petition debt may be avoided. In addition, the attorney fees that were part of the nondischargeability judgment, even though they were not assessed and liquidated until after the petition date, constitute a pre-petition claim for lien avoidance purposes under § 522(f). Finally, the B.A.P. rejected the Bank's argument that its lien could not be avoided because it was a consensual lien. It based that argument on the fact that the Debtors stipulated to the judgment of nondischargeability. The record in this case

revealed no agreement by the parties that would create a lien in favor of the Bank. The lien arose only upon the bank's recording of its judgment, and that constituted an avoidable judicial lien.

Caldwell v. Joelson (In re Joelson), 307 B.R. 689 (B.A.P. 10th Cir. 2004). The Debtor induced the Plaintiff to give her a loan by making false statements. She misrepresented her identity, her ownership of certain assets, and that she had a ready source of repayment for the loan. The statements were not in writing and so the Plaintiff filed an action under § 523(a)(2)(A). That subsection applies to misrepresentations other than statements regarding the Debtor's financial condition. The Debtor argued that her false statements were statements regarding her financial condition such that they could not form a basis for a nondischargeability action because they were not in writing and subject to action under § 523(a)(2)(B). In this matter of first impression, the B.A.P. chose to view the language “statement respecting the debtor’s or an insider’s financial condition” narrowly. The B.A.P. “defines a statement of financial condition to be a statement of a debtor’s net worth, overall financial health, or ability to generate income.” 307 B.R. at 696. After noting that each of the debtor’s misrepresentations pertained to an aspect of financial condition, the court determined that the statements pertaining to identity and to property ownership are actionable under § 523(a)(2)(A) because they did not constitute statements of overall financial health, net worth or ability to generate income.

BANKRUPTCY COURT CASES

In re Stephen William Lower; Case No. 03-18605 HRT; Order entered June 28, 2004.

The Court was asked to determine the effect of joint ownership of property on Debtor’s eligibility for chapter 13 relief. Section 109(e) prescribes limitations on the amounts of secured and unsecured debts that a debtor may have on the petition date to qualify for relief under chapter 13. The Court held that § 506(a) dictates how jointly owned property is to be treated for chapter 13 eligibility purposes. In this case, because the estate’s interest in the joint property amounted to only one-half of the property’s value, § 506(a) directed that the secured debt associated with the joint property could be no more than one-half of the property’s value. Bifurcation of the secured debt resulted in large amounts of unsecured debt from Debtor’s Schedule D being added to the unsecured debts appearing on Schedule E and Schedule F. The result was that Debtor’s unsecured debts exceeded the § 109(e) debt limits.

Bombardier Capital, Inc. v. Tinkler (In re Tinkler); Case No. 03-1304 HRT; Order entered June 2, 2004.

Mr. Tinkler was president, director and sole shareholder of a snowmobile dealership called Grand Lake Motor Sports, Inc. Bombardier provided the floor-plan financing for Grand Lake’s inventory. After a floor-plan audit showed that several rental snowmobiles had been sold by Grand Lake without notice, or payment, to Bombardier, remaining inventory was repossessed and the dealership ceased its operations. Afterward, Mr. Tinkler filed a personal chapter 7 bankruptcy case. Bombardier initiated an action under § 523(a)(6), claiming that Tinkler was personally liable for Grand Lake’s sale of inventory without paying over the sale proceeds and that the debt should be found to be nondischargeable due to Tinkler’s infliction of willful and

malicious injury upon Bombardier. The Court found that, under state law, with reference to Bombardier's rights under the Colorado U.C.C., Tinkler had caused Grand Lake to commit a conversion of Bombardier's collateral. However, the practice of selling rental machines in the spring and making payment to Bombardier for those machines in the fall was a long-standing business practice of Grand Lake. Focusing on the structure of the floor-plan financing agreement, the Court concluded that Tinkler's contractual obligations upon the sale of the rental machines was not clear enough for the Court to find that Tinkler possessed the intent to knowingly violate Bombardier's rights in the collateral.

