Bankruptcy and Creditors' Rights

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Recommended Citation
https://scholar.smu.edu/smulr/vol57/iss3/5

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THE authors have attempted to limit the reported cases to those involving state law, developments in enforcement of the debtor-creditor relationship, or cases that might not otherwise be addressed in a conventional bankruptcy survey. This is not an exhaustive survey of bankruptcy developments, but rather an update regarding cases

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of interest to the Texas-based debtor-creditor practitioner.¹

II. BANKRUPTCY IN THE SUPREME COURT

A. DISCHARGEABILITY—SETTLED FRAUD CLAIMS

In *Archer v. Warner*,² the United States Supreme Court addressed whether the unpaid portion of a fraud claim, later the subject of a compromise settlement agreement, remains non-dischargeable in a subsequent bankruptcy.³

Archer originally sued Warner for fraud in the sale of a business. That lawsuit was settled, and broad releases were executed; however, part of the consideration was Warren's payment of $100,000 to Archer, evidenced by a promissory note. The state court case was dismissed with prejudice.⁴

Warner defaulted under the note, and Archer sued to enforce it. Warner filed Chapter 7 bankruptcy. Archer sought to have the debt evidenced by the note held non-dischargeable under Section 523(a)(2)(A). The Fourth Circuit found that the settlement agreement and release was essentially a novation that replaced the old fraud-related debt with a new contractual obligation, which would be dischargeable in bankruptcy.⁵

The Supreme Court reversed, however, finding the remaining debt evidenced by the note to be non-dischargeable. Although the settlement agreement “completely addressed and released each and every underlying state law claim,” the agreement nevertheless left a debt owing, the origin of which was Warner's fraud.⁶ Even acknowledging “a kind of novation,” the Court found Archer was not barred from showing that the settlement debt arose out of “false pretenses, a false representation, or actual fraud, in which event the debt would nevertheless remain non-dischargeable under Section 523(a)(2)(A).”⁷

At least one circuit court has applied *Archer v. Warner* in another dis-

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5. *Id.* (the Court of Appeals opinion is found in *In re Warner*, 283 F.3d 230 (4th Cir. 2002)).
6. *Id.* at 318-19.
7. *Id.* at 323. The majority opinion relied on its earlier decision in *Brown v. Felsen*, 442 U.S. 127, 130 (1979), in which a consent decree and stipulation was entered in state court. The Supreme Court held that collateral estoppel and claim preclusion issues arising from the consent decree notwithstanding, the bankruptcy court was not precluded from looking beyond the record of the state court proceeding (i.e., the consent decree) to determine whether the underlying debt was for money obtained by fraud.
The settlement in *In re DeTrano* was embodied in an agreed judgment; however, the court did not apply claim or issue preclusion principles to block consideration of the dischargeability of the underlying claim.9

Similarly, in *In re Williams*, the Fifth Circuit reiterated in a Section 523(a)(6) context that the dischargeability of a debt was not litigated in a prior district court case. In a subsequent bankruptcy, however, the claim was found non-dischargeable.11

Two observations can be made as a result of these cases. First, to contract away a potential Section 523(a) claim (assuming it can be done), the drafter must call it what it is. In other words, any settlement agreement should contain an express acknowledgment of the potential Section 523(a) claim and the fact that it is being released. A covenant not to sue, with specific reference to dischargeability in a future bankruptcy, should also be included.

Second, state court practitioners may have a bit less to be concerned about regarding potential claim or issue preclusion issues in a later bankruptcy. Although specific issues actually litigated in state court actions (e.g., fraud or the like) may have consequences in a subsequent dischargeability proceeding, in the absence of actual litigation of that issue, it is quite possible for a state court claim to run its course while dischargeability is preserved.12

**B. SIXTY DAY SECTION 727 COMPLAINT DEADLINE NOT JURISDICTIONAL**

Under the Bankruptcy Rules, a creditor has sixty days after the date first set for the first meeting of creditors to file a complaint either seeking the dischargeability of certain indebtedness (Section 523) or objecting to the debtor’s discharge (Section 727). *Kontrick v. Ryan* addressed a complaint filed under Section 727, implicating Bankruptcy Rule 4004(a), which governed the sixty-day time period for a Section 727 complaint,

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8. *In re Detrano*, 326 F.3d 319 (2d Cir. 2003) (settlement of Section 523(a)(4) claim embodied in agreed judgment still left open the non-dischargeable nature of the underlying claim).
9. *Id.* at 322-23. Relying on *Archer* and *Brown*, the court stated: Congress also intended to allow the determination whether a debt arises out of fraud to take place in bankruptcy court, not to force it to occur earlier in state court when non-dischargeability concerns “are not directly in issue and neither party has a full incentive to litigate them.”
11. *In re Williams*, 337 F.3d 504 (5th Cir. 2003).
and Rule 4004(b), which addresses extensions of that time period.\textsuperscript{14}

In \textit{Kontrick}, the plaintiff creditor filed an amended complaint, with leave of court, but well outside of any original or extended deadline under Rule 4004. The amended complaint apparently added a new claim, which was not in the original pleading. The creditor moved for summary judgment, in response to which Kontrick moved to strike certain portions of the summary judgment pleadings. Significantly, Kontrick did not initially address the new allegations in the amended complaint; rather, Kontrick’s only pre-disposition action pertained to summary judgment pleadings and not the late filed amendment. Only after an adverse ruling on the merits did Kontrick raise the issue of the new allegations in the amended complaint.\textsuperscript{15}

A unanimous Supreme Court affirmed the decision of the Seventh Circuit Court of Appeals holding the time constraints pursuant to a procedural rule were not jurisdictional issues. Therefore, the debtor waived his right to assert the untimeliness of the amended complaint by waiting until after adjudication on the merits. With the rule non-jurisdictional in nature, Kontrick was effectively left with an affirmative defense, which was waived by not having been asserted in a timely defensive pleading.\textsuperscript{16}

