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THE MODIFICATION OF LIENS IN REORGANIZATION CASES PART DEUX -- WHAT PROCESS IS DUE?

Part II

By

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INTRODUCTION

As was demonstrated in Part I of this Article, the federal courts of appeals are badly split on the procedural issues surrounding the modification of liens through the bankruptcy reorganization process. The general dispute focuses on the procedures which are necessary to deprive a creditor of its security interest in the debtor's property. One line of cases suggests that liens on the debtor's property are automatically extinguished upon confirmation of a plan of reorganization, unless the liens are expressly preserved in the plan.[1] In contrast, other

[1] See, e.g., In the Matter of Penrod, 50 F.3d 459 (7th Cir. 1995) (lien is extinguished upon confirmation where Chapter 11 plan of reorganization is silent with respect to secured creditor's prepetition lien); In the Matter of Pence, 905 F.2d 1107 (7th Cir. 1990) (mortgage holder could not collaterally attack an order confirming a Chapter 13 plan for purposes of challenging a valuation of property given in exchange for release of a mortgage on debtor's residence).

courts have held that lien modification cannot be accomplished through the confirmation process, even if the plan explicitly terminates the lien. Rather, these courts require that the debtor utilize the claims allowance process whereby the debtor must first file an objection to the creditor's secured claim together with a separate adversary proceeding to challenge the creditor's lien.[2] Thus far, the debate has revolved around questions of statutory interpretation concerning various sections of the Bankruptcy Code and the related provisions of the Federal Rules of Bankruptcy Procedure. However, relatively few courts have focused on the potential constitutional implications of lien modification.[3]

The conflicting lines of authority were described in Part I of this Article. Part II attempts to analyze the procedural issues involved in lien modification from a constitutional perspective.[4] Specifically, this Article will address the minimum procedural due process requirements for depriving a creditor of some or all of its lien interest in the debtor's property. This Article also offers some suggested guidelines for insuring compliance with the minimum constitutional standards of due process when modifying lien rights in the context of a bankruptcy reorganization.[5]

A. CONSTITUTIONAL FRAMEWORK

The United States Constitution grants Congress the authority to pass laws affecting the rights of creditors and debtors in bankruptcy while also placing limits on the power of Congress to deprive persons of their property. The interplay between these Constitutional powers and limits is the subject of this Article.

1. The Bankruptcy Clause

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[2]See, e.g., Sun Finance Company, Inc. v. Howard (Matter of Howard), 972 F.2d 639 (5th Cir. 1992) (secured creditor was not bound by confirmed Chapter 13 plan which eliminated the creditor's lien, where the debtor had failed to object to the creditor's allowed secured claim); Cen-Pen Corp. v. Hanson, 58 F.3d 89 (4th Cir. 1995) (initiation of adversary proceeding is prerequisite to challenging validity or existence of lien).

[3]See, e.g., Piedmont Trust Bank v. Linkous (In re Linkous), 990 F.2d 160 (4th Cir. 1993) (secured creditor's due process rights were violated where notice of confirmation hearing did not specify that bankruptcy court would also consider security valuation issues at confirmation hearing).

[4]Relatively few articles have addressed the constitutional issues surrounding lien modification in bankruptcy. Nicholas A. Franke has written an excellent article on the related topic of constitutional limitations on the discharge of claims. See Nicholas A. Franke, The Code and the Constitution: Fifth Amendment Limits on the Debtor's Discharge in Bankruptcy, 17 Pepp. L. Rev. 853 (1990). While Franke's article focuses on the discharge of preexisting claims, two other authors have considered the constitutional implications of the discharge of future claims. See Ralph R. Mabey and Jamie Andra Gavrin, Constitutional Limitations on the Discharge of Future Claims in Bankruptcy, 44 S.C. L. Rev. 745 (1993) (hereinafter "Mabey and Gavrin"). In their thought-provoking article, the authors discuss the due process concerns involved in the settlement of future claims in mass tort cases involving the bankruptcy reorganizations of pharmaceutical giant A.H. Robins Company, Inc. and numerous asbestos manufacturers, including Johns-Manville Corporation. For a general discussion of the effect of plan confirmation, see Frank R. Kennedy and Gerald K. Smith, Postconfirmation Issues: The Effects of Confirmation and Postconfirmation Proceedings, 44 S.C. L. Rev. 621 (1993). The current leading article on the topic of due process and bankruptcy is by Robert M. Lawless, Realigning The Theory and Practice of Notice In Bankruptcy Cases, 29 Wake Forest L. Rev. 1215 (1994). Based on the premise that the current bankruptcy law lacks a coherent theory for the application of procedural due process, Professor Lawless proposes a "Restatement of Notice" for bankruptcy cases.

[5] An exhaustive review of all the Code sections that relate to liens is beyond the scope of this Article. The primary focus of this Article centers on the modification of liens by means of the confirmation of a plan of reorganization under Chapters 11, 12, and 13 of the Bankruptcy Code.

The "Bankruptcy Clause" of the United States Constitution grants Congress the power, "[t]o establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST., art. I, §8, cl.4. Traditionally, the Bankruptcy Clause has been interpreted broadly to give Congress wide latitude to define the rights of debtors and creditors under federal law. One nineteenth-century court described the scope of Congressional power under the Bankruptcy Clause as follows: "[I]t extends to all cases where the law causes to be distributed the property of the debtor among his creditors: this is its least limit. Its greatest is the discharge of a debtor from his contracts. And all intermediate legislation, affecting substance and form, but tending to further the great end of the subject -- distribution and discharge -- are in the competency and discretion of Congress." In re Klein, 14 F. Cas. 716, 718 (C.C.D. Mo. 1843)(No. 7865) (quoted in Mabey and Gavrin, supra note 4, at 760, n.55).

In a 1902 case involving the constitutionality of the Bankruptcy Act of 1898, the United States Supreme Court stated, "Congress may prescribe any regulations concerning discharge in bankruptcy that are not so grossly unreasonable as to be incompatible with fundamental law." Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 192 (1902). However, the plenary powers wielded by Congress under the Bankruptcy Clause are not without limits.[6] The Supreme Court has held that the laws passed pursuant to the Bankruptcy Clause are subject to the overarching constitutional requirements of due process. See United States v. Security Industrial Bank, 459 U.S. 70, 75 (1982) (citing Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555 (1935)).

