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Creditor and Consumer Rights

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CREDITOR AND CONSUMER RIGHTS

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THERE were a number of interesting decisions attempting to define or limit the broad and sometimes amorphous area of creditor and consumer rights during the past year. This article highlights developments in the law relevant to Texas practitioners during the period of December 1991 through November 1992. A large number of the significant cases of the past year turn on statutory construction and the approaches taken by various courts when they concluded that the statutes before them were ambiguous.

A. BANKRUPTCY

The United States Supreme Court unanimously resolved the conflicts between the federal courts of appeals as well as state courts and clarified the status of ERISA-qualified pension plans in connection with § 541 of the Bankruptcy Code in *Patterson v. Shumate.*[1] In *Patterson*, the Court held that a debtor's interest in an ERISA-qualified pension plan may be excluded from the property of the bankruptcy estate pursuant to § 541(c)(2) of the Bankruptcy Code.[2] Section 541 provides that the debtor's bankruptcy estate is comprised of "all legal or equitable interests of the debtor in property."[3] However, § 541(c)(2) of the Bankruptcy Code excepts from property of the estate "[a] restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law."[4]

Shumate, the Chapter 7 debtor, contended that his interest in a pension plan that satisfied all applicable requirements of the Employee Retirement Income Security Act of 1974 (ERISA)[5] was excluded from his estate under § 541(c)(2) of the Bankruptcy Code. The district court rejected Shumate's contention, holding that the reference in § 541(c)(2) to "nonbankruptcy law" did not include federal law, such as ERISA, but encompassed only

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1. 112 S. Ct. 2242 (1992).
2. *Id.* at 2250.
3. 11 U.S.C. § 541(a)(1) (1988).
4. 11 U.S.C. § 541(c)(2).
5. Employee Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. §§ 1001-1461 (1988).

state law.[6]

Like the district court that decided *Shumate*, the Court of Appeals for the Fifth Circuit similarly concluded that the term "applicable nonbankruptcy law" in § 541(c)(2) refers to state spendthrift trust law and not to federal statutes like ERISA.[7] The Fifth Circuit also held that the ERISA anti-alienation provision is not "other federal law" which would support a debtor's exemptions under § 522(b)(2)(A) of the Bankruptcy Code.[8] However, the Fifth Circuit concluded that the Texas exemption for interests in pension and profit sharing plans and individual retirement accounts[9] was not preempted by ERISA.[10] As a result, the Fifth Circuit held that an ERISA pension plan could be claimed as exempt pursuant to § 522(b)(2) of the Bankruptcy Code.[11]

The Court of Appeals for the Fourth Circuit reversed the district court.[12] The Fourth Circuit had previously held that ERISA-qualified plans by definition include a non-alienation provision consistent with § 541(c)(2) which requires a restriction on the transfer of a beneficial interest in a trust and therefore constitute "applicable nonbankruptcy law."[13] As a result, the Fourth Circuit concluded that Shumate's interest in the ERISA-qualified plan should be excluded from the estate under § 541(c)(2). The Fourth Circuit declined consideration of whether, in the alternative, Shumate's interest in the plan qualified for exemption under § 522(b).[14]

In its decision, the Supreme Court continued adherence to its previously enunciated "plain language of the statute" standard and stated that the plain language of the Bankruptcy Code and ERISA was determinative.[15] Thus, the Court rejected the assertion that "applicable nonbankruptcy law" refers exclusively to state law.[16] In doing so, the Court pointed out that the text of § 541 contains no such limitation on the phrase in question and that throughout the Bankruptcy Code, Congress was clear in restricting applica-

6. *See* Creasy v. Coleman Furniture Corp., 83 B.R. 404, 406 (W.D. Va. 1988).

7. Heitkamp v. Dyke (*In re* Dyke), 943 F.2d 1435, 1441 (5th Cir. 1991) (relying on *In re* Goff, 706 F.2d 574, 577 (5th Cir. 1983)).

8. *Heitkamp*, 943 F.2d at 1445.

9. TEX. PROP. CODE ANN. § 42.0021(a) (Vernon Supp. 1992).

10. *Heitkamp*, 943 F. 2d at 1449-50. The court relied on ERISA § 514(d) and the conclusion of the United States Supreme Court that § 514(d) ensures that ERISA does not impede either (1) other federal laws or (2) state laws which implement and enforce these other federal laws. *Id.* (citing Shaw v. Delta Airlines, Inc., 463 U.S. 85 (1983)).

11. *Heitkamp*, 943 F.2d at 1449.

12. Shumate v. Patterson, 943 F.2d 362 (4th Cir. 1991).

13. Anderson v. Raine (*In re* Moore), 907 F.2d 1476 (4th Cir. 1990).

14. *Shumate*, 943 F.2d at 365. Section 541(c)(2) sets forth an *exclusion* of what would otherwise constitute property of the bankruptcy estate. 11 U.S.C. § 541. Section 522 of the Bankruptcy Code provides that a debtor may *exempt* from property of the estate the property specified in either paragraph (1) or paragraph (2) of subsection (b). Section 522(b)(1) refers the debtor to a specific list contained in § 522(d), which permits a debtor to claim as exempt any property that is exempt under federal law (other than § 522(d)), or state or local law. 11 U.S.C. § 522.

15. *Patterson*, 112 S. Ct. at 2246; *see also* Toibb v. Radloff, 111 S. Ct. 2197, 2199 (1991); United States v. Ron Pair Enter., Inc., 489 U.S. 235, 241 (1989).

16. *Patterson*, 112 S. Ct. at 2246.

ble law to state law when it chose to do so.[17] The Court concluded that a plain reading of the statute incorporated any relevant nonbankruptcy law, including a federal law such as ERISA.[18]

The Court then turned to an assessment of whether or not the anti-alienation provision contained in the ERISA-qualified plan of the debtor satisfied the actual requirements of § 541(c)(2). Section 206(d)(1) of ERISA requires that "[e]ach pension plan shall provide that benefits provided under the plan may not be assigned or alienated."[19] The Internal Revenue Code provision which qualified the plan before the Court for favorable tax treatment states that "[a] trust shall not constitute a qualified trust under this section unless the plan of which such trust is part provides that benefits provided under the plan may not be assigned or alienated."[20] Because Shumate's plan stated that "[n]o benefit, right or interest" of any participant "shall be subject to alienation, sale, transfer, assignment, pledge, encumbrance or charge, seizure, attachment or other legal, equitable or other process," the Court concluded that the plan complied with the applicable requirements of ERISA and the Internal Revenue Code.[21]

The Court relied on ERISA provisions with respect to duties of plan trustees and fiduciaries[22] and the ability to enjoin any act or practice which violates ERISA or the terms of any plan[23] in holding that the plan restrictions met the "enforceable" requirement of § 541(c)(2).[24]

Petitioner asserted that the legislative history of § 541 indicated that Congress did not intend to extend the exclusion of property of the estate under § 541(c)(2) to a debtor's interest in an ERISA plan. The Court held that the "clarity of the statutory language at issue obviates the need for any such inquiry,"[25] but went on to examine the legislative records upon which the petitioner relied. The Court did not discern any clearly expressed legislative intent contrary to its plain reading of § 541(c)(2).[26]

The petitioner also attempted to assert that the Court's construction of

17. *Id.* (citing 11 U.S.C. § 109(c)(2)(entity may be a debtor under Chapter 9 if authorized "by State law"); 11 U.S.C. § 522(b)(1) (election of exemptions controlled by "the State law that is applicable to the debtor"); 11 U.S.C. § 523(a)(5)(a debt for alimony, maintenance, or support determined "in accordance with State or territorial law" is not dischargeable); 11 U.S.C. § 903(1)("a State law prescribing a method of composition of indebtedness" of municipalities is not binding on nonconsenting creditors)).

18. *Patterson*, 112 S. Ct. at 2247.

19. *Id.* (citing 29 U.S.C. § 1056(d)(1)).

20. *Id.* (citing Internal Revenue Code, 26 U.S.C. § 401(a)(13)).

21. *Id.*

22. "Plan trustees or fiduciaries are required under ERISA to discharge their duties in 'accordance with the documents and instruments governing the plan.' " *Patterson*, 112 S. Ct. at 2247 (citing 29 U.S.C. § 1104(a)(1)(D) (Supp. II 1990)).

23. "A plan participant, beneficiary or fiduciary, or the Secretary of Labor may file a civil action to 'enjoin any act or practice' which violates ERISA or the terms of the plan." *Patterson*, 112 S. Ct. at 2247 (citing 29 U.S.C. §§ 1132(a)(3)(5)); *see* Guidry v. Sheet Metal Workers Pension Fund, 493 U.S. 365 (1990) (enforcing ERISA's prohibition against assignment of pension benefits).

24. *Patterson*, 112 S. Ct. at 2248.

