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Bankruptcy and Creditors' Rights

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BANKRUPTCY AND CREDITORS' RIGHTS

Roger S. Cox*

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I. INTRODUCTION

THIS Article will focus primarily on significant developments in Bankruptcy Law and Creditors Rights and Remedies from the perspective of the Texas practitioner. In somewhat of a departure from years past, it will feature an analysis of one case dealing with valuation of collateral in bankruptcy reorganization proceedings. Otherwise, the cases included in this Article will be reviewed much more concisely. In keeping with the Survey's focus on Texas law, this Article is limited to significant developments impacting upon the creditors' rights or debtor/creditor practitioner during the Survey period.¹

II. BANKRUPTCY

A. SUPREME COURT

Early in the Survey period, the Supreme Court considered the level of a creditor's reliance on a fraudulent misrepresentation necessary to render a debt non-dischargeable. In *Field v. Mans*,² the Court was faced with a situation involving the "actual fraud" provision of § 523 of the Bankruptcy Code, which deals with non-dischargeability of certain debts. Specifically, subsection (a)(2) deals with dischargeability of a debt incurred either by: (i) false pretenses, a false representation, or actual fraud, other than a statement regarding financial condition, or (ii) the use of a materially false written financial statement on which the creditor "reasonably relies" and which the debtor published with an intent to

1. If a case or statutory amendment does not meet these criteria, chances are that it is not covered in this Article. The author has attempted to limit the focus of this Article to issues arising in the enforcement of the debtor/creditor relationship. The reader is urged to review the Survey Articles on Banking Law and Commercial Transactions, which address related topics such as usury, failed financial institutions, and Article 9 secured transactions. For more expansive coverage of bankruptcy developments during the Survey period, see E. Warren & J. Westbrook, *Recent Developments*, in UNIVERSITY OF TEXAS SCHOOL OF LAW 15TH ANNUAL BANKRUPTCY CONFERENCE (1996); R. Littlefield & T. Murphy, *New Case Update*, in TEXAS TECH UNIVERSITY SCHOOL OF LAW 12TH ANNUAL FARM, RANCH AND AGRI-BUSINESS BANKRUPTCY INSTITUTE (1996). Similar updates are also provided at the State Bar of Texas Advanced Consumer Bankruptcy Course and Advanced Business Bankruptcy Course. Additionally, the Texas Tech Law Review's Fifth Circuit Symposium typically features an annual update of bankruptcy developments in the Fifth Circuit.

2. 116 S. Ct. 437 (1995).

deceive.³ The provision dealing with false financial statements explicitly requires that a creditor "reasonably rely" on the false financial statement in order for the debt to be declared non-dischargeable.⁴ The statute dealing with actual fraud, however, is silent with respect to any level of reliance.⁵ The Court, faced with a conflict among the circuits, essentially had to decide whether and to what extent to impose a reliance requirement under the "actual fraud" provision of § 523.

The Court applied a concept of statutory construction known as "the apparent negative pregnant,"⁶ which essentially provides that "[a]n express statutory requirement here, contrasted with statutory silence there, shows an intent to confine the requirement to the specified instance."⁷ In the instant case, the Court essentially had to decide the effect of Congress excluding a reliance standard in one section of the statute while imposing a specific reliance standard in another. Justice Souter found the apparent negative pregnant analysis helpful but found danger in a blind, all-encompassing application of such a maxim.⁸

The Court noted a significant historical difference between the actual fraud provision and the false financial provision. The former referred to a long-standing common law tort, and the latter applied to a more specific bankruptcy related issue with an entirely different set of problems and policy considerations.⁹ The Court reviewed the Restatement (Second) of Torts, which in the context of common law fraud has long suggested the imposition of a "justifiable" reliance standard.¹⁰ The Court applied the same meaning to the actual fraud provision of the Bankruptcy Code.¹¹

3. 11 U.S.C. § 523(a)(2) (1996).

4. *Id.*

5. To find a debt non-dischargeable under the "actual fraud" provision, the creditor must prove certain elements that are not unlike common law fraud. Essentially, the creditor must prove the following: that the debtor made a material representation that he knew at the time to be false; that the debtor made the representation with the intention to deceive the creditor; that the creditor relied upon the representation; and that the creditor was damaged as a result. See generally *In re Eashai*, 87 F.3d 1082, 1086 (9th Cir. 1996) (credit card debt found non-dischargeable under "actual fraud" provision).

6. *Field*, 116 S. Ct. at 442.

7. *Id.* In other words, "where Congress includes particular language in one section of a statute, but omits it in another section of the same Act, it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion." *Gozlon-Perez v. United States*, 498 U.S. 395, 404, (1991) (citing *Russello v. United States*, 464 U.S. 16, 23 (1983)).

8. "Without more, the inference might be a helpful one. But there is more here, showing why the negative pregnant argument should not be elevated to the level of interpretive trump card." *Field*, 116 S. Ct. at 442. The opinion goes on to point out what would be in Justice Souter's analysis a nonsensical application of such a standard when there are obvious reasons not to do so.

9. *Id.* at 443. Given the history of the actual fraud provision and its relation to common law fraud, the Court is to infer, unless a statute otherwise dictates, that Congress means to incorporate established meaning of common law terms.

10. RESTATEMENT (SECOND) OF TORTS § 540 (1979).

11. As the Court stated:

The Restatement expounds upon justifiable reliance by explaining that a person is justified in relying on a representation of fact "although he might have ascertained the falsity of the representation had he made an investigation." Significantly, for our purposes, the illustration is given of a seller of

In applying the "justifiable" reliance standard, the Court pointed out that this is a lower threshold than the more difficult and objective standard of "reasonable" reliance found in the false statement provision.¹² Reasonable reliance imposes a reasonable person standard. Justifiable reliance merely requires the creditor to use common sense and not blindly rely upon a misrepresentation if the falsity is obvious or patent to the creditor, perhaps suggesting a cursory examination or investigation. The Court added that in addition to the statutory distinction, a historical discrepancy in bargaining power between large consumer lenders and unsophisticated borrowers provided a policy reason for imposing the reasonable reliance standard in the case of false financial statements.¹³

During the Survey period, the Court also issued a number of other opinions; however, those opinions dealt with issues that were either beyond the scope of this Survey¹⁴ or had previously been reviewed in last year's Survey.¹⁵

B. DEVELOPMENTS IN FIFTH CIRCUIT AND BELOW¹⁶

1. Collateral Valuation—*The Rash that Won't Go Away*

a. The En Banc Majority Opinion

In a case that by now should be familiar to regular readers of this Survey, the Fifth Circuit reversed itself and split with at least five other cir-

land who says it is free of encumbrances; according to the Restatement, a buyer's reliance on this factual representation is justifiable, even if he could have "walk[ed] across the street to the office of the register of deeds in the courthouse" and easily have learned of an unsatisfied mortgage.

Field, 116 S. Ct. at 444 (citation omitted) (citing RESTATEMENT (SECOND) OF TORTS, § 540 (1979)). Similarly, the Court further notes that, Illustration 1 of PROSSER'S LAW OF TORTS also suggested a justifiable reliance standard quoting "[i]t is only where, under the circumstances, the facts should be apparent to one of his knowledge and intelligence from a cursory glance, or he has discovered something which should serve as a warning that he is being deceived, that he is required to make an investigation of his own." *Id.* (citing WILLIAM L. PROSSER, HANDBOOK OF THE LAW OF TORTS, § 108, 718 (4th ed. 1971)).

12. *Field*, 116 S. Ct. at 439.

13. *Id.* at 447. It is worth noting that reasonableness is not rendered totally irrelevant: [A]s for the reasonableness of reliance, our reading of the Act does not leave reasonableness irrelevant, for the greater the distance between the reliance claimed and the limits of the reasonable, the greater the doubt about reliance in fact. Naifs may recover, at common law and in bankruptcy, but lots of creditors are not at all naive. The subjectiveness of justiciability cuts both ways, and reasonableness goes to the probability of actual reliance.

Id. at 446.

14. See *United States v. Noland*, 116 S. Ct. 1524 (1996) (priority of post-petition tax penalties); *United States v. Reorganized C.F. & I. Fabricators of Utah, Inc.*, 116 S. Ct. 2106 (1996) (treatment of federal tax penalties); *Things Remembered, Inc. v. Petrarca*, 116 S. Ct. 494 (1995) (appellate review of removal/remand proceedings); *Seminole Tribe of Florida v. Florida*, 116 S. Ct. 1114 (1996) (sovereign immunity).

15. See *Citizen's Bank of Maryland v. Strump*, 116 S. Ct. 286 (1995) (Bank's administrative freeze and set-off). This case was reviewed in last year's survey issue. See Roger S. Cox, *Bankruptcy and Creditors' Rights, Annual Survey of Texas Law*, 49 SMU L. REV. 731, 732-34 (1996) [hereinafter Cox, 1996 Annual Survey].

16. The Fifth Circuit has decided a number of cases dealing with bankruptcy and creditors' right since the Survey. For a preview of cases that may be reviewed in next

cuits¹⁷ in *In re Rash*.¹⁸ The Fifth Circuit has now decided, *en banc*, that in a Chapter 13 bankruptcy case, courts should begin any analysis of collateral valuation (even when the debtor proposes to keep the collateral) with the wholesale value of the collateral. This is a departure from the prior *Rash* opinion and numerous other circuits, where a majority rule had developed that in reorganization proceedings, collateral should be valued at what amounts to replacement cost, or at least without deducting hypothetical foreclosure costs. Given the risk of oversimplification, split among the circuits, vigorous dissent, and the far reaching economic consequences of this decision, some analysis of this decision is in order.¹⁹

In *Rash*, the debtor purchased a Kenworth truck tractor, the financing of which was ultimately provided by Associates Commercial Corporation (ACC). The debtor filed for Chapter 13 relief, and the debtor's plan provided for a "cram down" of ACC's secured claim under § 1325(a)(5)(B) of the Bankruptcy Code.²⁰ ACC filed a proof of claim and a motion for relief from the automatic stay. The court heard ACC's motion, the debtor's objection to ACC's claim, and other matters, the disposition of which required the court to determine the value of the truck for purposes of ACC's secured claim.²¹

The bankruptcy court denied ACC's motion for relief from stay and entered an order fixing the amount of ACC's secured claim at the truck's wholesale price. The court apparently reasoned that it had to value the truck from the "creditor's perspective" because § 506(a) of the Bankruptcy Code sets the amount of a secured claim at "the value of [the]

year's Survey, see, for example, *Swate v. Hartwell*, (*In re Swate*) 99 F.3d 1282 (5th Cir. 1996) (dischargeability of support obligations under divorce settlement agreement) (*res judicata* arising out of prior proceedings); *Carmichael v. Osherow*, (*In re Carmichael*) 100 F.3d 375 (5th Cir. 1996) (exempt status of IRA); *O'Connell v. Troy & Nichols, Inc.*, *In re Cabrera*, 99 F.3d 684 (5th Cir. 1996) (treatment of first lien residential mortgage debt in Chapter 13 plan).

17. See *infra* text accompanying note 37.

18. *Associates Commercial Corp. v. Rash* (*In re Rash*), 31 F.3d 325 (5th Cir. 1994), *modified on denial of rehearing*, 62 F.3d 685 (1995); *modified on rehearing en banc*, 90 F.3d 1036 (1996), *cert. granted*, 117 S. Ct. 758 (1997). Unless otherwise stated, further citations to *Rash* will be to the *en banc* opinion at 90 F.3d 1036 (5th Cir. 1996). The prior opinions in *Rash* have been discussed in previous Surveys. See Cox, *1996 Annual Survey*, *supra* note 15, at 741 ("The *Rash* saga is not over, however, because the Fifth Circuit has granted Rehearing En Banc."); Roger S. Cox, *Bankruptcy and Creditors Rights, Annual Survey of Texas Law*, 48 SMU L. REV., 875, 885 (1995) [hereinafter Cox, *1995 Annual Survey*] (substantive discussion of Fifth Circuit's initial panel opinion.)

19. It is this author's desire and that of the editors of this Survey to provide reporting on significant cases as concisely as possible. This is a departure from that policy. For a more concise review of the specific holding in *Rash*, see D. Pawlowic, 20 TEX. BANK LAW. 17 (1996). See also *Valuation of Collateral Revisited*, 15 AM. BANKR. INST. J. 16 (1996); *The Valuation Debate*, 15 AM. BANKR. INST. J. 1 (1996).