\section*{C. Other Pending Matters}

As of the end of the Survey period, other bankruptcy issues were pending before the United States Supreme Court. Of particular practical interest is \textit{Till v. SCS Credit Corp.},\textsuperscript{17} which should address the appropriate measure of the “cram down” rate of interest for a secured claim in a contested Chapter 13 plan. Other pending matters include compensation of debtor’s counsel from Chapter 7 estate funds, finance charge disclosures under the Truth in Lending Act, and qualification as an ERISA

\begin{footnotes}
\item[14] \textsc{Fed. R. Bankr. P. 4004(a), (b)}. The bankruptcy court may extend the sixty day period “for cause” on a motion “filed before the time has expired.” \textit{Id.}
\item[15] \textit{Kontrick}, 124 S. Ct. at 918.
\item[16] \textit{Id.} at 910. As the Supreme Court noted:

\begin{quote}
[I]t is axiomatic that such rules do not create or withdraw federal jurisdiction [citations omitted]. As Bankruptcy Rule 9030 states, the Bankruptcy Rules “shall not be construed to extend or limit the jurisdiction of the courts.” \textit{Id.} at 914.
\end{quote}

\textit{Kontrick} also noted that such procedural rules serve three purposes:

\begin{quote}
First, they inform the pleader, i.e., the objecting creditor, of the time he has to file a complaint. Second, they instruct the court on the limits of its discretion to grant motions for complaint-filing-time enlargements. \textit{Third, they afford the debtor an affirmative defense to a complaint filed outside the Rules 4004(a) and (b) limits.} This case involves the third office of the rules. \textit{Id.} at 916 (emphasis added). The Court did not address whether and to what extent such a procedural rule “could be softened on equitable grounds.” \textit{Id.} Apparently, lower courts are divided on whether Rules 4004 and 4007 (Section 523 complaints) allow equitable exceptions.
\end{quote}

\item[17] For the lower court opinion, \textit{see In re Till}, 301 F.3d 583 (7th Cir. 2002) (cert. granted).
\end{footnotes}
III. BANKRUPTCY AND HOMESTEAD ISSUES IN THE FIFTH CIRCUIT

A. DISCHARGEABILITY—WILLFUL AND MALICIOUS INJURY

In *In re Williams*, the Fifth Circuit addressed the non-dischargeability of damages resulting from a willful and malicious injury in the context of an intentional breach of contract and a subsequent violation of a court order. Section 523(a)(6) provides that a debt is non-dischargeable to the extent it arises out of a "willful and malicious injury by the debtor to another entity or to the property of another entity." According to the Supreme Court, Section 523(a)(6) applies to "acts done with the actual intent to cause injury," but it excludes intentional acts that result in unintended injury.

Following the Supreme Court's lead, the Fifth Circuit has held that for Section 523(a)(6) to apply, "a debtor must have acted with 'objective substantial certainty or subjective motive' to inflict injury." The Fifth Circuit further created an "implied malice" standard when a debtor acts "with the actual intent to cause injury." The test for willful and malicious injury, therefore, has been condensed by the Fifth Circuit into "a single inquiry of whether there exists 'either an objective substantial certainty of harm or a subjective motive to cause harm' on the part of the debtor."

In *Williams*, the debtor had violated the terms of a union collective bargaining agreement. The violation was apparently intentional; however, the court was not satisfied that the debtor actually knew the nature, extent, or certainty of any injury or damage arising out of the violation. The court held that with the lack of that knowledge or substantial certainty of injury, the court discharged the debt arising from the initial contractual breach.

A part of the union's claim, however, arose out of the debtor's subsequent violation of an agreed judgment and decree issued by a federal district court. After an audit determined that the restitution the debtor owed for non-compliance with the agreed judgment and decree, the district court awarded a judgment for that amount (effectively finding Williams in contempt). The court found that the debtor's contempt rose to the level of a willful and malicious injury, noting that "failure to obey a

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22. *Williams*, 337 F.3d at 508-09 (citing *In re Miller*, 156 F.3d 598, 603 (5th Cir. 1998)).
23. *Id.* at 509 (citing *Kawaauhau*, 523 U.S. at 61-62).
24. *Id.* at 510-11.
court order constitutes willful and malicious conduct, and a judgment against a defiant debtor is excepted from discharge."25

Arguably, Williams may not mean that all damages arising out of contempt or violation of a court order are per se non-dischargeable. Although the court provided an extensive analysis in support of its ruling on the initial breach of contract, there was no separate analysis in support of its conclusion on the contempt portion of the claim. However, notwithstanding its lack of support, the court made it clear that "[c]ontempt may be characterized as an act resulting in intentional injury."26

B. DISCHARGEABILITY OF STUDENT LOANS

Section 523(a)(8) of the Bankruptcy Code governs dischargeability of student loans, which are generally non-dischargeable unless they would "impose an undue hardship on the debtor and the debtor's dependents."27 The Fifth Circuit addressed this issue in In re Gerhardt.28 In addressing this issue for the first time, the Fifth Circuit adopted the test first applied by the Second Circuit in In re Brunner.29 The so-called Brunner test requires a three part showing by the debtor:

1. That the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans;
2. That additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
3. That the debtor has made good faith efforts to repay the loans.30

Mr. Gerhardt was described as a healthy, forty-three-year-old professional musician with a masters degree and who was the principal cellist for the Louisiana Philharmonic Orchestra (he also supplemented his income as a cello teacher). Applying the Brunner test, the court acknowledged that the debtor's monthly expenses exceeded his monthly income and that he did not have the present ability to maintain a minimal standard of living if forced to repay the loan. Thus, the debtor satisfied the first component of the Brunner test. The second prong (persisting state of affairs) was the debtor's weakness. The court found that the debtor could "teach full time, obtain night-school teaching jobs, or even work as