2. The Due Process Clause

The Fifth Amendment to the United States Constitution prohibits Congress from depriving any person of "life, liberty or property without due process of law." See U.S. CONST., amend. V. The Due Process Clause of the Fourteenth Amendment imposes similar restrictions upon the States. See U.S. CONST., amend. XVI, § 1. This Article addresses the authority of Congress to affect creditors' lien interests and property rights through bankruptcy legislation and the interpretation and enforcement of those statutes. Accordingly, most of the cases discussed in the Article concern the Fifth Amendment's restrictions on Congress and the federal bankruptcy courts. However, for purposes of describing the basic contours of due process, this Article will also discuss cases arising under the due process clause of the Fourteenth Amendment. Cf. Paul v. Davis, 424 U.S. 693, 702, n.3 (1976) (due process clause of fourteenth amendment comparable to due process clause in fifth amendment; and therefore, for purposes of its constitutional analysis, Court considers cases decided under either Clause).

There are essentially two prerequisites to the invocation of due process protections: (1) government action and (2) the deprivation of a constitutionally protected right or interest. With respect to the first requirement, it is beyond dispute that the enforcement of federal bankruptcy law by means of adjudication in federal courts constitutes government action which is subject to the

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[6] For an excellent discussion on the scope of Congressional powers under the Bankruptcy Clause, see Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 TENN. L. REV. 487 (1996). In this well written article, Professor Plank persuasively argues that federal bankruptcy legislation should be limited to prescribing the rights of insolvent debtors and their creditors and should not be used to create entitlements or liabilities for third parties.

restraints of due process. Cf. Tulsa Professional Collection Services, 485 U.S. 478 (1988) (state court's administration of probate estate constitutes governmental action)). Furthermore, the Supreme Court has held that a secured creditor's lien interest is a property right that is entitled to due process protections.[7] Thus, the utilization of the bankruptcy reorganization process to modify or extinguish a creditor's lien interest is clearly subject to the safe-guards of due process. However, assuming due process applies, the question remains as to what type of due process protections are afforded to secured creditors who hold liens on a debtor's property.

a. Substantive Due Process

Under the theory of substantive due process, legislation affecting "fundamental rights" that are guaranteed by the Constitution is subject to the highest standard of review, i.e., the "strict scrutiny test" under which it must be demonstrated that the legislation is necessary to promote a compelling government interest. In the post-Lochner era, economic interests generally do not qualify as "fundamental rights" of the type that are entitled to heightened constitutional protection.[8] Therefore, federal laws affecting economic interests, such as bankruptcy legislation, are generally not required to pass the strict scrutiny test. Rather, such legislation is subject to the lowest standard of review; namely, the "rational basis test," which merely requires that the legislation not be "arbitrary and capricious."

Because bankruptcy laws are primarily concerned with property rights and economic interests, it would be almost impossible to bring a substantive due process challenge to the Bankruptcy Code. While one might argue the point, it seems highly unlikely that a court would find that a particular section of the Bankruptcy Code is "arbitrary and capricious" under the lenient rational basis standard currently employed by the Supreme Court when reviewing constitutional challenges to economic legislation. Cf. Security Industrial Bank, 459 U.S. at 74 ("It may be readily agreed that § 522(f)(2) is a rational exercise of Congress' authority under Article I, Section 8, Clause 4 . . . ."). Moreover, given the broad powers granted to Congress under the Bankruptcy Clause, it could be argued that bankruptcy legislation is entitled to an even greater presumption of constitutional validity.

b. Procedural Due Process

Assuming a particular bankruptcy statute can easily pass the rational basis test, the application of the law must still comply with the requirements of procedural due process. If the

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[7] United States v. Security Indus. Bank, 459 U.S. 70, 74-76 (1982) (secured creditor's interest was "property" for purposes of Fifth Amendment); Louisville Joint Stock Land Bank v. Radford, 295 U.S. 555, 588-89 (1935) (bankruptcy power of Congress limited by mortgagee's Fifth Amendment rights); Mennonite Board of Missions v. Adams, 462 U.S. 791, 798 (1983) ("Since a mortgagee clearly has a legally protected property interest, he is entitled to notice reasonably calculated to apprise him of [an] impending sale.").

[8] In Lochner v. New York, 198 U.S. 45, 90 (1905), the Supreme Court struck down a New York statute limiting bakery employees to a 60-hour work week. Under what would become known as the doctrine of substantive due process, the Supreme Court held that the worker protection statute violated the individual worker's rights to freedom of contract. The Supreme Court subsequently repudiated Lochner in a series of cases upholding "New Deal" economic legislation. For a general discussion of the rise and fall of the Lochner doctrine, see LAURENCE H. TRIBE, AMERICAN CONSTITUTIONAL LAW, Chap. 8, at 560-86 (2d. ed. 1988). See also Planned Parenthood of Southeastern Pennsylvania v. Casey, 505 U.S. 833 (1992) (recognizing that Lochner has been overruled).

enforcement of the statute would result in the deprivation of a protected property interest, then the person who is adversely affected must be given adequate notice and an opportunity to object. This Article will examine the procedural due process limits on the ability of debtors to use federal bankruptcy law to deprive creditors of their security interests.

(1) Notice

In the landmark case of Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306 (1950), Justice Jackson set forth the classic exposition of the basic requirements of procedural due process: "An elementary and fundamental requirement of due process in any proceeding which has to be accorded finality is notice reasonably calculated, under all the circumstances, to apprize interested parties of the pendency of the action and afford them an opportunity to present their objections. The notice must be of such a nature as reasonably to convey the required information, and it must afford a reasonable time for those interested to make their appearance. But if with due regard for the practicalities and peculiarities of the case these conditions are reasonably met, the constitutional requirements are satisfied." Mullane, 339 U.S. at 413-15 (1950) (citations omitted).

