THE SUPREME COURT AND CONSUMER BANKRUPTCY

by
Honorable Jim D. Pappas
Chief U.S. Bankruptcy Judge, District of Idaho

In a time when the mega-Chapter 11 bankruptcy cases involving Debtors like Enron, Worldcom, United Airlines and PG&E dominate the national news headlines, isn't it interesting that the U. S. Supreme Court seems more interested in bankruptcy cases involving individual Chapter 7 and 13 debtors? Granted, of the 1.5 million cases filed in America's bankruptcy courts last year, all but about 40,000 were "nonbusiness" Chapter 7 and 13 cases. Still, the current legal battles where the terms "first day orders," "the absolute priority rule," and "breach of corporate fiduciary duties" are the focus of the courts' attention have to be more engaging to bankruptcy lawyers than those involving objections to discharge, cram-down interest rates, and (horrors) payment of consumer debtor's attorneys fees, right? Maybe not. Consider the following.

This spring, the Supreme Court granted *certiorari* in three bankruptcy cases, all to be decided during its next term. None involve business reorganizations. Instead, all three focus on consumer bankruptcy law issues.

In February, the Court agreed to review the Seventh Circuit's decision in *In re Till*, 301 F.3d 583 (2002). In *Till*, a divided Court of Appeals held that a secured creditor's contract rate, in this case 21% per annum, was the presumptive "present value" rate for use in the debtor's Chapter 13 plan providing for repayment of the creditor's claim over the term of the plan. In doing so, the court endorsed what is sometimes called the "coerced loan" approach to determining the proper interest rate, a method also approved in the Third, Fourth, Fifth, Sixth and Tenth Circuits. This approach views the restructure of a secured debt in Chapter 13 as akin to an involuntary loan from the creditor to the debtor. These courts

interpret Section 1325(a)(5)(B) to require that the secured creditor receive under the plan what it could have obtained had it foreclosed on the collateral and reinvested the sale proceeds in loans of equivalent duration and risk. That's why, according to the Seventh Circuit, in most cases the creditor's current contract rate will reflect the appropriate rate for use in the Chapter 13 plan, unless the parties agree to some other rate. Of course, the debtor can offer proof that some other rate more accurately reflects the creditor's hypothetical return on its money. Realistically, such evidence may be difficult to develop, and the debtor may not be able to afford to engage in that sort of litigation.

Earlier, the Second, Eighth and Ninth Circuit Courts had adopted some variation of the so-called "formula approach" to establish the appropriate rate of interest to be paid on allowed secured claims under 11 U.S.C. § 1325(a)(5)(B) in Chapter 13 plans. As compared to using the rate in the contract between the debtor and the secured creditor, the formula approach attempts to determine objectively, through fairly easily obtainable evidence, a baseline market interest rate in the credit community for loans like that involved in the Chapter 13 plan. Added to the baseline rate there may be some sort of risk premium to reflect the circumstances of the individual case, such as the age and condition of the collateral, or other factors impacting the viability of the plan.

A third, much smaller group of courts had endorsed what they called the "cost of funds approach" to setting interest rates on secured claims in Chapter 13. *See* 8 Lawrence P. King, *Collier on Bankruptcy,* ¶ 1325.06[3][B] (15th ed. rev. 2001) (advocating use of the approach and collecting the cases). These courts would give secured creditors a sum equivalent to what it would cost them to borrow the value of the collateral for the term of the plan.

So why would the Supreme Court intervene when most of the circuits have already established rules for setting the Section

1325(a)(5)(B) interest rate? Obviously, one major goal of the Court is to resolve splits in the circuits regarding how federal questions, like issues about the interpretation of federal statutes, are resolved. Chapter 13 debtors and secured creditors should expect consistent treatment under the Bankruptcy Code whether a case is filed in New York City or Pocatello. Moreover, of the 450,000 Chapter 13 cases filed last year, it's a safe bet that there was a "cram down" provision concerning a secured debt, such as an auto loan, in nearly every case. Adopting a uniform rule of law that would apply in so many different cases is certainly a laudable objective. Finally, while this issue arises in Chapter 13, it's important to remember that the method for determining a proper cram-down interest rate is also important for plans proposed by Chapter 11 and 12 debtors. Any analysis by the Court concerning the interpretation of the Chapter 13 rate will likely be extremely persuasive in cases under the business chapters.