25. *Id.*

26. *Id.*

§ 541(c)(2) rendered § 522(d)(10)(E) superfluous. Petitioner reasoned that if a debtor can exclude his entire interest in a pension plan under § 541(c)(2), there is no need for the more narrow exemptions of § 522(d)(10). The Court, in rebutting this assertion, observed that a debtor who chooses the federal exemptions may exempt a broader category of interests than § 541(c)(2) excludes.[27] The Court referred to a number of interests under pension plans which qualify for the § 522(d)(10) exemption, but which do not qualify for the § 541(c)(2) exclusion.[28]

Petitioner's final point was that the Court's conclusion frustrated the Bankruptcy Code's policy of an expansive inclusion of assets in a bankruptcy estate. The Court observed that petitioner was confusing a broad definition with a broad policy, but that the argument was irrelevant given the clarity of the statute.[29] Nevertheless, the Court buttressed its conclusion by observing that policy would be served because its holding would: (1) ensure that the treatment of pension benefits would not vary based on the beneficiary's bankruptcy status; (2) give full and appropriate effect to ERISA's goal of protecting pension benefits; and (3) further uniform national treatment of pension benefits and the underlying policy of ERISA.[30]

In another instance of strict statutory construction, the United States Supreme Court held that even where the debtor had no legal basis for claiming the exemption, the Chapter 7 trustee could not contest its validity after the thirty-day objection period established by Bankruptcy Rule 4003(b) had expired without the trustee having obtained any extension.[31]

Section 522(l) of the Bankruptcy Code requires a debtor or a dependent of the debtor to file a list of property that the debtor claims is exempt from property of the estate.[32] In the case before the Court, the Chapter 7 debtor had listed anticipated proceeds from an employment discrimination lawsuit on the list of property claimed as exempt which she filed pursuant to § 522(l). Section 522(l) specifies that "[u]nless a party in interest objects, the property claimed as exempt on such list is exempt."[33] Bankruptcy Rule

27. *Id.* (citing *e.g.*, 29 U.S.C. §§ 1003(b)(1)(2); 26 CFR 1.401(a)-13(a)(1991)(pension plans established by governmental entities and churches need not comply with Subchapter I of ERISA); 26 U.S.C. § 408 (1988); 29 U.S.C. § 1051(6) (Supp. II 1990) (IRA's are specifically exempted from ERISA's anti-alienation requirement)).

28. *Patterson*, 112 S. Ct. at 2248-49. 11 U.S.C. § 522(d)(10)(E) states that the following property may be exempted: (10) The debtor's right to receive -

> (E) a payment under a stock bonus, pension, profit sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor, unless - (i) such plan or contract was established by or under the auspices of an insider that employed the debtor at the time the debtor's rights under such plan or contract arose; (ii) such payment is on account of age or length of service; and (iii) such plan or contract does not qualify under section 401(a), 403(a), 403(b), 408, or 409 of the Internal Revenue Code of 1954 (26 U.S.C. 401(a), 403(a), 403(b), 408, or 409).

29. *Patterson*, 112 S. Ct. at 2249.

30. *Id.* at 2249-50.

31. Taylor v. Freeland & Kronz, 112 S. Ct. 1644, 1648-49 (1992).

32. 11 U.S.C. § 522(l).

33. *Id.*

4003(b) provides that "[t]he trustee or any creditor may file objections to the list of property claimed as exempt within thirty days after the conclusion of the meeting of creditors . . . unless, within such period, further time is granted by the court."[34]

The Chapter 7 trustee did not object to the claimed exemption within the thirty-day period. Later, upon discovering that the debtor had received approximately $110,000 in a settlement of the lawsuit, the trustee filed a complaint against the debtor. The trustee asserted that since the debtor had no legal basis for claiming the proceeds as exempt, the funds should be turned over as property of the estate.

The Court rejected the trustee's argument that if the debtor did not have a good faith or reasonably disputable basis for claiming the exemption, a court may invalidate an exemption after the thirty-day period has expired.[35] In refusing to imply a good faith or "colorably statutory basis" requirement in § 522(l), the Court specifically overruled a number of decisions of Courts of Appeals, including one rendered by the United States Court of Appeals for the Fifth Circuit.[36] The Court stated that "[d]eadlines may lead to unwelcome results, but they prompt parties to act and they produce finality."[37]

In *Dewsnup v. Timm*,[38] the United States Supreme Court held that where the creditor's claim has been allowed, a Chapter 7 debtor may not utilize § 506(d) of the Bankruptcy Code to 'strip down,' or reduce, a creditor's lien on real property to the current value of the property.[39] Aletha Dewsnup and her husband, T. LaMar Dewsnup,[40] debtors under Chapter 7 of the Bankruptcy Code, initiated an adversary proceeding to determine the validity and extent of a note and deed of trust held on real property. Dewsnup asserted that §§ 506(a) and (d) of the Bankruptcy Code, when read together, required that the bankruptcy court void the lien on the property to the extent that the lien amount exceeded the fair market value of the property. Debt on the property was approximately $120,000. At the trial, the bankruptcy court valued the property at $39,000. Section 506(a) of the Bankruptcy Code provides:

> An allowed claim of a creditor secured by a lien on property in which the estate has an interest, . . . is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, . . . and an unsecured claim to the extent that the value of such interest is less than the amount of such allowed claim.[41]

Section 506(d) states that "[t]o the extent that a lien secures a claim

34. Fed. R. Bankr. Proc. Rule 4003(b).

35. *Taylor*, 112 S. Ct. at 1648.

36. *Id.* (citing *inter alia*, *In re* Sherk, 918 F. 2d 1170, 1174 (5th Cir. 1990) (Section 522(l) contains an implicit additional requirement that there be a statutory basis for the claimed exemption before the failure of any party in interest to object timely has any legal effect)).

37. *Taylor*, 112 S. Ct. at 1648.

38. 112 S. Ct. 773 (1992).

39. *Id.* at 778.

40. T. LaMar Dewsnup passed away sometime during these proceedings.

41. 11 U.S.C. § 506(a).

against the debtor that is not an allowed secured claim, such lien is void."[42] As a result, the Dewsnups asserted that since under § 506(a), a claim is secured only to the extent of the value of the property which secures the lien, then under § 506(d), a lien on the property can be voided to the extent that a claim is not secured and consequently not "an allowed secured claim." The United States Supreme Court disagreed. The Court concluded that if a creditor's claim is secured by a lien, and has been allowed, then that claim cannot be "not an allowed secured claim" for the purposes of § 506(d).[43]

The Court asserted that Congress would not have used the Bankruptcy Code to implement a major change in pre-Code practice without leaving some clues in the record. The Court observed that where language of a statute is unambiguous, silence in legislative history does not control. However, because of what it perceived to be ambiguity in the text of § 506, the Court decided that in the absence of indicative legislative history, it must analyze pre-Code practice. The Court reviewed cases decided under the Bankruptcy Act of 1898, as well as post-Code cases discussing the Act and concluded that with the exception of reorganization proceedings, "no pre-Code statute permitted involuntary reduction of the amount of a creditor's lien for any reason other than payment on the debt."[44]

Justice Scalia, joined by Justice Souter, dissented in an opinion which is longer than that of the majority. He disagreed with the Court's conclusion that the text of § 506 is ambiguous.[45] He observed that the Court has never relied on pre-Code practice as a determinant in the face of contradictory statutory text. Scalia asserted that when Congress has rewritten entire provisions, regardless of whether pre-Code practice is retained or abandoned, the text means exactly what it says.[46] According to Justice Scalia, § 506(d), when "[r]ead naturally and in accordance with other provisions of the statute, . . . automatically voids a lien to the extent the claim it secures is not both an "allowed claim" and a "secured claim" under the Code."[47]

Scalia contrasted the Court's opinion with its opinion in *United States v. Ron Pair Enterprises Inc.*[48] and concluded that "[a]lmost point for point, today's opinion is the methodological antithesis of *Ron Pair* - and I have the greatest sympathy for the Courts of Appeals who must predict which manner of statutory construction we shall use for the next Bankruptcy Code case."[49]

It is important to remember that the Court was interpreting § 506(d) in the context of a proceeding under Chapter 7 of the Bankruptcy Code. Yet,

42. 11 U.S.C. § 506(d).

43. 112 S. Ct. at 778.

44. *Id.* at 779.

45. *See* 112 S. Ct. at 781, where Justice Scalia observed that the statute's characterization by the Court as ambiguous was "a status apparently achieved by being the subject of disagreement between self-interested litigants."

46. 112 S. Ct. at 787.

47. *Id.* at 780.

48. 489 U.S. 235 (1989).