The Mullane case involved a dispute as to whether a trust company could settle a common fund by simply publishing notice of the proposed settlement rather than contacting each of the numerous individual beneficiaries. The United States Supreme Court held that a New York statute which allowed notice by publication violated the fundamental tenants of due process, at least with respect to interested parties whose names and addresses were known and who could have been easily contacted. Because the Mullane decision involved a constitutional challenge to a state statute, it was decided under the Fourteenth Amendment, rather than the Fifth. However, the basic due process analysis with its emphasis on the importance of adequate notice is equally applicable to cases arising under the Fifth Amendment.

The Supreme Court applied a utilitarian approach in Mullane wherein the Court held that different types of claimants to a common fund were entitled to different types of notice. For instance, unknown beneficiaries could be notified by publication; whereas known beneficiaries were entitled to separate notice by mail, but were not entitled personal service of process. In other words, Mullane basically balanced the administrative costs of providing notice to the various types of claimants against the individual claimants' rights to due process.

Three years after issuing its decision in Mullane, the Supreme Court addressed the issue of adequate notice in the context of a bankruptcy case. In City of New York v. New York, New Haven & Hartford Railroad, 344 U.S. 293, 297 (1953) (hereinafter "New York Railroad"), the Court held that a creditor is entitled to adequate notice before its claim could be discharged and its liens extinguished. In that case, the City of New York had imposed liens for assessments on property owned by the debtor railroad. Pursuant to court order, the debtor sent notices to some of its creditors advising them of the bankruptcy and requiring them to file their claims before a specified date. The debtor also published the notice in several newspapers. The City did not receive a separate notice and it did not file a claim in the bankruptcy. After the deadline had passed, the debtor moved to bar the City from enforcing its liens. The district court granted the motion and the court of appeals affirmed.

The Supreme Court

granted certiorari on the question of whether the reorganization of the debtor railroad under the Bankruptcy Act destroyed the liens held by the City of New York. The City argued that its liens were still valid because it did not receive formal written notice of the bankruptcy. The debtor argued that notice by publication was sufficient. The debtor also argued that the City knew of the railroad's pending bankruptcy; and, therefore, the City was on inquiry notice. The Supreme Court rejected the debtor's arguments and held that, as a known creditor, the City was entitled to separate written notice of the proposed plan. In so holding, the Court stated that "even creditors who have knowledge of a reorganization have a right to assume that the statutory 'reasonable notice' will be given them before their claims are forever barred." Id. at 299. Several courts have relied on the Supreme Court's ruling in the New York Railroad case for the general proposition that known creditors are entitled to adequate notice and an opportunity to object prior to discharge of their claims.[9]

More recently, in Mennonite Board of Missions v. Adams, 462 U.S. 791 (1983), the Supreme Court struck down a state law which provided that property owners would be notified by certified mail of an impending tax sale, but that mortgage holders had to rely on posted and published notices. In so holding, the Court stated, "Notice by mail or other means as certain to ensure actual notice is a minimum constitutional precondition to a proceeding which will adversely affect the liberty or property interests of any party, whether unlettered or well versed in commercial practice, if its name and address are reasonably ascertainable." Id. at 800. In the Mennonite case, the Supreme Court expressly relied on the Due Process Clause of the Fourteenth Amendment in support of its conclusion that notice by publication was not an adequate substitute for individual written notice to known creditors. Id.

The Supreme Court has also stressed the importance of flexibility when attempting to establish the appropriate minimum requirements of substantive due process. Morrisey v. Brewer, 408 U.S. 471, 481 (1972) ("It has been said so often by this Court and others as not to require citation of authority that due process is flexible."). Justice Felix Frankfurter once observed that due process, "unlike some legal rules, is not a technical conception with a fixed content unrelated to time, places and circumstances. . . . [It] cannot be imprisoned with the treacherous limits of any formula." Joint Anti-Fascist Refugee Committee v. McGrath, 341 U.S. 123, 162 (1951) (Frankfurter, J., concurring). On the contrary, "the very nature of due process negates any concept of inflexible procedures universally applicable to every imaginable situation." Cafeteria & Restaurant Workers Union v. McElroy, 367 U.S. 886, 895 (1961).

In sum, the notice requirements set forth in Mullane are designed to be flexible and they vary according to the circumstances. For instance, a debtor may be able to rely on service by mail, rather than personal service in most cases. See, e.g., Mullane, 339 U.S. at 413-15. However, notice by publication may not be constitutionally sufficient, even if the creditor is generally aware of the existence of the bankruptcy proceedings. See, e.g., Mennonite, 462 U.S. at 800.

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[9]See, e.g., Spring Valley Farms, Inc. v. Crow (In re Spring Valley Farms, Inc.), 863 F.2d 832, 834 (11th Cir. 1989); Broomall Indus. v. Data Design Logic Sys., 786 F.2d 401, 405 (Fed. Cir. 1986); Reliable Elec. Co. v. Olson Const. Co. (In re Reliable Elec. Co.), 726 F.2d 620 (10th Cir. 1984); In re Intaco Puerto Rico, 494 F.2d 94 (1st Cir. 1974); In re Harbor Tank Storage, 385 F.2d 111 (3d Cir. 1967).

If the creditor's name and address is known or readily available, then the creditor should receive written notice of major events in the bankruptcy case which may affect the creditor's interests, such as the discharge of claims or the modification of the creditor's liens. However, if the creditors are unknown or individual mailings would be overly burdensome or impossible, then notice by publication may suffice.

