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Bankruptcy and Creditors' Rights

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BANKRUPTCY AND CREDITORS' RIGHTS

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I. INTRODUCTION

This Article addresses major cases of interest arising primarily in Texas-based bankruptcy courts that deal directly with the debtor-creditor relationship and state law issues arising under exemption and homestead claims. Given the substantial growth in consumer bankruptcy filings, this year's Survey focuses on recent developments affecting consumer cases, especially collateral valuation, interest rates on secured claims, and disposition of property securing consumer debts.

II. BANKRUPTCY

A. SECURED CLAIMS—CONSUMER CASES

1. Collateral Valuation

The saga of *In re Rash*[1] is over at last. The Supreme Court reversed the Fifth Circuit's *en banc* decision, which was analyzed in last year's Survey.[2] In short, the Supreme Court has held that when a debtor, over a secured creditor's objection, seeks to retain and use collateral, section 506 of the Bankruptcy Code directs application of a replacement-value standard.[3] The Court reversed the Fifth Circuit's application of a hypothetical liquidation standard, and it also rejected a "midpoint between foreclosure and replacement values."[4] Rather, the Court found that "under § 506 (a), the value of property retained. . .is the cost the debtor would incur to obtain a like asset for the same 'proposed. . .use.'"[5] In what may prove to be an important footnote, however, the Court cautions that its holding leaves to bankruptcy courts the determination of whether replacement value is the equivalent of retail value, wholesale value or some other value, depending upon the nature of the debtor and the proposed use of the property.[6]

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* Shareholder, Sanders, Baker & Jesko, P.C., Amarillo, Texas. Board Certified in Business Bankruptcy Law, Texas Board of Legal Specialization and American Bankruptcy Board of Certification.

1. Associates Commercial Corp. v. Rash (*In re* Rash), 117 S. Ct. 1879 (1997).
2. *See* Roger S. Cox, *Bankruptcy and Creditors' Rights*, 50 SMU L. REV. 989 (1997).
3. This resolved a conflict arising out of what the Court identified as three different standards for valuing a security interest in a bankruptcy reorganization or debt adjustment case. *See Rash*, 117 S. Ct. at 1883-84 (discussing several circuit-level cases).
4. *Id.* at 1886.
5. *Id.*
6. In that footnote, the Court stated:

> Our recognition that the replacement-value standard, not the foreclosure-value standard, governs in cram down cases leaves to bankruptcy courts, as

It would appear, however, that in the context of motor vehicles, for example, retail valuation may be the appropriate starting point.[7]

2. Interest Rates on Secured Claims

In another major case affecting reorganizations and debt adjustments, the Fifth Circuit Court of Appeals held that in determining post-confirmation interest rates for secured claims in Chapter 13 cases, a court should apply a rebuttable presumption that the contract rate is the appropriate rate. In *In re Smithwick*[8] the court noted that in prior cases it recognized that "[o]ften the contract rate will be an appropriate rate[ ] and that [n]umerous courts have chosen the contract rate if it seemed to be a good estimate as to the appropriate discount rate."[9] The court also noted the Third Circuit's observation of a need to minimize administrative and litigation costs in Chapter 13 cases, which are "high in volume and low in absolute value."[10] Additionally, the court recognized the entitlement of the secured creditor to a return on its investment as if it had foreclosed and reinvested in loans of equivalent duration and risk, recognizing that this may indeed preserve a "profit" for the lender.[11]

After addressing these issues in the context of the economic reality faced by Chapter 13 debtors and creditors, the Fifth Circuit concluded that using a rebuttable presumption that the contract rate should apply "balances the competing considerations of maximizing judicial economy and ensuring an accurate reflection of the costs and risks associated with the secured lender's 'forced' extension of credit in the chapter 13 plan."[12] In effect, the court rejected the local rule then in effect in the Southern District of Texas.[13]

> triers of fact, identification of the best way of ascertaining replacement value on the basis of the evidence presented. Whether replacement value is the equivalent of retail value, wholesale value, or some other value will depend on the type of debtor and the nature of the property. We note, however, that replacement value, in this context, should not include certain items. For example, where the proper measure of the replacement value of a vehicle is its retail value, an adjustment to that value may be necessary: A creditor should not receive portions of the retail price, if any, that reflect the value of items the debtor does not receive when he retains his vehicle . . . . Nor should the creditor gain from modifications to the property—e.g., the addition of accessories to a vehicle—to which a creditor's lien would not extend under state law.