49. *Dewsnup*, 112 S. Ct. at 787.

in *Nobleman v. American Savings Bank (In re Nobleman)*,[50] the United States Court of Appeals for the Fifth Circuit held that § 1322(b)(2) of the Bankruptcy Code prohibits a debtor under Chapter 13 of the Bankruptcy Code from using Chapter 13 plan to bifurcate a mortgage lien claim on its principal residence into a secured and unsecured claim.[51] The circuit court relied in part on the analysis of the United States Supreme Court in *Dewsnup*, as support for its view that bifurcation was impermissible.[52]

The United States Court of Appeals for the Fifth Circuit, interpreting § 506(b) of the Bankruptcy Code,[53] held that where an oversecured creditor's claim arises from a contract, the contract rate dictates the rate at which postpetition interest is payable.[54] The court further held that whether the default rate or the predefault rate should apply depends on the equities involved in the bankruptcy proceeding.[55]

The creditor filed a motion for payment of interest, costs and fees at the eighteen percent default rate specified by the note, under § 506(b) of the Bankruptcy Code. Although § 502(b)(2) of the Bankruptcy Code proscribes the allowance of postpetition interest against the estate,[56] § 506(b) provides an exception where the value of the collateral which secures an allowed secured claim is greater than the amount of the allowed claim.[57] The bankruptcy court originally determined that the creditor was entitled to postpetition interest on its claim at the contract rate of ten percent. Upon reconsideration, the bankruptcy court vacated its prior opinion and held that the federal judgment interest rate was the proper rate of postpetition interest.[58]

The bankruptcy court based its conclusion on the opinion of the United States Supreme Court in *United States v. Ron Pair Enterprises, Inc.*[59] In *Ron Pair*, the Court was required to determine whether or not § 506(b) applies only to claims arising under an agreement or to *all* oversecured claims whether based on agreement or nonconsensual statutory liens. The Court held that a statute's plain meaning should be the primary source for interpretation and application of that statute and emphasized "[t]he natural read-

50. 968 F.2d 483 (5th Cir. 1992).

51. *Id.* at 489. Section 1322(b)(2) provides that a Chapter 13 plan may: "(a) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims." 11 U.S.C. § 1322(b).

52. 968 F.2d at 487.

53. 11 U.S.C. § 506(b) states:

> To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which such claim arose.

54. Bradford v. Crozier, 958 F.2d 72, 75 (5th Cir. 1992).

55. *Id.*

56. 11 U.S.C. § 502(b)(2).

57. 11 U.S.C. § 506(b).

58. *In re* Laymon, 117 B.R. 856, 864 (Bankr. W.D. Tex. 1990) (relying on 28 U.S.C. § 1961).

59. 489 U.S. 235 (1989).

ing of the [relevant] phrase," and the "grammatical structure of the statute."[60] Because the phrase "interest on such claim," is framed by commas and separated by use of the conjunction "and" which precedes the phrase which refers to "any reasonable fees, costs or charges provided for under the agreement," the Court concluded that "interest on such claim" encompasses consensual and nonconsensual claims.[61]

In keeping with the United States Supreme Court's determination in *Ron Pair* that the concept of "interest on such claim" was distinct from the existence of any agreement which provides the basis of a claim, the bankruptcy court held that "the entire issue of interest is completely divorced from either the existence or the content of any underlying agreement."[62] The bankruptcy court held that since § 502(b)(2) of the Bankruptcy Code prohibits the recovery of contract interest postpetition, § 506(b) should not be interpreted to give back what § 502(b)(2) takes away.[63] The bankruptcy court observed that an allowed claim, whether secured or unsecured, is the functional equivalent of a federal judgment against the estate's assets.[64] As a result, an oversecured creditor's federal judgment should accrue interest at the federal judgment interest rate.[65] The district court affirmed.

In reversing the lower courts' decisions, the United States Court of Appeals for the Fifth Circuit held that nothing in *Ron Pair* addressed the issue of the applicable rate of interest under § 506(b).[66] Turning away from statutory construction and relying on the pre-Code practice analysis utilized by the United States Supreme Court in *Dewsnup v. Timm*,[67] the circuit court determined that since the legislative history of § 506(b) was silent with respect to a rate of interest, Congress had no intention of changing pre-Code practice with respect to interest on oversecured claims.[68] Relying on pre-Code cases, the Fifth Circuit concluded that the contract rate of interest should be utilized when granting an oversecured creditor postpetition interest under § 506(b).[69]

This decision seems inconsistent with the decision of the United States

60. *Ron Pair*, 489 U.S. at 241.
61. *Id.* at 241-42.
62. *Laymon*, 117 B.R. at 859.
63. *Id.* at 863.
64. *Id.* at 864.
65. 117 B.R. at 864 (citing 28 U.S.C. § 1961).
66. *Bradford*, 958 F.2d at 74.
67. 112 S. Ct. 773, 779 (1992).
68. *Bradford*, 958 F.2d at 74.
69. *Id.* at 75 (citing *In re* Sheppley & Co., 62 B.R. 271 (Bankr. N.D. Iowa 1986) (discussing the following pre-Code cases: Vanston Bondholders Protective Comm. v. Green, 329 U.S. 156 (1946); American Surety Co. v. Sampsell, 327 U.S. 269 (1946); U.S. Trust Co. v. Zelle, 191 F.2d 822 (8th Cir. 1951), *cert. denied*, 342 U.S. 944 (1952); *In re* Black Ranches, Inc., 362 F.2d 8 (8th Cir.), *cert. denied sub nom.*, Black v. Strand, 385 U.S. 990 (1966); Ruskin v. Griffiths, 269 F.2d 827 (2d Cir. 1959), *cert. denied*, 361 U.S. 947 (1960)). By agreement of the parties, the original motion for payment under 11 U.S.C. § 506(b) was withdrawn. During the pendency of the proceedings, the value of the collateral diminished to a point where the oversecured status of the creditor was uncertain. In addition, the trustee intends to propose a plan of reorganization which treats the creditor's claim. (February 1, 1993 telephone conversation with Stephen W. Sather, Overstreet, Winn & Edwards, counsel for James Crozier, trustee).

Supreme Court in *Ron Pair.* The *Ron Pair* Court held that the plain meaning of a statute, based on its language, should be conclusive unless literal application of the statute will "produce a result demonstrably at odds with the intention of its drafters."[70] Only then should courts look to legislative history and pre-Code practice.[71] The *Ron Pair* Court concluded that, based on the plain language of the statute, § 506(b) applies to claims based on contract as well as involuntary claims such as those which arise from a judicial or statutory lien.[72] The bankruptcy court relied on this interpretation in reaching its conclusions in *Laymon.*

The Fifth Circuit's conclusion in *Bradford v. Crozier*[73] is based on an interpretation of § 506(b) of the Bankruptcy Code that conflicts with the United States Supreme Court's interpretation of that same statute. As a result, the Fifth Circuit leaves unanswered the question of what interest rate should be applied under § 506(b) when the creditor's claim is *not* based on a contract.

The bankruptcy court granted the request of the Official Unsecured Creditor's Committee to equitably subordinate the claims of parties it concluded were insiders of the debtor in *Herby's Foods, Inc. v. Summit Coffee Co., Inc. (In re Herby's Foods, Inc.).*[74] In *Herby's Foods,* the parties agreed that the company which owned 100 percent of the debtor's stock, the individual who owned 100 percent of the voting securities of that company, and an individual who managed the debtor were all insiders of the debtor. As a result, Judge Felsenthal held that their conduct was subject to a greater degree of scrutiny.[75]

Judge Felsenthal stated that equitable subordination allows a court to get beyond the form of a transaction, examine its substance and change claim priorities based upon the conduct of creditors.[76] He then applied the three-part test that has been enunciated repeatedly by the Fifth Circuit: "(i) the claimant must have engaged in some type of inequitable conduct; (ii) the misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (iii) equitable subordination of the claim must not be inconsistent with the provisions of the Bank-

70. *Ron Pair,* 489 U.S. at 242.

71. *Id.* at 242-46.

72. *Id.* at 241.

73. 958 F.2d 72 (5th Cir. 1992).

74. 134 B.R. 207 (Bankr. N.D. Tex. 1991). The doctrine of equitable subordination is incorporated in the Bankruptcy Code at 11 U.S.C. §§ 510(c)(1) and (2) which provide that a court may -

> (1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
> (2) order that any lien securing such a subordinated claim be transferred to the estate. 11 U.S.C. § 510 (c)(1) and (2).

75. *Herby's Foods,* 134 B.R. at 211 (citing Fabricators, Inc. v. Technical Fabricators, Inc. (*In re* Fabricators, Inc.), 126 B.R. 239, 246 (S.D. Miss. 1989), *aff'd, In re* Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991)).