(2) Hearing

In addition to adequate notice, the other essential element of due process is an opportunity to be heard. In the case of Frank v. Mangum, 237 U.S. 309 (1915), Justice Oliver Wendell Holmes wrote: "Whatever disagreement there may be as to the scope of the phrase "due process of law" there can be no doubt that it embraces the fundamental conception of a fair trial, with opportunity to be heard." Id at 347. The Supreme Court has basically adopted a utilitarian approach to procedural due process which weighs various factors that are used to determine the appropriate minimum standards of due process. The Court set forth the relevant factors in its 1976 opinion in Mathews v. Eldridge: "Our prior decisions indicate that identification of the specific dictates of due process generally requires consideration of three distinct factors: First, the private interest that will be affected by the official action; second, the risk of an erroneous deprivation of such interest through procedures used, and the probable value, if any, of additional or substitute procedural safeguards; and finally, the Government's interest, including the function involved and the fiscal and administrative burdens that the additional or substitute procedural requirements would entail." Mathews v. Eldridge, 424 U.S. 319, 334-35 (1976) (due process did not require an evidentiary hearing prior to termination of benefits to a social security recipient).

It is clear that a lienholder possesses a constitutionally protected property right. Thus, the first factor identified in Mathews v. Eldridge weighs in favor of a thorough adjudication of the issues prior to depriving a creditor of its lien rights. However, the third factor tends to weigh against imposing a complicated hearing process, and instead suggests the need for a simple and expeditious process of determining the creditor's lien rights. The second factor relates to the adequacy of the existing procedures.

B. DUE PROCESS LIMITS ON LIEN AVOIDANCE

The Bankruptcy Code and the Bankruptcy Rules contain various procedures that can be used to modify or extinguish a creditor's lien rights. The final part of this Article analyzes the alternative procedures in the context of the constitutionally mandated due process requirements of notice and hearing.

1. Notice of Plan

First, under Mullane and its progeny, a creditor is entitled to adequate notice that its lien interests will be modified upon confirmation of a proposed plan of reorganization. In cases filed under Chapters 12 and 13, the Bankruptcy Rules require that a creditor receive a copy of the plan or a summary of the plan prior to confirmation See FED. R. BANKR. P. 3015(d). A similar requirement exists in Chapter 11 cases. See FED. R. BANKR. P. 3017(d). However, in addition to the procedural requirement, there is also a constitutional mandate that the creditor be given adequate notice. Under the Supreme Court's decisions in the New York Railroad case and the more recent decision in the Mennonite case, the creditor is entitled to receive separate notice of the proposed plan, even if the creditor is already aware of the

debtor's pending bankruptcy. Thus, to the extent that the Seventh Circuit's opinion in Pence holds that a creditor is on constructive notice of the possibility that it will lose its liens upon confirmation of the plan, such a rule violates the minimum notice requirements of due process. In re Basham, 167 B.R. at 907-908 (In rejecting the Seventh Circuit's decision in Pence, the Basham court noted that the concept of "constructive notice" was particularly unfair to unsophisticated creditors).

Second, with respect to the type of notice required, Mullane makes it clear that personal service of process is not necessary; but that notice by publication is inadequate where the creditor is known to the debtor. In most cases, a debtor will be aware of the creditors who hold liens on the debtors property and it would not be unduly burdensome for the debtor to notify the creditors by mail of the debtor's intent to modify the creditors' lien interests. Thus, the minimum standards of due process require that the creditor receive some form of written notice that its lien interests will be adversely affected if it fails to object to the debtor's proposed plan of reorganization.

Third, in regards to the quality of the notice, Mullane commands that it should be "reasonably calculated, under all the circumstances, to apprize interested parties of the pendency of the action and afford them an opportunity to object." Mullane, 399 U.S. at 413-15. The Seventh Circuit's decision in Penrod runs afoul of this constitutional mandate to the extent that it holds that a creditor's liens are automatically terminated upon confirmation, even though the plan is silent with respect to the treatment of the creditor's liens. Leaving aside the statutory questions of whether a plan must specifically provide for (or deal with) a creditor's claims and interests, there is a constitutional imperative which obligates the debtor to expressly identify both the individual creditor and the specific property interests that are at stake. Thus, both the plan and the plan summary should explicitly describe the effect of the plan on the lien interests of each secured creditor.

As a matter of constitutional law, there is no reason that a debtor cannot combine a notice of hearing on the confirmation with a notice of hearing on the debtor's proposal to modify the creditor's liens. To require two separate mailings seems unnecessary and inconsistent with the Supreme Court's flexible approach to due process which balances the administrative costs associated with providing notice against the creditor's right to adequate notice. Although the notices may be combined, the notice of hearing should include at least some explicit and conspicuous information to alert the creditor whose lien interests at stake. See Linkous, 990 F.2d at 162-63. At a minimum, the notice of hearing should direct the creditor to the pertinent part of the proposed plan which prescribes the treatment of the creditor's lien. Although the notice need not be "expanded into a treatise on bankruptcy procedure," In re Rodgers, 180 B.R. 504, 506-507 (Bankr. E.D. Tenn. 1995) it should be more than "mere boilerplate." 4 NORTON BANKRUPTCY LAW § 95:5, at 133 (Supp. 1996) ("To allow the discharge of a creditor's property interest through 'boilerplate' language in a plan without serving notice of the debtor's intention is contrary to the due process protections under the Fifth Amendment."). See also Cen-Pen, 58 F.3d at 93 ("We do not think, however, that the Hansons' inclusion of this boilerplate language in the plan avoided the liens . . . .").

In a burst of rhetorical flourish, Bankruptcy Judge John J. Thomas once wrote: "A Chapter 13 plan must bear 'constitutional and statutory muster as to the vested property rights of secured creditors.' Without the measure of

protection afforded by clear language in the plan and sufficient notice to the creditor, the plan can be no more binding than if it has sat, unfiled, on the lawyer's desk." Burgess, 163 B.R. at 729 (quoting Matter of Anderson, 6 B.R. 601, 609 (Bankr. S.D. Ohio 1980)). Thus, while the precise content of the notice and plan will obviously vary from case to case, the fundamental principles of due process require that the notice be sufficiently detailed to alert even an unsophisticated creditor that its lien rights are in jeopardy if it fails to object to the proposed plan of reorganization.

2. Confirmation Hearing

Part of the debate between the claims allowance approach and the plan confirmation approach revolves around the degree of procedural requirements that are associated with each process. Under Bankruptcy Rule 7001, if a debtor files an objection to a secured claim which requires a determination of "the validity, priority or extent of a lien," then the debtor is required to file a separate adversary proceeding. In contrast, if a debtor seeks to modify a creditor's lien through the proposed plan, and the creditor objects to confirmation, the dispute will be treated as a "contested matter" and will be resolved at the confirmation hearing. See FED. R. BANKR. P. 9014.