25. Id. at 512 (citing In re Allison, 176 B.R. 60, 64 (Bankr. S.D. Fla. 1994)).
26. Id.
28. In re Gerhardt, 348 F.3d 89, 91 (5th Cir. 2003). At the outset, the Fifth Circuit recognized that whether to apply a de novo review to the undue hardship determination was a matter of first impression in the Fifth Circuit. Following other circuits, the Fifth Circuit determined that this question of dischargeability is a question of law subject to de novo review. Id.
29. Id. (citing Brunner v. N.Y. State Higher Educ. Servs. Corp., 831 F.2d 395, 396 (2d Cir. 1987) (emphasis added)). Other circuits have adopted the Brunner test. See, e.g., In re Cox, 338 F.3d 1238, 1241 (11th Cir. 2003); In re Saxman, 325 F.3d 1168, 1173 (9th Cir. 2003). See also In re Blair, 301 B.R. 181, 184 (Bankr. D. Md. 2003).
30. Gerhardt, 348 F.3d at 91 (quoting Brunner, 831 F.2d at 396). The debtor bears the burden of proof on each of the Brunner elements. Id.
a music store clerk.” Noting the potential avenues for additional income, the court found that there was no reason beyond the debtor’s control that would perpetuate his inability to repay his student loans. The court also found that nothing in the Bankruptcy Code provided a debtor with a pre-existing right to work only in a certain field or intentionally remain in a low-paying job and yet still claim an undue hardship to repay student loans.

As to the third prong of the Brunner test (efforts to repay the loan), the debtor had virtually nothing to show the court. Although the court did not actually reach the third prong, it seemed to emphasize that the debtor had repaid only $755 of a $77,000 student loan debt, and found the debt non-dischargeable.

This case is indicative of a number of recent court decisions addressing this undue hardship exception to non-dischargeability of student loans. In the absence of any statutory change, it is unlikely that the approach taken by the Fifth Circuit will change anytime soon, and it is consistent not only with the other circuit court opinions cited above, but with earlier bankruptcy court decisions from Texas-based bankruptcy courts.

Student loan cases produce results that can seem (and may indeed be) harsh from the debtor’s perspective and also come at the expense of private sector creditors. For better or worse, these courts are doing no more than applying what they perceive to be the clear congressional intent contained in the statute, and any change will need to come from Congress.

That said, a less restrictive application of the Brunner test may be developing, at least in other circuits. A practice pointer: A common circumstance in many of the cases is the debtor’s apparent disregard for what is embodied in the third prong of the Brunner test. Many of the unsuccessful debtors came into the bankruptcy court with no evidence of any effort to repay their student loans. This was apparent in both Gerhardt and in In re Hollins (an earlier case out of the Northern District

31. Id. at 92.
32. Id. at 92-93. “Our analysis of the second Brunner prong inevitably overlaps to some degree with the third prong…” Id. at 92 n.3.
33. See, e.g., In re Murphy, 282 F.3d 868, 873 (5th Cir. 2002) (use of student loan proceeds for living expenses did not affect non-dischargeability under 523(a)(8)); In re Hollins, 286 B.R. 310, 316 (Bankr. N.D. Tex. 2002) (debtor could not maintain minimal standard of living, but failed to establish inability to make payments in the future or that she made good faith efforts to repay student loans).
34. For an example of the potentially harsh results that can befall a debtor, see In re Wetzel, 213 B.R. 220, 225-26 (Bankr. N.D.N.Y. 1996) (woman suffering from fibrocystic breast disease, also the single mother of an autistic child, only allowed to discharge a portion of her student loan debt). For a critical commentary of Section 523(a)(8), see B.J. Huey, Comment, Undue Hardship or Undue Burden: Has the Time Finally Arrived for Congress to Discharge Section 523(a)(8) of the Bankruptcy Code?, 34 Tex. Tech. L. Rev. 89 (2002); see also Jennifer L. Frattini, The Dischargeability of Student Loans: An Undue Burden?, 17 Bankr. Dev. J. 537 (2001) (comments upon In re Wetzel).
35. See, e.g., In re Polleys, 356 F.3d 1302, 1309 (10th Cir. 2004) (Brunner “must be applied such that debtor, who truly cannot afford to repay their loans may have their loans discharged”); see also In re Long, 322 F.3d 549, 554 (8th Cir. 2003) (“totality of the circumstances” test less restrictive than Brunner).
of Texas). Whether this actually impacts the results of these or similar cases is pure speculation; however, regardless of which test is applied, the bankruptcy court is ultimately left with a difficult judgment call, and a debtor who has made good faith efforts to repay his or her student loan before seeking bankruptcy relief should certainly be in a better position than the debtors in some of these cases.

C. RURAL HOMESTEADS IN TEXAS

The Fifth Circuit issued two opinions addressing the Texas rural homestead, which generally allows Texas debtors to claim up to 200 acres of property “used for the purposes of a rural home. . . .”

In In re Bouchie, the debtor claimed approximately eighty-five acres of property as rural homestead, which the trustee and a trade creditor asserted was urban in nature and therefore limited to ten acres. The court had to determine the applicable test to use, given both historical developments in the common law and more recent amendments to the Texas Property Code. Historically, courts applied a multiple-factor test first adopted in United States v. Blakeman, and cases arising since Blakeman had even applied a bifurcated test, which was a combination of an analysis under the Texas Property Code combined with application of the so-called Blakeman test.