76. *Herby's Foods,* 134 B.R. at 210-11.

ruptcy Code."[77]

The *Herby's Foods* case is interesting because Judge Felsenthal held that undercapitalization constitutes a form of inequitable conduct.[78] Relying on expert testimony and other evidence, Judge Felsenthal concluded that the debtor was undercapitalized at the time the insiders acquired it and that the capital infusions characterized as loans were, in fact, equity capital contributions.[79]

Observing that in some cases, in addition to undercapitalization, some aggravating conduct may need to be found, the court held that the improper characterization of the capital contributions as loans constituted aggravating conduct.[80] Also damning was the fact that the claimants did not perfect their security interests until it became clear that the debtor was insolvent.[81]

The bankruptcy court held that these insiders' conduct harmed other creditors of the debtor because characterizing their contributions as secured debt increased other creditors' exposure and reduced their dividend in liquidation.[82] Importantly, the court observed that if these insider claims were subordinated, the general unsecured claims could be paid in full.[83] Judge Felsenthal concluded that equitable subordination was consistent with the provisions of the Bankruptcy Code because proper recharacterization of the claimants' contributions as equity contributions, rather than loans, ensured consistency with the absolute priority rule of § 1129(b)(2) of the Bankruptcy Code.[84]

The United State District Court for the Northern District Of Texas affirmed.[85] The case is pending before the Court of Appeals for the Fifth Circuit.

B. EXEMPTIONS

In re Griffin,[86] one of the first reported cases interpreting the amended personal property exemptions, the bankruptcy court concluded that a sailboat may not be claimed exempt as "athletic and sporting equipment" under § 42.002(a)(8) of the Texas Property Code.[87] Judge Ronald King observed that prior to the May, 1991 amendments to the Texas Property Code,[88] certain items of personal property, including athletic and sporting equipment,

77. *Id.* at 211 (citing *In re* Fabricators, Inc., 926 F.2d 1458 (5th Cir. 1991); *In re* Mobile Steel Co., 563 F.2d 692 (5th Cir. 1977)).
78. *Herby's Foods*, 134 B.R. at 211 (citing *In re* Fabricators, Inc., 926 F.2d at 1467).
79. *Herby's Foods*, 134 B.R. at 212.
80. *Id.*
81. *Id.* at 212-13.
82. *Id.* at 213.
83. *Id.*
84. *Id.* (citing 11 U.S.C. § 1129(b)(2)).
85. Summit Coffee Co. v. Herby's Foods, Inc., No. 3:92-CV-01189 (N.D. Tex. July 20, 1992).
86. 139 B.R. 415 (Bankr. W.D. Tex. 1992).
87. TEX. PROP. CODE ANN. § 42.002(a)(8) (Vernon Supp. 1993).
88. Act of May 13, 1991, 72nd Leg. R.S. ch. 175, § 1, 1991 Tex. Sess. Law Serv. 789-792 (Vernon).

were exempt only if *reasonably necessary* for the family or single adult.[89] Because Griffin had filed for relief under Chapter 7 of the Bankruptcy Code after the effective date of the amendments, this subjective "reasonably necessary" standard was not applicable and the sailboat was required only to fit within the category of "athletic and sporting equipment."[90] The *Griffin* court reviewed existing pre-amendment case law applying the sporting goods exemption and decided that "athletic and sporting equipment" only includes small items for personal or individual use.[91]

In his analysis, Judge King relied heavily on an unreported 1989 opinion in which Judge Leif Clark concluded that a bass boat was not exempt as athletic sporting equipment.[92] There, the bankruptcy court compared two different exemptions of § 42.002 and decided that the legislature intended that a boat be exempt only if it were used in a trade or profession.[93] The *Schwarzbach* court held that with respect to the tools of trade exemption, specification of a boat in the category of equipment was necessary because "equipment" does not ordinarily connote boat.[94] Applying similar reasoning, the *Griffin* court observed that the legislature had specifically included bicycles, but not boats in the category of "athletic and sporting equipment."[95]

C. FDIC

In *FDIC v. Wright*[96] the Court of Appeals for the Fifth Circuit refused to allow the Federal Deposit Insurance Corporation, in its capacity as receiver of a failed financial institution (FDIC-as-Receiver), the protection available under § 550(b) of the Bankruptcy Code, as a defense against a trustee's avoidance of a preferential transfer pursuant to § 547 of the Bankruptcy Code.[97] The court held that FDIC-as-Receiver does not take "for value" as

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89. *Griffin*, 139 B.R. at 416 (citing former TEX. PROP. CODE ANN. § 42.002(3)(E) (Vernon 1984), *enacted as* Act of May 26, 1983, 68th Leg., ch. 576, § 1 Tex. Gen. Laws 3475, 3523).

90. *Griffin*, 139 B.R. at 417 (citing TEX. PROP. CODE ANN. § 42.002(a)(8) (Vernon Supp. 1993)).

91. *Griffin*, 139 B.R. at 416 (relying on *In re* Payton, 73 B.R. 31 (Bankr. W.D. Tex. 1987) (not subject to exemption if objection filed); *In re* Gibson, 69 B.R. 534 (Bankr. N.D. Tex. 1987) (limited to small items for individual use); *In re* Schwarzbach, No. 87-30817 (Bankr. W.D. Tex. May 22, 1989) (Leif Clark, J.) (athletic and sporting equipment exemption is limited to small items for personal use)).

92. *Griffin*, 139 B.R. at 417, (citing *Schwarzbach, supra* note 88).

93. *Schwarzbach, supra* note 88 (comparing the former § 42.002(3)(B) which allowed an exemption "if reasonably necessary for the family or single adult" for "tools, equipment, books and apparatus, including a boat, used in a trade or profession," with former § 42.002(3)(E) which allowed an exemption "if reasonably necessary for the family or single adult" for "athletic and sporting equipment." Formerly TEX. PROP. CODE ANN. § 42.002(3)(E) *enacted as* Act of May 26, 1983, 68th Leg., ch. 576, § 1 Tex. Gen. Laws 3475, 3523). The current § 42.002(a)(4) exemption refers to "boats and motor vehicles."

94. *Schwarzbach, supra* note 88.

95. *Griffin*, 139 B.R. at 417.

96. 963 F.2d 75 (5th Cir. 1992).

97. 11 U.S.C.A. § 547(b) (West Supp. 1992) allows a trustee to avoid any transfer of an interest of the debtor in property:

(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt

required by § 550(b)(1).[98]

In *Wright*, in order to enforce a guaranty, the First State Bank of Abilene obtained a judgment against William H. Still in June, 1988. The bank obtained a writ of garnishment against obligors of Still in July, 1988. Still filed for protection under Chapter 7 of the Bankruptcy Code in August, 1988 and the bank timely filed a proof of claim in the amount of $308,334. The bank failed in February, 1989 and FDIC was appointed receiver.

Pursuant to § 547 of the Bankruptcy Code, the Chapter 7 trustee avoided the writs of garnishment. The bankruptcy court refused to permit FDIC's attempts to gain the protection of § 550(b)(1) and allowed the Trustee's avoidance of the garnishments.[99] The district court affirmed.[100]

The trustee and FDIC-as-Receiver agreed that the garnishments constituted preferential transfers pursuant to § 547(b) of the Bankruptcy Code. The parties also agreed that if FDIC-as-Receiver were a transferee, it was a transferee under § 550(a)(2) of the Bankruptcy Code because it received the transfer from the initial transferee, the bank, when the bank went into receivership. Section 550(a) of the Bankruptcy Code provides that a preferential transfer may be recovered from (1) the initial transferee or the party for whose benefit the transfer was made, or (2) any immediate or mediate transferee of the initial transferee.[101]

FDIC-as-Receiver argued that it was subject to the limits against recoverability set forth in § 550(b) of the Bankruptcy Code. Pursuant to § 550(b)(1), the trustee may not recover from an immediate or mediate transferee if the transferee: (1) takes for value, including satisfaction or securing of a present or antecedent debt; (2) in good faith; and (3) without knowledge of the voidability of the transfer avoided.[102]

The Fifth Circuit agreed with the bankruptcy court and the district court that FDIC-as-Receiver does not qualify for § 550(b)(1) protection because it does not take "for value."[103] FDIC-as-Receiver asserted that it takes "for value" when it takes a failed bank's assets in two ways: (1) by assuming a bank's liabilities, and (2) by performing its statutory duties. The circuit court rejected both assertions.

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owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made - (A) on or within 90 days before the date of the filing of the petition; or (B) between 90 days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and (5) that enables such creditor to receive more than such creditor would receive if - (A) the case were a case under Chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title.

98. *Wright*, 963 F.2d at 78. 11 U.S.C. § 550(b)(1) provides that the trustee may not recover from "a transferee that takes for value, including satisfaction or securing of a present or antecedent debt, in good faith, and without knowledge of the voidability of the transfer avoided."

99. Wright v. FDIC (*In re* Still), 113 B.R. 311 (Bankr. N.D. Tex. 1990).

100. FDIC v. Wright (*In re* Still), 124 B.R. 24 (N.D. Tex. 1991).

101. 11 U.S.C. § 550(a).

102. 11 U.S.C. § 550(b)(1).

103. *Wright*, 963 F.2d at 77.

