In re Espinosa
Clarifying Student Loan Treatment in Chapter 13 Plans (or not)

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According to the United States Bankruptcy Courts statistical data, there were 1,593,081 bankruptcies filed in the United States in 2010, which means that there were five times more bankruptcy filings than all other Federal civil and criminal cases combined. Due to sheer volume, it can be presumed (at a minimum from first-hand knowledge) that debtors' counsel have made mistakes in plan drafting and treatment of creditor claims, and it follows that creditors have also overlooked errors in those proposed plans. The United States Supreme Court's recent decision in *United Student Aid Funds v. Espinosa*," –U.S.–, 130 S.Ct. 1367 (March 23, 2010) asks judges to determine the difference between these mistakes and "unscrupulous" behaviour while placing a significant burden on both debtors' counsel and creditors' counsel to avoid mistakes in setting up and reviewing Chapter 13 plans that deal with student loans. If the trustee or creditor fails to catch the error made, *Espinosa* holds that the student loans may be discharged without going through the "required" adversary proceeding; however, if a debtor in the Southern District of Indiana tries to discharge student loans without proving undue hardship through an adversary proceeding debtor's counsel could "be looking down the barrel of a Rule 9011 motion for sanctions" [Quoting Judge Coaches the *In re* Wright 09-06323-JKC-13)]. The question would remain whether a mistake was made or whether counsel had knowledge of the law and intended to "discharge by ambush" otherwise non-dischargeable debts.

Pursuant to 11 U.S.C. §§ 523(a)(8) and 1328, "an educational benefit overpayment or loan made, insured or guaranteed by a governmental unit …; or an obligation to repay funds received as an educational benefit, scholarship, or stipend; or any other educational loan that is a qualified education loan as defined in section 221(d)(1) of the Internal Revenue Code of 1986" is not discharged unless such exception from discharge would cause an "undue hardship". The Internal revenue Code [Section 221(d)(1)] defines "qualified education loan" as "any indebtedness incurred by the taxpayer solely to pay qualified higher education expenses: (A) which are incurred on behalf of the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred; (B) which are paid or incurred within a reasonable period of time before or after the indebtedness is incurred; and (C) which are attributable to education furnished during a period during which the recipient was an eligible student. Such term includes indebtedness used to refinance indebtedness which qualifies as a qualified education loan."

Once counsel has determined that a debt is an educational loan, pursuant to Federal Rule of Bankruptcy Procedure 7001(6), the undue hardship determination must be made by the court in an adversary proceeding, with service of the summons and complaint being made upon the student loan creditor as required by Federal Bankruptcy Rules 7003 and 7004.

The facts of the *Espinosa* case show that Mr. Espinosa filed a Chapter 13 plan with the student loans totalling $13,250.00 as his only debt. The plan proposed to pay the principal balance in full through the plan with no interest and that the remaining balance would be discharged. The plan did not even take any steps to support the proposition that paying the interest on the student loan would cause an undue hardship. Mr. Espinosa failed to file any adversary proceeding as required by FRBP 7001(6), or serve any complaint on the student loan creditor under FRBP 7004 (he sent the plan to a student loan agency at a lockbox address intended solely to receive payments). The lender filed a proof of claim for accrued principal and interest totalling $17,832.15. The lender failed to object to the plan, the plan was confirmed, and the debts were paid in full through the Chapter 13 trustee with the last payment made in May 1997. Several years after completion of the plan, the creditor sought to collect the remaining balance of the student loans and the debtor reopened the case with the Bankruptcy Court asking the court to enforce its discharge order. The creditor filed a cross-motion under FRCP 60(b)(4) seeking to set aside the 1993 confirmation order as void claiming that the confirmation order was inconsistent with the Code and that its due process rights had been violated by failure to comply with the FRBP service requirements. The Bankruptcy Court denied United's cross-motion and ordered that United cease and desist all further collection efforts. United appealed to the District Court and the District Court reversed holding that United was denied due process because the confirmation order was issued without proper service of a complaint and summons. Mr. Espinosa appealed to the Ninth Circuit which reversed the District Court holding that while there may have been a legal error, it was never appealed and was not a basis for setting aside the confirmation order.