In 1999, Section 41.002 of the Texas Property Code was amended to provide a more detailed statutory framework for determining when a property is “urban.” Although the statute did not expressly state that it was an exclusive test, the Bouchie court found that this most recent amendment left no room for the Blakeman test or other common-law schemes. Rather, Section 41.002 was found to be “the exclusive vehicle for distinguishing between rural and urban homesteads.”

Exclusive application of the Property Code amendments was not the only issue addressed by the Bouchie court. The objecting creditor also asserted that the bankruptcy court erred in not requiring the debtor to show that the land was used “for rural purposes.” The Fifth Circuit easily disposed of this issue, stating that under Texas law, “all that is required for rural homestead purposes is that the property be used as a home.”

36. Hollins, 286 B.R. at 310.
37. TEX. PROP. CODE ANN. § 41.002(b) (Vernon Supp. 2004).
38. In re Bouchie, 324 F.3d 780 (5th Cir. 2003).
40. In re Perry, 267 B.R. 759, 766 (Bankr. W.D. Tex. 2001) (vacated on other grounds by In re Perry, 345 F.3d 303 (5th Cir. 2003)).
41. Section 41.002 lists certain factors, such as location of the property within a municipality or its extraterritorial jurisdiction and service by police or fire protection and certain utilities. If the property meets those criteria, then it is considered urban. TEX. PROP. CODE ANN. § 41.002 (c) (Vernon Supp. 2004). Under Bouchie, if the property does not meet those criteria, then it is considered rural, and that is the end of the inquiry.
42. Bouchie, 324 F.3d at 785.
43. Id. at 786. The court essentially disregarded an earlier Western District bankruptcy court case. The court declined to follow In re Spencer, 109 B.R. 715 (Bankr. W.D. Tex.
The same three judge panel addressed another rural homestead claim in *In re Perry*. The facts in *Perry* were somewhat more complicated, including the debtor’s earlier conveyance of a twenty-six acre tract to a wholly-owned corporation in anticipation of a bank loan some years earlier. The court found that the earlier conveyance was not a sham, and that record title to the property remained in the corporation. The debtor was, however, found to maintain a possessory interest in the twenty-six acre tract as an at-will tenant, which was sufficient to maintain a very limited possessory homestead claim to the extent of the at-will tenancy.

In *Perry*, the debtor used the twenty-six acre tract, along with an adjoining fifty-six acre tract, for the operation of a mobile home and RV park, including related sewage treatment and recreation facilities. The debtors lived on a 1.3 acre tract within the twenty-six acre tract. The bankruptcy court found that the debtor had forfeited his homestead protection to all but the 1.3 acre home tract because of his operation of a commercial business on the property. The Fifth Circuit disagreed, because the only fundamental requirement, as most recently stated in *Bouchie*, was that the rural homestead must be “used for the purposes of a rural home.”

As a practical matter, rural homesteads had always been used not only as a place for a home but also for the operation of a business, albeit agrarian in nature. In effect, farming or ranching activity was tantamount to operating a business. According to *Perry*, the historical purpose of all homestead exemptions “has been to protect not only the home, but also the property that enables the head of the household to support the family.”

As noted in *Bouchie*, the Texas Supreme Court had not yet been presented with this combination of a rural resident using his rural (homestead?) property for non-agricultural business purposes. Based in part on the historical analysis of *Perry*, however, this is not much of a departure from the historically agrarian uses in older cases, and the court allowed the homestead claim.

The court remanded the case to the bankruptcy court for a determination of whether and to what extent the operation of the mobile home and RV park constituted an abandonment of all or a portion of the claimed

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1989), which the Fifth Circuit described as “an outlier,” which had never been relied upon by any other bankruptcy court in the Western District. *Bouchie*, 324 F.3d at 786.

44. *In re Perry*, 345 F.3d 303 (5th Cir. 2003).

45. *Id.* at 315. This homestead interest would remain good against all general creditors; however, this claim was essentially subject to the whim of the present or any subsequent owner or other person with better title to the property, because of the at-will nature of the underlying tenancy. See, e.g., *Cleveland v. Milner*, 170 S.W.2d 472, 475 (Tex. 1943).

46. *Perry*, 345 F.3d at 316.

47. *Id.* at 317.

48. *Id.* at 318. The court noted, however, that had the RV park been separated from the residence, the case would have been decided differently. Apparently, the doctrine that “property that is separated from the land on which the claimant resides must be used principally for the purposes of the home if it is to be included in a claimant’s rural homestead” is still alive. *Id.* at 318 n.22.
homestead. Arguably, the debtors not only operated a business on the property, but much of the property was actually rented to other non-family persons over the years of the park's operation. Noting that abandonment is an affirmative defense, however, the court placed the burden of carrying the abandonment issue on the objecting creditor.49

IV. BANKRUPTCY COURT CASES

A. NON-DEBTOR GUARANTORS—TEMPORARY INJUNCTION

In In re Bernhard Steiner Pianos USA, Inc.,50 a Northern District of Texas bankruptcy court considered whether it could confirm a Chapter 11 plan providing for a limited injunction in favor of a non-debtor guarantor.51 The debtor dealt in the sale, servicing, and consignment of both new and used pianos. The debtor's president individually guaranteed loans to certain floor plan lenders, and as of the bankruptcy filing, those floor plan loans had not been repaid. Prior to plan confirmation, the floor plan lenders had obtained relief and had repossessed their collateral still on hand at the debtor.