What will the Supreme Court do with interest rates? Of course, it's foolhardy to predict an outcome. One thing to consider though, is that in *Assocs. Commercial Corp. v. Rash,* 520 U.S. 953 (1977), the Court decided that Chapter 13 debtors must pay a secured creditor the "replacement value" of its collateral in any cram-down provision in a Chapter 13 plan. While the Court could have allowed debtors to pay the wholesale, or even the "garage sale" value of collateral in restructuring secured claims, it interpreted Sections 1325(a)(5) and 506(a) as requiring the debtor to pay the creditor what it would cost the debtor to replace the collateral in the current marketplace. If a debtor must use current replacement value for the secured creditor's collateral, and also must pay the contract rate of interest on that value under the plan, a Chapter 13 restructure of secured claims will become a substantially more expensive and less attractive option to debtors. As opposed to higher payments to secured creditors, the result may be more Chapter 7s where the collateral is either surrendered to the secured creditor, or the debt is reaffirmed, and in neither event will unsecured creditors receive any benefit.

In March, the Court granted *certiorari* in *U.S. Trustee v. Equip. Servs., Inc. (In re Equip. Servs., Inc.)*, 290 F.3d 739 (4th Cir. 2002). In doing so, the Court agreed to decide whether Section 330(a) authorizes the payment of a Chapter 7 debtor's attorneys fees from the bankruptcy estate along with other professionals employed in the case. At issue is a 1994 amendment to Section 330(a), which modified the prior version of the statute in a manner which omitted the phrase "or the debtor's attorney" from the list of those professionals entitled to receive reasonable compensation from a Chapter 7 bankruptcy estate. In *Equipment Services*, the Fourth Circuit held that, under the "plain language approach" to interpreting the statute, because Section 330(a) as amended was not ambiguous, the court could not simply add back to the statute words that may have been omitted when it was amended. Therefore, the court refused to allow a Chapter 7 debtor's attorney to be paid from the bankruptcy estate under amended Section 330(a). This decision placed the Fourth Circuit in the same camp as the Fifth and Eleventh Circuits. However, the ruling is at odds with the Second, Third, and Ninth Circuits (*see e.g., In re Century Cleaning Servs., Inc.*, 195 F.3d 1053 (9th Cir. 1999)), each of which had held that Congress had clearly committed a "scrivener's error" when it amended the statute, and by legislative oversight had simply forgotten to add debtor's attorneys to the amended list. As a result, these courts decided they could judicially "correct" the error and allow payment to Chapter 7 debtor's lawyers.

Again, predicting what the Supreme Court will do when faced with a fairly obvious legislative "goof" is a challenge. Will the Court's many admonitions about interpreting the Bankruptcy Code based solely on the plain language employed by Congress in the statutes carry over here? Or is this a case where, because payment to Chapter 7 debtor's attorneys from the estate was a "long-standing practice" in bankruptcy court prior to the 1994 amendment, the courts should presume Congress intended the practice to continue unless Congress clearly indicates an intent to change the rules?

In May, we learned the Seventh Circuit's decision in *In re Kontrick*, 295 F.3d 724 (7th Cir. 2002) will be scrutinized by the Supreme Court. The court of appeals held that the Fed. R. Bankr. P. 4004(a) 60-day time limit for filing an objection to a Chapter 7 debtor's discharge in bankruptcy is not "jurisdictional," but rather may be "waived" by the debtor. Like the Second and Fourth Circuits, the court concluded that, based upon the structure, legislative history and underlying policies of the Rule, the time limit was not absolute, but instead was subject to a variety of judicially-created equitable defenses, such as waiver and estoppel. Several bankruptcy courts had concluded the time limit must be strictly applied, and could be extended solely under the procedure and for the limited reasons provided in the Rules. In making its decision, the Seventh Circuit relied heavily upon the Ninth Circuit BAP's decision in *Schunck v. Santos* (*In re Santos*), 112 B.R. 1001 (B.A.P. 9th Cir. 1990) (also holding that the time limit in Rule 4007(c) for filing a complaint to determine dischargability of a debt under Section 523(c) may be waived).

Obviously, one goal of every Chapter 7 debtor is to obtain relief from debt, and the debtor has an interest in an early determination of the right to a discharge. Because discharge is so important in bankruptcy, perhaps that's why the Supreme Court felt compelled to intervene and settle this issue. On the other hand, recall that in *Taylor v. Freeland & Kronz,* 503 U.S. 638 (1992), the Court seemed firmly dedicated to the strict enforcement of the time limits in the Bankruptcy Rules, which in that case concerned an objection to the debtor's claim of exemptions. As usual, the Supreme Court could go either way.

While the "Enrons" of the bankruptcy system garner the headlines and involve the big dollars, collectively consumer bankruptcy cases, both in number of filings and parties effected, likely have a greater impact on the economy and credit markets. While there are many important, fascinating legal issues at play in the business mega-cases, most bankruptcy cases involve people and consumer debt.

Under a Bankruptcy Code which must accommodate all types and sizes of cases, it seems significant that the Supreme Court is not too busy to examine all important issues, regardless of the amounts in controversy.