Id. at 1886 n.6.

7. As noted in the preceding footnote, when applying retail valuation, care should be taken not to include unusual, non-recurring value added items unless there is direct evidence they would be applicable to the collateral under the facts of a particular case.

8. Greentree Fin. Servicing Corp. v. Smithwick (*In re* Smithwick), 121 F.3d 211 (5th Cir. 1997).

9. *Id.* at 213 (quoting In re Briscoe Enters., Ltd., II, 994 F.2d 1160, 1169 (5th Cir. 1993)).

10. *Id.* at 214 (quoting General Motors Acceptance Corp. v. Jones, 999 F.2d 63, 70 (3d Cir. 1993)).

11. *See id.* at 214. *See also* Koopmans v. Farm Credit Servs., 102 F.3d 874, 875 (3d Cir. 1996).

12. *Smithwick*, 121 F.3d at 215.

13. *See id.*

Smithwick provides some predictability to treatment of secured claims in Chapter 13 cases. More importantly, however, the Fifth Circuit expressly recognized the economic realities facing courts and parties arising out of what seems to be an exponential increase in the number of consumer filings. Some may criticize this holding along with the *Rash* decision as favoring secured lenders at the expense of unsecured creditors and debtors; however, given the economic considerations pointed out by the Fifth Circuit in *Smithwick*, this may prove to be the only workable solution.[14]

3. *Interest on Mortgage Arrearages*

During the Survey period, the Fifth Circuit addressed yet another situation involving secured claims in Chapter 13 cases. In *In re Cabrera*,[15] the court addressed the issue of the appropriate interest rate to apply in the treatment of an arrearage on a home mortgage claim in a Chapter 13 bankruptcy. Chapter 13 generally provides that a claim secured by a first lien against a debtor's residence may not be modified by the plan;[16] however, pre-petition installment arrearages are typically treated in a Chapter 13 plan. The question facing the *Cabrera* court was what interest rate to apply. The debtors contended that they should be entitled to apply a typical Chapter 13 present value discount rate; the secured creditor, however, sought the contractual rate for past due installments.

The 1994 amendments to the Bankruptcy Code addressed this situation, specifying that the amount necessary to cure a default would be based upon the underlying agreement and applicable non-bankruptcy law. However, that provision applied only to agreements arising on and after October 22, 1994.[17] The Cabrera mortgage was signed in 1989.

The Fifth Circuit concluded that the secured claim for the arrearage should bear interest at the default rate provided in the contract rather than the rate proposed by the debtors.[18] Accordingly, it appears that in the Fifth Circuit, pre-petition home mortgage arrearages should bear interest at the contract rate.[19]

4. *Statement of Intent Regarding Consumer Loans*

As reported in last year's Survey issue, the Fifth Circuit, in *In re Johnson*,[20] applied a literal interpretation of section 521 of the Bankruptcy

14. Additionally, this author asserts that these are correct decisions under the plain meaning of the Code and applicable state law.

15. O'Connell v. Troy & Nichols, Inc. (*In re* Cabrera), 99 F.3d 684 (5th Cir. 1996).

16. *See* 11 U.S.C. § 1322(b)(2) (1994).

17. *See id.* § 1322(e).

18. *See Cabrera*, 99 F.3d at 686.

19. The Fifth Circuit, however, did not expound upon the correctness of the rationale of *In re* Sauls, 161 B.R. 794 (Bankr. S.D. Tex. 1993), on which the lower court had relied. The court pointed out that the *Cabrera* decision was limited to the facts before it; however, it is difficult to contemplate a substantially different fact pattern arising out of installment arrearages on a home mortgage.