Thereafter, the debtor filed a Chapter 11 plan contemplating repayment to all of his creditors in full, including the floor plan creditors, who by that time, were unsecured creditors with deficiency claims. The debtor's plan classified consignment creditors separately from the general unsecured creditors and proposed to pay those consignment creditors on an expedited basis. The floor plan creditors objected to the plan on two bases: First, the plan improperly classified consignment creditors separately from other unsecured creditors and proposed to pay them more quickly. Second, the plan provision that the only remedy for payment of the floor plan lenders' unsecured debt (for so long as the Plan was not in default) would be the Plan payments proposed, was an improper injunction recovery from the non-debtor guarantor.52

The bankruptcy court held that the debtor had presented a sound business reason for the separate classification, because the debtor's undisputed testimony was that development of future consignment business was critical to its successful reorganization, and without expediting payment to consignment creditors, the debtor could not get any new consignment business.53

Turning to the non-debtor guarantor issue, the Court found that the plan proposed that the guarantor was not discharged or released from any liability under the plan, and therefore, the plan did not purport to

49. Id. at 319-20.
51. Id. Generally, in a bankruptcy case, a plan of reorganization cannot be confirmed if it releases guarantors of a debtor's debt and a creditor objects to the release. See Republic Supply Co. v. Shoaf, 815 F.2d 1046, 1050 (5th Cir. 1987).
53. Id. at 114. The court further held that no evidence of gerrymandering had been offered at the confirmation hearing.
grant a release to a non-debtor third party. Further, the bankruptcy court found that nothing in the plan affected the guarantor's ultimate liability under the guarantee agreement; it merely controlled the timing of when a claim, if any, against the guarantor could be brought.\(^{54}\)

The debtor effectively requested something more akin to a temporary injunction, which could be allowed under unusual circumstances, as opposed to a permanent injunction, which would be prohibited under the Fifth Circuit's ruling in *Feld v. Zale Corp.* (In re Zale Corp.).\(^{55}\) The *Bernhard Steiner* court found that the plan, as modified at confirmation, did not affect the guarantor's ultimate liability to the objecting creditors because the objecting creditors were being repaid in full. The tolling of limitations on the causes of action against the guarantor pending the repayment preserved any causes of action for the objecting parties, and the debtor's undisputed testimony was that the guarantor was the sole director and driving force behind the success or failure of the debtor's business.\(^{56}\) As a result, if the debtor was forced to defend state court lawsuits, it would be a considerable drain on his resources, which could be better used to navigate the debtor's day-to-day business efforts. Thus, the totality of the circumstances and criteria required under *Zale* had been met.\(^{57}\)

### B. Homesteads & Exemptions

Another interesting twist in the continuing homestead litigation saga was reviewed in *In re Brown*,\(^{58}\) in which the court had to consider whether the debtors, whose primary residence was on a Texas military base, could exempt their interest in a Florida vacation timeshare as their homestead under 11 U.S.C. § 522(d)(1). The Chapter 13 trustee objected to the exemption contending that the timeshare could not constitute a residence for purpose of the federal exemption. The court started with a finding that the Code did not define the term "residence," but that the legislative history of the Code showed that the section did intend to provide debtors with a homestead exemption. The court then turned to Florida law on homestead exemptions, which is fairly similar to Texas law, and requires the establishment of a homestead by actual intention to live permanently in a place, coupled with actual use and occupancy. The timeshare did not fit within the definition of a homestead established by Florida courts because the debtors maintained their permanent residence on a Texas military base, and had neither intention nor ability to change their permanent residence to the timeshare, which they could occupy only for a limited time period each year.\(^{59}\)

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54. *Id.* at 116.
55. *In re Zale Corp.*, 62 F.3d 746 (5th Cir. 1995); *see, e.g., In re Seatco, Inc.*, 257 B.R. 469 (Bankr. N.D. Tex. 2001) (temporary injunction allowed).
56. *Bernhard Steiner*, 292 B.R. at 117.
57. *Id.* at 117-18.
59. *Id.* at 427-28.
A case that shows that creditors and trustees should review a debtor's exemption claims closely is found in *In re Martinez.* The debtors filed their case under Chapter 13 and listed in their schedules as exempt a personal injury claim. They listed the estimated market value of the claim to be $10,000 and claimed 100% of the value of the exemption, as opposed to attempting to exempt a specific amount. The debtors included a similar description of that claim in their Schedule B of personal property, showing it as a contingent and unliquidated claim with an estimated value of $10,000.

After the deadline for objection to exemptions under Bankruptcy Rule 4003, the claim was settled for $23,000. The debtors moved for approval of the settlement and authorization of disbursements. The Chapter 13 trustee objected to the settlement because the exemption was limited to the debtors' estimate of the value of the claim in their schedules and that no disbursement of proceeds was allowable whether the funds were exempt or non-exempt, because the funds constituted additional disposable income which had to be used in funding the debtors' plan.

The court determined that the debtors, having claimed 100% of the asset as exempt, were entitled to the full amount that was recovered, further determining that the $10,000 stated value of the personal injury claim was merely an estimate. Once it had made the determination that the full amount of the settlement proceeds were exempt, the court logically found that it was not part of the estate. Because the claim was excluded from the estate, the court determined that it had no authority over distribution of the proceeds nor jurisdiction to hear or determine the settlement motion.

Obviously, diligent creditors should scrutinize debtors' schedules closely to make sure they do not try to use this "estimate" and percentage method to exempt more than they would be entitled to under the Code.

C. Chapter 13—Early Lien Release

An area in which there appears to be a conflict in decisions not only between bankruptcy judges in different districts in Texas, but even within the same district, is the issue of early release of a lien in a Chapter 13 bankruptcy upon payment of the secured portion of a claim before completion of the plan.

