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IN THIS ISSUE

STUDENT LOAN DEBT IS NOT DISCHARGEABLE MERELY BECAUSE OF THE SIZE OF THE DEBT

In *Educ. Credit Mgmt. Corp. v. Jesperson*, 571 F.3d 775 (8th Cir. 2009), the Eighth Circuit Court of Appeals reversed the Bankruptcy Court's holding that the debtor's ("Jesperson") student loan debt was dischargeable.

In the Eighth Circuit the totality-of-the-circumstances test is applied to determine if the debtor met the undue hardship standard required under § 523(a)(8) to discharge student loans. Courts must consider the debtor's past, present, and reasonably reliable future financial resources, the debtor's reasonable and necessary living expenses, and any other relevant facts and circumstances.

Jesperson was a recently licensed attorney, 43 years of age, in good health, and unmarried with two noncustodial sons. He owed student loan debt of $304,463.62 to ECMC. Jesperson had never made a payment on these loans.

One of the primary issues in the case was the size of the debt. The Court of Appeals found that the only reason Jesperson had even a colorable claim of undue hardship was the "sheer magnitude" of his student loan debt. The Court found that "when size of the debt is the principal basis for a claim of undue hardship, the generous repayment plans Congress authorized … under the William D. Ford Direct Loan Program become more relevant." One such option is the income contingent repayment plan ("ICRP"). If the borrower has not repaid the loan in full under the ICRP, at the end of twenty-five years, the unpaid portion of the loan is canceled.

The ICRP became a primary focus of the opinion, generating both concurring and dissenting opinions. The law of the case holds the ICRP to be very significant. The majority finding that Jesperson's budget allowed him to make ICRP payments without compromising a minimal standard of living and thus "the debt should not be discharged."

The Bankruptcy Court had rejected the ICRP noting concerns over capitalized interest, future tax consequences and the fresh start, holding that "without the relief of discharge now, the debtor would, in effect, be sentenced to 25 years in a debtors' prison without walls."

However, the Court of Appeals disagreed on all fronts, noting that the Bankruptcy Court ignored both the explicit federal regulation that limited the capitalization of unpaid interest and the solvency requirements of the tax code. Further finding that, Congress "carved an exception to the 'fresh start' permitted by discharge for unpaid, federally subsidized student loans." Concluding that "[i]f the debtor with the help of an ICRP program can make student loan repayments while still maintaining a minimal standard of living, the absence of a fresh start is not undue hardship."

The budget calculation was also an area of contention. The Bankruptcy Court had concluded that the debtor's surplus income is "at best a trifle and more likely a fiction."

The Eighth Circuit again found error, holding that "[a] court may not engage in speculation when determining net income and reasonable and necessary living expenses." Concluding that a reasonable estimate would be a surplus of approximately $900 per month and consequently finding that "it is apparent that the [bankruptcy] court underestimated Jesperson's monthly net income and overestimated his reasonable and necessary living expenses…"

Finally, the Court of Appeals took issue with the Bankruptcy Court's findings regarding Jesperson's earning potential. The Bankruptcy Court had found that "it unlikely he would increase or even maintain his current rate of pay in the future." The Court of Appeals, held, "this pessimistic speculation is unwarranted and inappropriate. A debtor is not entitled to an undue hardship discharge of student loan debts when his current income is the result of self imposed limitations…"

The Court of Appeals accordingly reversed the Bankruptcy Court.

INCLUDING THE LANGUAGE "ALL ASSETS" IN A FINANCING STATEMENT IS ENOUGH UNDER THE UCC TO PUT A CREDITOR ON NOTICE THAT ANY OF THE DEBTOR'S ASSETS MAY BE ENCUMBERED.

In the case of *ProGrowth Bank, Inc, v. Wells Fargo Bank, N.A.*, 558 F.3d 809 (8th Cir. 2009), the Eighth Circuit Court of Appeals reversed the District Court's grant of summary judgment in favor of ProGrowth Bank.

Global One entered into a Promissory Note and Security Agreement with Hanson for a loan of one million dollars and as security for the loan, Hanson assigned his interests in two annuity accounts valued at a total of one million dollars. Wells Fargo, acting as a collateral agent for Global One, filed a financing statement for each annuity with the Secretary of State of Missouri. However, both the contract number and the issuer were incorrect.

Wells Fargo then filed a second financing statement correcting the contract number, but again the issuer was incorrect.