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

Code, which requires the filing of a statement of intent regarding consumer debts secured by property of the estate.[21] Essentially, the debtor must decide whether to redeem the collateral, reaffirm the debt, or surrender the property under the Fifth Circuit's interpretation (and indeed as the statute is written). There is no so-called fourth alternative of simply retaining the collateral and paying the contracted debt payments.[22]

Some confusion was created, however, by an opinion issued by Judge Clark of the Western District in *In re Castillo*[23] in which Judge Clark insisted that the so-called fourth alternative did exist. In the opinion, Judge Clark followed decisions of the Fourth and Tenth Circuits.[24]

Toward the end of the Survey period, however, Judge Clark was reversed by the District Court, which followed the Fifth Circuit's ruling in *Johnson*.[25] Accordingly, it remains well settled that in the Fifth Circuit, the Chapter 7 debtor is limited to the three choices enumerated in section 521. Given what is an apparent split among the circuits, however, it is possible that this issue may be addressed by the Supreme Court.

B. EXEMPTIONS

1. Retirement Plans

The Fifth Circuit reiterated the exempt status of a qualified individual retirement account (IRA) in *In re Carmichael*.[26] The court reiterated the exempt status of an IRA despite the absence of anti-alienation provisions found in other retirement plans.[27]

In *Carmichael*, the debtors elected the federal exemption scheme, which unlike the Texas Property Code,[28] does not specify IRAs as among the exempt pension and profit sharing plans. Rather, when electing federal exemptions, debtors must rely on the plans enumerated under section 522(d)(2)(E) of the Code. That section includes four specifically enumerated types of plans, and also allows exemptions for a "similar plan or contract."[29] The court noted that what was exempt was the debtor's "right to receive a payment" under such a plan, and thus, it is not the plan or contract that is exempt, but the right to receive payment from such a

21. *See* 11 U.S.C. § 521(2)(A) (1994). *See also* Cox, *supra* note 2, at 1000 (discussing *In re* Johnson).

22. This unwritten fourth alternative effectively renders a secured claim a non-recourse debt after discharge, a result not contemplated by the Code, nor bargained for by the parties.

23. 209 B.R. 59 (Bankr. W.D. Tex. 1997).

24. *See In re* Belanger, 962 F.2d 345 (4th Cir. 1992); *In re* West, 882 F.2d 1543 (10th Cir. 1989).

25. *See* Government Employees Credit Union v. Castillo (*In re* Castillo) 213 B.R. 316, 317 (Bankr. W.D. Tex. 1997).

26. Carmichael v. Osherow (*In re* Carmichael), 100 F.3d 375 (5th Cir. 1996).

27. *See id.* at 378.

28. Section 42.0021 of the Texas Property Code includes "any individual retirement account" among the various qualified retirement plans included within the state exemptions. TEX. PROP. CODE ANN. § 42.0021 (Vernon Supp. 1998).

29. *Carmichael*, 100 F.3d at 377.

plan.[30] The court concluded that the facts that IRAs were not enumerated under the federal statute and that a debtor may receive payment from an IRA prematurely (subject to penalty) were of no significance.[31] Rather, exempting an IRA is consistent with the exemption allowed the other enumerated types of plans, thereby protecting the policy of providing honest debtors with a fresh start and protecting such a person's future income stream.[32]

2. *Self-Settled Trusts*

The Fifth Circuit also faced a partially self-settled trust in *In re Shurley*.[33] In *Shurley*, the debtor was the beneficiary of a spendthrift trust settled in part by the debtor, and in part by other members of her family. The court concluded that to the extent assets were self-settled by the debtor, those assets were not exempt, and therefore property of the bankruptcy estate; however, to the extent assets were contributed by persons other than the debtor, the spendthrift nature of the trust protected the exempt nature of those assets.[34]