The Supreme Court affirmed the Ninth Circuit holding that because United Student Aid had actual notice of the Court's error and failed to object to the plan or timely appeal the order confirming the plan, the order remained enforceable. Further, the legal error in the Bankruptcy Court's confirmation of the plan without an undue hardship finding did not void the confirmation order. The Court's holding stressed that a judgment is not void simply because it was erroneous and that Rule 60(b)(4) applies only when a judgment is premised on "a certain kind of jurisdictional error" or on a "violation of due process that deprives a party of notice or the opportunity to be heard." Rule 60(b)(4) [which, subject to certain conditions, is incorporated by FRBP 9024] are reserved for "the exceptional case in which the court that rendered judgment lacked even an 'arguable basis' for jurisdiction." The Court concluded that, while the Bankruptcy Court committed legal error, the order remained enforceable and binding on United because it had notice of the error and failed to object.

United finally argued that a failure to declare the court's order void would encourage "unscrupulous debtors to abuse the Chapter 13 process" by filing plans that fail to comply with the Code and without proving undue hardship in the hopes that the court and creditors will make a mistake and overlook the proposal. The Court acknowledged the United's argument and responded that "expanding the availability of relief under Rule 60(b)(4) is not an appropriate prophylaxis" for such behavior. However, the Court noted that debtors and their attorneys are subject to a number of penalties (as described in the case *Taylor* v. *Freeland & Kronz,* 503 U. S. 638 (1992)) for engaging in improper conduct in a bankruptcy case, and that if existing sanctions are not sufficient to discourage bad faith attempts to discharge student loans, Congress should enact additional provisions. The obvious problem with such a statement is that the Supreme Court failed to state why debtor's counsel in *Espinosa* was not subject to sanctions by the Bankruptcy Court, whether United could now seek such sanctions, or what actions would subject a debtor to such penalties if this particular case did not warrant sanctions. Indeed, by its very nature, if a judge or creditor fails to notice the error, it might be years after the fact that anyone notices that there was any error to start with.

Rule 9011 [Signing of Papers; Representations to the Court; Sanctions; Verification and Copies of Papers] states *inter alia*:

(b) *Representations to the Court*. By presenting to the Court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances,—

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

(c) Sanctions. If, after notice and a reasonable opportunity to respond, the court determines that subdivision (b) has been violated, the court may, subject to the conditions stated below, impose an appropriate sanction upon the attorneys, law firms, or parties that have violated subdivision (b) or are responsible for the violation.

(1) How initiated.

(A) By motion. A motion for sanctions under this rule shall be made separately from other motions or requests and shall describe the specific conduct alleged to violate subdivision (b). It shall be served as provided in Rule 7004. The motion for sanctions may not be filed with or presented to the court unless, within 21 days after service of the motion (or such other period as the court may prescribe), the challenged paper, claim, defense, contention, allegation, or denial is not withdrawn or appropriately corrected, except that this limitation shall not apply if the conduct alleged is the filing of a petition in violation of subdivision (b). If warranted, the court may award to the party prevailing on the motion the reasonable expenses and attorney's fees incurred in presenting or opposing the motion. Absent exceptional circumstances, a law firm shall be held jointly responsible for violations committed by its partners, associates, and employees.

(B) On court's initiative. On its own initiative, the Court may enter an order describing the specific conduct that appears to violate subdivision (b) and directing an attorney, law firm, or party to show cause why it has not violated subdivision (b) with respect thereto.