20. For convenience, references to "the Code" shall mean the United States Bankruptcy Code as codified at Title 11, United States Code.

21. See *Rash*, 90 F.3d at 1039-40. The majority compares the expert testimony of each party's valuation expert; however, the credibility or experience of the experts did not appear to be an issue in the trial court. See *In re Rash*, 149 B.R. 430, 430-31 (Bankr. E.D. Tex. 1993).

creditor's interest in the estate's interest in the property."²² In short, the bankruptcy court determined that the value of the truck "was equal to the amount that ACC could realize if it exercised its right under the Security Agreement to repossess and sell the truck."²³

On rehearing *en banc*,²⁴ the majority affirmed the bankruptcy court.²⁵ The majority's analysis focused on its perception of Texas law regarding secured transactions and on its reading of § 506(a) of the Bankruptcy Code, which prescribes the method for determining valuation of secured claims. Section 506 provides that an allowed claim is secured "to the extent of the value of such creditor's interest in the estate's interest in such property Such value *shall be* determined in light of the purpose of the valuation and of the proposed disposition or use of such property."²⁶

The majority initially examined the first sentence of § 506 in an effort to determine the creditor's interest in the estate's interest in the property. The majority reasoned that under state law the creditor's interest is in the nature of a security interest, "giving the creditor the right to repossess and sell the collateral and nothing more."²⁷ The court also hypothesized that either of the two "cram down" alternatives found in § 1325 (specifically: (i) surrender of collateral, or (ii) retaining and paying the present value of the collateral over time) should effectively yield the same result for the secured creditor.²⁸ The majority sought symmetry between the two "cram down" alternatives, expressing a concern that valuing a creditor's secured claim at replacement cost (in the retention and use context) would provide more protection than the secured creditor would realize under the collateral surrender scenario.²⁹ For some reason, the court found this unacceptable.³⁰

The court then focused on the second sentence of § 506, which mandates that a court value collateral in light of the purposed disposition or use of that property.³¹ The court concluded that such mandatory language did not offer the "clear textual guidance" needed to justify departure from what the majority thought was established state law regarding realization upon security interests.³² Specifically, the majority viewed state law under the UCC as limiting a secured creditor's interest in collateral to what amounts to its remedies upon default.³³ As the dissent points out, however, there really is no state law regarding treatment of

22. *Rash*, 90 F.3d at 1040, (quoting *In re Rash*, 149 B.R. at 433).

23. *In re Rash*, 149 B.R. at 433.

24. Initially, the Fifth Circuit disagreed with the wholesale approach and found that the inquiry should begin at the replacement cost, which is in effect a retail valuation. See *In re Rash*, 62 F.3d 685 (5th Cir. 1995).

25. *Rash*, 90 F.3d at 1061.

26. 11 U.S.C. § 506(a) (1996) (emphasis added).

27. *Rash*, 90 F.3d at 1044.

28. *Id.* at 1046.

29. *Id.* at 1047.

30. *Id.*

31. *Id.* at 1047-51.

32. *Id.* at 1050.

33. *Id.* at 1041-42.

secured claims in a reorganization context.³⁴

In conclusion, based upon the majority's reading of the statutory language, economic considerations, and legislative history, the valuation of a secured creditor's interest (at least according to the majority opinion) "should start with what the creditor could realize if it repossessed and sold the collateral pursuant to its security agreement, taking into account the purpose of the valuation and the proposed disposition or use of the collateral."³⁵ Importantly, however, bankruptcy courts are allowed to make adjustments depending upon considerations arising from the facts of each particular case.³⁶

b. The Dissent (and Majority Rule in Other Circuits)

The *en banc* majority not only has the Fifth Circuit effectively reversing itself, but it now has placed itself clearly within the minority view. As of this writing, *Rash* is inconsistent with holdings in at least five other circuits.³⁷ There is perhaps no better critical analysis of the majority opinion than is found in Judge Smith's dissent.³⁸ Although the dissent speaks for itself, the majority opinion warrants some analysis here, especially

34. *Id.* at 1069. (Smith, J., dissenting). This is further discussed *infra* note 39.

35. *Id.*, at 1061. *Rash* has been followed by at least one district court. See *In re Maddox*, 200 B.R. 546 (N.J. 1996) (apparently decided before most recent opinion in *Taffi* (see *infra* note 37)).

36. *Id.* at 1061. In the bankruptcy court opinion, however, Judge Sharp found "no justification" from varying from wholesale valuation of Mr. Rash's truck. *In re Rash*, 149 B.R. at 433.

37. See *In re Hoskins*, 102 F.3d 311, 313-16 (7th Cir. 1996) (average between wholesale and retail most suitable "middle ground"); *Taffi v. United States*, 96 F.3d 1190 (9th Cir. 1995) (holding that in Chapter 11 context, confirmation value of secured claim is measured by fair market value with no deduction for hypothetical foreclosure and repossession costs); *Metrobank v. Trimble (In re Trimble)*, 50 F.3d 530 (8th Cir. 1995) (holding that in Chapter 13 case, confirmation value of secured claim is measured by retail value without hypothetical sale cost deduction); *Winthrop Old Farm Nurseries v. New Bedford Institution for Savings (In re Winthrop Ole Farm Nurseries)*, 50 F.3d 72 (1st Cir. 1995) (holding that in Chapter 11 confirmation value is measured by "fair market value" rather than liquidation value); *Huntington Nat'l Bank v. Pees (In re McClurkin)*, 31 F.3d 401 (6th Cir. 1994) (no deduction for hypothetical sale cost when debtor purposes to retain collateral in Chapter 13); *Coker v. Sovran Equity Mortgage Corp. (In re Coker)*, 973 F.2d 258 (4th Cir. 1992) (value of collateral measured without deduction for hypothetical sale cost when debtor retains collateral in Chapter 13). Compare *Lomas Mortgage USA v. Wiese*, 980 F.2d 1279, 1286 (9th Cir. 1992), *vacated on other grounds* 508 U.S. 958, (1993) with *General Motors Acceptance Corp. v. Mitchell (In re Mitchell)*, 954 F.2d 557, 560 (9th Cir.), *cert. denied*, 506 U.S. 908, (1992). *Mitchell*, however, has been overruled. See *Taffi*, 96 F.3d at 1193.

38. For starters, the dissent notes:

The majority dismantles 11 U.S.C. § 506(a) (1994) by combining a question-begging interpretation of the statute's first sentence with an unreasonably restrictive reading of the second. Having thereby obscured the section's plain meaning, the majority turns to an inapposite presumption, an incorrect economic analysis, and the last resort of judicial redrafting—selective reading of the legislative history. Not surprisingly, this policy-driven reconstruction of the statute has been squarely rejected by every other circuit that has considered it.

Rash, 90 F.3d at 1061 (Smith, J., dissenting).

given what may have been a misapplication of existing state law regarding security interests.

As mentioned above, § 506(a) contains two sentences. In effect, the first sentence relies upon existing state law. The bankruptcy court must first determine the nature and extent of the creditor's interest in the estate's interest in an item of property. Arguably, this is the secured creditor's "security interest." Once this determination is made, then the court looks to the second sentence of § 506(a), which mandates that the court make the valuation in light of the purpose for which the collateral will be disposed of or used. What follows is a brief analysis of how this author believes the Fifth Circuit first misunderstood substantive state law regarding security interests and second, how the court then applied that substantive law in an illogical fashion. Additionally, the court's analysis further goes askew when it essentially defers to a body of state law that simply does not exist.

First, an analysis of the state law regarding secured transactions reflects that the court's reading of the first sentence of § 506(c) may be flawed. In the context of personal property, the applicable state law is article 9 of the Texas Business and Commerce Code. Article 9 deals with the creation, perfection, and enforcement of security interests in personal property.³⁹ Article 9, however, is silent with respect to any limitation on the extent of the creditor's security interest, other than to the extent the creditor has given value. In other words, under state law, the lien simply exists to the extent of the indebtedness, which remains an encumbrance against the property.

More specifically, section 9.504 provides the secured party's remedies upon default.⁴⁰ Those remedies consist of disposing of the collateral in a "commercially reasonable" manner, applying the net proceeds to satisfaction of the debt,⁴¹ or retaining the collateral in total satisfaction of the debt.⁴² The rules regarding disposition of collateral, however, do not dictate that a creditor dispose of collateral in a wholesale fashion, nor do they purport to limit a creditor's interest in collateral to such a hypothetical result.⁴³ Rather, in the spirit of attempting to obtain the highest value possible (which benefits both the debtor and the secured creditor), there is nothing to preclude the creditor from attempting to dispose of the collateral on a more "retail" basis. If and to the extent the creditor is successful in obtaining such a higher value, that value goes to the creditor (to

39. TEX. BUS. & COM. CODE ANN. §§ 9.101-9.507 (Tex. UCC) (Vernon 1991). Actually, the term "security interest" is defined in article 1. *See id.* at § 1.201(37)(A) ("Security interest" means an interest in personal property or fixtures which secures payment or performance of an obligation . . .").

40. *Id.* § 9.504.

41. *Id.*

42. *Id.* § 9.505.

43. As reviewed elsewhere in this Article, at least one Texas court has noted that § 9.504 "does not *require* but rather *allows* a secured party to sell the collateral." *Schmid v. Texas Commerce Bank*, 912 S.W.2d 845, 846 (Tex. Civ. App.—Fort Worth 1995, writ denied) (emphasis added).

the extent of the debt) because it constitutes part of the secured creditor's security interest.⁴⁴ Alternatively, the creditor may retain the collateral in a "strict foreclosure" of its security interest.⁴⁵

Article 9, however, is absolutely devoid of even any mention of restructuring or reorganizing such secured debt, in a bankruptcy context or otherwise. This is because there simply is no state law regarding the rights of secured creditors in reorganizations. This field has been preempted by the Code, which is federal law. Additionally, in the context of day to day commercial expectations, there is likewise no such limitation in the absence of an intervening bankruptcy. These principles are equally applicable to transactions involving real and personal property.⁴⁶

Turning to the Code, the second sentence of § 506(a) unequivocally mandates that valuation "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."⁴⁷ When the purpose is a "cram down" of property to be retained and utilized by a reorganizing debtor, the only logical conclusion is that the court "shall" look to the value of the property "in the hands of the debtor, not on the auction block."⁴⁸ It is logically and factually incongruous to analyze an actual situation involving retention and use of an item of property by valuing it based upon the purely hypothetical cost of a foreclosure sale that (if a plan is successful) would never happen. As the Eighth Circuit has clearly stated (and as quoted in the *Rash* dissent):

[W]here a debtor intends to retain and use the collateral, the purpose of the valuation is to determine the amount an undersecured creditor will be paid for the debtor's continued possession and use of the collateral, *not* to determine the amount such creditor would receive if it hypothetically had to repossess and sell the collateral. Such an interpretation ignores the expressed dictates of § 506(a).⁴⁹

More recently, in *In re Taffi*, the Ninth Circuit, in concluding that fair market value is the appropriate measure, put the entire issue in perspective:

When a Chapter 11 debtor or a Chapter 13 debtor intends to retain property subject to a lien, the purpose of a valuation under § 506(a) is not to determine the amount the creditor would receive if it hypothetically had to foreclose and sell the collateral. Neither the foreclosure value nor the costs of repossession are to be considered

44. Obviously, if the collateral was disposed of in a commercially reasonable manner, and the proceeds insufficient to satisfy the debt, then the creditor may have a claim for a deficiency. See *Tanenbaum v. Economics Labs.*, 628 S.W.2d 769, 771-72 (Tex. 1982).

45. TEX. BUS. & COM. CODE ANN. § 9.505(b) (Tex. UCC) (Vernon 1991).

46. Imagine the nonsensical result if security interests and liens were so limited. For example, when real or personal property that secures a debt is sold in the ordinary course of business, the "payoff" is always the full amount of the debt or lien, and in the absence of an agreement between the parties, the secured creditor is not limited to the net proceeds of a hypothetical forced sale. This is not contemplated in the typical transaction, and there is no state law that would mandate such approach.

47. 11 U.S.C. § 506(a) (1996) (emphasis added).