What was somewhat unique in *Shurley* was that although the court was faced with a self-settled trust, the trust was only partially self-settled. The court recognized that there was no compelling Texas authority on the issue of whether the entirety of the beneficiary's interest is subject to creditors' claims when the trust is only partially self-settled.[35] The court construed Texas law that in upholding the spendthrift nature of spendthrift trusts, Texas courts have looked not to consideration for the beneficiary, but rather to the expectations of third party donors to a trust.[36] The court concluded that "[a]llowing creditors to reach only that portion of the trust contributed by Shurley would further the policy of allowing her parents to create a spendthrift trust for the benefit of Shurley that is protected from her creditors, while giving effect to the exception for self-settled trusts."[37]

3. *Homesteads—Exceptions*

While most consider Texas homesteads to be absolutely sacrosanct, there are exceptions. For example, in *In re Davis*,[38] the Fifth Circuit allowed a debtor's ex-spouse to levy upon homestead property that was

30. *Id.*
31. *See id.*
32. *See id.* at 378. Additionally, the court emphasized what it perceived as clear congressional intent that IRAs be treated similarly to other retirement plans, noting that "in the overall retirement scheme of the [Internal Revenue Code], [Congress] selected the IRA to serve as a sort of universal conductor through which transfers must pass if they are to avoid the rocks and shoals of inadvertent taxable events." *Id.*
33. Shurley v. Texas Commerce Bank (*In re* Shurley), 115 F.3d 333 (5th Cir. 1997).
34. *See id.* at 336.
35. *See id.* at 337.
36. *See id.*
37. *Id.* at 338.
38. Davis v. Davis (*In re* Davis), 105 F.3d 1017 (5th Cir. 1997).

otherwise exempt under state law in order to satisfy that ex-spouse's judgment that was considered in the form of maintenance, alimony, or support. The court found that the Bankruptcy Code in effect superseded the Texas exemption laws to the extent that the Code expressly limits the applicability of those laws. In *Davis*, the court found that section 522 (c)(1) of the Code authorizes certain creditors and lienholders to reach exempt property.[39] Specifically, the court noted that under the Code, property that is exempt from the estate is immunized against liability for pre-bankruptcy debts; however, the Code provides a specific exception for alimony, maintenance, child support, taxes and other specific liabilities.[40]

4. *Timing of Exemption Claims*

Two cases during the Survey provide some guidance with respect to the timing of exemption claims in bankruptcy. In *In re Sandoval*,[41] the Fifth Circuit held that in a converted case, the effective date of a homestead exemption claim should be the date of the original filing, not the date of conversion. In *Sandoval*, the debtors filed a Chapter 13, claiming one house as homestead, and scheduling another house as rental property. After they were unable to make payments on their original homestead property, they moved into the rent house, converted the case to a Chapter 7, and sought to claim the rent house which they moved into, as their homestead. The schedule amendments reflecting the new homestead claim were filed at or near the time of the conversion from Chapter 13 to Chapter 7. The Fifth Circuit, however, concluded that the right to exemptions is determined by facts as they exist on the date of the original bankruptcy petition.[42] Therefore, the rent house was not exempt, and remained property of the estate.[43]

In *In re Malone*,[44] the bankruptcy court was faced with the Texas Property Code exemption of proceeds of a homestead sale for "six months" after the date of sale.[45] In *Malone*, the debtor filed bankruptcy on May 21, 1996, claiming as exempt remaining proceeds from a pre-petition sale of a homestead, which occurred on November 21, 1995. The trustee objected to the debtor's exemption claim, asserting that the sale had oc-

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39. *See id.* at 1022.

40. *See id.* The court added:

> The code does not in such cases, however, preserve or effectuate the state exemption laws with all of their built in characteristics . . . . The code uses the state exemption laws only as a means of identifying and quantifying the property that the debtor may exempt under federal law from the bankruptcy estate.

Id.

41. Sandoval v. Sandoval (*In re* Sandoval), 103 F.3d 20 (1997).

42. *See id.* at 23.

43. The court did not address, however, the potential effect of a dismissal and re-filing.

44. 201 B.R. 175 (Bankr. W.D. Tex. 1996).