Assuming that the statutory interpretation issue is resolved in favor of the plan confirmation process, there is no constitutional reason that would prohibit a court from modifying a creditor's lien interests in connection with a confirmation hearing. Under the balancing test set forth by the Supreme Court in Mathews v. Eldridge, the adverse affect on the creditor's property rights must be weighed against the administrative costs associated with additional judicial procedures. Those courts which require the debtor to file an objection to claim and a separate adversary proceeding impose a significant burden on debtors seeking to modify liens. Several courts have commented on the administrative problems associated with the claims allowance approach:

"As a practical matter, were [creditor's] reading of the code adopted, chapter 11 reorganization would be greatly complicated, for debtors would be required to challenge the claims of each and every lienholder prior to submitting a plan of reorganization, in order that the extent of its liabilities be known." See, e.g., In re Arctic Enterprises Inc., 68 B.R. 71, 80 (D. Minn. 1986); In re Northeast Office and Commercial Properties, Inc., 178 B.R. 915, 927 (Bankr. D. Mass. 1995)(same).

The problem is further complicated in Chapter 13 where a creditor may file a timely secured claim after the Chapter 13 plan has already been confirmed. Under these circumstances, a debtor would be required to file a claim on behalf of the creditor and then file an objection to the claim in order to comply with the requirements of the claims allowance approach. This procedure has been described as "unworkable" and has been cited as a reason for rejecting the claims allowance approach. See In re Basham, 167 B.R. 903, 908 (Bankr. W.D. Mo. 1994). The same procedure has also been criticized for being overly formalistic where the same result could be more easily achieved through the confirmation process. See 2 LUNDIN § 6.10, at 6-25.

Because of the significant administrative burdens associated with the claims allowance process, application of the Mathews v. Eldridge balancing test compels the conclusion that debtors should be allowed to accomplish lien modification through the confirmation process, so long as the creditor receives adequate notice and an opportunity to

object to confirmation of the plan.

Another key factor is the extent to which the additional procedures will reduce the risk of an erroneous deprivation of the creditor's property interest. Applying these general principles, it would appear that a debtor may use the confirmation process to modify a creditor's liens without violating due process. Because the creditor has the right to object to confirmation, it seems unnecessary to require that the debtor first file an objection to the creditor's secured claim. Thus, the due process clause does not require that a debtor address the creditor's liens through the claims allowance process as opposed to the confirmation process.

Not only does the creditor have a right to object to confirmation, but, as with any other contested matter, the creditor is free to call witnesses and present arguments to the court at the confirmation hearing. The creditor's rights are adequately protected in the hearing process and there is no compelling reason to require that the debtor comply with the additional procedures required to bring an adversarial proceeding.

If the creditor believes that the procedures used to resolve a contested matter are insufficient, then the creditor can request that the court exercise its authority to impose the rules which govern adversary proceedings pursuant to Rule 9014 which provides in part, "The court may at any stage in a particular matter direct that one or more of the other rules in Part VII shall apply." See FED. R. BANKR. P. 9014. Alternatively, the creditor may initiate an adversary proceeding to determine the validity of its lien even in the absence of an objection to its claim.

Indeed, the additional costs and delay that are typically associated with adversarial proceedings weigh heavily against imposing these procedural requirements, especially when viewed in light of the procedural safeguards that already exist as part of the confirmation process. Because the creditor has an opportunity to present objections at the confirmation hearing, the risk of erroneous deprivation is relatively small.

Moreover, all of the parties have a strong interest in completing the bankruptcy reorganization process in an expeditious manner so that the creditors can maximize their recovery and the debtor can quickly begin to take advantage of the "fresh start" offered by bankruptcy. Assuming the creditor has received adequate notice, there is no constitutional impediment that would prevent a court from determining a creditor's lien interests at the confirmation hearing. Those cases which hold that the filing of an adversary proceeding is a necessary prerequisite to modifying a creditor's lien, cannot be justified on the basis of fulfilling the requirements of due process. Due Process merely requires that the creditor have an opportunity to have its objections heard in court. This can be easily accomplished in the context of a confirmation hearing without unduly prejudicing the creditor.

CONCLUSION

Part I of this Article has identified an existing conflict in the case law. Part II has proposed a new approach to addressing the problem by focusing on the constitutional implications associated with the modification of liens through the bankruptcy process. The various Code provisions relating to the valuation of liens, the claims allowance process and the plan confirmation process are obviously inconsistent and cannot be easily reconciled. The courts are badly split on the question of which of these conflicting statutory schemes prevails, and the issue must ultimately resolved by Congress. In the interim,

however, courts must consider the overriding constitutional imperatives that must be obeyed, regardless of which approach courts choose to follow with respect to the statutory conflict. This Article has proposed an analytical framework which courts and practitioners can use to ensure compliance with the constitutional requirements of due process in connection with lien modification in bankruptcy reorganizations.

Rash Decision Settles Dispute Over Valuation of Secured Claims

By: Jim Shepherd

The Supreme Court has decided that replacement cost is the correct measure of a secured creditor's interest in collateral the debtor elects to retain under a plan of reorganization. *Associates Commercial Corp. v. Rash (In re Rash)*, 1997 WL 321231. The 8-1 majority, reversing the *en banc* Fifth Circuit, held that retained collateral must be valued at "the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." The case resolves a sharp split in authority over cramdown valuations.