(2) Nature of sanction; limitations. A sanction imposed for violation of this rule shall be limited to what is sufficient to deter repetition of such conduct or comparable conduct by others similarly situated. Subject to the limitations in subparagraphs (A) and (B), the sanction may consist of, or include, directives of a nonmonetary nature, an order to pay a penalty into

> court, or, if imposed on motion and warranted for effective deterrence, an order directing payment to the movant of some or all of the reasonable attorneys' fees and other expenses incurred as a direct result of the violation.
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> (A) Monetary sanctions may not be awarded against a represented party for a violation of subdivision (b)(2).
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> (B) Monetary sanctions may not be awarded on the court's initiative unless the court issues its order to show cause before a voluntary dismissal or settlement of the claims made by or against the party which is, or whose attorneys are, to be sanctioned.
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> (3) Order. When imposing sanctions, the Court shall describe the conduct determined to constitute a violation of this rule and explain the basis for the sanction imposed.

In short, Rule 9011 requires attorneys to certify that the legal contentions contained within petitions and plans are warranted by existing law, and gives a court on its own initiative authority to order sanctions limited to an amount sufficient to deter repetition of such conduct or comparable conduct by others similarly situated. However, if the error is not discovered until years after the fact, will a sanction deter repetition of conduct that may have already continued for years unchecked?

Several questions therefore arise within the student loan context and even outside the student loan context. In drafting a Chapter 13 plan, debtor's counsel must first consider the question, "What constitutes a student loan?" Clearly 523(a)(8)(A)(i) covers a government insured student loan. In addition, Sections 523(a)(8)(B) would now cover "private loans" which are incurred for higher education (regardless of whether they are actually used for education benefits). But this still leaves the broad language in Section 523(a)(8)(A)(ii) which excepts from discharge "an obligation to repay funds received as an educational benefit, scholarship or stipend." There is a question as to whether unpaid school tuition, credit extended by a school bookstore, or an unused high school scholarship would be excepted from discharged. Will an attorney be subject to Rule 9011 sanctions for making a practice of drafting plans which propose to discharge tuition due and owing to a university without demonstrating undue hardship?

Consider a factual pattern where an attorney proposes a plan that will discharge a student loan debt and intends to file an adversary proceeding, but mistakenly fails to file such a complaint in a timely manner and the confirmation order is granted. Such are the facts of a local case, *In re Wright* [Southern District of Indiana, Indianapolis Division, Cause No. 09-06323-JKC-13], where debtors filed a plan which stated under the Miscellaneous Provisions section on the uniform plan, "Student loan debt to Direct Loan will be discharge (sic) due to hardship upon completion of debtors (sic) Chapter 13 Bankruptcy." Neither the creditor nor the Chapter 13 trustee objected to the language contained within the plan, and it was later confirmed. Following confirmation, the trustee filed a motion to set aside the confirmation and testified that the trustee's office made a mistake in failing to timely object to the plan due to sheer volume of her caseload. Debtor's counsel indicated that he had intended to file an adversary proceeding (the facts recited in the opinion fail to state why an adversary proceeding had not been initiated), but listed this treatment in the plan as he wanted every creditor to be treated in the plan. The Bankruptcy Court denied the trustee's motion to set aside under Trial Rule 60(b)(1) finding that the trustee had more than enough opportunity to find the error as the trustee had objected to prior plans filed in the case.

Judge Coachys ended his opinion stating, "That said, the Court wants to make it extremely clear to Debtors and their counsel–and to the consumer bar in general–that it takes an extremely dim view of their inclusion of the Student Loan Provision. Counsel insisted that he included the provision in order to treat "every claim" in the plan. If that were true, then the plan presumably could have merely stated only that Debtors intended to file an adversary proceeding to seek discharge of their student loan obligation as an undue hardship. Arguably, Debtors could *still* simply file one now … Debtors' counsel and the consumer bar are well advised to take heed of this language and to exercise more care in how they treat student loans within Chapter 13 plans; otherwise they could, and probably should, be looking down the barrel of a Rule 9011 motion for sanctions."