45. *See* TEX. PROP. CODE ANN. § 41.001(c) (Vernon Supp. 1998).

curred more than six months prior because more than 180 days had elapsed from the date of sale to the petition date.

The bankruptcy court, however, determined that the counting of *days*, did not resolve the question, because the statute specified *months*.[46] The court concluded that based upon the express language of the statute, the six month period should be just that: six months, regardless of how many days are in a given month.[47] The six month period was found to have begun running the day after the foreclosure sale.[48]

5. *Homesteads—Urban or Rural/Family Limited Partnerships*

In *In re Cole*[49] a judgment creditor objected to what amounted to a rural homestead claim to six tracts of land that were located within the city of Denton, Texas. The objecting party, however, did not meet its burden of proof with respect to whether the property actually constituted an urban homestead, which would have limited the debtors to one acre.[50] Moreover, one of the debtors testified that the tracts were used by his family as either living quarters or pasture area. Accordingly, the court found that the tracts were located in a rural area, and therefore potentially subject to the 200 acre rural homestead exemption.[51]

Unfortunately for the debtors, however, they had apparently conveyed most or all of this property to a family limited partnership. The objecting party presented evidence of deeds to three of the six tracts of land (into the partnership), and the debtors did nothing to refute that evidence other than stating that they thought they had transferred the property back. Based upon partnership law, however, the court found that the debtors' ownership interests were in the nature of partnership interests, and therefore considered personal property not subject to a homestead exemption.[52]

Two things can be gleaned from this case. First, just because property is situated within the city limits of a municipality does not deprive it of rural character for homestead purposes. Second, despite the fact that the family limited partnership seems to be a commonly used estate planning tool, such partnerships are still governed by partnership law, and conveying a homestead to a family limited partnership will most likely deprive it of its homestead character.[53]

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46. *See Malone*, 202 B.R. at 176.
47. *See id.*
48. *See Malone*, 201 B.R. at 175-76.
49. 205 B.R. 382 (Bankr. E.D. Tex. 1997).
50. Texas homestead exemptions are described in Chapter 41 of the Texas Property Code.
51. *See Cole*, 205 B.R. at 383.
52. *See Cole*, 205 B.R. at 385. *See* TEX. REV. CIV. STAT. ANN. art. 6132a-1, § 7.01 (Vernon Supp. 1998) (stating that, "A partnership interest is personal property. A partner has no interest in specific limited partnership property.").
53. As the *Cole* court noted, it is established Texas law that a homestead terminates upon abandonment, and there is no better evidence of abandonment than conveyance of the property. *See* 205 B.R. at 385.

6. Motor Vehicles—Tools of the Trade?

In *In re Juhasz*[54] the debtor attempted to avoid a non-possessory, non-purchase money security interest in a Porsche 944 Turbo, which the debtor had claimed as exempt as a tool of the trade. No party in interest had filed a timely objection to the debtor's exemption claim. However, the court found that the vehicle was not particularly adapted to the debtor's trade, and therefore, denied lien avoidance.[55] This holding is consistent with at least two other Texas bankruptcy cases.[56]

Also of interest in *Juhasz* was the court's disposition of a motion to lift stay that had been filed by the creditor whose claim was secured by the Porsche. The court found that the value of the vehicle was to have been measured by its approximate replacement cost.[57] Accordingly, the creditor was found to have been oversecured. The court further held that in the absence of evidence regarding ongoing depreciation of the vehicle, the oversecured creditor would not be entitled to periodic adequate protection payments, despite the fact that the creditor's equity cushion (if for no other reason than the continued accrual of interest) was continuing to erode.[58]

C. DISCHARGEABILITY

1. Collateral Estoppel

The Fifth Circuit heard at least three dischargeability cases involving the collateral estoppel effect of state court judgments.

