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U.S. SUPREME BANKRUPTCY COURT'S CONFIRMATION OF A CHAPTER 13 PLAN EVEN IF THE PLAN CONTAINS AN INAPPROPRIATE TREATMENT UNDER CHAPTER 13 PLANS MAY STILL BE ENFORCEABLE IF CREDITOR FAILS TO MAKE A TIMELY OBJECTION

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The United States Supreme Court has recently ruled that even where a Chapter 13 plan contains provisions not supported under the Bankruptcy Code, as long as the creditor was apprised of the Chapter 13 plan and had an opportunity to object, the creditor may not later challenge the confirmation and/or discharge. While the foregoing case deals with student loan debt, the same can be said, for example, a Chapter 13 lien stripping motion where a Court approves a Chapter 13 plan setting forth an intent to strip a secured lien but the debtor fails to file an adversary action.

The ruling opens the door for a debtor to include inappropriate plan provisions where the creditor fails to pay attention and fails to object at the time of confirmation.

On March 23 2010, the United States Supreme Court upheld a Ninth Circuit Court of Appeals decision refusing to grant a creditor relief from the confirmation of a Chapter 13 plan provision, even though the plan's treatment of a student debt was inconsistent with the Bankruptcy Code provisions concerning that type of debt. *United Student Aid Funds, Inc. v. Espinosa*, 130 S.Ct. 1367 (2010).

In the *Espinosa* case, a debtor filed a Chapter 13 bankruptcy

plan in 1983 which proposed to pay the principal balance of his student loan debt, but proposed to discharge all accrued interest in violation of 11 U.S.C. §523(a)(8). Section 523(a)(8) then required the Bankruptcy Court to make an undue hardship determination which could only be commenced by a debtor filing and serving on the affected creditor an adversary proceeding under Federal Bankruptcy Rule 7001 *et seq.*

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In order to modify a student loan, 11 U.S.C. §523(a)(8) and 1328 require the debtor to file not only a Chapter 13 plan but an adversary proceeding to obtain a finding that payment of the student loan debt would constitute an undue hardship thus permitting the debtor to modify the loan obligation.

The facts of this case are as follows:

1988-1989	Francisco Espinosa (“Espinosa”) obtained four federally guaranteed student loans totaling \$13,250.00.
1992	Espinosa filed a Chapter 13 bankruptcy petition

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Espinosa prepared a Chapter plan to pay the principal balance only and to discharge the interest.

Pursuant to the Federal Rules of Bankruptcy Procedure, the Court mailed the notice of the plan to all creditors.

The plan promised to discharge the interest on the student loan upon obtaining a Chapter 13 discharge. The notice was mailed to creditor, United Student Aid Funds, Inc. (“USAFI”).

The Notice stated in boldface type: **WARNING: IF YOU ARE A CREDITOR YOUR RIGHTS MAY BE IMPAIRED BY THIS PLAN.**

USAFI did not object but did file a claim for \$17,832.15.

May 1993 Espinosa’s Chapter 13 plan was approved without objection – including the discharge of interest on his student loan debt. The Court entered a judgment on the Chapter 13 plan.

May 1997 Espinosa finished paying off the principal balance on the student loan through his bankruptcy plan.

2000 The U.S. Department of Education commenced efforts to collect the unpaid interest.

2003 Espinosa filed a motion for a cease and desist order in the United States Bankruptcy Court.

USAFI filed an opposition and a cross-motion under FRCP 60(b)(4) to set aside the conformation order asserting two grounds for its position:

1. the discharge of the student loan interest was inconsistent with the Bankruptcy Code which requires a finding of undue hardship by the Bankruptcy Court; and

2. the approval of the discharge of the student loan debt without Espinosa filing and serving a summons and an adversary complaint on USAFI giving USAFI notice and opportunity to be heard, thus denying USAFI’s due process rights.

The Bankruptcy Court denied USAFI’s Cross-Motion, rejected USAFI’s arguments and issued a cease and desist order.

USAFI sought review by the United States District Court, which reversed holding that USAFI’s due process rights were denied as a result of the failure to serve a summons and adversary complaint.