48. See *Rash*, 90 F.3d at 1061 (Smith, J., dissenting).

49. *In re Trimble*, 50 F.3d 530, 532 (8th Cir. 1995) (emphasis added).

because no foreclosure is intended. Instead, when the proposed use of the property is continued retention by the debtor, the purpose of the valuation is to determine how much the creditor will receive for the debtor's continued possession. Hypothetical sale costs are not to be considered because no sale is intended

. . . .
. . . [V]aluation must be accomplished within the actual situation presented. Consequently, the value has to be the fair market value of what the debtors are using.⁵⁰

In what amounts to a disregard of the second sentence of § 506(a) (which results in an overly narrow reading of the first sentence), the majority refers to a canon of construction that disfavors displacement of well established areas of state law. As mentioned above and in the dissent, however, that maxim does not apply to *Rash* because there simply is no state law that addresses reorganization of debts.

The majority's search for symmetry between the "cram down" alternatives of retention and surrender of the collateral to the secured creditor seems similarly incongruent. The majority seems concerned that valuation at a replacement or similar cost would give a creditor more protection and even more potential return than it would have under the surrender/foreclosure scenario. This concern is misplaced, however, because the two situations are in no way symmetrical. On the contrary, they arise out of two very different scenarios. First, surrender of collateral to a secured creditor truly is like the situation contemplated by section 9.504 of the UCC because the creditor in fact will be disposing of the collateral. The cost of repossession and disposition are not merely hypothetical, but they will in all likelihood be incurred. Thus, it makes sense to take a wholesale approach in a "surrender" situation.

On the other hand, retention and use of the collateral create an entirely different situation. Not only are there no repossession and sale costs to be taken into account, but the collateral truly is worth more to the debtor and the estate and, therefore, to the secured creditor. To the extent the debtor retains and uses collateral for a greater purpose (reorganization), the creditor's interest in the collateral is simply worth more. This is consistent with the majority's own statement and recognition of the fundamental concept that valuation for one purpose does not necessarily control for another, especially in light of the admonition of the second sentence of § 506(a).

Finally, although in a somewhat different context, the Supreme Court has stated on more than one occasion that the "creditor's interest in the estate's interest in such property" means "the value of the collateral."⁵¹

50. *Taffi*, 96 F.3d at 1192. As another circuit explained, by retaining the collateral, the reorganizing debtor is insuring that the very event that gives rise to the majority's starting point for valuation will not take place. *See In re Winthrop Old Farm Nurseries*, 50 F.3d at 74.

51. *See Nobleman v. American Savings Bank*, 508 U.S. 324, 328-29, (1993) (Under § 506(a), a claim is secured "to the extent of the value of [the] property"); *United Savings*

The Fifth Circuit even alluded to this concept in an earlier case.⁵² Of course, the secured creditor's interest is limited to the estate's interest in the property. Not only is this common sense, but it is consistent with the fundamental concept of state law—the secured creditor's interest in an item of property can be no greater than the interest conveyed by the debtor. In effect, the debtor's interest that was pledged to the creditor is the interest that is being valued. This does not mean, however, that the creditor's interest is limited to the proceeds of a hypothetical, imaginary forced sale that may never occur.

c. Conclusion

It is not the place of this Survey issue to determine whether a decision is "right" or "wrong." It is important to note, however, that with the *Rash* decision, the *en banc* majority now puts the Fifth Circuit in the minority view. Although there may be no set answer to the issue of collateral valuation in the absence of new legislation, the *Rash* majority seems to have misapplied state law, which leads to logical inconsistencies in the majority opinion. These inconsistencies cannot be explained, especially coming from a circuit that has in the past been so consistent with its "plain meaning" approach to statutory construction.

A tempting "practical" approach is taken by the Ninth Circuit in *Taffi*, in which that court concluded that "the value has to be the fair market value of what the debtors are using."⁵³ Although *Taffi* dealt with real property, the court made the following observation with respect to motor vehicles: "We make no judgment whether the fair market value of an automobile is high blue book or low blue book or some other value; that value is to be determined by the facts presented to the bankruptcy court."⁵⁴

Obviously, *Taffi* does not provide what may be a much needed hard and fast guideline for valuing motor vehicles, but neither does the Bankruptcy Code.⁵⁵ Given the choice between the two extremes, however,

Ass'n v. Timbers of Inwood Forest Assocs. (*In re* Timbers of Inwood Forest Assocs.), 484 U.S. 365, 372, (1988) (The value of a creditor's interest in context of § 506(a) means "the value of the collateral").

52. See *Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank* (*In re* Sandy Ridge Dev. Corp.), 881 F.2d 1346, 1349 (5th Cir. 1989) ("In situations involving only one creditor and one debtor, the value of the . . . secured claim is simply the value of the underlying collateral.").

53. *In re Taffi*, 96 F.3d at 1192.

54. *Id.* at 1193.

55. See, e.g., *In re Johnson*, 165 B.R. 524, 529-30 (S.D. Ga. 1994) where the Court stated:

[T]he legislative history of Section 506(a) makes clear that "value" does *not* necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case by case basis, taking into account the facts of each case and the competing interest in the case. . . . A fixed "wholesale" or "retail" standard for Section 1325(a)(5)(B)(ii) valuations is inconsistent with Section 506(a)'s aversion to standardized procedure [T]he Bankruptcy Code nowhere implies that NADA "wholesale" and "retail" values should operate

state law, statutory construction, and logic all dictate that retained collateral used in a debtor's reorganization should be valued based upon its actual value, which is in effect its actual replacement cost.

Certiorari has been granted for *Rash*.⁵⁶ The well-prepared practitioner should know, however, that the wholesale value approach suggested by *Rash* is only the starting point. Those who provide courts with well-reasoned, qualified expert testimony and fact evidence will be well served.

2. Consumer Case Administration

a. Statement of Intent

The Fifth Circuit decided another case that should have a direct impact on the administration of consumer bankruptcies. In *In re Johnson*,⁵⁷ the court addressed what had been some uncertainty regarding the effect of the Statement of Intent required by § 521. Under § 521, an individual Chapter 7 debtor is required to file, within thirty days after the petition date, a statement of intent regarding consumer debts secured by property of the estate.⁵⁸ Specifically, the debtor is required to state whether he intends to retain or surrender such property, and if such property is exempt, to specify the exemption and to state whether the debtor intends to redeem the property or reaffirm the debt secured by that property.⁵⁹ The debtor is required to exercise that stated intention within forty-five days after the filing of the notice of intent.⁶⁰ Whether the debtor is in fact limited to these three options (reaffirmation, redemption, or surrender) "has been hotly contested in recent jurisprudence."⁶¹

The Fifth Circuit found that the specific language of § 521 mandates the filing of such a statement.⁶² Moreover, the court agreed with an earlier Eleventh Circuit case that decided that Chapter 7 debtors are limited to the three options set forth in the statute, and that compliance is

as any sort of a standard for measuring compliance with Section 1325(a)(5)(B)(ii). . . . Fair market value is "[t]he amount at which property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of the relevant facts." . . . Ascertaining "fair market value" is an objective broad enough to permit use of NADA Guide Books and similar authoritative sources as evidence of value, but without implying that the valuation determination is limited to those sources.

Id. (citations omitted). For cases applying both wholesale and retail values, see for example, *In re Madison*, 186 B.R. 182 (Bankr. E.D. Pa. 1995); *In re Myers*, 178 B.R. 518 (Bankr. W.D. Ok. 1995); *In re Carlan*, 157 B.R. 324 (Bankr. S.D. Tex. 1993). For a thorough discussion of collateral valuation in Chapter 13, see, Keith M. Lundin, CHAPTER 13 BANKRUPTCY SECTION 5.46-5.48 (Wylie 1991 & Supp. 1996) (Author discusses most of above cases and comes to conclusions similar to that found in *Rash*).

56. 117 S. Ct. 758 (1997).

57. *Johnson v. Sun Finance Co.* (*In re Johnson*), 89 F.3d 249 (5th Cir. 1996).

58. 11 U.S.C. § 521(2)(A) (1996).

59. *Id.*

60. 11 U.S.C. § 521(2) (1996).

61. *In re Johnson*, 89 F.3d at 251.

62. *Id.* at 252.

mandatory.⁶³ Therefore, it would appear that simply ignoring § 521 is no longer an option in the Fifth Circuit.⁶⁴

b. Case Administration—Chapter 13 Best Efforts

In *In re Jobe*,⁶⁵ Judge Monroe denied confirmation of a Chapter 13 plan proposed by a debtor who apparently was intentionally underemployed and who did not devote “his best efforts” to funding the Chapter 13 plan.⁶⁶ Under § 1325(b), a Chapter 13 plan may not be confirmed on objection, unless the plan provides that all of the debtor’s projected disposable income to be received during the three year period of the plan is applied to make payments under the plan.⁶⁷ A crucial point in *Jobe* is that the Chapter 13 income test is more than just multiplying the debtor’s current income by the number of months in the plan.⁶⁸ Rather, Chapter 13 requires that all of the debtor’s *projected* disposable income be dedicated to funding the plan.⁶⁹ According to *Jobe*, “the capacity of the debtor to earn more money and, thereby, pay more in plan payments has been a factor that the Fifth Circuit and other courts have considered.”⁷⁰

In *Jobe*, the debtor was a relatively young able-bodied man with no apparent medical problems and with marketable skills gained while in the Army. The debtor apparently owned a small family farm; however, no crops were grown on that farm, and the debtor had no other work. The court found that “sitting idly by on a farm, the down payment for which was advanced by one’s second largest unsecured creditor, and collecting ‘early’ retirement pay from the Army while offering unsecured creditors four cents on the dollar hardly strikes the court as one’s ‘best efforts.’”⁷¹

63. *Id.*

64. *Id.* The court denied the creditor’s motion to dismiss; however, the creditor’s motion to compel in compliance with § 521 was granted. The debtors were allowed ten (10) days within which to notify the creditor of their intention, and, in the event of the debtor’s failure to do so, then the Bankruptcy Court was authorized to dismiss the case or deny the debtor’s discharge under 11 U.S.C. § 727(a)(6). *Id.* As mentioned above, the Court relied on the Eleventh Circuit in holding in *Taylor v. AGE Federal Credit Union (In re Taylor)*, 3 F.3d 1512 (11th Cir. 1993).

65. *In re Jobe*, 197 B.R. 823 (Bankr. W.D. Tex. 1996).

66. *Id.* at 827.

67. 11 U.S.C. § 1325(b).

68. 197 B.R. at 826-27.

69. *Id.* at 826.

70. *Id.* at 827; *see also* *Commercial Credit Corp. v. Killough (In re Killough)*, 900 F.2d 61, 66 (5th Cir. 1990) (“[T]here may be instances where income obtained through working overtime can and should appropriately be included in a debtor’s projected and disposable income for the purposes of a Chapter 13 plan.”); *In re Dunning*, 157 B.R. 51, 53 (Bankr. W.D. N.Y. 1993).

71. *In re Jobe*, 197 B.R. at 827. For a discussion of non-exclusive factors applied in a case decided prior to the 1984 Amendments, *see In re Estus*, 695 F.2d 311, 315 (8th Cir. 1982). In *Jobe*, the Court seemed to indicate that the *Estus* factor and the “best efforts” or “ability to pay” test under Section 1325(b) to be equally applicable. *Id.* at 826.

3. Dischargeability⁷²—Willful and Malicious Injury

In what may become known as "The Shotgun Case,"⁷³ the Fifth Circuit apparently narrowed somewhat the scope of willful and malicious injury necessary to render a debt non-dischargeable under § 523(a)(6). In *In re Delaney*,⁷⁴ Delaney (the debtor), apparently in anticipation of a confrontation with Corley, loaded his double-barreled shotgun and took it with him to face Corley, who remained seated in the car that had stopped in Delaney's driveway. Delaney aimed the loaded shotgun at Corley through the car's windshield, and, with his finger on the trigger, tapped the shotgun twice on the windshield. The gun discharged, apparently by accident.