Section 506(a) and "Cramdown"

At issue in *Rash* was how to set the value of collateral subjected to a chapter 13 cramdown under § 1325(a)(5)(B). In order to present a confirmable chapter 13 plan, a debtor who possesses encumbered property must make a choice: 1) retain the collateral, with the creditor's consent; 2) surrender the collateral; or 3) effect a cramdown. *See* § 1325(a)(5). A cramdown allows the debtor to keep and use the collateral over the objection of the creditor; in exchange, the creditor retains its lien and is entitled to receive payments through the plan of "not less than the allowed amount" of its secured claim. The "allowed amount" of the secured claim is determined under § 506(a). The first sentence of that section effectively splits secured claims into two parts, namely a secured portion "to the extent of the value of [the] creditor's interest in the estate's interest in [the collateral]," and the rest, which is unsecured. The second sentence, in pertinent part, states that the creditor's interest in collateral "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of [the secured] property ...."

Courts disagreed over how to measure § 506(a) "value" in the cramdown context. Was it limited to a measure of the creditor's rights, to the amount recoverable in a foreclosure? Or should courts take into account the debtor's proposed retention and use of the collateral, so that replacement cost was the right measure? Was the answer somewhere in-between? In *Rash* the Supreme Court provides a resolution.

Typical Chapter 13 Case

In 1989, Mr. Rash purchased a $73,000 Kenworth truck for his business. He paid $16,000 down and took out a loan to finance the rest, pledging the truck as collateral. Three years later he and his wife filed chapter 13, at the time owing $41,000 on the truck. They listed Associates, the note-holder, as a secured creditor in their bankruptcy schedules. The debtors' plan proposed a cramdown of Associates' claim. The 58-month plan provided for payments in an amount equal to the debtors' estimate of the present value of the truck at wholesale, $28,500. Associates objected and filed a proof of claim for an amount equaling the fair market value of a similar vehicle, about $41,000.

The bankruptcy court opted for a wholesale value of about $32,000 - the amount it believed Associates could recover under a hypothetical repossession and resale of the truck. The district court affirmed but a panel of the Fifth Circuit reversed. On rehearing *en banc* a sharply divided (9-6) Fifth Circuit affirmed, holding that, as § 506(a) mandates a valuation

from the creditor's perspective, the creditor should receive no more than wholesale, or, the amount Associates would likely have received had it pursued its state law remedies. The dissent called for replacement value.

The United States and other creditor interests filed *amicus* briefs in favor of reversal, while the National Association of Chapter 13 Trustees and the National Association of Consumer Bankruptcy Attorneys, among others, wrote in support of affirmance.

Three-way Split

Courts were sharply divided over the issue. Some concentrated on the phrase "value of the creditor's interest" from the first sentence of § 506(a), taking it to mean that secured claims were limited to the amount the creditor could expect to recover from a hypothetical foreclosure sale. Although the *en banc Rash* decision was the only one at the circuit-level calling for foreclosure value, a few lower courts agreed. *See, e.g., In re Owens*, 120 B.R. 487 (Bkrtcy.E.D.Ark. 1990). Three circuits opted for fair market or replacement value. *In re Taffi*, 96 F.3d 1190 (9th Cir. 1996), *cert. pending; In re Trimble*, 50 F.3d 530 (8th Cir. 1995); *In re Winthrop*, 50 F.3d 72 (1st Cir. 1995). These courts, relying more on the second sentence of § 506(a), found in the debtor's choice to retain collateral a sufficient basis to set value at the debtor's cost of replacement.

Finally, two circuits recently adopted a split-the-difference approach, settling mid-way between fair market and wholesale values. The Second Circuit held that the bankruptcy court was within its discretion in applying a local split-the-difference rule; the Seventh, finding that § 506(a) gave the court room to create a suitable benchmark, reasoned that a mid-way regime would foster economic efficiency by providing a clear rule that properly balanced debtor and creditor rights. *In re Valenti*, 105 F.3d 55 (2nd Cir. 1997); *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996).

The Sixth Circuit, ruling on a closely related issue, refused to allow the trustee to deduct from the value of a fully secured claim the cost of a hypothetical foreclosure sale. *In re McClurkin*, 31 F.3d 401 (1994); *accord In re Coker*, 973 F.2d 258 (4th Cir. 1992); *In re Dinsmore*, 141 B.R. 499 (Bkrtcy.W.D.Mich. 1992) (Howard, J.).

Code Trumps State Law

Speaking for the *Rash* majority, Justice Ginsberg launched the court's analysis by rejecting the Fifth Circuit's interpretation of the phrase "an allowed claim ... is a secured claim to the extent of the value of such creditor's interest [in collateral]" from the first sentence of § 506(a). In the Fifth Circuit's view, the phrase required the court to value the secured claim from the creditor's perspective. The Code, the lower court explained, did not "clearly compel" a departure from state law, and thus Associates' claim was limited to the amount it could recover from a foreclosure sale under Texas law. After dismissing the legislative history as "unedifying, offering snippets that might support either standard of valuation," the majority ruled that the first sentence of § 506(a) is silent regarding valuation method; instead, it merely splits a secured claim into a secured and unsecured part and tells courts to measure the value the "creditor's interest" in collateral - the secured part. The second sentence dictates the proper valuation method. According to the court, where cramdown is invoked to stave off foreclosure, § 506(a) prohibits a valuation at wholesale. The replacement value rule, on the other hand, accurately accounts for the debtor's "proposed use" of the property, and is, therefore, the correct valuation standard. The court explained that, the debtor in this case elected to use the collateral to generate an income stream. That actual use, rather than a foreclosure sale that will not take place, is the proper guide under a prescription hinged to the property's "disposition or use."

The majority, continuing with its attack on the Fifth Circuit's "state law wins" view, observed that a cramdown, by its terms, disrupts the state law debtor/creditor relationship: the debtor, armed with a power available only in bankruptcy, is able to severely restrict the creditor's state law foreclosure rights. The court concluded that the debtor's cramdown power is tempered properly under a valuation policy that takes account of the debtor's retention and use of collateral. In the justices' view, when a debtor retains encumbered property under a cramdown, "the creditor obtains at once neither the property nor its value and is exposed to double risks: the debtor may again default and the property may deteriorate from extended use." Further, § 361 and other Code-provided creditor protections "do not fully offset these risks." Replacement value, on the other hand, "accurately gauges the debtor's 'use' of the property." In short, where cramdown is concerned, federal bankruptcy law dictates the proper valuation of collateral.