The court observed that FDIC-as-Receiver did not pay cash or any other property to the bank when it succeeded to the bank's assets. Although the circuit court agreed with the FDIC that an assumption of liabilities constitutes value, the court held that FDIC-as-Receiver does not actually assume any liabilities.[104] In support of this conclusion, the court noted that FDIC-as-Receiver is statutorily required to "pay valid obligations of the insured depository institution in accordance with the prescriptions and limitations of [FIRREA]."[105] The court further stated that under FIRREA, the "receiver *may* in the receiver's discretion *and to the extent funds are available*, pay creditor claims which are allowed by the receiver, approved by the [FDIC]. . . or determined by the final judgment of any court of competent jurisdiction . . . ."[106]

Alternatively, the Fifth Circuit pointed out that FDIC-as-Receiver may settle "all uninsured and unsecured claims of the receivership with a final settlement payment which shall constitute full payment and disposition of the [FDIC's] obligation to such claimants."[107] The circuit court distinguished the statutorily limited obligation of FDIC-as-Receiver to pay creditors only to the extent there are available funds, from the actual assumption of another's liabilities and concomitant personal liability.[108]

The court also rejected FDIC's notion that it gave value merely by performing its statutorily imposed duties.[109] Addressing itself to policy concerns, the Fifth Circuit observed that "FDIC's special role is not all-empowering."[110] The court pointed out that in the case before it, FDIC-as-Receiver, as one of many unsecured creditors, was at odds with the trustee who represented *all* of the debtor's unsecured creditors. The circuit court also observed that Congress established FDIC "to protect the nation's banking system" but also established the "Bankruptcy Code to allocate and adjust rights among a debtor's creditors."[111]

In conformance with federal decisions on the issue, the Texas Supreme Court held in *Larsen v. FDIC*[112] that the Federal Deposit Insurance Corporation has no right to assert *D'Oench Duhme* type defenses and their statutory codification for the first time on appeal.[113] The Larsen Trust sold land

104. *Id.*

105. *Id.* (citing the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) Federal Deposit Insurance Act, § 2[11](d)(2)(H), as amended, 12 U.S.C. § 1821(d)(2)(H) (Supp. III 1991)).

106. *Wright*, 963 F.2d at 77 (citing 12 U.S.C. § 1821(d)(10)(A) (Supp. III 1991)).

107. *Id.* (citing 12 U.S.C. § 1821(d)(4)(B)(i) (Supp. III 1991)). The statutory formula requires that each claim be multiplied by the final settlement payment rate which is the percentage rate reflecting an average of the FDIC's receivership recovery experience across all failed banks. 12 U.S.C. § 1821(d)(4)(B)(ii) and (iii) (Supp. III 1991).

108. *Wright*, 963 F.2d at 77.

109. *Id.* at 78.

110. *Id.*

111. *Id.*

112. 835 S.W.2d 66 (Tex. 1992).

113. *Id.* at 74; *See* D'Oench Duhme v. FDIC, 315 U.S. 447 (1942). The asserted purpose of the doctrine is protection of FDIC and its assignees from unrecorded side agreements which are not reflected in a failed financial institution's records. The *D'Oench Duhme* doctrine has

for a condominium project and retained a vendor's lien to secure payment of a $400,000 note. In connection with a refinancing of the project, the condominium project developer convinced Larsen, as trustee, to release a claim and subordinate the vendor's lien to the deed of trust securing the new construction loan. The mortgage company assigned its note and deed of trust securing repayment of the note to American Savings Bank.

At trial, Larsen successfully sued the condominium project developer, the mortgage corporation, and American Savings for fraudulently inducing him to sign the release and subordination agreement. American Savings perfected an appeal of the judgment against it. Thereafter, the Federal Home Loan Bank Board approved a supervisory merger of American Savings into Citizens Federal Bank. Pursuant to the supervised merger plan, the Federal Savings and Loan Insurance Corporation (FSLIC) approved certain liabilities and purchased certain assets of American Savings, including the note that was the subject of the Larsen suit.

The court of appeals granted FSLIC's motion to be substituted as appellant, and also granted FSLIC's motion to file an amended brief which raised the *D'Oench Duhme* federal defenses and their statutory codification for the first time. During the pendency of the appeal, FIRREA was enacted by Congress.[114] Because FIRREA abolished FSLIC and effectively replaced it with FDIC, the Court of Appeals substituted FDIC for FSLIC. The court then permitted FDIC to further amend the appellate briefs to include FIRREA provisions. FDIC asserted that the provisions of 12 U.S.C. § 1821(d)(13)(B)[115] permitted it to assert *D'Oench Duhme* type defenses for

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been codified in FIRREA at 12 U.S.C. § 1823(e) (Supp. III 1991), which provides (with "Corporation" referring to FDIC):

> (e) Agreements against interests of Corporation - No agreement which tends to diminish or defeat the interest of the Corporation in any asset acquired by it under this section or section 1821 of this title, either as security for a loan or by purchase or as receiver of any insured depository institution, shall be valid against the Corporation unless such agreement — (1) is in writing, (2) was executed by the depository institution and any person claiming an adverse interest thereunder, including the obligor, contemporaneously with the acquisition of the asset by the depository institution, (3) was approved by the board of directors of the depository institution or its loan committee, which approval shall be reflected in the minutes of said board or committee, and (4) has been, continuously, from the time of its execution, an official record of the depository institution.

Id. As noted by the Texas Supreme Court in *Larsen*, "[t]he federal courts have regarded these statutory provisions as codifications of the *D'Oench Duhme* doctrine to the extent that they discuss the common law doctrine and the provisions together." *Larsen*, 835 S.W.2d at 68 n.3, (citing Langley v. FDIC, 484 U.S. 86, 90-93 (1987); Kilpatrick v. Riddle, 907 F.2d 1523, 1526 n.4 (5th Cir. 1990); FDIC v. McCullough, 911 F.2d 593, 598 n.4 (11th Cir. 1990), cert. denied, 111 S. Ct. 2235 (1991)).

114. Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA), Pub. L. No. 101-73, 103 Stat. 183 (1989).

115. As amended by FIRREA, 12 U.S.C. § 1821(d)(13) (Supp. III 1991), now provides (with "Corporation" referring to FDIC):

> (d)(13) Additional Rights and Duties (A) Prior Final Adjudication - The Corporation shall abide any final unappealable judgment of any court of competent jurisdiction which was rendered before the appointment of the Corporation as conservator or receiver. (B) Rights and Remedies of Conservator or Receiver - In the event of any appealable judgment, the Corporation as conservator or re-

the first time on appeal. The court of appeals then concluded that pursuant to 12 U.S.C. § 1823(e),[116] as interpreted by the United States Supreme Court in *Langley v. FDIC*,[117] Larsen's claims were barred.

In reversing the Dallas court of appeals,[118] the Texas Supreme Court observed that the appellate court's decision was at odds with several federal courts' decisions and reviewed those decisions.[119] The Texas Supreme Court concluded that the "federal appellate decisions are all in agreement: § 1821 does not give the FDIC the absolute new substantive right to assert *D'Oench Duhme* - type federal defenses for the first time on appeal."[120] The court also relied on Texas procedure, which provides that in the absence of fundamental error, a court of appeals has no discretion to reverse a judgment based on an argument raised for the first time on appeal.[121]

D. PERSONAL PROPERTY FORECLOSURE

The Texas Supreme Court affirmed the conclusion of the Houston court of appeals[122] that in an action by a creditor against a debtor for the deficiency due after disposition of the collateral, the creditor has the burden of pleading and proving that it disposed of the collateral in a commercially reasonable manner as required by Section 9.504 of the Texas Business and Commerce Code.[123] The court noted a split of authority on this issue between Texas

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ceiver shall — (i) have all the rights and remedies available to the insured depository institution (before the appointment of such conservator or receiver) and the Corporation in its corporate capacity, including removal to Federal court and all appellate rights; and (ii) not be required to post any bond in order to pursue such remedies.

116. *See* note 110, *supra*.

117. *Langley v. FDIC*, 484 U.S. 86 (1987).

118. FDIC v. Larsen, 793 S.W.2d 37, 45 (Tex. App.—Dallas 1990), *rev'd*, 835 S.W.2d 66 (Tex. 1992).

119. *Larsen*, 35 Tex. S. Ct. J. at 825-827; *See* First Interstate Bank v. First Nat'l Bank, 928 F.2d 153, 156 (5th Cir. 1991) (*D'Oench Duhme* doctrine could not be asserted to protect solvent bank); Union Federal Bank v. Minyard, 919 F.2d 335 (5th Cir. 1990) (*D'Oench Duhme* doctrine of no use to FDIC where venturer's attempts to base usury claim on pleading contentions were not reflected in lender's records); Grubb v. FDIC, 868 F.2d 1151 (10th Cir. 1989) (neither *D'Oench Duhme* doctrine nor 12 U.S.C. § 1823(e) afforded protection to FDIC where judgment had been rendered against bank prior to FDIC's receivership of bank); Olney Sav. & Loan Ass'n v. Trinity Banc Sav. Ass'n, 885 F.2d 266 (5th Cir. 1989) (*D'Oench Duhme* doctrine did not protect FSLIC's rights under an agreement where agreement had been voided by entry of judgment for rescission prior to FSLIC's conservatorship); Thurman v. FDIC, 889 F.2d 1441 (5th Cir. 1989) (FSLIC not allowed to assert *D'Oench Duhme* doctrine as a post-judgment intervenor).