Espinosa appealed to the 9th Circuit Court of Appeal which reversed the judgment of the District Court, 530 F.3d 895, 899 (2008).

Concluding that by confirming Espinosa’s plan without first finding undue hardship in an adversary proceeding, the Bankruptcy Court, at most, committed a legal error which USAFI might have appealed but which was not a basis for setting aside the Chapter 13 plan confirmation as void under FRCP 60(b).

The Court of Appeals held that although Espinosa’s failure to serve USAFI with a summons and complaint violated the Bankruptcy Rules, the service defect was not a basis to declare the judgment void because USAFI received actual notice of the plan and failed to object.

The United States Supreme Court granted *certiorari*.

The Court confirmed that 11 U.S.C. §523(a)(8) held that upon completing a confirmed plan, a Bankruptcy Court “shall grant the debtor a discharge of all debts provided for by the plan or disallowed under Section 502 of this title except, *inter alia*, any debt of the kind specified in [§523(a)(8)],” 11 U.S.C. §1328(a)(2). Section 523(a)(8), in turn, specifies that “certain student loan debts, unless excepting such debt from discharge . . . would impose an undue hardship on the debtor and debtor’s dependents.”

The Court further acknowledged that the Bankruptcy Rules require a party seeking to determine a hardship exception for



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the dischargeability of a student loan debt to commence an adversary proceeding by serving a summons and complaint on affected creditors.

The Supreme Court held that the Bankruptcy Court order confirming the plan was a final judgment from which USAFI did not appeal. “Ordinarily [the finality of a [a] Bankruptcy Court’s orders following the conclusion of direct review]” would stand in the way of challenging [their] enforceability.

The Court held that Rule 60(b) provides an exception to finality which allows a party to seek relief from a final judgment under a limited set of circumstances.

In this case, the Supreme Court held that:

“A judgment is not void,” for example, “simply because it is or may have been erroneous. Similarly a motion under Rule 60(b)(4) is not a substitute for a timely appeal where a judgment is promised either on a certain type of jurisdictional error or on a violation of due process that deprives a party of notice or the opportunity to be heard.”

The Court found that the error USAFI alleges fails in neither category, holding that: (a) the statutory requirement of finding undue hardship before discharging a debt is a pre-condition to obtaining a discharge order, but not a limitation on the Bankruptcy Court’s jurisdiction, and (b) the requirement for an adversary action is a procedural rule, not a jurisdictional rule.

USAFI, while it conceded that the Bankruptcy Court had jurisdiction to enter the order, contends that the judgment is void because USAFI was not given notice and an opportunity to be heard.

While the Court found that Espinosa’s failure to serve USAFI with an adversary action deprived it of a procedural right, USAFI could have timely objected to this deprivation and appealed. The Supreme Court ruled that:

“[D]ue process requires notice ‘reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections. [D]ue process does not require actual notice . . .”

The Supreme Court ruled that USAFI received *actual notice* of the filing and content of Espinosa’s plan. This more than satisfied USAFI’s due process rights. Therefore, the Court held that Espinosa’s failure to serve a summons and complaint did not entitle USAFI to relief under FRCP 60(b)(4).

Despite the inability to demonstrate a jurisdictional error or a due process violation, the U.S. Government and the USAFI’s urged the Court to expand the type of judgment defects under FRCP 60(b)(4) to include an order that lacked statutory authority. The Court was not persuaded that a failure to find undue hardship in accordance with §523(a)(8) is on par with jurisdictional failings that define void judgments.

Therefore, even though there was a plan which contained a provision that lacked statutory authority, the Supreme Court held that the order remained enforceable because USAFI had notice of the error and failed to object or timely appeal.

While this case involves interest on a student loan debt which is not at issue in any foreclosure, the Court’s ruling should not be overlooked by creditors and trustees. If a Chapter 13 plan contains improper provisions (i.e., fails to comply with lien stripping procedures), the creditor may not sleep on its rights and later seek relief – the lender must take a proactive approach rather than simply assuming that the debtor or their counsel will comply with the appropriate provisions –of the Bankruptcy Code.



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