The first of two cases involving state court default judgments was *In re Gober*.[59] In *Gober*, the court addressed the issue of whether a state court default judgment entered as a sanction for discovery abuse is entitled to issue preclusive (collateral estoppel) effect in a subsequent bankruptcy proceeding. The creditor filed a civil suit in state court alleging the negotiation of unauthorized loans and conversion of loan proceeds and client funds in an unauthorized account. The debtor filed a general denial and counterclaims against the creditor. The parties "actively litigated" for two years; however, the state court ultimately struck the debtor's pleadings and entered a default judgment against him.

The Fifth Circuit reiterated that collateral estoppel may apply in certain circumstances to bar re-litigation of dischargeability issues in bank-

54. 208 B.R. 32 (Bankr. S.D. Tex. 1997)

55. *See id.* at 35. The court did not elaborate on how a two-seat, high-performance luxury sports car could ever be adapted as a tool of the trade.

56. *See* Hrncirik v. Farmers Nat'l Bank of Seymour, Tex. (*In re* Hrncirik), 138 B.R. 835 (Bankr. N.D. Tex. 1992); *In re* Weiss, 92 B.R. 677 (Bankr. N.D. Tex 1988).

57. This was based on a prior version of *Rash*, issued before the *en banc* decision was ultimately reversed by the Supreme Court.

58. *See Juhasz*, 208 B.R. at 36. The court acknowledged that denial of the motion for relief from stay was without prejudice upon a later showing of the decline in value of the vehicle. *See id.*

59. Gober v. Terra + Corp. (*In re* Gober), 100 F.3d 1195 (5th Cir. 1996).

ruptcy court.[60] The court also noted that it is to "look to the state that rendered the judgment to determine whether the courts of that state would afford the judgment preclusive effect."[61]

Essentially, this means the court must determine that the facts asserted in the second proceeding were "fully and fairly litigated" in the first, that the facts were essential to the judgment, and that the parties were adversaries. The court again distinguished a pre-answer default, in which the plaintiff's allegations are simply deemed admitted, from a post-answer default, in which the plaintiff is required to offer evidence. The latter is typically afforded preclusive effect.[62] The Fifth Circuit concluded that a damages hearing was held and that the court heard sufficient evidence to determine that the defendant's actions were of "a wanton and a malicious nature."[63] Because the debtor had the right to participate in that damages hearing, the court determined that the debtor's mental state was fully and fairly litigated, and the debtor was precluded from re-litigating whether his conduct was willful and malicious for purposes of section 523(a) dischargeability.[64]

In *In re Pancake*,[65] however, the Fifth Circuit held that a record presented to the bankruptcy court did not establish whether an evidentiary hearing was held. The only indication before the bankruptcy court was language in the state court judgment in which the court stated that it heard "the evidence and arguments of counsel."[66] This conclusory statement alone did not satisfy the Fifth Circuit that these same issues were fully and fairly litigated. In *Pancake*, the debtor's answer was stricken by the state court in a situation similar to *Gober*. However, one can only conclude that the record in *Gober* was more complete, explaining the distinction between the two cases. It should be noted, however, that the court added that if the creditor can produce record evidence on remand that the state court actually conducted an evidentiary hearing, "collateral estoppel may be found to be appropriate."[67]

The last of the three cases did not involve a default judgment, but rather addressed collateral estoppel following a state court jury trial. In *In re Schwager*[68] the debtor was accused of fraud, defalcation in a fiduciary capacity, and willful and malicious injury.[69] In the state court, the jury awarded compensatory damages against the debtor, finding that he

60. *See id.* at 1201.
61. *See id.* at 1205.
62. *See id.*; Garner v. Lehrer (*In re* Garner), 56 F.3d 677, 680-81 (5th Cir. 1995) (holding that issues in a post-answer default judgment are "actually litigated" for collateral estoppel purposes and may be given preclusive effect in dischargeability proceedings).
63. *Gober*, 100 F.3d at 1205.
64. *See id.*
65. Pancake v. Reliance Ins. Co. (*In re* Pancake), 106 F.3d 1242 (5th Cir. 1997).
66. *Id.* at 1244.
67. *Id.* at 1245.
68. Schwager v. Fallas (*In re* Schwager), 121 F.3d 177 (5th Cir. 1997).
69. These acts, if proven, may render a debt non-dischargeable under section 523(a) of the Bankruptcy Code.

breached a partnership agreement and his fiduciary duty to limited partners. The court further found that the breach was committed "intentionally, maliciously or with heedless and reckless disregard of the rights of the limited partners."[70] The jury also awarded exemplary damages and found that the debtor fraudulently induced the limited partners to enter into the partnership agreement.