120. *Larsen*, 835 S.W.2d at 74.

121. *Id.* (citing Pirtle v. Gregory, 629 S.W.2d 919, 920 (Tex. 1982); McCauley v. Consolidated Underwriters, 157 Tex. 475, 477-78, 304 S.W.2d 265, 266 (1957); TEX. CONST. art. V, § 6)).

122. Greathouse v. Charter Nat'l. Bank - Southwest, 795 S.W.2d 1 (Tex. App.—Houston [1st Dist.] 1990), *aff'd*, 35 Tex. Sup. Ct. J. 1017 (July 1, 1992), *supplemental opinion*, 36 Tex. Sup. Ct. J. 378 (Dec.22, 1992) (Doggett & Mauzy, J.).

123. 35 Tex. Sup. Ct. J. 1017 (July 1, 1992). Section 9.504(c) of the Texas Uniform Commercial Code (UCC) provides that "[s]ale or other disposition may be as a unit or in parcels and at any time and place and on any terms but every aspect of the disposition including the method, manner, time, place and terms must be commercially reasonable." TEX. BUS. & COM. CODE ANN. § 9.504(c) (Vernon 1991).

courts, as well as other states.[124] In support of placing the burden on the creditor as an element of its case, rather than on the debtor as an affirmative defense, the court held that commercially reasonable disposition of the collateral is a condition to a creditor's recovery in a deficiency suit.[125]

The Texas Supreme Court observed that the creditor controls disposition of the collateral and a debtor often has little or no input in such disposition. As a result, the court concluded that the creditor in a deficiency suit must plead that disposition of the collateral was reasonable, either specifically or through a general averment that all conditions precedent have been performed or have occurred.[126] A creditor is then required to prove that disposition was commercially reasonable only if a debtor specifically denies it in his answer.[127]

In *MBank El Paso v. Sanchez*, the Texas Supreme Court held that a creditor is liable for any breaches of the peace committed by its independent contractor in carrying out repossession.[128] Because of her default on a note, MBank El Paso hired El Paso Recovery Service to repossess Yvonne Sanchez's car. Two individuals hired by El Paso Recovery Service drove to Sanchez's home with a tow truck and hooked it to the MBank-financed TransAm. Sanchez intervened and told the men to leave her premises. The men refused and proceeded with the repossession. Sanchez got into the car, locked the doors and would not get out. In spite of this, the men towed the car, with Sanchez inside, to the fenced repossession yard patrolled by a Doberman guard dog, parked the car inside and padlocked the gate. Sanchez remained in the locked yard until her husband and the police came and rescued her.

Sanchez sued MBank for the tortious acts of the towing service. MBank asserted that the towing service was an independent contractor for which MBank was not responsible and moved for summary judgment on that ground. The trial court granted MBank's motion for summary judgment. The court of appeals reversed the trial court and held that Section 9.503 of the Texas Business and Commerce Code[129] imposes a nondelegable duty on a secured party pursuing nonjudicial repossession to do so without breaching the peace.[130] MBank argued that although Section 9.503 imposes a duty on a secured party not to breach the peace, the secured party may delegate that duty to an independent contractor. The Texas Supreme Court affirmed the

124. *Greathouse*, 35 Tex. Sup. Ct. J. at 1018-1019.

125. *Id.* at 1020, (citing Tannenbaum v. Economics Lab., Inc., 628 S.W.2d 769, 771 (Tex. 1982)).

126. *Greathouse*, 35 Tex. Sup. Ct. J. at 1020.

127. *Id.*

128. 826 S.W.2d 151 (Tex. 1992).

129. Section 9.503 of the Texas Uniform Commercial Code (UCC) provides: "Unless otherwise agreed a secured party has on default the right to take possession of the collateral. In taking possession a secured party may proceed without judicial process if this can be done without breach of the peace or may proceed by action." TEX. BUS. & COM. CODE ANN. § 9.503 (Vernon 1991).

130. Sanchez v. MBank El Paso, 792 S.W.2d 530, 532 (Tex. App.—El Paso 1990), *aff'd*, 836 S.W.2d 151 (Tex. 1992).

court of appeals' rejection of this assertion.[131]

In support of its conclusion, the Texas Supreme Court adopted the reliance by the court of appeals on the Restatement (Second) of Torts, Section 424, which sets forth an exception to the general rule that an employer or owner is not liable for the tortious acts of an independent contractor.[132] Section 424 provides that in spite of this general rule, where the employer is by statute or administrative regulation under a duty to provide specific safeguards for the safety of others, he is liable to the others for whose protection the duty is imposed for the harm caused by the failure of the contractor employed by him to provide the required safeguards.[133] The appellate court also concluded that because there is an inherent danger in nonjudicial repossession, the exception to the general rule set forth in Section 427 of Restatement (Second) of Torts was also applicable.[134] That section provides that the employer remains liable where the employer hires an independent contractor to do work involving a special or inherent danger to others.[135]

The Texas Supreme Court observed that pursuant to Section 9.503, nonjudicial repossession is only one of a secured creditor's alternatives for relief, the other is judicial action. The court held that if a creditor selects self-help, he is expected to take precautions to protect "society's interest in the public peace."[136]

E. REAL PROPERTY FORECLOSURE

A foreclosure sale that occurred on the day after the owner of the property filed for protection under Chapter 11 of the Bankruptcy Code was declared void in *Graham v. Pazos de la Torre*.[137] The court held that upon filing of the petition, the real property became property of the bankruptcy estate.[138] As a result, any action to enforce a lien against that property was stayed by the automatic stay provision of § 362 of the Bankruptcy Code.[139] The appellate court also held that the fact that neither the lienholder nor the substitute trustee who conducted the foreclosure sale had notice of the bank-

131. 836 S.W.2d at 151.

132. *Sanchez*, 792 S.W.2d at 531 (quoting RESTATEMENT (SECOND) OF TORTS, §§ 424, 427 (1965)).

133. RESTATEMENT (SECOND) OF TORTS, § 424 (1965).

134. 792 S.W.2d at 531 (relying on RESTATEMENT (SECOND) OF TORTS, § 427 (1965)).

135. RESTATEMENT (SECOND) OF TORTS, § 427 (1965).

136. 836 S.W.2d at 154. In a dissenting opinion, Justice Cook expressed concern that the court's decision creates unwarranted strict liability. 35 Tex. Sup. Ct. J. at 1012 (Cook, J., dissenting).

137. Graham v. Pazos de la Torre, 821 S.W.2d 162, 164 (Tex. App.—Corpus Christi 1992, writ denied).

138. *Id.*

139. *Graham*, 821 S.W.2d at 164. Subsequent to the trial court's ruling on July 3, 1990, the lienholder and substitute trustee obtained an Order Annulling and Modifying the Automatic Stay which specifically annulled and retroactively modified the automatic stay in order to validate the March 6, 1990 foreclosure sale. As a result, the lienholder and substitute trustee attempted to supplement the appellate record with the order. The appeals court refused the supplementation holding that although the appellate rule allows an appellate record to be supplemented concerning omitted matters, it does not allow creation of a new trial court record. 821 S.W.2d at 165; *see* discussion of Larsen v. FDIC, *supra* note 109 and accompanying text.

ruptcy filing was irrelevant.[140]

F. USURY

In *George A. Fuller Co., Inc. v. Carpet Services, Inc.*,[141] the Texas Supreme Court overruled existing case law and held that a pleading containing a demand for usurious prejudgment interest does not make the pleader liable for statutory usury penalties.[142] Carpet Services, Inc. was a subcontractor of the George A. Fuller Company of Texas on a commercial construction project. When Fuller did not pay for work performed by Carpet Services, Carpet Services sued Fuller for breach of contract. The contract between Carpet Services and Fuller specified that Carpet Services was not entitled to payment or interest by Fuller until payment to Fuller by the owner of the project. In its original petition, Carpet Services pleaded for prejudgment interest on the contract debt for a period which began prior to the date on which the owner paid Fuller.

At trial, the court held that the petition of Carpet Services constituted a usurious charge of interest since it demanded interest before amounts owed under the contract were due. In its defense, Carpet Services asserted that it had charged a legal rate of interest, but that the interest claimed was for an improper period. Texas law holds that any interest charged during a period when no interest is due is in excess of twice the legal rate of zero.[143] Concluding that the charge was not the result of accident or bona fide error, the trial court held that Carpet Services must forfeit all principal, interest and other charges. The court also imposed the statutorily imposed minimum penalty of $2,000.[144]

The court of appeals reversed the trial court, holding that a demand for usurious interest in a pleading is not a usurious charge of interest.[145] Prior to this ruling by the Dallas court of appeals, Texas courts of appeals, including Dallas, had held that a statement made in a pleading could constitute a usurious charge of interest.[146]

In affirming the court of appeals, the Texas Supreme Court began with the

140. *Graham*, 821 S.W. 2d at 164. Judge Abel imposed sanctions against an attorney he concluded had willfully and continuously violated the automatic stay. *In re* Leaf River Dev. Corp., Case No. 91-41848-A (Bankr. E.D. Tex., Aug. 4, 1992). There, on behalf of the second lienholder who had notice of the bankruptcy, the attorney attempted to foreclose real property owned by a Chapter 11 debtor. After learning of the purported foreclosure, debtor's counsel asked the attorney to take all actions necessary to undo the attempted foreclosure. The attorney refused.