In re Newell, Case No. 03-26743-ABC. The Court was asked to determine the appropriate date for calculating whether a judicial lien impairs the homestead exemption. Judgment creditor recorded its lien against debtors' homestead at a time when it did not impair the exemption. However, subsequent to the judgment lien but prior to filing bankruptcy, Debtor allowed the filing of a consensual lien against the property, thereby causing the judicial lien to impair the homestead. The Court determined that the calculation, pursuant to Section 522(f)(1) must be made at the time of the bankruptcy filing.

In re: Global Water Technologies, Inc.; Case No. 03-19278 HRT; Order entered July 1, 2004. The Debtor moved for confirmation of its chapter 11 plan and the Securities and Exchange Commission ["SEC"] and United States Trustee ["UST"] objected. The Debtor was engaged in the business of providing water treatment programs for commercial cooling water systems. Debtor lost a significant part of its business after the Enron bankruptcy because it had large contracts with an Enron subsidiary. In 2003, Debtor sold off one of its wholly owned subsidiaries in an effort to maintain its core business. Debtor alleges that the buyer failed to perform on the purchase contract and, as a result, debtor ceased its operations and filed a Chapter 11 case. Debtor's most significant asset is its cause of action against the buyer of its subsidiary business. Debtor's plan involves the proposed auction sale of the cause of action with the Debtor to receive a share of any recovery. Creditors would be paid from proceeds of the lawsuit. Debtor's plan provides for it to resume its business operations. The plan was approved by a vote of the creditors. Grounds for the objections included 1) that the plan provides for a discharge in violation of § 1141(d)(3); 2) bad faith; and 3) feasibility. The Court agreed with the objectors that the plan, in effect grants the Debtor a discharge, but found that Debtor's plan to resume business operations takes the case outside the ambit of § 1141(d)(3). The Court further found the plan to be proposed in good faith and to be feasible. The Court confirmed the plan. The primary thrust of the objections was the concern that the post-petition Debtor would be a shell public corporation cleansed of liabilities by the bankruptcy. By merging with such a shell, a private corporation may "go public" and avoid some of the SEC disclosure regulations. But the Debtor's plan complied with the plain language of the statute and the fact that the post-petition Debtor may be an attractive merger candidate for those reasons could not form a basis for denial of confirmation to a Debtor who met all statutory confirmation requirements.

In re Barnes, 310 B.R. 209 (Bankr. D. Colo. 2004). The Court considered whether a Debtor who had elected to be treated as a small business pursuant to Section 1121(e)(2) could withdraw the election after missing the deadline for filing its plan. The court applied a balancing test pursuant to Section 105 and determined that under the circumstances of this case the withdrawal of the small business exception was non-prejudicial. Accordingly, the withdrawal was allowed and the US Trustee's motion to convert was denied.

In re: Castre, Inc.; Case No. 03-22159 HRT; Oral ruling entered on record May 28, 2004. Motion, pursuant to § 363, to sell virtually all of Debtor's assets. After soliciting offers, Debtor selected a "stalking horse" bid from All Copy Products, Inc., ["All Copy"] for the assets and gave notice of the planned sale. Advanced Copy Systems, Inc. ["Advanced"] submitted a competing bid and the Debtor conducted an auction sale. At the conclusion of protracted bidding, Debtor selected the bid of All Copy as the winning bid. The Court characterized the winning bid as a "leveraged buy-out" of the assets because All Copy will draw down an existing line of credit to make the down payment and would pay the remainder over 12 months depending, in large part, on future operations of the Debtor's assets for the payment. By contrast the competing Advanced bid was not dependent on any financing for the down payment and would be fully paid in four months without depending on future operation of the purchased assets. However, the total bid of All Copy was the highest bid. While the Court acknowledged that the risk involved in the All Copy bid may have caused the Court to choose differently than the Debtor did, the Court was obliged to approved the Debtor's decision so long as the Debtor could demonstrate that it exercised sound business judgment. Despite some concerns regarding the All Copy Bid, the Court approved the sale because a debtor-in-possession is entitled to great judicial deference in exercising its business judgment. The evidence demonstrated that the Debtor had adequately considered the bids and explained its reasons for choosing the All Copy bid.