The debtor argued, and the Fifth Circuit agreed, that because the jury found both a breach of the partnership agreement and a breach of fiduciary duty, the conjunctive nature of these findings made it impossible to determine the basis for the judgment. The theory behind this was found in a Texas Supreme Court case, which applied the Restatement (Second) of Judgments in determining when to allow issue preclusion.[71] Essentially, the state court determined that if a judgment of a state court is based upon determinations of two issues, either of which standing independently would support the judgment, the judgment is inconclusive with respect to either issue standing alone. Accordingly, the Fifth Circuit remanded the case for a redetermination of the dischargeability issue on the breach of partnership agreement versus breach of fiduciary duty findings.

The Fifth Circuit did, however, affirm the lower court's finding that the debtor was in a fiduciary relationship with the limited partners as a matter of law.[72] The court further found that by citing section 523(a)(4) as a basis of non-dischargeability, the debtor was on notice that defalcation in a fiduciary capacity was adequately plead in the lower court.[73]

The net effect of these three cases is that, according to the Fifth Circuit, collateral estoppel (issue preclusion) is alive and well in dischargeability litigation; however, the prudent practitioner should be familiar with the state law applicable to these issues. In addition, in default judgment situations regarding potentially non-dischargeable claims, a prove-up hearing is advised. Under the "full faith and credit" clause of the Constitution, collateral estoppel will only apply if a state court would have provided the same preclusive effect.

2. *Dischargeability—Credit Card Debt*

Another issue that has come to the forefront as a result of the increase in consumer bankruptcies is the dischargeability of credit card debt, especially that incurred at or near the time of a bankruptcy filing. Many of these cases turn on the level of reliance necessary to render a credit card debt non-dischargeable, or whether reliance can be imputed or disposed of upon an implied representation of ability and intent to pay by the debtor.

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70. *Schwager*, 121 F.3d at 180.

71. *See* Eagle Properties, Ltd. v. Scharbauer, 807 S.W.2d 714, 722 (Tex. 1991) (applying section 27 of the Restatement).

72. *See Schwager*, 121 F.3d at 181.

73. *See id.*

In *In re Hernandez*[74] Judge Leif Clark wrote extensively on this issue. Faced with a two-party credit transaction between the debtor and Sears, the court denied a non-dischargeability finding under section 523 (a)(2)(A), because there was apparently no evidence of any actual reliance by Sears.[75] The court further disposed of the so called "implied representation theory" under which a debtor is held to have implicitly represented that upon his use of a credit card he has the ability and intention to pay. This has been an ongoing debate for years; however, Judge Clark pointed out an interesting issue raised by the "implied representation" theory. Judge Clark noted that section 523 (a)(2)(A) explicitly excludes statements regarding a debtor's financial condition.[76] If that is the case, then section 523 (a)(2)(B) would apply, argued Judge Clark, which would require any such statement to be in writing.[77] Additionally, the court noted one practicality: "One of the primary reasons people use credit cards, after all, is a present *lack* of ability to repay—hence the name, *credit* cards."[78]

This was not the end of the issues facing the court, however. Sears also cited section 523(a)(2)(C), the so-called luxury goods exception to discharge, which was enacted by Congress "in an effort to deter the particular practice of debtors' purchasing numerous unnecessary items on credit on the eve of bankruptcy with the knowledge that the debt incurred purchasing the items would be discharged in bankruptcy."[79] In *Hernandez*, the debtors had charged $3,000 of merchandise on their new Sears credit card, and the next day attended a previously scheduled meeting with a bankruptcy lawyer. The debtors argued that they had returned some exercise equipment, leaving the debtor only with goods necessary for their support and maintenance. The court noted, however, that apparently having purchased drapes, curtains, rugs, basketballs, speaker phones, jewelry, and other items, the debtors had "effectively refurbished their home at a time when they knew bankruptcy was eminent."[80] The court noted that this was exactly the type of purchase that section 523(a)(2)(C) was enacted to prevent. Accordingly, the court found that

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74. Sears, Roebuck & Co. v. Hernandez (*In re* Hernandez), 208 B.R. 872 (Bankr. W.D. Tex. 1997).