Subsequently, Hanson obtained a loan from ProGrowth. Again, as security he assigned his interests in the annuities. ProGrowth filed financing statements with the Secretary of State of Missouri, in which they accurately described the collateral.

ProGrowth then commenced this lawsuit in which it asked the court to enter a declaratory judgment holding that Wells Fargo had not perfected its security interest in the annuities due to the inaccurate descriptions of the collateral in the financing statements, and as such, ProGrowth's perfected security interests with respect to the annuities were superior to those of Wells Fargo.

The District Court granted ProGrowth's motion for summary judgment and this appeal followed.

In order to make the determination as to who's interest in the annuities had been perfected, the Eighth Circuit looked to Article 9 of the Missouri Uniform Commercial Code ("Missouri UCC").

Section 400.9-502(a) of the Missouri UCC requires a financing statement to contain the following in order to be sufficient: "(1) [p]rovides the name of the debtor; (2) [p]rovides the name of the secured party or a representative of the secured party; and (3) [i]ndicates the collateral covered by the financing statement." The parties' dispute involves the third requirement.

In order for a description of collateral to be considered sufficient, it must either meet the requirements of § 400.9-108, or it must indicate that the financing statement covers all assets or personal property. *See Id.*, § 409.9-504. Section 400.9-108 provides, "a description of real or personal property is sufficient, whether or not specific, if it reasonably identifies what's described." And this requirement is considered to be satisfied even if the description contains minor errors or omissions, unless those errors make the financing statement seriously misleading.

The Court held that since the purpose of a financing statement is to put subsequent creditors on notice that the debtor's property is secured, then the sufficiency of the financing statement rests upon whether "it provides notice that a person *may* have a security interest in the collateral claimed," citing, Mo. Rev. Stat. § 400.9-504 (UCC cmt. 2).

The Court concluded that it is necessary to analyze the financing statements in their entirety. Thus, identifying the collateral as "all assets or personal property", is enough to put subsequent searchers on notice that any item of collateral owned by the Debtor *may* be encumbered, which serves the purpose of the financing statement. The burden then rests with the creditor who uncovers the "all assets" language in the financing statement to investigate further as to whether the collateral at issue is covered by a security agreement.

Based upon this analysis and the fact that both financing statements filed contained the language which included all of debtor's assets or personal property, the Court held that Wells Fargo had met the filing requirements of the Missouri UCC, and the collateral had been sufficiently described. As such, the District Court's grant of summary judgment in favor of ProGrowth was reversed.

NON-DISCHARGEABILITY FINDING REVERSED WHERE CREDITOR'S RELIANCE WAS UNJUSTIFIED AND NO FIDUCIARY RELATIONSHIP EXISTED

In *R & R Ready Mix inc. v. Freier* (*In re Freier)*, 402 B.R. 891 (B.A.P. 8th Cir. 2009), the B.A.P. reversed the Bankruptcy Court's ruling that the Debtor's judgment debt was non-dischargeable under 11 U.S.C. § 523(a)(2)(A), § 523(a)(2)(B) and § 523(a)(4).

R&R Ready Mix, Inc. ("R&R"), provided the Debtor with concrete and related services on unsecured credit terms. The Debtor accrued a significant indebtedness to R&R and eventually defaulted on several agreed to payment schedules.

R&R sued the Debtor. The parties entered into a settlement agreement under which the Debtor agreed to make monthly payments and R&R agreed to continue to supply the Debtor with product.

After several months of compliance, the Debtor defaulted on the settlement agreement and under the terms thereof default judgment was entered against it. The Debtor filed Chapter 7 shortly thereafter and R&R initiated an adversary proceeding seeking a determination that the judgment debt was dischargeable.

The Bankruptcy Court ruled that the debt was non-dischargeable. It found that R&R justifiably relied on a false statement the Debtor's president made indicating that he was not taking any money out of the corporation for himself personally. The Bankruptcy Court further found that the financial statement Debtor provided was false because it understated the Debtor's liabilities. The B.A.P. reversed in all respects.

The B.A.P began its analysis with 11 U.S.C. § 523(a)(2)(A). Under that section, a debt is non-dischargeable if (1) the debtor made a false representation; (2) the debtor knew at the time that the representation was false; (3) the debtor made the representation deliberately and intentionally with the intention and purpose of deceiving a creditor; (4) the creditor justifiably relied on such representation; and (5) the creditor sustained alleged losses and damages as a proximate result.