The court found that Corley's damages were dischargeable, reasoning that for willfulness and malice to prevent discharge under § 523(a)(6), "the debtor must have intended the actual injury that resulted."⁷⁵ Quoting a Georgia bankruptcy court, the Fifth Circuit noted that § 523(a)(6) "excepts from discharge debts arising from 'willful and malicious injury' rather than 'willful and malicious acts which cause an injury.'"⁷⁶ In other words, had Delaney meant to pull the trigger, then the damages would have been non-dischargeable; however, under the Fifth Circuit's logic, no matter how foreseeable the consequences of Delaney's inexcusable acts, those consequences apparently do not give rise to non-dischargeability.⁷⁷

Similarly, in *In re Greenway*,⁷⁸ the debtor apparently crashed a motor boat into another vessel, causing a fatality and various injuries. The debtor had apparently been drinking. The creditor sued in state court, and a jury, finding the debtor sixty percent responsible, awarded damages. The state court jury, however, did not find that the debtor was grossly negligent.⁷⁹ Subsection (a)(9) excepts from discharge, death or personal injuries caused by the operation of a "motor vehicle" if that op-

72. For an expansive update on dischargeability litigation, see Keith Lundin, *Recent Developments in Discharge and Dischargeability Litigation*, in TWELFTH ANNUAL TEXAS TECH FARM, RANCH, AND AGRI-BUSINESS BANKRUPTCY INSTITUTE (1996).

73. Judge Keith Lundin coined this phrase at the 1996 Texas Tech Farm, Ranch, and Agri-business Bankruptcy Institute.

74. *Corley v. Delaney* (*In re Delaney*), 97 F.3d 800 (5th Cir. 1996).

75. *Id.* at 802.

76. *Id.* (quoting *In re Hampel*, 110 B.R. 88, 93 (Bankr. M.D. Ga. 1990)).

77. One could easily conclude that this inequitable result points out the need for a legislative amendment to what in hindsight appears to be a poorly drafted statute. Numerous courts have found claims nondischargeable when an intentional act has resulted in a foreseeable injury. See, e.g., *Perkins v. Scharfe*, 817 F.2d 392 (6th Cir. 1987); *In re Cecchini*, 780 F.3d 1440 (9th Cir. 1986); *In re Quezada*, 718 F.2d 121 (5th Cir. 1983). This has even arisen in a medical malpractice context. See *Kelt v. Quezada* (*In re Cole*), 136 B.R. 453, 459 (Bankr. N.D. Tex. 1992) (doctor's willful disregard of his duties and acceptable medical practices rendered malpractice claim nondischargeable); see also *First Nat'l Bank v. Franklin* (*In re Franklin*), 726 F.2d 606 (10th Cir. 1984); *Kawaauhau v. Geiger* (*In re Geiger*), 172 B.R. 916 (Bankr. E.D. Mo. 1994).

78. *Boyce v. Greenway*, (*In re Greenway*), 71 F.3d 1177 (5th Cir. 1996).

79. The Fifth Circuit faced two issues. First, the Fifth Circuit had to determine whether a motor boat was a "motor vehicle" as that term is used under section 523(a)(9).

eration was unlawful due to the debtor's intoxication.⁸⁰ The court found that under its "plain meaning" statutory analysis, the term "motor vehicle" did not include a motor boat.⁸¹ Therefore, the court found subsection (a)(9) inapplicable to the operation of a motor boat.⁸²

The court also addressed a collateral estoppel issue arising out of the state court litigation regarding the accident. As mentioned above, the state court jury did not find that the debtor was grossly negligent. The court inferred that if the debtor was found not to be grossly negligent in an actually litigated state court proceeding between the same parties, then it necessarily followed that it had been preclusively decided that the debtor's actions did not come up to the "intentional" and lacking "just cause for excuse" standard required for a non-dischargeability finding under the "willful and malicious" provisions of subsection (a)(6).⁸³

4. Dischargeability—False Financial Statements

The Fifth Circuit revisited the issue of non-dischargeability of debts incurred as a result of a false financial statement in *In re Norris*.⁸⁴ The false financial statement in *Norris* was made as part of an annual renewal process of what apparently was a series of year to year notes. Specifically, the debtors represented that they had a cash flow surplus of \$45,000 at a time when their excess cash flow was almost non-existent.⁸⁵ The debtor contended, however, that the debt was dischargeable because no "new" funds were disbursed in response to the false financial statement,⁸⁶ and that they lacked the requisite intent to deceive the bank. The Fifth Circuit, however, noted that § 523(a)(2) expressly lists "renewal . . . of credit"⁸⁷ as one of the classes of obligations excepted from discharge.⁸⁸ The court also determined that regardless of the actual intent, the bankruptcy court found that at a minimum "there was a reckless disregard for the truth."⁸⁹ The Fifth Circuit found no error in this reasoning.

80. 11 U.S.C. § 523(a)(9) (1996).

81. 71 F.3d at 1180.

82. *Id.*

83. *Greenway*, 71 F.3d at 1180-81. This case was decided before the *Delaney* shotgun case. Under the *Delaney* rationale, it is even less likely that the debtor's operation of the motorboat would have resulted in a non-dischargeable claim.

84. *Norris v. First Nat'l Bank (In re Norris)*, 70 F.3d 27 (5th Cir. 1995).

85. *Id.* at 29.

86. *Id.* Section 523(a)(2)(B) of the Bankruptcy Code provides that a debt is nondischargeable "for money . . . or an extension, renewal, or refinancing of credit" obtained by a written statement: "(i) that is materially false; (ii) respecting the debtor's . . . financial condition; (iii) on which the creditor . . . reasonably relied; and (iv) that the debtor caused to be made or published with intent to deceive." Each of these four elements must be proven by a preponderance of the evidence. See *Grogan v. Garner*, 498 U.S. 279 (1991).

87. 70 F.3d at 29 (citing 11 U.S.C. § 523(a)(2)). The Fifth Circuit noted that although the purpose of the Bankruptcy Act is to provide debtors a fresh start, the Supreme Court has concluded that with respect to the non-dischargeability provisions "Congress evidently concluded that the creditors' interest in recovering full payments of debts in these categories outweighed the debtors' interest in a complete fresh start." *Id.* at 30 (quoting *Grogan*, 498 U.S. at 287).

88. *Id.* at 29.

89. *Id.* at 30 n.12.

5. Dischargeability—Unscheduled Creditors

In *In re Faden*,⁹⁰ the Fifth Circuit affirmed a finding of non-dischargeability of a claim of an unlisted, unsecured creditor, even in a no-asset case. The debtor apparently had full knowledge of the creditor's correct address; however, he failed to provide that information to counsel, whose secretary was left to resort to the telephone book. The secretary found an address for its parent company, and that is the address to which the notice was mailed. Apparently, the creditor never received the notice and filed an adversary proceeding after the debtor's discharge seeking a finding that the debts owed were non-dischargeable.

The court noted that the burden is on the debtor to complete schedules accurately and that the burden of proof rests upon the debtor to show that a creditor had notice or actual knowledge in order to avoid applicability of § 523(a)(3)(A).⁹¹ The court identified what it had previously referred to as the three *Robinson* factors in evaluating whether an unlisted creditor's debt would be discharged: (1) the reasons the debtor failed to list the creditor; (2) the amount of disruption that would likely occur; and (3) the prejudice suffered by the listed creditors and the unlisted creditor in question.⁹²

In *Faden* there was arguably little or no prejudice to the unlisted creditor because *Faden* was a no asset case. No bar date had ever been set, so there was no deadline by which creditors had to file proofs of claim, and there were no assets for distribution to creditors. What is critical to note, however, is that the Fifth Circuit gave great deference to the bankruptcy court's apparent conclusion that the debtor was not credible and gave virtually no excuse for why the creditor's address was not provided to counsel.⁹³ The court then alluded to other authority to the effect that notwithstanding factors like those found in *Robinson* (in particular prejudice to the creditor), the unscheduled debt should remain non-dischargeable if the debtor's failure to schedule the debt is due to any intentional design, fraud, or improper motive (in other words, more than "mere negligence or inadvertence").⁹⁴ Accordingly, the court found that the bankruptcy court did not abuse its discretion and held the debt non-dischargeable despite the fact that the creditor would have received no disbursement had a claim been filed.⁹⁵

90. *Faden v. Insurance Co. of N. Am. (In re Faden)*, 96 F.3d 792 (5th Cir. 1996).

91. § 523(a)(3)(A) provides that an unlisted creditor's claim is not discharged "unless such creditor had notice or actual knowledge of the case in time for . . . timely filing" of a proof of claim. 11 U.S.C. § 523(a)(3)(A) (1996).

92. 96 F.3d at 796 (quoting *Robinson v. Mann*, 339 F.2d 547, 550 (5th Cir. 1964)).

93. *Id.* at 796.

94. *Id.* at 797 (citing *In re Stone*, 10 F.3d 285, 291 (5th Cir. 1994)); see also *In re Smith*, 21 F.3d 660, 665 (5th Cir. 1994) (unscheduled creditor's claim held non-dischargeable when debtor's scheduled creditor two and a half years after filing the case, but listed the wrong address, which could have been easily corrected by attempts to contact creditor).

95. 96 F.3d at 797. "The decision to reopen a bankruptcy case and allow amendment of schedules is committed to the sound discretion of the bankruptcy judge and will not be set aside absent abuse of discretion." *Id.* at 796.

6. Dischargeability—State Court Default Judgment

A federal district court revisited the issue of the preclusive effect of a state court default judgment in the context of dischargeability issues. In *In re Pancake*,⁹⁶ the federal district court reversed a bankruptcy court summary judgment that held a state court default judgment preclusive on the issue of dischargeability of a debt arising out of fraud in a fiduciary capacity.

In the state court, the debtor's pleadings were stricken for discovery abuse, and a summary judgment was entered. The district court noted that there was no summary judgment evidence regarding whether and to what extent the state court took evidence, conducted a "prove up" hearing, or otherwise took testimony from witnesses in support of the judgment.⁹⁷ Rather, the only summary judgment evidence before the bankruptcy court was a reference in the judgment that it was entered "after hearing the evidence and arguments of counsel."⁹⁸

The district court distinguished its finding from *In re Garner*,⁹⁹ a Fifth Circuit case reviewed in last year's Survey, in which the Fifth Circuit applied collateral estoppel issue preclusion based upon a state court default judgment.¹⁰⁰ The district court noted that in *Garner*, however, the summary judgment evidence presented to the bankruptcy court clearly indicated that an evidentiary hearing was conducted by the state court.¹⁰¹ The court recognized that preclusive effect of state court default judgments must be determined under state law;¹⁰² however, that same court cited federal case law to the effect that a default judgment does not meet the "actually litigated" test for application of collateral estoppel.¹⁰³ The court stressed the "actually litigated" requirement for collateral estoppel effect, even in the face of Texas authority that a pre-answer default judgment is not subject to collateral attack under state law.¹⁰⁴

7. Dischargeability—Credit Cards

The issue of non-dischargeability of credit card debt based on fraud has

96. 199 B.R. 350 (N.D. Tex. 1996).

97. *Id.* at 354.

98. *Id.*

99. *In re Garner*, 56 F.3d 677 (5th Cir. 1995).

100. The Fifth Circuit reached a similar conclusion reflected in an opinion published after the survey period. See *In re Gober*, 100 F.3d 1195 (5th Cir. 1996) (state court default judgment following stricken pleadings given collateral estoppel effect).

101. *Pancake*, 199 B.R. at 359.

102. *Id.*

103. *Id.* (citing *In re Turner*, 144 B.R. 47, 51-53 (Bankr. E.D. Tex. 1992)).

104. See, e.g., *Allen-West Comm'n Co. v. Gibson*, 288 S.W. 342, 244 (Tex. App.—Dallas 1921, writ ref'd)(pre-answered default judgment establishes allegations in petition and cannot be collaterally attached).