In re: Chamness; Case No. 03-35099 HRT; Oral ruling entered on the record May 28, 2004. Chapter 7 Debtor objected to a motion to extend the deadline to file a complaint to dismiss Debtor's case under § 707(b) filed by the United States Trustee ["UST"]. After a contested hearing on the motion, the Court allowed the extension of the deadline. Cause for the extension under Rule 1017(e) existed both 1) because the case had been selected for a detailed audit under a pilot Debtor Audit Program and the UST was proceeding, pursuant to its statutory duties, to conduct that audit; and 2) notwithstanding the audit program, the UST acted diligently in investigating the activities of the Debtor under the facts and circumstances of the case.

In re: Phouminh; Case No. 03-26899 HRT; Oral ruling entered on the record June 10, 2004. Chapter 7 Debtor objected to a motion to extend the deadline to object to Debtor's discharge filed by the United States Trustee ["UST"]. After a contested hearing on the motion, the Court allowed the extension of the deadline. In this case, the UST did not have reason to investigate the Debtor until it sat in on a creditor's 2004 exam of the Debtor conducted seven days before the complaint deadline expired. Rule 4004(b) requires "cause" for an extension. While the Court does not necessarily endorse a

"liberal" policy with respect to the granting of such extensions, it granted the motion. Cause existed because the UST is required by statute to investigate the activities of the Debtor when information to justify such investigation comes to its attention. The UST had no control over the fact that information, not apparent from the schedules, came to its attention just a few days before expiration of the complaint deadline. The Court found that the UST acted diligently, under the circumstances of the case.

Fowler & Peth, Inc. v. Regan; Case No. 03-1783 MER; Order entered July 6, 2004.

Creditor filed an adversary proceeding against chapter 7 Debtors to determine dischargeability of debt under § 523(a)(4). The Court addressed: (1) whether the Debt, owed by Debtor's corporation, Eagle Roofing, Inc. ["Eagle"], was created by defalcation of a fiduciary duty; and (2) whether the Debtors, as Eagle's sole shareholders, could be held personally liable under § 523(a)(4) for a debt of the corporation. The case arises under Colorado's Mechanics Lien Trust Fund Statute, COLO. REV. STAT. § 38-22-127. The Court found that, under the statute, Eagle became a fiduciary with respect to funds it received on its roofing projects and that its failure to pay the Plaintiff, one of its roofing suppliers, was a defalcation of its fiduciary duty. The Court rejected Debtors' argument that Plaintiff forfeited its rights under the statute by failing to file a mechanics lien. Debtors also argued that they could not be held personally liable for the debts of their corporation. They argued that *Leonard v. McMorris*, 63 P.3d 323 (Colo. 2003), a case which denied officer and director liability for violation of the Colorado Wage Claim Act, should be applied to shield the Debtors from liability for Eagle's defalcation in this case. But the Court distinguished *McMorris* by citing general trust law principles that officers and directors who personally participate in a misuse of trust property by the corporation may be held liable. Thus, *McMorris* was found to be inapplicable and the Court found that the total control the Debtors exercised over the actions of the corporation made them personally liable, under § 523(a)(4) for the corporation's breach of its fiduciary duties under the trust fund statute.

In re Telluride Income Growth Limited Partnership, Case No. 03-13632-ABC. The Court considered whether a Chapter 7 case filed by a limited partnership should be dismissed. The petition was filed by a limited liability company that had previously been a general partner of the debtor, but had been dissolved. The Court determined that the petition was invalid and dismissed the case.

The *Nobelman/Tanner* Debate—Can a Chapter 13 debtor seek to modify the rights of a lender secured only by the debtor’s principal residence when the lender makes a wholly unsecured loan against the residence in the first instance? Judge Campbell in three unpublished rulings has: (1) dismissed an adversary case seeking to avoid such a lien relying on the language of section 506(a) of the Code which requires such valuation to be determined “in conjunction with any hearing . . . on a plan affecting such creditor’s interest,” (*Smith v. Beneficial Mortgage of Colorado*, 03-1390 ABC, Docket # 28 (March 31, 2004)); (2) denied a motion to confirm containing the same provision, refusing to follow *Tanner v. Firstplus Financial, Inc.*, 217 F.3d 1357 (11th Cir. 2000) and its progeny (*In re Anderson*, 03-24723 ABC, Docket # 31 (March 29, 2004)); and (3) denied a motion to void lien pursuant to section 506(d), again relying on the language of section 506(a) of the Code (*In re Anderson*, 03-24723 ABC, Docket # 41 (May 17, 2004)).