Next, the majority dispensed with the Seventh Circuit's split-the-difference method as lacking textual support from § 506(a). The justices explained that "[§ 506(a)] calls for the value the property possesses in light of the 'disposition or use' in fact 'proposed,' not the various dispositions or uses that might have been proposed." Finally the court rejected without comment the "ruleless," facts-and-circumstances approach endorsed by the Second Circuit.

Justice Stevens dissented. In his view, the purpose of a cramdown valuation is "to put the creditor in the same shoes as if he were able to exercise his lien and foreclose." Creditors are provided the present value of liens under § 1325(a)(2)(B), are protected under § 361, and receive interest to off-set their risks. The majority erred in reading § 506(a)'s "proposed use" language as a call for replacement value. That phrase, he explained, need not be given special meaning in the cramdown context because § 506(a), as a "utility" provision, is applied in various ways throughout the Code. Justice Stevens concluded that the replacement cost rule "simply grants a general windfall to undersecured creditors at the expense of unsecured creditors."

While we may be left to argue over issues such as how to derive "replacement cost" in particular cases, the *Rash* decision provides a conceptual starting point and squarely rejects several widely-used valuation methods. Incidently, as the court did not expressly limit its ruling to chapter 13 cramdowns, *Rash* would appear to apply in chapter 11 as well. *See* § 1129(b)(2)(A)(i).

Relation-back periods: *In re Beasley*

The Supreme Court has agreed to hear another bankruptcy case involving state-versus-federal law, *In re Beasley,* 102 F.3d 334 (8th Cir. 1996), *cert. granted,* 1997 WL 107169 (May 12, 1997). In that case, a preference matter, the Eighth Circuit held that the 20-day "relation-back" period of § 547(c)(3)(B) prevailed over a state law which allowed greater than twenty days. While many courts have agreed that § 547(c)(3)(B) trumps state relation-back laws relating to whether and when a purchase money security interest is perfected, there is a split in circuit court authority over the issue.

Twenty-One Days After Purchase

The *Beasley* creditor took the last step necessary to perfect a purchase money security interest in the debtor's car on the twenty-first day after it was purchased. Nevertheless it argued that Missouri's thirty-day relation-back period governed the issue of perfection. The bankruptcy court disagreed, holding the state "relation-back" statute inapplicable. The district court affirmed, as did the Eighth Circuit

In accord with *Beasley* is *In re Locklin,* 101 F.3d 435 (5th

Cir. 1996) and *In re Walker,* 77 F.3d 322 (9th Cir. 1996). The opposite result was reached in *In re Hesser,* 984 F.2d 345 (10th Cir. 1993) and *In re Busenlehner,* 918 F.2d 928 (11th Cir. 1990), *cert. denied,* 500 U.S. 949, 111 S.Ct. 2251 (1991). No Western District bankruptcy or district level opinion has been published on the issue, nor has the Sixth Circuit ruled, although in an analogous case concerning a "contemporaneous exchange" under § 547(c)(1), the Code prevailed over state law. *See In re Arnett,* 731 F.2d 358, 364 (6th Cir. 1984).

Preferences: Purchase Money Security Interest Perfected?

Section 547 allows the trustee to avoid preferential transfers subject to several exceptions, including one for purchase money security interests, found in § 547(c)(3). Under that section, "the trustee may not avoid the transfer of [an otherwise preferential purchase money security interest] that is perfected on or before 20 days after the debtor receives possession of [the property subject to the interest]."

Section 547(e)(2)(A) instructs that when a transferee perfects an interest in property within a certain number of days - the relation-back period - the transfer is deemed "made ... at the time such transfer takes effect between [the parties]," that is, when they sign their agreement. In such a case, no antecedent debt and thus no preference exists. If, on the other hand, the transferee fails to perfect within the relation-back period, the transfer is deemed made "at the time such transfer is perfected, and an antecedent debt is born. *See* § 547(e)(2)(B). At issue in *Beasley* is, as between § 547(c)(3)(B) and state relation-back law, which determines whether the creation of a purchase money security interest was "for or on account of an antecedent debt"?

Law Amended in 1994

Prior to 1994, the holder of a purchase money security interest was allowed only ten days to perfect under § 547(c)(3)(B), the same period allowed for other transfers pursuant to § 547(e)(2)(A). Legislative history of the amendment suggests that Congress sought to square bankruptcy law with state law, where the majority of states had lengthened the time creditors were allowed to perfect purchase money security interests. *See* HR Rep. No. 989, 95th Cong., 2d Sess 20; 140 Cong.Rec. H10767 (Oct. 4, 1994); *see also* M.C.L.A. § 440.9301(d)(2) (Michigan relation-back period is 20 days).

RECENT BANKRUPTCY COURT DECISIONS

The Western District cases were summarized by Dean Reitberg.

Dischargeability Under §523(a)(6)

The issue facing the U.S. District Court in *Hall* was whether a debtor-employer who failed to purchase and maintain workers' disability compensation insurance may be found to have caused willful and malicious injury to his subsequently injured employee and therefore fall within the discharge exception as defined by 11 U.S.C. §523(a)(6). Federal District Court Judge Quist upheld the Honorable Jo Ann C. Stevenson's grant of summary judgment in favor of the Debtor, agreeing that §523(a)(6) "requires a willfully-caused injury, not just willful conduct." Accordingly, the Debtor was discharged from paying the disability award.

Right to Setoff under §553(a)

In the matter of *Wiegand v Tahquamenon Area Credit Union (In re Wiegand),* 199 B. R. 639 (W.D. Mich. 1996), U.S. District Court Judge Quist affirmed the Honorable Jo Ann C. Stevenson's bench opinion in which she held that the Debtors' exempt property remained subject to the credit union's right of setoff.

In the Bankruptcy Court, Judge Stevenson had dismissed the Chapter 7 Debtors' Motion to hold the Credit Union in contempt for failing to turnover to them post-discharge funds held in a credit union account which the Debtors had exempted. In upholding the Bankruptcy Court's ruling, Judge Quist affirmed that while the Debtors had properly exempted the funds in their credit union account, the credit union nonetheless possessed a right to set off the Debtors' account against the Debtors' prepetition debt to the credit union under Michigan Law. Moreover, the credit union could exercise its setoff right despite both the discharge of the credit union's debt and the account's exempt status.