The analysis in *Pancake* appears to differ slightly from that found in *Garner*; however, if *Pancake* is correct, then the cautious practitioner seeking a dischargeability finding based on collateral estoppel should at a minimum include some reference in summary judgment evidence to whatever evidentiary proceedings were conducted in the state court.

been the subject of substantial litigation in recent years.¹⁰⁵ In addition to the cash advance and luxury goods provisions found in the Bankruptcy Code,¹⁰⁶ many of the cases seem to deal with whether the debtor's use of the credit card constitutes an express or implied representation as to that person's ability to repay the debt.¹⁰⁷

In a recent case, Judge Akard of the Northern District weighed in on the issue. In *In re McDaniel*,¹⁰⁸ the court was faced with a classic case of an unsolicited promotional campaign in which the credit card issuer unilaterally raised the debtor's credit limit and sent the debtor "Access Checks" to take advantage of a new low interest rate. According to the bankruptcy court, the debtor was having some financial difficulty at the time she took a cash advance to pay other debts; however, she testified that she did not make a final decision to file bankruptcy until approximately two and a half months later. In the ensuing adversary proceeding, the bankruptcy court held the bank to the new standard of "justifiable reliance" on any false pretenses, false representation, or actual fraud on the part of the debtor.¹⁰⁹ The opinion states that the creditor offered no evidence of reliance but apparently relied upon the inference that "where hopeless insolvency at the time of the purchases make payment impossible, fraudulent intent may be inferred."¹¹⁰

The court, recognizing that fraud is rarely proven by direct evidence, looked to a totality of the circumstances test supplied by another bankruptcy court.¹¹¹ Specifically, the court listed the following factors: (i) the length of time between the loan and the bankruptcy; (ii) changes in the buying habits of the debtors; (iii) the debtor's financial sophistication; (iv) the debtor's employment status; (v) whether the debtor consulted an attorney regarding bankruptcy before incurring the charges; (vi) whether the purchases were for luxuries (as opposed to necessities); and (vii) whether the debtor was hopelessly insolvent.¹¹²

105. See, e.g., *In re Eashai*, 87 F.3d 1082 (9th Cir. 1996) (credit card debt found non-dischargeable based upon debtor's express or implied representations of intention to repay debt); *In re Ladouceur*, 95-CV-271, 1996 WL 596718 (N.D.N.Y. Oct. 15, 1996) (upheld summary judgment based upon debtor's admissions of the elements of fraud in credit card transaction); see also *In re Haji*, 201 B.R. 176 (E.D. Mich. 1996); *In re Willis*, 200 B.R. 868 (W.D. Mo. 1996); *In re Bordgee*, 198 B.R. 773 (9th Cir. App. 1996) (panel decision).

106. 11 U.S.C. § 523(a)(2)(C) (certain charges for luxury goods or cash advances within sixty days prior to bankruptcy presumed non-dischargeable).

107. See, e.g., *In re Samoni*, 192 B.R. 877 (Bankr. S.D. Tex. 1996). Courts have generally taken one of three approaches in determining dischargeability of credit card debt: the "implied representation" theory, the "assumption of the risk" theory, and the "totality of the circumstances" theory. See generally *Citibank v. Eashai* (*In re Eashai*), 87 F.3d 1082.

108. 202 B.R. 74 (Bankr. N.D. Tex. 1996).

109. See *Field*, 116 S. Ct. 437. For a discussion of *Fields*, see *supra* note 2 and accompanying text.

110. 202 B.R. at 78 (quoting *Sears Roebuck and Co. v. Boydston* (*In re Boydston*), 520 F.2d 1098, 1101 (5th Cir. 1975)).

111. 202 B.R. at 79 (quoting *In re Samani*, 192 B.R. 877, 879-80 (Bankr. S.D. Tex. 1996)).

112. *Id.*; see also *In re Eashai*, 87 F.3d at 1087-88 for a listing of twelve factors reviewed in the Ninth Circuit.

In *McDaniel*, the court, obviously offended by what it perceived to be overreaching on the part of the creditor, concluded that the creditor could not now complain that the debtor committed fraud by doing the very thing the creditor induced it to do.¹¹³ The debtor obtained cash advances to pay other bills. Other bankruptcy courts have reached different conclusions on similar facts;¹¹⁴ however, the court gave notice that when the solicitation comes from the creditor unilaterally and is unsolicited by the debtor, the creditor will have a tough row to hoe in having that debt declared non-dischargeable.¹¹⁵

8. Homesteads

a. Family Rural Homestead Applied to Widower

In *In re McDaniel*,¹¹⁶ the Fifth Circuit (somewhat reluctantly) allowed an adult widower with grown children to claim a full "family" rural homestead of up to 200 acres.¹¹⁷ The Court noted that although the debtor was a widower with no dependent children, he remained a "family" for the purpose of Texas Homestead Law given that under Texas law, the surviving spouse has the same homestead rights as both spouses had prior to the death of one.¹¹⁸

The *McDaniel* court also addressed the effect of a written disclaimer signed by the debtor to induce a bank to make a loan.¹¹⁹ The court repeated the long-standing rule that in Texas "a homestead claimant is not estopped to assert his homestead rights in property on the basis of declarations made to the contrary if . . . the claimant was in actual use and possession of the property."¹²⁰ In *McDaniel*, the debtor's execution of

113. 202 B.R. at 79. "To allow the bank to prevail in this situation would result in converting dischargeable debts into non-dischargeable debts and would amount to this court condoning commercial entrapment." *Id.*

114. For example, taking advances from one card to pay on another may constitute "credit card kiting," which according to the Ninth Circuit, provides the fraudulent intent element of nondischargeability. See *In re Eashai*, 87 F.3d at 1088-89. ("[T]he kiting scheme enables a dishonest debtor to hide his fraudulent intentions and engage in a spending spree which results in increasing amounts of credit card debt."). The Ninth Circuit has been a source of much of the development of credit card cases in chapter 7. Compare *In re Eashai*, 87 F.3d at 1088-89 with *In re Hashemi*, 104 F.3d 1122 (9th Cir. 1996) and *In re Anastas*, 94 F.3d 1280 (9th Cir. 1996). See also *In re Dougherty*, 84 B.R. 653 (9th Cir. 1988) (Panel decision).

115. 202 B.R. at 790.

116. *Border v. McDaniel (In re McDaniel)*, 70 F.3d 841 (5th Cir. 1995).

117. *Id.* at 843.

Indeed, we must uphold and enforce the Texas homestead laws even though in so doing we might unwittingly—or even knowingly but powerless to avoid it—"assist a dishonest debtor in wrongfully defeating his creditor." This may account for the oft repeated creditor's lament "debtors either die or move to Texas."

Id. (citations omitted).

118. *Id.* at 844.

119. *Id.* at 843-44.

120. *Id.* at 843; see also *Kennard v. MBank Waco (In re Kennard)*, 970 F.2d 1455, 1458 (5th Cir. 1992); *Truman v. Deason (In re Niland)*, 825 F.2d 801, 808 (5th Cir. 1987).

the disclaimer did not fit within two established exceptions,¹²¹ so the court was left with no choice but to conclude that the disclaimer was ineffective to preclude McDaniel from later asserting his homestead claim.¹²²

b. Temporary Abandonment

In *In re Leonard*,¹²³ Judge Akard of the Northern District was provided with another opportunity to write on the homestead issue. In *Leonard*, the debtors temporarily vacated their 4,500 square foot home in Midland, Texas and moved to a smaller town to enroll their daughter in school. They testified that they intended to return to their home when their daughter was old enough for junior high school. The debtors rented out their Midland house from 1993 through and including their 1996 bankruptcy filing. They continued to receive mail at their Midland home, maintained a listing in the Midland telephone directory, had call-forwarding from their Midland home, continued to vote in Midland, and listed their Midland house as their address on their drivers' licenses. When they filed bankruptcy, however, they listed their temporary home as their residence address.

The creditor asserted that the debtors were judicially estopped from claiming their Midland house as their homestead because they had listed their other temporary home as their residence in their bankruptcy filing. As the court stated, however, "a residence and a homestead may be two different properties." The court determined that the debtors had not abandoned their homestead, notwithstanding the temporary renting of the home.¹²⁴ This is consistent with two earlier Texas cases that allowed temporary abandonment of homesteads to enable families to educate

121. "When, at the time of the disclaimer, (1) the debtor owned two or more noncontiguous pieces of property any of which—but not more than one—could constitute a homestead; or, (2) the property described in the disclaimer was not being used for homestead purposes." 70 F.3d at 843. The Court did not address it, but there may also be other exceptions, including (i) when an owner does not occupy the property or uses it in such a manner as to render its homestead status dubious; (ii) when owners create a lien by way of a disguised sale; or (iii) when an owner represents to an assignee of a note that a note is secured by a valid mechanic's lien for improvements. See, e.g., *Niland*, 825 F.2d at 809; *Lincoln v. Bennett*, 156 S.W.2d 504, 505 (Tex. 1941).

122. 70 F.3d at 843-44.

123. 194 B.R. 807 (Bankr. Ct. N.D. Tex. 1996).

124. *Id.* at 810. As Judge Akard stated:

Courts first look to see whether the property at issue has been the homestead. . . . Next, the Court must determine if they have abandoned that homestead, either with or without acquiring another homestead. The bank has the burden of proof because "anyone asserting an abandonment has the burden of proving it by competent evidence." (Citations omitted) Whether the homestead has been abandoned is a question of intent. . . . Temporary renting of the homestead does not change its homestead character if the homestead claimant has not acquired another homestead "The ultimate question to be resolved is as to whether the claimant intended to resume the possession of the premises as homestead." (citations omitted).

Id. at 810 (citing *El Paso v. Long*, 209 S.W.2d 950, 954 (Tex. Civ. App.—El Paso 1947, writ ref'd n.r.e.)).

their children in other locations.¹²⁵

9. *Personal Property Exemptions—The Insurance Saga Continues*

At least two bankruptcy courts continued the struggle with the insurance exemptions found in the Texas Property Code and the Texas Insurance Code. In Chapter 42 of the Texas Property Code, which contains the general statutory scheme for exempting personal property, among the items listed is the "present value of any life insurance policy to the extent that a member of the family of the insured . . . is a beneficiary of the policy."¹²⁶ This interest is listed among the categories of property that are subject to the limitation of \$60,000 for a family and \$30,000 for an individual.¹²⁷

The Texas Insurance Code, however, provides a broad unlimited exemption for a wide variety of insurance benefits including "all money or benefits of any kind, including policy proceeds and cash values . . ." ¹²⁸ This exemption is unlimited in value, and as mentioned, it applies not only to cash values, but to virtually any money or benefit arising from qualifying policies.¹²⁹

This leaves a difficult issue on which there is yet no consensus: Whether a debtor may claim the unlimited insurance exemption under the Insurance Code and still enjoy the benefits of the \$60,000/\$30,000 personal property exemption under the Property Code. Prior to the survey period, at least three bankruptcy courts had struggled with this issue with differing results.¹³⁰ During the Survey period, two more bankruptcy

125. See *Leonard*, 194 B.R. at 811; see also *Birdwell v. Burleson*, 72 S.W. 446 (Tex. Civ. App. 1902, writ ref'd); *C. Aultman & Co. v. Allen*, 33 S.W. 679 (Tex. Civ. App. 1896, writ ref'd).

126. TEX. PROP. CODE ANN. § 42.002 (Vernon Supp. 1996).

127. *Id.* § 42.002(a)(1) and (2).

128. Article 21.22 of the Texas Insurance Code provides as follows:

Art. 21.22. Unlimited Exemption of Insurance Benefits and Annuity Proceeds From Seizure Under Process.

Sec. 1. Notwithstanding any provision of this Code other than this Article, all money or benefits of any kind, including policy proceeds and cash values, to be paid or rendered to the insured or any beneficiary under any policy of insurance . . . issued by a life, health or accident insurance company, including mutual and fraternal insurance, or under any plan or program of annuities and benefits in use by any employer, shall:

(a) inure exclusively to the benefit of the person for whose use and benefit the insurance is designated in the policy or contract;

(b) be fully exempt from execution, attachment, garnishment or other process;

(c) be fully exempt from being seized, taken or appropriated or applied by any legal or equitable process or operation of law to pay any debt or liability of the insured or of any beneficiary, either before or after said money or benefits is or are paid or rendered; and,

(d) be fully exempt from all demands in any bankruptcy proceeding of the insured or beneficiary.

TEX. INS. CODE ANN. art. 21.22 (Vernon's Supp. 1996).

129. *Id.*

130. See *In re Young*, 166 B.R. 854 (Bankr. E.D. Tex. 1994); *In re Shurley*, 163 B.R. 286 (Bankr. W.D. Tex. 1993); *In re Bowes*, 160 B.R. 290 (Bankr. N.D. Tex. 1993).

courts also attempted to reconcile the statutes, again with diametrically differing results.