In reversing, the B.A.P. found that the Debtor's compliance with the settlement agreement for several months (which compliance reduced the debt by thousands of dollars) was inconsistent with a finding that the Debtor had no intent to pay R&R. The B.A.P. further found that R&R's reliance on the Debtor's alleged statements were unjustified because if true, the Debtor would have been able to make payments for the year prior to the alleged statements. The B.A.P. also noted that the Debtor's president had informed R&R that if it did not continue to provide the Debtor with materials or demanded harsh repayment terms, a bankruptcy would be filed.

Turning to 11 U.S.C. § 523(a)(2)(B), the B.A.P held that R&R's reliance on the financial statement was not reasonable. The B.A.P. noted that R&R was aware that the statement did not include the money owed to R&R and that with inclusion of that liability the Debtor was insolvent. Despite this and other inaccuracies, the B.A.P. noted, R&R failed to make any inquiry or engage in even minimal investigation.

Finally, the B.A.P. addressed the Bankruptcy Court's finding that the judgment debt was non-dischargeable under 11 U.S.C. § 523(a)(4) by virtue of a fiduciary relationship between the Debtor and R & R. In reversing the Bankruptcy Court's finding, the B.A.P. held that the statue relied upon by the Bankruptcy Court to find a fiduciary relationship (Minn. Stat. § 514.02 sub. 1(a)) was inapplicable because it expressly precluded the finding of a fiduciary relationship between the Debtor and R&R. Absent a fiduciary relationship § 523(a)(4) was inapplicable and the Bankruptcy Court's finding thereunder was in error.

DISCHARGE CHALLENGE DISMISSED WHERE ALLEGED HARM TO CREDITOR NOT INFLICTED BY THE DEBTOR

In *In re Scott*, 403 B.R. 25 (Bankr. D. Minn. 2009), the Bankruptcy Court granted the Debtors' Rule 12(b)(6) motion to dismiss a complaint seeking to except debt from discharge under 11 U.S.C. §523(a)(2)(A), §523(a)(4) and §523(a)(6).

The Plaintiffs alleged that (1) they had been fraudulently induced to invest in Avidigm Capital Inc. ("Avidigm"), (2) were not provided the promised security for their investment and (3) that the Debtors' actions had deprived the Plaintiffs' investment of economic value. The 39 page amended complaint (described by the Bankruptcy Court as rambling, non-sequential and rhetorically-embellished), did not allege that the Debtors were employees, officers or authorized agents of Avidigm nor did it make any specific allegation that that Debtors had participated in an act of fraud that induced the Plaintiffs to invest. Instead, the Plaintiffs sought to impute to the Debtors the acts and conduct of third parties who allegedly participated in a conspiracy with the Debtors to defraud the Plaintiffs.

The Bankruptcy Court first addressed whether the Debtors could be denied a discharge where the alleged harm was inflicted by a third party.

The Bankruptcy Court noted that the inquiry on dischargeability focuses on the acts of the debtor, but recognized that Supreme Court authority contemplated denial of a discharge to an innocent debtor for harm caused by a third party. The Bankruptcy Court further noted that a small number of other courts have held that "acts intrinsically meriting non-dischargeability… can be attributed to a debtor who did not perform them, if the debtor was a knowing active participant in a scheme or conspiracy though which a third-party malefactor performed the acts, and that the court can except from discharge any debt imposed… for damage done by the conspiracy."

The Bankruptcy Court found that the Plaintiffs had made only a blanket assertion that the Debtors participated in a "Avidigm-based cabal" and had provided no detail to establish that the Debtors were "knowing, active participants" in its operations. Without more than such a label and conclusion, the Bankruptcy Court held that the Plaintiffs' derivate non-dischargeability theory did not pass muster under Rule 8 of the Federal Rules of Bankruptcy Procedure.

With the analysis focused solely on the acts and conduct of the Debtors, the Bankruptcy Court readily disposed of the Plaintiffs' claims for exception from discharge under 11 U.S.C. §523(a)(2)(A), §523(a)(4) and §523(a)(6). Finding the complaint devoid of any specific recitations (1) that the Debtors had anything to do with the alleged inducement (§ 523(a)(2)(A)), (2) that a fiduciary relationship existed between the Debtors and the Plaintiffs or that they clearly identified the property of the Plaintiffs that would have been the subject of a misappropriation by the Debtors (§ 523(a)(4)) or (3) that the Debtors inflicted injury with the requisite intent (§ 523(a)(6)). The

Bankruptcy Court thus dismissed the Complaint pursuant to Rule 12(b)(6).