One of the most recent decisions in the area is *In re Day,* which came out of the Northern District of Texas. Ford Motor Credit Company ("FMCC") objected to confirmation of the debtor's Chapter 13 plan and specifically objected to the plan provision that required FMCC to release its lien upon full payment of the stated value of the collateral, which was

60. *In re Chaparro Martinez,* 293 B.R. 387 (Bankr. N.D. Tex. 2003).
61. *Id.* at 388.
62. *Id.* at 388-89.
63. *Id.* at 389-90.
scheduled to occur after forty-seven months of the debtor's fifty-eight-month plan. This would have required FMCC to release its lien prior to plan completion and the debtors' receipt of their discharge.\textsuperscript{65}

The \textit{Day} court reviewed \textit{In re Thompson} and \textit{In re Gray}, prior cases in the Northern District of Texas, which had reached conflicting results on this issue.\textsuperscript{66} The \textit{Day} court opined that the \textit{Thompson} court had held that a Chapter 13 plan was a "new contract," containing bilateral covenant considerations, and recognized that if the debtor's case was dismissed prior to completion of the plan payments and discharge, Section 349(b) worked to unravel the bankruptcy in the Code's attempt to leave the parties as it found them. In that situation, upon dismissal of a debtor's Chapter 13 bankruptcy case, title to the collateral would revest in the debtor and the secured parties' interest in the property revests in the secured creditor. Thus, if the lien could be released prior to discharge, this would potentially frustrate revesting of the pre-bankruptcy rights of the parties, and the creditor's lien in the collateral could possibly be prevented from being reinstated if the debtor sold the property to a third party between the time a lien could be forced to be released and dismissal of the debtor's case.\textsuperscript{67}

The \textit{Day} court opined that \textit{Gray} had started within the premise that lien stripping was available in Chapter 13 cases. The \textit{Gray} court then reviewed Section 1325 of the Code, which generally provides that the plan must comply with provisions of the Code. Next, the \textit{Gray} court used Section 1322(b)(10), which allows any plan provision "not inconsistent" with the Code, to conclude that the Code allows confirmation of a plan that contains a lien release provision. This conclusion was based on reading together Section 1322(b)(a), which permits vesting of property with the debtor on confirmation, with Sections 1327(a)-(b), which provide that, except as otherwise stated in the plan, property vests in the debtor free and clear of liens. In addition, the \textit{Gray} court had addressed Sections 1322(b)(2) and 1325(a)(5)(B), as well as Section 506, and found that they contained nothing that prohibited a provision requiring a release of lien upon payment of the secured portion of a claim. Finally, the \textit{Gray} court found that neither Section 1328, which addresses Chapter 13 discharges, nor Section 349, which addresses the effect of a case dismissal, prohibited a lien release provision.\textsuperscript{68}

The \textit{Day} court indicated that both of the earlier opinions were persuasive, but the court ultimately sided with \textit{Thompson}, holding that a provi-

\textsuperscript{65} \textit{Id.} at 134. Unlike a Chapter 11, a Chapter 13 discharge is typically granted only upon successful completion of a debtor's plan obligations. 11 U.S.C. § 1328(a) (2000).

\textsuperscript{66} \textit{Compare In re Thompson}, 224 B.R. 360, 367 (Bankr. N.D. Tex. 1998) (holding that a secured creditor could not be forced to release its security interest until all payments were made by the debtor under the Plan and the debtor had received a discharge) \textit{with In re Gray}, 285 B.R. 379, 389 (Bankr. N.D. Tex. 2002) (finding no prohibition in the Code included in the Chapter 3 plan of provision requiring release of a secured creditor's lien upon satisfaction of the secured claim).

\textsuperscript{67} \textit{Day} 292 B.R. at 135 (citing \textit{Thompson}, 224 B.R. at 366-67).

\textsuperscript{68} \textit{Id.} at 135-36 (citing \textit{Gray}, 285 B.R. at 386-89).
sion requiring a lien release prior to completion and discharge was inconsistent with the Code.\textsuperscript{69} The Day court also held that neither of the prior decisions had addressed whether the property at issue was exempt property, questioned whether Section 349 was even applicable, or whether in the case of such exempt property, the court should instead look to Section 522(c).\textsuperscript{70}

Accordingly, the Day court held that a debt, which incorporates both secured and unsecured portions claim, did not go away in a Chapter 13 case until a discharge was granted which, in turn, occurred only upon completion of the Chapter 13 plan.\textsuperscript{71} While debtor and creditor could certainly agree that the creditor would release its lien upon payment of the secured portion of its claim in return for a shorter payout, the Code could not be construed to allow, over a creditor's objection, a provision requiring release of lien upon payment of the secured portion of the claim and before completion of the plan and granting of discharge to the debtor.\textsuperscript{72}

Another thoughtful opinion on this issue, coming out of a Western District of Texas Bankruptcy Court, is \textit{In re Smith},\textsuperscript{73} in which bankruptcy judges King and Clark confirmed a number of Chapter 13 plans conditioned upon the deletion of early lien release provisions.\textsuperscript{74}

\textbf{D. State Law—Limitations on Real Estate Lien Debt}

Section 16.035 of the Texas Property Code provides the statute of limitations for the enforceability of a lien against real property. In short, the limitations period is four years from the date the cause of action accrues, which typically means the date of maturity of the debt secured by the real property. This limitation extends to the exercise of a power of sale in a deed of trust, which likewise must be made not less than four years after maturity.\textsuperscript{75}

Upon expiration of the four year limitations periods, "the real property lien and a power of sale to enforce the real property lien become void."\textsuperscript{76} Section 16.036 provides the exclusive means by which a real property lien may be extended in order to remain enforceable under the limitations period. Essentially, any extension agreement must be in writing, signed