Judge Leif Clark first addressed the issue in *In re Borchers*.¹³¹ Judge Clark found the two statutes to be at odds with each other—recognizing, however, that the court should nevertheless construe statutes in a way to give each of them meaning and effect if possible.¹³² The court analyzed and disagreed with *In re Bowes*,¹³³ in which Judge Akard had earlier allowed Chapter 7 debtors to exempt their full \$77,000.00 cash surrender value, exhausting their \$60,000.00 Texas Property Code cap in the process. In *Borchers*, Judge Clark disagreed based both on statutory construction and legislative history.¹³⁴ Reasoning that the 1991 amendments to the Texas Insurance Code were a legislative reaction to another bankruptcy case,¹³⁵ it was apparent to him that the legislature expressly intended to overrule that case, the net effect of which was “to enable debtors . . . to completely exempt the cash value of life insurance policies without regard to the monetary cap set out in section 42.001 of the Texas Property Code.”¹³⁶ Accordingly, the *Borchers* court allowed the debtors to take full advantage of both exemption schemes without regard to the Property Code caps.¹³⁷

Shortly thereafter, Judge Felsenthal of the Northern District was faced with a similar issue in the context of an annuity contract and cash surrender values. In *In re Scott*,¹³⁸ Judge Felsenthal, also relying in part on statutory construction principles, disagreed with *Borchers* and instead followed the approach taken by the *Bowes* court.¹³⁹ Judge Felsenthal found that the legislature intended to maintain present value of life insurance policies within the Property Code.¹⁴⁰

As of this writing, the number of bankruptcy courts that have wrestled with this issue is now up to five, each with somewhat different results.¹⁴¹ Given the various tools of statutory construction of which the courts have availed themselves, it may simply be that there is no right answer to this issue. This author joins in Judge Clark’s appeal that the Legislature take

131. 192 B.R. 698 (Bankr. W.D. Tex. 1996).

132. *Id.* at 701.

133. 160 B.R. 290 (Bankr. N.D. Tex. 1993).

134. *Borchers*, 192 B.R. 701-05.

135. *See In re Brothers*, 94 B.R. 82 (Bankr. N.D. Tex. 1988) (previously held that cash surrender values were limited by Texas Property Code cap because they were excluded from any mention in the Insurance Code).

136. *Borchers*, 192 B.R. at 705.

137. *Id.*

138. 193 B.R. 805 (Bankr. N.D. Tex. 1996).

139. *Id.* at 809.

140. *Id.* at 810-11. Judge Felsenthal found that because both amendments were enacted virtually simultaneously, and because the legislature did not manifest an intent for the general to prevail over the specific, the special limitation of \$60,000 must apply over the general unlimited provision of the Insurance Code. *Id.* at 811.

141. *Bowes* could have resolved the issue; however, after the case had been on appeal in the district court for over two years, the parties settled. 160 B.R. at 290.

the steps necessary to fix this problem.¹⁴²

10. *Personal Property Exemptions—Tools of the Trade*

At least two bankruptcy courts addressed the issues of tools of the trade, although in somewhat different contexts. Judge Akard applied what has become known as the “use test” to determine whether an item is a tool of the trade under the ever expanding definition of that term.¹⁴³ In this context, Judge Akard found that a variety of items of restaurant equipment¹⁴⁴ were all necessary to carry on the business of operating a restaurant. The court distinguished prior Texas cases that had in effect discriminated against restaurant operators in the “tool of the trade” analysis under earlier statutes and found that under the “more modern and inclusive approach” the exemption should be allowed for such restaurant equipment.¹⁴⁵

A subsequent opinion from Judge Greendyke of the Southern District reminds us that there are limits to this expanding definition tools of the trade. In *In re Erwin*,¹⁴⁶ Judge Greendyke denied an exemption claim to a county constable who used his Ford Crown Victoria to serve papers and carry out other constable duties.¹⁴⁷ Recognizing Judge Akard's prior rulings in *In re Nash*¹⁴⁸ and *Baldowski*,¹⁴⁹ the court found that this expansion is not unlimited, especially when the property in question has “only a remote, or even a moderate nexus with [a debtor's] trade or profession.”¹⁵⁰ Recognizing that the debtor used his vehicle for personal and family use, that any 4-door vehicle would suffice for the constable duties, and that the debtor was not self-employed, the court concluded that the debtor's use of the vehicle was too tenuous in relation to his employment to justify avoidance of a non-purchase money non-possessory lien as a tool of the trade.¹⁵¹

11. *BFP Extended To Post-Petition Tax Sale*

In the 1994 case of *BFP v. Resolution Trust Corp.*,¹⁵² the Supreme

142. “The legislature could save further litigation and uncertainty on the part of litigants with a simple clarifying amendment to the Property Code.” 192 B.R. at 705. Judge Clark suggests two amendments that would lead to a result consistent with his ruling in *Borchers*. See *id.*

143. *In re Baldowski*, 191 B.R. 102 (Bankr. N.D. Tex. 1996). “Tracing the evolution of the Texas Exemption Statute, it is apparent that the legislature continually expanded the statute to cover more property.” *Id.* at 105.

144. *Id.* at 106 (for example, booths, a cash register, plates, platters, knives, forks, spoons, tables, chairs, and glasses).

145. *Id.* at 106-07.

146. 199 B.R. 628 (Bankr. S.D. Tex. 1996).

147. *Id.* at 630-31.

148. 142 B.R. 148 (Bankr. N.D. Tex. 1992) (Tool of the trade exemption applies to large farm items—plows, tractors, etc.)

149. 191 B.R. 102.

150. *Erwin*, 199 B.R. at 631.

151. *Id.*

152. 511 U.S. 531 (1994).

Court held that the price received at a regularly conducted non-collusive foreclosure sale establishes "a fair and proper price, or a 'reasonably equivalent value,' for foreclosed property" in the context of the reasonably equivalent value standard found in § 548 of the Bankruptcy Code (which deals with pre-petition fraudulent conveyances). In *In re T.F. Stone Co.*,¹⁵³ the Fifth Circuit applied similar reasoning in upholding a post-petition tax foreclosure sale. The debtor had sought to set aside the sale under § 549 of the Bankruptcy Code, which provides for avoidance of certain post-petition transfers.¹⁵⁴

One exception to the avoidance powers found under § 549 protects from avoidance "a transfer of real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value."¹⁵⁵ There is a subtle distinction, however, between this statutory language and the "reasonably equivalent value" provision found in § 548, which deals with pre-petition transfers. The *T.F. Stone* court compared the two statutes and concluded that Congress did not intend a meaningful difference between the term "reasonably" and the phrase "present fair" as applied in the context of the forced sale at issue.¹⁵⁶ Moreover, the court also found that neither phrase was synonymous with "fair market value," which would have had a more profound effect upon the public policy interest in insuring "security of the titles to real estate" in the context of mortgage foreclosure sales and tax sales of real property.¹⁵⁷

III. FEDERAL STATUTES OF LIMITATIONS

During the Survey period, at least two cases arose in the federal courts dealing with applicability of the federal statutes of limitation in the context of failed financial institutions.¹⁵⁸ These cases dealt with both the general federal statute of limitations¹⁵⁹ and the more specific statute deal-

153. *T.F. Stone Co. v. Harper (In re T.F. Stone Co.)*, 72 F.3d 466 (5th Cir. 1995).

154. 11 U.S.C. § 549(a) (1993).

155. 11 U.S.C. § 549(c) (1993).

156. 72 F.3d at 470-71.

157. *Id.* at 471.

In sum, we read BFP to say that, in the context of a forced sale, (1) § 549(c)'s requirement of "present fair equivalent value" ought not be measured against the property's "fair market value"; and (2) given the State's essential interest in maintaining clear titles to real property, we should not attempt to ascertain the substantive content of "present fair equivalent value."

Id. at 472. The court, acknowledging that Congress intended stricter limitations on post-petition transfers than pre-petition transfers, did not mandate any difference in determining the "equivalent value" received by the bankruptcy estate. *Id.* at 470.

158. In addition to the two cases arising in Texas based courts, an Oklahoma appellate court recently ruled that a purchaser of a note and mortgage that the FDIC acquired as receiver of an insolvent mortgagee stepped into the shoes of the FDIC and had six years from the date of the FDIC's appointment as a receiver to foreclose on a mortgage. See *SMS Fin. v. Ragland*, 918 P.2d 400 (Okla. Ct. App. 1995).

159. 28 U.S.C. § 2415(a) ("[E]very action for money damages brought by the United States . . . founded upon any contract . . . shall be barred unless the complaint is filed within six (6) years after the right of action accrues.").

ing with failed financial institutions enacted as part of FIRREA.¹⁶⁰

The more significant of the two cases was *Cadle Co. v. 1007 Joint Venture*,¹⁶¹ which addressed the two year state statute of limitations for recovery of deficiency judgments following real property foreclosures *vis-à-vis* FIRREA's six year statute.¹⁶² Courts have routinely allowed assignees of the FDIC to enjoy the full benefits of the applicable federal statute, both in a limitations context and otherwise;¹⁶³ however, the distinguishing fact in *Cadle Co.* was that the loan in question was performing at the time of the receivership and the note remained current the entire time the FDIC had ownership of it. The Fifth Circuit held that an assignee of the FDIC can invoke FIRREA's six year limitations period "only if the note at issue was in default either before the FDIC acquire[d] it or while the FDIC owned it."¹⁶⁴ The court reasoned that FIRREA's six year limitations period had no significance independent of a "claim" to which it applies; rather it applies only to an accrued claim and not to a performing note.¹⁶⁵ As the Fifth Circuit's reasoning continued: "Until a note is in default, there is no claim and hence no need to ask whether FIRREA's federal limitations rule supplants an otherwise applicable state statute of limitations."¹⁶⁶

In *Cadle Co.*, the surviving bank foreclosed in October of 1991, and suit was filed in September of 1994. With *Cadle Co.* left to rely only upon the two year state statute, the trial court entered a summary judgment that *Cadle Co.* take nothing, which the Fifth Circuit affirmed based upon the foregoing reasoning.¹⁶⁷

As mentioned above, there are actually two federal statutes of limitations that appear to apply to suits on notes. In the context of failed financial institutions, however, one unresolved issue has been whether and to what extent the newer FIRREA statute completely supersedes the long-standing general federal statute of limitations. In what was apparently a case of first impression, a federal district court addressed this issue in

160. 12 U.S.C. § 1821(d)(14)(A). This statute, enacted as part of the Financial Institutions Reform, Recovery, and Enforcement Act, provides that the six year limitation period begins to run on the later of the date of the appointment of the FDIC as conservator or receiver or the date on which the cause of action accrues. *Id.*

161. 82 F.3d 102 (5th Cir. 1996).

162. Section 51.003 of the Texas Property Code provides a two (2) year statute of limitations for a deficiency following a foreclosure sale:

If the price at which real property is sold at a foreclosure sale under section 51.002 is less than the unpaid balance of the indebtedness secured by the real property, resulting in a deficiency, any action brought to recover the deficiency must be brought within *two (2) years* of the foreclosure sale and is governed by this section.

TEX. PROP. CODE ANN. § 51.003(a) (Vernon 1995) (emphasis added).

163. See, e.g., *Davidson v. FDIC*, 44 F.3d 246 (5th Cir. 1995); *FDIC v. Bledsoe*, 989 F.2d 805 (5th Cir. 1993).

164. *Cadle Co.*, 82 F.3d at 105.

165. *Id.*

166. *Id.*

167. *Id.* at 106. The court went on to discuss other public policy issues.

Midstates Resources Corp. v. Farmer's Aerial Spraying Service,¹⁶⁸ which was originally filed more than six years after the original maturity date.¹⁶⁹ Less than six years prior to suit, however, the borrowers, through counsel, acknowledged the indebtedness in writing, which under § 2415 (the old federal statute) is effective for renewing limitations. The FIRREA statute, however, contains no such acknowledgment of indebtedness provision. The borrowers asserted that FIRREA's limitation statute completely superseded § 2415, giving the written acknowledgment of the debt no effect.

The court addressed the issue as one of statutory construction—the application of an existing broad statute (§ 2415) following the enactment of a more recent narrow statute (FIRREA), each covering related subject matter. The court found that the more specific FIRREA statute controls only when one of its specific statutory rules conflicts with one of § 2415's more general rules.¹⁷⁰ The court therefore found that both statutes applied, and in the context of *Midstates Resources*, the acknowledgment of indebtedness provision of the old federal statute governed.¹⁷¹ Therefore, under *Midstates Resources*, the general federal statute of limitations still applies to notes payable to failed financial institutions subject only to more specific provisions found in FIRREA.¹⁷²

IV. DEVELOPMENTS IN THE STATE COURTS

A. ARTICLE 9—DISPOSITION OF COLLATERAL

By way of example, three cases are worthy of note with respect to disposition of personal property collateral upon default. In the first of those three cases, *Havins v. First National Bank of Paducah*,¹⁷³ the Amarillo court, in what it determined to be a deficiency action, addressed both the commercially reasonable sale and notice of disposition provisions of section 9.504 of the Texas Business and Commerce Code.¹⁷⁴

168. 914 F. Supp. 1424 (N.D. Tex. 1996).