75. The court noted:

> The evidence presented at the trial in this case proves that the debtor filled out some kind of credit application; that this information was forwarded to Sears' Central Credit Application Bureau; and, that a card was issued to the debtor. *From this, we cannot determine whether any of the application information was even looked at, let alone relied on, by Sears personnel.*

Id. at 877 (emphasis added).

76. *See id.* at 879.

77. *See id.* Section 523(a)(2)(B), which deals with false, written financial statements, also contains its own objective reliance standard, which imposes an even higher reliance burden on the creditor.

78. *Hernandez*, 208 B.R. at 879 (emphasis provided by court). The court continued, "More importantly, *the* primary reason creditors want customers to use their credit cards is that very inability of their customers to timely repay their credit card debt." *Id.*

79. *Id.* at 880.

80. *Id.* at 881.

although the creditor did not establish the necessary element of reliance under section 523(a)(2)(A), the creditor had established a claim under section 523(a)(2)(C), rendering the debt non-dischargable.[81]

III. DEBT COLLECTION

Finally, yet another issue of continuing importance raised by the consumer credit phenomenon is compliance with the Fair Debt Collection Practices Act (the Act). During the Survey period, the Fifth Circuit addressed at least one situation involving a lawyer acting as a "debt collector" under the Act. In *Taylor v. Perrin, Landry, deLaunay & Durand*[82] a creditor sent to its borrower a letter drafted on the letterhead of an outside law firm, bearing the facsimile signature of one of the firm's lawyers. The letters were internally generated by the creditor, the law firm apparently never billed the creditor for these demand letters, and neither the lawyer nor the law firm was involved in any way in the selection or account evaluation. The Fifth Circuit found that although the creditor was collecting its own debt, it was a "debt collector" under the Act because it used names other than its own in collecting its debt.[83] In analyzing this case, the court recognized the "least sophisticated consumer" and the "unsophisticated consumer" tests used by other courts in determining whether collection letters contain false, deceptive, or misleading representations.[84] The court did not, however, adopt either standard, finding instead that the acts of the creditor in this case would have been found deceptive and misleading under either.[85]

A case out of another circuit may ultimately prove instructive on the issue of "overshadowing" or in other words, imposing deadlines on consumer debtors that are different than the thirty day opportunity to dispute a debt under the Act. In *Bartlett v. Heibl*[86] the initial written communication from the lawyer/debt collector to the consumer/borrower required the borrower to take action within a week of the date of the letter. The borrower took the position that this one week deadline was inconsistent with a consumer's thirty day opportunity to dispute the debt. The court found that the initial communication violated the act.[87] However, the court, in an opinion authored by Chief Judge Posner, provided a sample letter in which a creditor, at least in the Seventh Circuit, could request that a consumer debtor take certain steps within a period less than the thirty day period, as long as the debtor is notified of his or her

81. *See id.* at 882.
82. 103 F.3d 1232 (5th Cir. 1997).
83. *See id.* at 1236.
84. *See id.*
85. *See id. See also* McKenzie v. E.A. Uffman & Assocs., 119 F.3d 358 (5th Cir. 1997) (holding that a collector identifying itself as "Collections Department, Credit Bureau of Baton Rouge" violated the Act).
86. 128 F.3d 497 (7th Cir. 1997).
87. *See id.* at 501.

rights under the Act.[88] It is uncertain how the Fifth Circuit would deal with this issue, but this opinion by Judge Posner may ultimately prove instructive.

88. *See id.* at 501-02.