\textsuperscript{69} Id. at 136.
\textsuperscript{70} Id. (citing 11 U.S.C. §522(c)(2)(A) which states that property is not generally liable for pre-petition debts of the debtor except debt secured by a lien against the exempt property).
\textsuperscript{71} Id. at 137 (citing 11 U.S.C. § 1328(a) (2000)).
\textsuperscript{72} Id. at 138.
\textsuperscript{73} In re Smith, 287 B.R. 882 (Bankr. W.D. Tex. 2002).
\textsuperscript{74} Id. at 884-88. "What is different in Chapter 13, however, is that the debtor's discharge is delayed until the debtor completes the plan. 11 U.S.C. § 1328(a). Indeed, most of the benefits of the Chapter 13 process are deferred until completion of the debtor's plan." Id. at 885.
\textsuperscript{75} TEX. CIV. PRAC. & REM. CODE ANN. § 16.035 (Vernon Supp. 2004).
\textsuperscript{76} Id. § 16.035(d).
by the parties, acknowledged, and recorded.\textsuperscript{77}

In \textit{In re Tilton},\textsuperscript{78} the debtor and a lender executed one or more written extension agreements; however, the most recent extension had not been recorded, and from the state of the public record, the maturity date appeared to be December 21, 1995. On June 7, 2001 (over four years after maturity of the last recorded extension), the obligor filed for Chapter 7 relief. The Chapter 7 trustee sought to avoid the bank’s lien because it appeared of record to be barred as of the petition date. This was based upon the trustee’s status of a hypothetical judicial lienholder or a bona fide purchaser, who, under state law, could rely on the state of the record and assume that the lien had become void.\textsuperscript{79}

The court held for the trustee, concluding that limitations applicable to real estate debt in Texas runs from the maturity date of the note, and where a renewal agreement is not recorded, it is void as against a bona fide purchaser, including a bankruptcy trustee. The court found that the bank’s lien was void and of no force and effect against the trustee as of the petition date.\textsuperscript{80}

\section*{V. OTHER CREDITORS’ RIGHTS CASES}

\subsection*{A. Texas Foreclosure Practice}

\subsubsection*{1. Duties of a Substitute Trustee}

In \textit{Powell v. Stacy},\textsuperscript{81} the Fort Worth Court of Appeals reviews the practical realities of foreclosing a deed of trust lien. The opinion also reviews the duties of a trustee or substitute trustee under a deed of trust when that person is counsel for the lender, which is a common practice in Texas.

Early on in the enforcement activities, the noteholder’s attorney sent a notice of acceleration, which was later withdrawn because the attorney discovered that one of the makers actually lived on the subject property. Notice was then provided under Section 51.002(d) of the Texas Property Code, which requires a twenty-day notice and opportunity to cure when the debt is secured by the debtor’s principal residence.\textsuperscript{82}

\begin{itemize}
\item \textsuperscript{77} \textit{Id.} § 16.036.
\item \textsuperscript{78} \textit{In re Tilton}, 297 B.R. 478, 483 (Bankr. E.D. Tex. 2003).
\item \textsuperscript{79} \textit{Tex. Civ. Prac. & Rem. Code} § 16.037 (Vernon Supp. 2004). “An extension agreement is void as to a bona fide purchaser for value... who deals with real property affected by a real property lien without actual notice of the agreement and before the agreement is acknowledged, filed, and recorded.” \textit{Id.}
\item \textsuperscript{80} \textit{Tilton}, 297 B.R. at 483-84. The court also refused to put the trustee on any additional level of inquiry based on the prior deed of trust or the earlier renewal agreement. The court also refused to find that the debtor’s schedules somehow resurrected an expired lien or corrected an improperly perfected one. \textit{Id.} at 485.
\item \textsuperscript{81} \textit{Powell v. Stacy}, 117 S.W. 3d 70, 71 (Tex. App.—Fort Worth 2003, no pet.).
\item \textsuperscript{82} \textit{Tex. Prop. Code Ann.} § 51.002(d) (stating “Notwithstanding any agreement to the contrary, the holder of the debt shall serve a debtor in default under a deed of trust or other contract lien on real property used as the debtor’s residence with written notice by certified mail stating that the debtor is in default under the deed of trust or other contract...”)}
The notice letter provided the required cure deadline, along with a statement of principal and interest, both of which overstated the amount actually owed. One of the makers hired counsel, who requested clarification of the amounts owed. The lender's lawyer did not respond, and neither borrower made any further payments on the note. After waiting some additional time to see if the borrowers could sell the property, the noteholders ultimately sent notice of acceleration. The lender's lawyer again quoted principal and interest, both of which were still in excess of the amount owed. The letter went to the borrowers' last known address; however, the borrower in possession had since moved but had not given the noteholder a change of address. The notice was not sent to the borrower's counsel.83

A trustee's sale ensued, and the noteholders purchased the property by credit bid of $55,000. One of the borrowers challenged the entire process, complaining of nearly every step taken by the lender and its counsel. First, the borrower challenged the acceleration because of the lack of a response to a general inquiry by borrower's counsel. The court noted, however, that the borrowers ultimately had 159 days within which to cure any default. At no time during this extended period did either borrower submit any payment. "[T]he fact that there may have been a dispute about the total amount of outstanding principal and interest due on the note before acceleration did not excuse [the borrowers] from making payments on the note from April to November 2000."84

Next, the borrower asserted that the noteholders owed the borrowers a duty of good faith and fair dealing, which was purportedly breached by the inaccurate notice and failure to respond to the earlier inquiries about the note balance. The court noted, however, the long-standing principle that "the duty of good faith and fair dealing is ordinarily not imposed on the mortgagor/mortgagee relationship."85

The borrower also argued that the note, which was a negotiable instrument, was subject to the UCC's good faith requirement.86 The court found, however, that any notice of intent to accelerate and notice of acceleration was expressly waived in the note; therefore, the borrowers were not entitled to notice in the first place. The only notice recognized by the court was the notice and opportunity to cure requirement found in Section 51.002(d) of the Property Code. The court found that the notice letter under the Property Code "contained all the information required by Section 51.002, which does not require the noteholder to include the