169. *Id.* at 1426. One point of disclosure: this author's firm represented the Plaintiff in this case. In *Midstates Resources*, all original limitations periods had apparently expired by the time *Midstates* filed suit.

170. *Id.* at 1426 (citing *Resolution Trust Corp. v. Seale*, 13 F.3d 850, 854 (5th Cir. 1994)).

171. 914 F. Supp. at 1427.

172. This is consistent with an earlier observation of the Texas Supreme Court in *Jackson v. Thweat*, 883 S.W.2d 171, 177 (Tex. 1994) (FIRREA "does not create an entirely new limitations scheme, but rather clarifies and amends existing law under 28 U.S.C. § 2415(a)."). This survey was cited by the *Midstates Resources* court in anticipating this issue. See *Midstates Resources*, 914 F. Supp. at 1426 n.3. (At least one commentator has anticipated this issue. See Cox, 1995 *Annual Survey*, *supra* note 18, at 908).

173. 919 S.W.2d 177 (Tex. App.—Amarillo 1996, no writ)

174.

Section 9.504 grants creditors the right, after default by the debtor, to sell, lease, or otherwise dispose of any collateral securing payment of the debt. TEX. BUS. & COM. CODE ANN. § 9.504(a) (Tex. UCC) (Vernon 1991). Should they opt to dispose of it, they must take care to assure that "every aspect of the disposition including the method, manner, time, place, and terms . . . [is] commercially reasonable." *Id.* at 9.504(c).

In *Havins*, the creditor repossessed some cattle, and within approximately six weeks thereafter the cattle were sold by the bank at auction in a local sale barn. The Court of Appeals reversed a summary judgment in favor of the lender after having addressed "no evidence" points regarding the commercial reasonableness of the sale and whether and to what extent there was any notice provided thereof.¹⁷⁵ As a practical matter, this case really turned upon whether the collateral was "perishable, threatening to decline speedily in value, or of a type customarily sold on a recognized market," in which event the creditor may have been excused from providing the debtor with notice of the sale.¹⁷⁶ The court found that there was no evidence regarding the debtor having been provided with prior notice of the sale, nor was the trial court provided with any evidence to assist it in determining whether the cattle were of the type sold on a recognized market.¹⁷⁷ Importantly, the court did not reject out of hand the possibility that cattle are collateral that may be sold on a recognized market at a cattle auction like that found in the instant case. To the contrary, the court found that in the context of cattle auctions, the "recognized market" issue is a fact intensive determination that should be determined by courts on a case to case basis.¹⁷⁸ As mentioned, however, the court reversed and remanded the trial court's judgment due to the lack of evidence of notice and commercial reasonableness of the disposition.¹⁷⁹

In *Acuff v. Lamesa National Bank*,¹⁸⁰ the lender had previously accepted certain collateral in partial satisfaction of a debt, also entering into a written agreement regarding the debt and the application of credits based upon the surrender of the collateral. The bank subsequently disposed of the collateral and then sought to reduce the remaining indebtedness to a judgment. The court held that the surrender of the collateral in partial and specific satisfaction of a portion of the debt was in essence a sale from the debtor to the lender.¹⁸¹ Therefore, at the time of the ultimate disposition of the collateral by the bank, the bank had already become the owner of that property and "there was no sale or disposition by the 'secured party' which would require notice under section 9.504."¹⁸²

919 S.W.2d at 180-81.

175. *Id.* at 182-84.

176. "Unless collateral is perishable or threatens to decline speedily in value or is of a type customarily sold on a recognized market, reasonable notification [of a public or private sale] shall be sent by the secured party to the debtor . . ." *Id.* at 182-83 (citing TEX. BUS. & COM. CODE ANN. § 9.504(c) (Tex. UCC) (Vernon 1991)).

177. The court provides an analysis of this "recognized market" issue. 919 S.W.2d at 183.

178. *Id.*

179. *Id.* at 184. The court listed numerous factors that should have been elicited at the trial would have assisted the court in making a determination on the "recognized market" issue. *Id.* The court also noted that the trial court's taking judicial notice that cattle are normally sold through livestock auction commission merchants did "nothing to fill the void." *Id.*

180. 919 S.W.2d 154 (Tex. App.—Eastland 1996, no writ).

181. *Id.* at 157.

182. *Id.*

In *Schmid v. Texas Commerce Bank*,¹⁸³ the court of appeals upheld a summary judgment in favor of a lender who had retained some pledged stock certificates in its possession while ultimately seeking a judgment prior to disposition of that stock.¹⁸⁴ The court of appeals found that the bank's choosing to retain that stock while at the same time attempting to reduce its claim to judgment did not constitute an election of remedies.¹⁸⁵ The court found that section 9.501(a) allows a secured party to reduce its claim to judgment, foreclose, or enforce its security interest by any available judicial procedure.¹⁸⁶ The court noted further that section 9.504 "does not *require* but rather *allows* a secured party to sell the collateral."¹⁸⁷

B. REAL PROPERTY FORECLOSURES

In *Provident National Assurance Company v. Stevens*,¹⁸⁸ the Texas Supreme Court allowed a creditor who had foreclosed two notes secured by two tracts of property upon one blanket bid to allocate the foreclosure proceeds after the fact as it saw fit.¹⁸⁹ The guarantor, in defense of a deficiency suit filed by the lender claimed that the creditor's single bid for the two separate properties effectively precluded it from ever being able to prove deficiencies on either note or either property. The supreme court, however, disagreed and allowed the creditor to pursue a deficiency on this basis, even though the creditor's allocation occurred after the sale.¹⁹⁰

In *Bonilla v. Roberson*,¹⁹¹ the court of appeals held that a holder of a deed of trust who discovered after foreclosure that the debtor had apparently committed substantial waste on the property could not in effect change its mind and rebid the property at a subsequent sale.¹⁹² The court held that the only remedy for the holder of the deed of trust would be to bring a judicial action seeking to set aside the sale and canceling the trustee's deed.¹⁹³ The lender could not simply enter into a private arrangement with the trustee to cancel the prior trustee's deed and re-no-

183. 912 S.W.2d 845 (Tex. App.—Fort Worth 1995, writ denied).

184. *Id.* at 846.

185. *Id.* at 847.

186. *Id.* at 846.

187. *Id.* (emphasis added). The borrower had also filed a counterclaim alleging conversion; however, the trial court entered summary judgment that the debtor take nothing on that claim. That was also upheld on appeal. The court factually distinguished other cases that dealt with an unreasonable delay in disposing of collateral under different facts. In *Schmid*, the collateral was held by the bank for over three years before seeking summary judgment. The court did not address whether and to what extent such collateral retention would ultimately lead to a strict foreclosure or otherwise limit the creditor's remedies. *Id.* at 846-47.

188. 910 S.W.2d 926 (Tex. 1995).

189. *Id.* at 229.

190. *Id.*

191. 918 S.W.2d 17 (Tex. App.—Corpus Christi 1996, no writ).

192. *Id.* at 22.

193. *Id.* at 21-22.

tice a sale that had already been conducted and closed.¹⁹⁴

In *In re Gayle*,¹⁹⁵ a Texas based bankruptcy court found that a creditor holding a claim secured by a deed of trust could seek to reduce the claim to judgment prior to seeking foreclosure of its deed of trust lien.¹⁹⁶ The court determined that this was not an election of remedies as is the case when deciding between judicial foreclosure and non-judicial foreclosure.¹⁹⁷

The court found that the situation regarding reducing a debt to judgment prior to foreclosure was somewhat analogous to the previously well settled situation regarding debts secured by personal property.¹⁹⁸ The court found that because the note and the lien are separate and severable rights held by a creditor, and further finding that doctrine of merger did not effect the lien, the court ruled that the creditor could reduce the debt to judgment and thereafter seek a non-judicial foreclosure.¹⁹⁹ The court acknowledged, however, that if a judicial foreclosure had been sought in the prior case and not granted, that could have been a bar to future foreclosure relief.²⁰⁰

C. GUARANTOR NOTICE AND LIABILITY

In *Bishop v. National Loan Investors*,²⁰¹ the court addressed two issues: whether a creditor was required to sue the maker of a note prior to suing the guarantor and whether the guarantor was entitled to notice of a foreclosure sale on deed of trust property securing the guaranteed debt. The court found that the guaranty in question was unconditional in nature, restating the long standing rule as follows: "The unconditional guarantor

194. *Id.* at 21-23.

195. 189 B.R. 914 (Bankr. S.D. Tex. 1995).

196. *Id.* 916-19.

197. *Id.* at 916.

198.

The law pertaining to the right to nonjudicially foreclose on *personal property* after a judgment on a promissory note has been rendered is well settled. After a debtor defaults on a secured personal property note, the creditor may exercise any right provided in the security agreement (with restrictions), reduce its claim to judgment, foreclose, or otherwise enforce the security interest by any available judicial procedure. TEX. BUS. & COM. CODE ANN. § 9.501(a) (Tex. UCC) (Vernon 1991). These rights and remedies are *cumulative*.

Id. at 916. Moreover, the judgment would be secured by the same property, relating back to the inception of the original security interest. See TEX. BUS. & COM. CODE ANN. § 9.501(e) (Tex. UCC) (Vernon 1991) which provides:

When a secured party has reduced his claim to judgment, the lien of any levy which may be made upon his collateral by virtue of any execution based upon the judgment shall relate back to the date of the perfection of the security interest in such collateral. A judicial sale, pursuant to such execution, is a foreclosure of the security interest by judicial procedure within the meaning of this section, and the secured party may purchase at the sale and thereafter hold the collateral free of any other requirements of this Chapter.

TEX. BUS. & COM. CODE ANN. § 9.501(e) (Tex. UCC) (Vernon 1991).

199. *In re Gayle*, 189 B.R. at 921.

200. *Id.*

201. 915 S.W.2d 241 (Tex. App.—Fort Worth 1995, writ denied).

of a note is primarily liable, and waives any requirement that the holder of the note take action against the maker as a condition precedent to the guarantor's liability unless the guaranty specifically states otherwise."²⁰²

The court determined that the guaranty in questions was such an unconditional guaranty.²⁰³ The court further found that the guarantor was not entitled to notice of a deed of trust foreclosure sale affecting real property.²⁰⁴ The court noted the distinction between that rule regarding real property and a requirement to the contrary in article 9 of the UCC as to personal property.²⁰⁵

In *In re El Paso Refining*,²⁰⁶ a bankruptcy court dealt with a guaranty agreement that specifically authorized the creditor to release any obligor without impairing that creditor's ability to seek payment from a guarantor. Noting that "[a] guaranty of payment creates direct and primary liability for the guarantor[,]"²⁰⁷ there is likewise no requirement that a creditor take action against the primary obligor as a condition precedent to the guarantor's liability. Therefore, in the situation facing that court, the release of the primary obligor in and of itself "had no effect on [the guarantor's] liability for the Guaranteed Obligations."²⁰⁸

D. TAX LIEN SUBROGATION

In *Benchmark Bank v. Crowder*,²⁰⁹ the Texas Supreme Court found that a third party lender may be subrogated to a federal tax lien and thus entitled to enforce the tax lien against the taxpayers' homestead. In *Crowder*, the borrowers obtained a loan from Benchmark Bank's predecessor, the proceeds of which were used to discharge a federal tax lien against the borrowers' homestead. The borrowers asserted that the lien was invalid because it impaired their homestead rights; however, the supreme court recognized that under the Supremacy Clause of the United States Constitution, the federal government may obtain a valid, enforceable tax lien against a Texas homestead.²¹⁰ The court further found that when such a tax lien is refinanced, the new lender is subrogated to the tax lien much in the same way that a third party who refinances a debt se-

202. *Id.* at 244 (citing *Hopkins v. First Nat'l Bank*, 551 S.W.2d 343, 345 (Tex. 1977)).

203. 915 S.W.2d at 244.

204. *Id.* at 245.

205. *Id.* ("There is a definite distinction between guarantors of a loan secured by realty under the Property Code and a loan secured by consumer goods under the Business and Commerce Code.").

206. 192 B.R. 144 (Bankr. W.D. Tex. 1996).

207. *Id.* at 148.

208. *Id.* at 148. The court relied on a Seventh Circuit case that reiterated that such a guarantee may stay in full force and effect until all indebtedness from the underlying obligation is paid in full, regardless of any settlement, compromise, release, or modification involving the primary obligor. *Id.* at 149 (quoting *Central Soya Co. v. Epstein Fisheries*, 676 F.2d 939 (7th Cir. 1982)).