141. 823 S.W.2d 603 (Tex. 1992).

142. *Id.* at 604.

143. *Id.*

144. *Id.* (relying on TEX. REV. CIV. STAT. ANN. art. 5069 § 1.06(1), (2) (Vernon 1987)).

145. Carpet Servs., Inc. v. George A. Fuller Co., Inc., 802 S.W.2d 343 (Tex. App.—Dallas 1990), *aff'd*, 823 S.W.2d 603 (Tex. 1992).

146. *See* Sumrall v. Navistar Fin. Corp., 818 S.W.2d 548, 553-54 (Tex. App.—Beaumont 1991, no writ); Moore v. White Motor Credit Corp., 708 S.W.2d 465, 468 (Tex. App.—Dallas 1985, writ ref'd n.r.e.); Nationwide Fin. Corp. v. English, 604 S.W.2d 458, 461 (Tex. Civ. App.—Tyler 1980, writ dism'd); Moore v. Sabine Nat'l Bank, 527 S.W.2d 209, 212 (Tex. Civ. App.—Austin 1975, writ ref'd n.r.e.).

language of the applicable statute which imposes penalties on "[a]ny person who contracts for, charges or receives interest which is" greater than a lawful amount.[147] Since the contract did not require usurious interest and no interest was ever received by Carpet Services, the court focused on the meaning of "charge." Because the statute itself is silent with respect to what constitutes a "charge" of interest, the court examined the legislative history. The court found that the statement of legislative intent that accompanied the usury statute contained no indication that the legislature intended for the usury laws to apply to pleadings.[148]

The court also held that a charge must be communicated to the debtor before it is a charge within the meaning of the usury statute.[149] The court held that a claim for prejudgment interest, which is designed to compensate a plaintiff for the delay between his injury and recompense for that injury, arises from the judicial process.[150] As a result, the Texas Supreme Court concluded that pleadings demanding usurious prejudgment interest are best dealt with in the judicial context in which they arise and not through Texas usury laws.[151]

In the *Fuller* opinion, the court makes no reference to *Briones v. Solomon*,[152] where the Texas Supreme Court concluded that the usury statutes are applicable to demands for postjudgment interest. Presumably, the case is distinguishable because in *Solomon*, demands for payment were sent to the judgment debtor by the attorney for the judgment creditor, thereby constituting a "charge." But in the *Solomon* opinion, the court specifically states

147. *Fuller*, 823 S.W.2d at 604 (citing TEX. REV. CIV. STAT. ANN. art. 5069-1.06(1), (2) (Vernon 1987)).

148. *Fuller*, 823 S.W.2d at 604 (relying on Act of May 23, 1967, 60th Leg., R.S., ch. 24, § 1, 1967 Tex. Gen. Laws 609).

149. *Fuller*, 823 S.W.2d at 605.

150. *Id.*

151. *Id.* (citing Gibraltar Sav. v. LD Brinkman Corp., 860 F.2d 1275, 1296 (5th Cir. 1988), *cert. denied*, 490 U.S. 1091 (1989); Fibregrate Corp. v. Research-Cottrell, Inc., 481 F. Supp. 570, 572 (N.D. Tex. 1979)). In his concurring opinion, Justice Mauzy criticized the court's conclusion given the facts before it stating that the court's ruling "has no basis in either the language or the intent of the usury statute; nor is it necessary to the disposition of the case." *Fuller*, 823 S.W.2d at 607 (Mauzy, J., Concurring). Subsequent to the opinion of the Dallas court of appeals, but while the Texas Supreme Court had not yet written or acted upon the granted writ, the Beaumont court of appeals criticized this analysis stating:

> In Texas, creditors have many and varied types of resources to collect debts. . . . Generally, parties have the choice of selecting the route they wish to pursue to gain relief. However, whichever route is chosen is only a procedural method to accomplish a desired result. Demands by a creditor are directed at the debtor, not the procedural method. A judicial system is only one procedural method to resolve disputes or seek relief. Thus, we conclude that in the bankruptcy action, Navistar's demands were on Sumrall, not the bankruptcy court, and that the use of the judicial system was only a procedural means to an end.

Sumrall v. Navistar Fin. Corp., 818 S.W.2d 548, 553 (Tex. App.—Beaumont 1991, no writ) (creditor's filing of stipulation in bankruptcy court containing incorrect information regarding amounts due on time/price differential contracts constituted demand for payment from debtor, not merely demand upon court constituting charge of interest within meaning of Texas usury laws).

152. 842 S.W.2d 278 (Tex. 1991); *see* Sander L. Esserman and Cynthia Johnson Rerko, *Creditor and Consumer Rights, Annual Survey of Texas Law*, 45 SW. L.J. 1553, 1563-64 (1992).

that "defining 'interest' in that manner [characterizing postjudgment interest as interest subject to the usury statutes] is consistent with this court's characterization of prejudgment interest as being for the use of money."[153]

G. DTPA

In *Prudential Insurance Co. v. Jefferson Associates*[154] two years after purchasing an office building in Austin, the purchasers, Jefferson Associates and F.B. Goldman, discovered that certain fireproofing material used throughout the building contained asbestos. In the sale contract, Jefferson and Goldman had expressly agreed that Prudential was selling the facility "as-is." Alleging that the presence of asbestos significantly reduced the building's value, Jefferson and Goldman sued Prudential for fraud, negligent concealment, negligent misrepresentation, and violations of the Texas Deceptive Trade Practices Act.[155] The jury concluded that Jefferson and Goldman sustained actual damages in the amount of $6,023,993.03 and were also entitled to exemplary damages in the amount of $14,300,000.

At trial, Jefferson introduced evidence, including the expert testimony of an appraiser, that the presence of asbestos materially reduces the value of any property. Prudential called no expert witness to testify on actual damages, but many of the Prudential officials who testified stated that it would be appropriate to discount the value of an asbestos-containing facility.

At trial, plaintiffs introduced no direct evidence that Prudential had actual knowledge that the building contained asbestos material. Plaintiffs, however, contended that there was abundant circumstantial evidence from which the jury could impute such knowledge. Such circumstantial evidence included Prudential's failure to turn over the plans and specifications for the building which, if delivered to Jefferson, would have disclosed the use of a fireproofing material with the trade name of MonoKote, a product which sometimes contains asbestos. Prudential argued that its failure to deliver the plans was an innocent mistake without any intent to deceive. The plaintiffs also put on evidence to establish that Prudential recognized that its asbestos containing properties were a serious problem and deliberately withheld that information.[156]

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153. 842 S.W.2d at 280.

154. 839 S.W.2d 866 (Tex. App.—Austin 1992, n.w.h.). Although no writ was filed at the time of this writing, an application requesting an extension of time to file for writ of error was filed on November 10, 1992.

155. Deceptive Trade Practices - Consumer Protection Act (DTPA), TEX. BUS. & COM. CODE ANN. §§ 17.41 - 17.854 (Vernon 1987 & Supp. 1993).

156. This evidence also included a 1979 memo prepared by a Prudential corporate headquarters employee comparing the economic consequences of asbestos contamination with those following the outbreak of Legionaire's disease in downtown Philadelphia; a survey by Prudential of plans and specifications for its buildings in order to determine if any of the buildings contained asbestos; the fact that when the office of General Services Administration of the United States Government submitted an asbestos survey questionnaire to Prudential, Prudential had issued a memo to its leasing and management staff instructing them not to complete the form; articles about public health hazards related to buildings with asbestos were circulated at Prudential headquarters with instructions that the articles were not be circulated outside Prudential; *and* although a Prudential official had drafted a policy proposal for disclo-

An asbestos consultant hired by Goldman issued a report which indicated that the asbestos in the building did not pose a health risk and that the fireproofing was in very good condition. The report further recommended adoption of an operations and maintenance program, the total cost of which was almost $61,000. As a result, Prudential contended that recovery should be limited to $61,000 - the actual damages incurred by plaintiff.