Note: The decision in *Wiegand* appears to be contrary to Judge Howard's ruling in *In re Miel*, 134 B.R. 229 (Bankr. W.D. Mich. 1991)(I.R.S. not permitted to setoff Debtor's exempted tax refund against taxes owing).

STEERING COMMITTEE

The next Steering Committee meeting will be held on August 15, 1997 at noon at the Peninsular Club in Grand Rapids.

BANKRUPTCY NEWS

The following is a summary of future events:

Website Address: http://www.miw.uscourts.gov

EDITOR'S COMMENTS

The Pro Bono Program has received its first request for possible candidates. Those who have already agreed to participate maybe receiving a call in the very near future. I would like to thank the following individuals for agreeing to offer their services to the program:

Robert L. Lalley
Robert A. Hendricks
Peter A. Teholiz
James H. Richards (co-counsel)
James H. Cossit
William J. Napieralski
James Boyd (Trustee)
Perry G. Pastula
Thomas P. Sarb
David L. Conklin
Roger G. Cotner
Joseph M. Ammar
Robert F. Wardrop II
William H. Shaw
Lori L. Purkey
Robert J. Pleznac
Paul B. Newman
Timothy Hillegonds
Roland F. Rhead
Norman C. Witte
Barry G. Crown
Lisa E. Gocha
James B. Frakie
Steven L. Williams
Sirius L. Struble
Roger J. Bus
Alexander C. Lipsey
Martin L. Rogalski
Stephen L. Langeland
Philip Hodgman
Bruce R. Grubb
Harold E. Nelson
Daniel L. Kraft

The Program is still very much in need of additional attorneys - please volunteer a few hours of your time to this program. An application is enclosed. Please complete the application and return it to:

Rayman & Hamlin
Mary K. Viegelahn Hamlin
Pro Bono Liaison
141 East Michigan Ave. Ste. 301
Kalamazoo, MI 49007

Please also include your full name (printed), address and phone number.

This is my last edition of the Newsletter as editor. It is now time to pass the baton to Michael Donovan.

I would like to thank those attorneys and trustees who have contributed articles and case summaries. You made my job easy. Anyone who is interested in writing an article or doing case summaries please contact Michael Donovan.

FBA Boyne Highlands Bankruptcy Seminar Great Success!

Both attendees and participants praised the 1997 Boyne Highlands Seminar, terming it informative, helpful, and entertaining. Everyone heartily enjoyed "The Names Have Been Changed to Protect the Ignorant," with some remarking that the practice hints were well-presented and duly noted. Congratulations are due Judge James Gregg, Brett Rodgers, and Pat Mears for a job well done. Next year's FBA Seminar has been scheduled for **July 30th -August 1st at the Park Place Hotel in Traverse City**. The 1998 Committee, Judy Walton, Peter Teholiz and Judge JoAnn Stevenson ask that you mark your calendar and send along any and all ideas you might have as to educational topics, speakers, and social events.

LOCAL BANKRUPTCY STATISTICS

The following is a summary of the number of bankruptcy cases commenced in the United States Bankruptcy Court for the Western District of Michigan (Lower Peninsula) during the month of May and June, 1997. These figures are compared to those made during the same period one year ago and two years ago.

Bankruptcy Chapter	May of 1997	May of 1996	May of 1995
Chapter 7	718	588	477
Chapter 11	9	8	8
Chapter 12	3	3	0
Chapter 13	260	194	150
Totals	990	793	635

Bankruptcy Chapter	January - May of 1997	January - May of 1996	January - May of 1995
Chapter 7	2715	2247	1700
Chapter 11	30	28	26
Chapter 12	5	5	5
Chapter 13	1012	830	572
§304			1
Totals	3762	3110	2304

Bankruptcy Chapter	June of 1997	June of 1996	June of 1995
Chapter 7	639	470	379
Chapter 11	7	9	4
Chapter 12	2	0	3
Chapter 13	210	217	164
Totals	858	696	550

Bankruptcy Chapter	January - June of 1997	January - June of 1996	January -June of 1995
Chapter 7	3354	2717	2079
Chapter 11	37	37	30
Chapter 12	7	5	8
Chapter 13	1222	1047	736
§304			1
Totals	4620	3806	2854

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THE FEDERAL BAR ASSOCIATION FOR THE WESTERN DISTRICT OF MICHIGAN BANKRUPTCY *PRO BONO* PROGRAM

Attorney Enrollment Form

I wish to volunteer my services to the FBA's Bankruptcy *Pro Bono* Program. I understand this Program will provide *pro bono* counsel in adversary proceedings in which creditors object to the discharge of individual debtors or claim the nondischargeability of certain debts. *Pro bono* legal help will also be available to an indigent former spouse who sues the debtor regarding the dischargeability of obligations contained in the judgment for divorce. In completing this form I represent that I have sufficient experience in the areas of legal services to be provided (11 U.S.C. Sections 523 and 727).

I speak the following languages:

_____	American Sign Language	_____	Korean
_____	Arabic	_____	Polish
_____	Chinese	_____	Vietnamese
_____	Italian	_____	Other _____

_____ I am not interested in doing trial or hearing work, but would be willing to handle bankruptcy appeals.

_____ I have my own professional liability coverage for delivery of *pro bono* legal services to clients of the FBA Bankruptcy *Pro Bono* Program.

Please indicate any other availability for participation (*e.g.*, acting as an expert advisor to volunteer attorneys, providing training, making research tools available such as library, Lexis and Westlaw access, providing secretarial services, etc.): _____

_____

_____.

Please set forth any known conflicts of interest (*e.g.*, representation of institutional clients such as banks, credit unions, mortgage and automobile financing companies): _____

_____

_____.

Dated: _____ Signature: _____

Please complete and return to:

Mary K. Viegelahn Hamlin, Esq.
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