209. 919 S.W.2d 657 (Tex. 1996).

210. *Id.* at 660.

cured by a valid mechanic's lien is also subrogated.²¹¹ The court reiterated that once valid, a lien does not become invalid simply because it is refinanced. Moreover, the court further found that not only could the subrogated lien be refinanced, but that a future deed of trust renewing and extending the old lien may also provide for new terms, including the power of sale authorizing a non-judicial foreclosure.²¹² The court, however, found that because there was no federal tax lien against Crowder, she was entitled to compensation for her interest in the homestead that was foreclosed.²¹³

It should be noted that an amendment to the Texas Constitution has been approved pursuant to which a homestead may be encumbered for the refinancing of a lien, including a federal tax lien.²¹⁴ That amendment, however, had no bearing in *Crowder* because the tax lien and subrogation rights were fixed before the amendment's adoption.²¹⁵ Therefore, although this issue has, to some extent, been addressed constitutionally, *Crowder* remains instructive as to situations that predate the amendments and also with respect to foreclosure rights and the enforceability of other terms subsequently agreed to by the borrower and the lender.

On the other hand, a creditor attempting to equitably subrogate itself to the position of an ad valorem taxing entity may be in a different situation. In *Jackson v. Stonebriar Partnership*,²¹⁶ the Dallas Court of Appeals found that a creditor could not subrogate itself to the position of an ad valorem taxing entity in an effort to recover ad valorem taxes it paid on a tract of property after foreclosure.²¹⁷ This opinion does not necessarily reflect a change in Texas law; however, it should be read and analyzed in an effort to gain an understanding of how to deal with ad valorem taxes with respect to real property that is in the process of being foreclosed.

E. LENDER LIABILITY

There were no significant developments regarding lender liability. There were a number of interesting cases, however, that addressed situations where debtors sought to impose liability based on wrongful foreclosure or other collection action or otherwise as a result of a breach of an alleged agreement. For example, in *Bluebonnet Savings Bank, F.S.B. v. Grayridge Apartment Homes, Inc.*,²¹⁸ the Houston Court of Appeals found that statements to the effect that a loan restructuring proposal "looked fine" and that "everything would be okay" did not rise to the

211. *Id.* at 661 ("We see no difference between the refinancing of debts secured by a mechanic's lien and the refinancing of debt secured by a federal tax lien.") (citing *Farm & Home Savings Ass'n v. Martin*, 88 S.W.2d 459, 469-70 (Tex. 1935)).

212. *Benchmark Bank*, 919 S.W.2d at 662.

213. *Id.* at 659, 662.

214. *Id.* at 660 (citing TEX. CONST. art. xvi, § 50 (Vernon 1996)).

215. 919 S.W.2d at 660.

216. 931 S.W.2d 635 (Tex. App.—Dallas 1996, writ requested).

217. *Id.* at 640.

218. 907 S.W.2d 904 (Tex. App.—Houston [1st Dist.] 1995, writ denied).

level of negligent misrepresentation.²¹⁹ The court further found that the debtor did not "justifiably rely" on such representations.²²⁰ This case was followed by the Fifth Circuit in *Clardy Manufacturing Co. v. Marine Midland Business Loans, Inc.*,²²¹ where the court found that a lender's statement that a loan commitment would be issued "in a few days" did not give rise to a promissory estoppel claim.²²²

In *Maginn v. Norwest Mortgage, Inc.*,²²³ an unsuccessful mortgage loan applicant sued a bank for breach of contract (both written and oral), promissory estoppel, violations of the Deceptive Trade Practices Act (DTPA), negligence, gross negligence, fraud, and negligent misrepresentation. With the exception of certain of the tort claims, the court of appeals upheld a summary judgment against the unsuccessful applicant.²²⁴ Most importantly, the court found that the loan applicants were not consumers under the DTPA.²²⁵ Moreover, the court found that the borrower's contract claim failed to satisfy the statute of frauds.²²⁶ The court did, however, allow the tort claims to survive, remanding the case for further proceedings.²²⁷

V. CONSUMER CREDIT COLLECTIONS

A. STATE COURT—TEXAS DEBT COLLECTION ACT

In *Waterfield Mortgage Co. v. Rodriguez*,²²⁸ the San Antonio court upheld a trial court finding that a mortgage company violated the Texas Debt Collection Act and, further upheld an award of exemplary damages to the debtors.²²⁹ According to the court of appeals, the borrowers had repeatedly attempted to bring the payments current, but those attempts were refused. Moreover, after refusing such attempts, the creditor continued to add late charges to the debt. The court of appeals recognized that the creditor telephoned the borrowers' bank and were told that one of the checks tendered for late payments would not clear because of insufficient funds; however, the debtors apparently made a subsequent tender by cashier's check of the full amount due. The lender rejected that cashier's check and raised the demand by an additional sum because of posting and reinstatement fees. The debtor testified he would have paid

219. *Id.* at 909-10.

220. *Id.* at 911-12.

221. 88 F.3d 347, 351 (5th Cir. 1996).

222. *Id.* at 351. The court also found that the borrower was not a consumer under the DTPA.

223. 919 S.W.2d 164 (Tex. App.—Austin 1996, no writ).

224. *Id.* at 166-69.

225. *Id.* at 167.

226. The court also addressed claims arising out of or pertaining to section 26.02(e) of the Texas Business and Commerce Code regarding "merger" clauses in loan agreements. *Id.* at 167-68.

227. *Id.* at 168-69.

228. 929 S.W.2d 641 (Tex. App.—San Antonio 1996, no writ).

229. A DTPA claim was dismissed, so there was no ruling on the borrowers' standing as "consumers" under the DTPA. One can only assume that under established cases law they would not have been considered consumers under that act.

that amount but was never given the chance because the foreclosure occurred before receiving that notification.

The court found that "the haste in pushing through foreclosure, then forcible entry and detainer, and selling the family home while the owner is offering the money that would essentially bring him current, is ample evidence to support [a finding of] actual damages and violation of the Texas Debt Collection Statute."²³⁰ The court further allowed the imposition of punitive damages, noting that although legislative amendments codified much of the law relating to exemplary damages, the Texas Debt Collection Statute was specifically excluded.²³¹ The court of appeals upheld the punitive damage award even though there were no showings of personal abuse, phone calls, or other intimidating factors typically found in situations of that nature.²³² The court simply found that "taking someone's home away from them when they are making good faith attempts to pay ever-escalating demands is worse than insulting or threatening them. Better harassed than homeless."²³³ The court further disregarded the bona fide error defense, finding that there was no pleading or evidence to support such a defense in the trial court.²³⁴ Although one might argue that the court may have gone a bit too far,²³⁵ especially in imposing exemplary damages, this case should be required reading for every consumer lender and counsel.

B. FEDERAL COURT—FAIR DEBT COLLECTION PRACTICES ACT

While the Fair Debt Collection Practices Act (FDCPA)²³⁶ still proves somewhat of a mine field for the unwary practitioner in other jurisdictions,²³⁷ the Fifth Circuit took a step toward placing some reasonable parameters on the FDCPA in the context of violations where no actual damages result. In *Johnson v. Eaton*,²³⁸ a lawyer representing a furniture company attempting to collect a past due debt, along with his legal assistant, were sued based upon a demand letter and a second letter, which included a questionnaire and proposed consent judgment. The debtor stipulated before trial that she had suffered no actual damages as a result

230. *Id.* at 645.

231. *Id.* (citing TEX. CIV. PRAC. & REM. CODE ANN. § 41.002(b)(6) (Vernon Supp. 1996)).

232. 929 S.W.2d at 649 (Duncan, J., concurring and dissenting).

233. *Id.* at 647.

234. *Id.*

235. *See id.* at 647 (Duncan, J., concurring and dissenting) (dissent disagrees with imposition of punitive damages).

236. 15 U.S.C. § 1692k.

237. *See, e.g.,* Avila v. Rubin, 84 F.3d 222 (7th Cir. 1996) (mass produced letters bearing lawyer's facsimile signature misleading because not actually from lawyer; contradictions in notice rendered notice improper); Sandlin v. Shapiro & Fishman, 919 F. Supp. 1564 (M.D. Fla. 1996) (lawyer's attempt to collect unauthorized payoff fee violated act); *see also* Wadlington v. Credit Acceptance Corp., 76 F.3d 103, 105-06 (6th Cir. 1996). *Cf.* Dickerman v. National Educators, Inc., 81 F.3d 949 (10th Cir. 1996) (initial contact with debtors lawyer).

238. 80 F.3d 148 (5th Cir. 1996).

of the initial demand letter, and the jury subsequently found that the lawyer's conduct was likewise not a cause of any actual damage to the debtor. The trial court, however, awarded the debtor \$500 in "additional damages" against the lawyer, and in excess of \$10,000 in attorney's fees against both defendants.

The Fifth Circuit reversed the award of attorney's fees against the legal assistant, stating that the express language of the FDCPA expressly conditions an award of attorney's fees, "which are available only where the Plaintiff has succeeded in establishing that the defendant is liable for actual and/or additional damages."²³⁹ The court reasoned further that to allow an attorney's fee recovery where the plaintiff has failed to prove damages, "rewards lawyers for bringing suits to stop behavior that, by definition, has caused legal injury to no one."²⁴⁰

As to the lawyer against whom five hundred dollars in "additional damages" was awarded, the court remanded for reconsideration of the issue of attorney's fees with instructions that the court reduce the award of fees against Eaton to the extent that the fees originally awarded were attributable to the preparation of the case against the legal assistant. Obviously, the implication here is that the court allowed the recovery of attorney's fees from the lawyer because of the award of "additional" damages.

Unfortunately, this determination still left what would appear to be a somewhat nonsensical result—the award of attorney's fees based on an award of *additional* damages when there were no *actual* damages incurred. This was unresolved by the Fifth Circuit because of a procedural point regarding the submission of the jury charge.²⁴¹ This is pure speculation, but one would think that the same logical reasoning that the court applied in refusing to allow the award of attorney's fees against the legal assistant would likewise apply to the inconsistency of allowing an award of "additional" damages in the absence of actual damages. Again, however, this issue appears to be unresolved.

On the subject of the FDCPA, a case from another circuit is worthy of note. In *Avila v. Rubin*,²⁴² the Seventh Circuit found that mass produced collection letters issued under a facsimile signature on a law firm's letterhead were misleading because they gave the appearance of having been written by a lawyer when in fact they were not.²⁴³ Although the Fifth Circuit had not addressed this specific situation as of the Survey period, this case appears to indicate that if a letter is coming from a lawyer seek-

239. *Id.* at 151. The court did not address whether the award of additional damages is appropriate in the absence of a finding of actual damages because neither party preserved the issue for appeal by objecting to the jury charge. *Id.* at 150.

240. *Id.* at 151. "Our interpretation of the statute will require attorneys to look for more than a technical violation of the FDCPA before bringing suit and will deter suits brought only as a means of generating attorney's fees." *Id.*

241. *Id.* at 150.

242. 84 F.3d 222 (7th Cir. 1996).

243. *Id.* at 228-29.

ing to recover a consumer debt, the lawyer should be careful about signing collection letters (or allowing use of a facsimile signature) unless the lawyer has had some involvement in reviewing the file and actually generating or having some input into the content of the letter.

Additionally, the *Avila* court also took issue with the terms of the notice used by that lawyer.²⁴⁴ In addition to attempting to comply with the thirty day notice requirement, the notice also included a reference that to the extent the FDCPA notice did not apply, then all actions required of the debtor were to be undertaken within ten days. The Seventh Circuit found this confusing and misleading to an unsophisticated consumer.²⁴⁵ In effect, the court found the inconsistent messages in the notice to be too confusing and potentially misleading.²⁴⁶

The bottom line with respect to the FDCPA is that it is still alive and well, and in most situations, it still applies to lawyers. One or more bills have been offered in Congress in an effort to narrow the scope of the FDCPA to truly intentional and misleading action by debt collectors. Unfortunately, however, in addition to providing the consumer protection for which it originally intended, the FDCPA still serves as a dangerous trap for the unwary practitioner.

244. *Id.* at 226.

245. The court also analyzed the effect of its use of the *unsophisticated* consumer as opposed to the *least sophisticated* consumer test used by other courts. *Id.*

246. *Id.* at 227.