There remains a question as to whether the *Espinosa* decision can be expanded to other areas beyond student loans. Can a debtor's attorney ethically propose a Chapter 13 plan which includes non-traditional treatment to secured creditors? For example, can debtor's counsel have a standard practice of surrendering secured collateral in "full satisfaction of any and all claims" even though the Bankruptcy Code [see 11 U.S.C. § 506(b)] and 7th Circuit case law [*Wright v. Santander Consumer USA Inc. (In re Wright)*, No. 07-1483, 2007 U.S. App. LEXIS 15843, 2007 WL 1892502 (7th Cir. July 3, 2007)] allow a bifurcation of the claims following surrender of collateral. Such a practice would disallow deficiency claims following surrender and sale of secured collateral and potentially allow plans to be paid in full by disallowing potentially large claims. Several unpublished opinions from local bankruptcy judges have stated that that the failure of a secured creditor to object to its treatment in the plan may be deemed to be acceptance of the plan, but could those creditors later seek sanctions for their own failure to timely object to an "illegal" provision?

In addition the Supreme Court recognized that, "in some cases, a debtor and creditor may agree that payment of a student loan debt will cause the debtor an undue hardship sufficient to justify discharge. In such a case, there is no reason that compliance with the undue hardship requirement should impose significant costs on the parties or materially delay confirmation of the plan. Neither the Code nor the Rules prevent the parties from stipulating to the underlying facts of undue hardship, and neither prevents the creditor from waiving service of a summons and complaint." Would debtor's counsel, therefore, be able to stipulate through a proposed plan the following provision, "The debtor believes that payment of the student loan obligation is an undue hardship, and if the student loan creditor fails to timely object to this plan, the creditor hereby agrees and stipulates to the undue hardship of the student loan and the subsequent discharge of the debt upon completion of the plan and hereby waives the requirement of an adversary proceeding or service of a complaint"? Could the judge award sanctions when the proposed plan conforms to the holding of the court, or is more necessary?

Debtor's counsel should be pleased with the United States Supreme Court's holding that creditor's cannot sleep on their rights despite debtor's failure to follow the minimum requirements of the Code, failure to provide proper service under the Rules, or the Bankruptcy Court's subsequent legal error. The Court said, United's argument "that it had no obligation to object to Espinosa's plan until Espinosa served it with the summons and complaint the Bankruptcy Rules require, Brief for Petitioner 33 -- is unavailing. Rule 60(b)(4) does not provide a license for litigants to sleep on their rights. United had actual notice of the filing of Espinosa's plan, its contents, and the Bankruptcy Court's subsequent confirmation of the plan." However, both the *Espinosa* ruling as well as the *Wright* decision in Indianapolis make clear that the debtor has the obligation to propose plans in conformity with the Bankruptcy Code or face potential discipline.

Debtor's counsel must therefore answer the questions:

1) How do you determine what is an illegal provision (e.g. what constitutes an educational benefit"?);
2) How do you propose an alternative treatment (e.g. bifurcation of a 910 car claim) in a Chapter 13 plan that doesn't constitute an "illegal provision"?
3) If you propose an illegal provision in your plan, what obligation do you have to discuss the potential ramifications with your client?

I would suggest that you make the following rules within your own practice:

1) Don't file plans with the intent of hiding alternative treatments for creditors in anticipation of confirmation and then springing the "confirmation by ambush" on the creditor.
2) When filing plans with alternative treatment, make the proposed treatment clear and obvious. Put the language in bold, caps and underline. Also, include in the plan the language of the statute or case you rely upon for the alternative treatment
3) Contact creditor's counsel, if any, to discuss the treatment before confirmation.
4) Send a letter to the creditor upon filing with a description of your proposal requesting a response.
5) Don't include issues in the Chapter 13 plan that are listed as adversary proceedings under Bankruptcy Rule 7000.
6) Keep your client (and malpractice insurance carrier) advised of the potential consequences if you propose an illegal provision in a chapter 13 plan.