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83. Powell, 117 S.W.3d at 77 (noting that additionally, one of the borrowers was in jail for a period of months during this time).
84. Id. at 73.
85. Id. at 74 (citing FDIC v. Coleman, 795 S.W.2d 706, 709 (Tex. 1990)).
86. Id. at 75; see TEX. BUS. & COM. CODE ANN. §§ 1.201(20), .304 (Vernon 1994 & Vernon Supp. 2003). The UCC imposes a duty of good faith; however, it is defined as "honesty in fact and the observance of reasonable commercial standards of fair dealing."
amount that would be due after acceleration."\textsuperscript{87} With no evidence that the noteholder or counsel did anything more than make a mistake in calculating the amounts due, there was no evidence of dishonesty in fact, and thus no violation of any duty of good faith found in the UCC.\textsuperscript{88}

The borrower also claimed that the substitute trustee violated his duty of fairness and impartiality. It is clear that a trustee becomes "a special agent for both parties, and he must act with absolute impartiality and with fairness to all concerned in conducting a foreclosure."\textsuperscript{89} Additionally, the trustee must conduct the sale fairly and he should not discourage bidding by statements made before or during the sale. That said, the trustee "has no duty to take affirmative actions beyond that required by statute or the deed of trust to ensure a fair sale."\textsuperscript{90}

The court found that the trustee abided by the terms of the deed of trust and the Property Code. Of interest to practitioners, the court also found that "the fact that he was also representing the [noteholders] does not show that he breached his duty of fairness and impartiality."\textsuperscript{91}

Finally, the borrower also claimed that the erroneous payoff information constituted an irregularity in the sale that resulted in a grossly inadequate sale price. Turning again to the limited duties of the trustee, the court held that "[a] trustee owes no duty to provide either the debtor or any potential bidders at the foreclosure sale any information about the payoff amount of the underlying obligation."\textsuperscript{92} Thus, the sale was upheld.

2. Notice to Inferior Lien Claimants

\textit{TMS Mortgage, Inc. v. Golias}\textsuperscript{93} provides a somewhat different twist on the well-settled concept that an inferior lien claimant is not entitled to notice of a trustee's foreclosure sale under a deed of trust. In \textit{TMS}, the borrower defaulted under both its first and second lien payment obligations. A bankruptcy followed, and the holder of the first lien filed a motion for relief from the automatic stay. A local rule required that motions to lift stay be served on all parties claiming an interest in the property including, for example, junior lienholders.\textsuperscript{94}

Golias, the second lienholder, was not scheduled by the debtor, and counsel for the first lienholder did not notify Golias of the motion. By the time \textit{TMS} (the first lienholder) foreclosed, it was six months after the stay was lifted, and \textit{TMS} had run a title report and was aware of the Golias

\textsuperscript{87} Powell, 117 S.W.3d at 75; see also Tex. Prop. Code Ann. § 51.002(d) (Vernon Supp. 2004).
\textsuperscript{88} Powell, 117 S.W.3d at 74.
\textsuperscript{89} Id.
\textsuperscript{90} Id. see also Hammonds v. Holmes, 559 S.W.2d 345, 347 (Tex. 1977).
\textsuperscript{91} Id. see also Sanders v. Shelton, 970 S.W.2d 721, 726-27 (Tex. App.—Austin 1998, pet. denied.) (trustee under no duty to disclose payoff information; inadequacy of consideration alone does not render foreclosure sale void).
\textsuperscript{92} Powell, 117 S.W.3d at 75.
\textsuperscript{93} TMS Mortgage, Inc. v. Golias, 102 S.W.3d 768 (Tex. App.—Beaumont 2003, no pet.).
\textsuperscript{94} Id. at 769-70 (discussing Local R. 4001 in effect in the Eastern District of Texas).
lien claim. TMS did not, however, notify Golias of the foreclosure "because Texas law does not require such notice."95

The court focused on state law, and it reiterated that nothing in the Property Code "requires the holder of a superior lien to contact junior lienholders before conducting a trustee's sale."96 The court further found no fiduciary relationship between TMS and Golias, so there could be no breach of a fiduciary duty (nor was there any ordinary negligence by the first lienholder). The court refused to impose any new common-law duty that did not already exist, and any remedy for the apparent failure of TMS to comply with the local rule of a bankruptcy court should have been asserted in that court.97

VI. FAIR DEBT COLLECTION PRACTICES ACT

Two district court opinions during the Survey period may be of interest. In Goswami v. American Collections Enterprise, Inc.,98 a district court held that the use of the phrase "priority letter" on the outside of a debt collector's envelope to a debtor did not violate the Fair Debt Collection Practices Act. Similarly, creditor's use of the word "amnesty" in the enclosed letter did not violate the Act. The court apparently used an "unsophisticated consumer standard," but it found that "amnesty" did not imply any sort of a threat of criminal action. Thus, the court found that "nothing in the letter was dishonest" and the Act was not violated.99

Additionally, the unreported decision in Bergs v. Hoover, Bax, & Slovacek, L.L.P.,100 addressed allegations under both the Fair Debt Collection Practices Act and the Texas Debt Collection Act. A central issue was whether a law firm who conducted foreclosure activity constituted a "debt collector" under the Act. In short, the court found that merely instituting foreclosure proceedings does not constitute debt collection under the FDPCA, and the defendant law firm was granted summary judgment.101

95. Id. at 770.
96. Id. at 771.
97. Id. at 771-72. Any cause of action arising out of conduct in litigation would require malfeasance rather than mere misfeasance. The remedy for misfeasance as opposed to some form of affirmative wrongdoing in the judicial process "is to seek judicial relief as part of that process." Id. at 772 (citing Prappas v. Meyerland Cmty. Improvement Ass'n, 795 S.W.2d 794, 797 (Tex. App.—Houston [14th Dist.] 1990, writ denied)).