The appellate court observed that Texas courts recognize two methods to measure damages for misrepresentation. One is the "out-of-pocket" measure, which allows an injured party compensation equal to "the difference between the value of that which he has parted with, and the value of that which he has received."[157] The second remedy is known as the "benefit of the bargain" measure and permits the injured party to recover the difference between the "value as represented and the actual value received."[158] The court of appeals considered that there was factually sufficient evidence to support the jury verdict on actual damages and refused to substitute its judgment for that of the jury.[159]

Prudential also argued that even if it had a duty to disclose the presence of asbestos in the building that such duty was contractually eliminated under the "as-is" clause contained in the contract. The appellate court disagreed and held that actionable fraud or DTPA violations create tort liability irrespective of contractual disclaimers and that an "as-is" agreement does not defeat an action for fraud.[160]

A car buyer successfully sued a used car dealer under the Deceptive Trade Practices Act and for violations of the Vehicle Installment Sales Act[161] in *Villareal v. Elizondo.*[162] Walter Elizondo purchased a used car from Joe Villareal in December 1987. Evidence at trial showed that pursuant to negotiations between the parties in Spanish, Villareal agreed that the first car payment would not be due until January 22, 1987. Elizondo signed a note, written in English, which provided for biweekly payments of $65.00.

Elizondo's DTPA claim was based on Villareal's representations that the purchase agreement conferred certain rights and obligations which it did

sure of the existence of asbestos with respect to any building being sold by Prudential, it was redrafted by the chief lawyer of Prudential's real estate department to delete any reference to asbestos. In addition, Prudential officials testified that they felt no obligation to share their knowledge of asbestos dangers with other Prudential employees or potential buyers of Prudential-owned properties which contained asbestos. Evidence also showed that although Prudential had the building plans and specifications, when a representative of the purchasers had asked for the plans and specifications during negotiations, he had been told that none was available. *Prudential*, 839 S.W. 2d at 870-71.

157. *Prudential*, 839 S.W. 2d at 875 (citing George v. Hesse, 100 Tex. 44, 93 S.W. 107 (Tex. 1906)).

158. *Prudential*, 839 S.W. 2d at 875 (citing Johnson v. Willis, 596 S.W.2d 256, 262 (Tex. Civ. App.—Waco), *writ ref'd n.r.e. per curiam*, 603 S.W. 2d 828 (Tex. 1980)).

159. *Prudential*, 839 S.W. 2d at 875.

160. *Id.* at 873. In a footnote, however, the court of appeals conceded that "the sale of property on an "as-is" basis is a long-standing practice that Texas courts have recognized and enforced." *Id.* at 873 n. 6.

161. Motor Vehicle Installment Sales Act, TEX. REV. CIV. STAT. ANN., art. 5069-7.01 (Vernon 1987).

162. 831 S.W.2d 474 (Tex. App.—Corpus Christi 1992, no writ).

not, in fact, confer.[163] Specifically, Elizondo testified that the parties had agreed to postpone the first payment until January 22. Yet Villareal, claiming that Elizondo had missed three payments, repossessed the car on January 20. The appeals court rejected Villareal's assertion that since Elizondo did not show that the contract was based on mistake or fraud or was ambiguous, admission of Elizondo's oral testimony violated the parol evidence rule. The court held that oral representations are admissible and can serve as the basis for a DTPA action.[164] The court also upheld Villareal's liability under the Motor Vehicle Installment Sales Act because although the transaction between Villareal and Elizondo had been conducted in Spanish, Villareal had never supplied Elizondo with a copy of the written contract in Spanish.[165]

H. MISCELLANEOUS

The Texas Supreme Court, in response to a certified question from the United States Court of Appeals for the Fifth Circuit,[166] concluded that a promissory note providing that interest is to be charged at a rate which is determinable only by reference to a "bank's published prime rate," is a negotiable instrument as defined by the Texas Uniform Commercial Code.[167] The court emphasized that when referring to a "bank's published prime rate" the court included only public rates which are either known or readily available to the public.[168]

The Texas Supreme Court held that where summary judgment had been granted in favor of the guarantor of a promissory note, *res judicata* barred a

163. *Id.* at 478 (citing Deceptive Trade Practices - Consumer Protection Act (DTPA), TEX. BUS. & COMM. CODE ANN. § 17.46(b)(12) (Vernon 1987)).

164. *Villareal,* 831 S.W.2d at 478.

165. *Id.* (citing TEX. BUS. & COMM. CODE ANN. art. 5069-7.01 (h-l)(v) (Vernon 1987)). The act does not require that the entire contract be provided in the language in which the transaction was negotiated, but does require that a copy of the notice set forth in art. 5069-7.01 (h-l) (iv) be provided in the language "primarily used in the oral sales presentation." The court of appeals also upheld the jury's award of exemplary damages in connection with the attack on Elizondo by a guard dog on Villareal's premises. *Villareal,* 831 S.W.2d at 478.

166. Ackerman v. FDIC, 930 F.2d 3 (5th Cir. 1991), *certified question accepted sub nom.,* Amberboy v. Societe de Banque Privee, 34 Tex. Sup. Ct. J. 690 (Tex. 1991).

167. Amberboy v. Societe de Banque Privee, 831 S.W.2d 739 (Tex. 1992); Ackerman v. FDIC, 930 F.2d 3, 4 (5th Cir. 1991), *certified question accepted sub nom.,* Amberboy v. Societe de Banque Privee, 34 Tex. Sup. Ct. J. 690.

168. *Amberboy,* 831 S.W.2d at 796. In the case in which the certificate was made, Societe de Banque Privee had purchased investor promissory notes from Vanguard Group International, Inc. The notes had been given in connection with certain individuals' purchase of interests in an oil and gas limited partnership formed by Vanguard. Societe de Banque Privee sued the notemakers, asserting that it was a holder in due course. The note makers contended that the bank was not a holder in due course because the notes were not "negotiable instruments" as defined by the Texas Uniform Commercial Code. Section 3.104(a) of the Texas Business and Commerce Code provides that for a writing to be a negotiable instrument, it must -

> (1) be signed by the maker or drawer; and (2) contain an unconditional promise or order to pay a sum certain in money and no other promise, order, obligation or power given by the maker or drawer except as authorized by this chapter; and (3) be payable on demand or at a definite time; and (4) be payable to order or to bearer.

TEX. BUS. & COM. CODE ANN. § 3.104(a) (Vernon 1968).

subsequent suit against the same individual for his partnership liability on the underlying indebtedness.[169] George Barr and Ron Knott were partners in a general partnership called Bar III Venture. In March, 1985, Bar III executed a promissory note payable to Sunbelt Savings' predecessor in interest. Barr and Knott concurrently executed a personal guaranty of the note. Subsequent to Bar III's default on the note, Sunbelt filed two separate suits on the note. In one suit, Sunbelt sued Barr for personal liability because of his guarantee of the note. In the other suit, Sunbelt sued the partnership as maker of the note and Knott as guarantor. Barr moved for summary judgment on the grounds that the terms of the guaranty were too uncertain to be enforceable and the trial court entered a final, take-nothing judgment.

Sunbelt amended its pleadings in the remaining lawsuit and added Barr as defendant on the basis of his status as a partner. In his answer, Barr asserted *res judicata* with his other defenses. Barr then moved for summary judgment asserting that the take-nothing judgment in the first lawsuit barred the litigation of the claims brought against him in the second lawsuit because those claims arose out of the subject matter of the first lawsuit and involved matters which could have been litigated in the first lawsuit. The trial court granted the motion for summary judgment.

The court of appeals reversed the trial court.[170] The appellate court based its holding on its conclusion that the execution of a promissory note and a guaranty are not a *single* transaction. Because they were not a single transaction, the court held that although Barr had won a take-nothing judgment in his capacity as a guarantor, *res judicata* did not preclude a second suit against Barr in his capacity as a general partner of the obligor on the note.[171]

The Texas Supreme Court reversed the court of appeals and affirmed the judgment of the trial court.[172] In reviewing the doctrine of *res judicata*, the court distinguished *res judicata*, which it referred to as claims preclusion, from *collateral estoppel*, which it referred to as issue preclusion.[173] Relying on the Restatement of Judgments and the Texas Rule of Civil Procedure with respect to compulsory counterclaims, the court adopted a transactional approach to *res judicata*.[174] The court observed that the execution of the guaranty and promissory note were part of the same transaction, that in both suits, the bank sought to hold Barr primarily liable, that the amount of damages sought against Barr in each suit was the same and that the proof which would be required in each lawsuit was also the same.

On this basis, the court held that there was "no valid reason to subject Barr to two lawsuits."[175] The court concluded by holding that a subsequent suit will be barred if it arises out of the same subject matter as a previous suit

169. Barr v. Resolution Trust Corp., 837 S.W.2d 627 (Tex. 1992).
170. Sunbelt Savings, FSB v. Barr, 824 S.W.2d 600, 604 (Tex. App.—Dallas 1991), *rev'd sub nom.*, Barr v. Resolution Trust Corp., 837 S.W.2d 627 (Tex. 1992).
171. *Id.*
172. *Barr*, 837 S.W.2d at 631.
173. *Id.* at 628.
174. *Id.* at 629.
175. *Id.* at 630.

and could have been litigated in a prior suit.[176]

176. *Id.*