IRS CLAIM DISALLOWED FOR TRUST FUND RECOVERY AGAINST DEBTOR WITH NO INDEPENDENT DECISION MAKING AUTHORITY

In *In re Palmer*, 403 B.R. 18 (Bankr. D. Minn. 2009), the Bankruptcy Court disallowed a proof of claim filed by the IRS which asserted a priority claim for a trust fund recovery penalty against Debtor.

The disputed tax penalty stemmed from Debtor's failure to remit employment and income tax withholdings to the IRS on behalf of his employer. Debtor worked as a deputy director for a non-profit charter school in Minneapolis. Prior to his hiring, the school had already failed to remit tax withholdings to the IRS, and he was not told of the delinquencies upon his arrival.

Part of Debtor's job responsibilities includes signing payroll checks and tax returns, but he did so strictly at the behest of the school's director. The director made all business decisions as to who to pay, and whether or not to deposit tax withholdings. The director also made decisions regarding payment of employees and other vendors.

Debtor became aware of the school's tax liability shortly after his arrival, and the school's director requested that Debtor communicate with the IRS in settlement of the liability. During that process, Debtor executed a power of attorney on behalf of the school so that the IRS could negotiate with him. Debtor also felt during negotiations that he should claim he had full authority over all business decisions at the school, which was not true. Debtor exaggerated the importance of his position because he thought it was necessary in order for the IRS to provide information to him on the liabilities. The IRS, not knowing Debtor's real position, justifiably believed his statements of authority and assessed a trust fund recovery penalty against him as the responsible person who willfully failed to remit tax withholdings. Accordingly, in Debtor's bankruptcy, the IRS filed a proof of claim in the amount of $38,450.80.

The Bankruptcy Court applied a two-part test to determine liability for a trust-fund recovery penalty. First, was the assessed party a responsible party. Second, was non-payment a willful act.

The Bankruptcy Court disallowed the priority claim because Debtor was not a responsible party. He could sign checks and tax returns, but had no independent decision making authority. Rather, he performed these ministerial acts entirely under the control of the school's director.

DEBTOR NOT ALLOWED TO MODIFY THE RIGHTS OF SECURED MORTGAGE CREDITOR

In *In re Hughes*, 403 B.R. 634 (Bankr. D. Minn. 2009), the Bankruptcy Court affirmed a long-standing rule in Chapter 13 cases that a debtor cannot modify the rights of a secured creditor that claims a mortgage on debtor's principal residence. In this case, TCF National Bank claimed a second mortgage on Debtor's homestead. Debtor's Chapter 13 plan did not propose any payments to

TCF, and instead classified TCF as an unsecured creditor. Debtor argued that the first mortgage exceeded the value of her homestead, and as a result TCF's second mortgage and debt was unsecured.

TCF requested that the Court lift the automatic stay to permit foreclosure of the homestead as Debtor was not making payments and the plan did not provide for payments. The Court granted the motion citing 11 U.S.C. § 1322(b)(2) which provides that a Chapter 13 plan may not modify "a claim secured only by a security interest in real property that is the debtor's principal residence." As a result, TCF could foreclose its mortgage since Debtor did not provide for TCF in the plan. Quoting its prior decision in *In re McConnell*, 296 B.R. 197 (Bankr. D. Minn. 2003), the Court stated "the purpose of the statute is to protect the stability and affordability of the residential lending market by excluding cram down of residential loans."

MORTGAGE AGAINST DEBOTRS' HOMESTEAD HELD TO BE NULL AND VOID FOR LACK OF VALID SIGNATURE BY ONE SPOUSE

In the case of *In re Holmes*, 403 B.R. 634 (Bankr. D. Minn. 2009), the Bankruptcy Court held that, "[t]he Debtors proved their entitlement to a judgment that the registered mortgage against their homestead is null and void."

Debtors fell behind on their mortgage payments to the first mortgage holder on their homestead, Ocwen Federal Bank. In an attempt to catch up on the mortgage payments and other household expenses, the Debtors sought to refinance the loan on their homestead. Specifically, Debtors chose to work with Ameriquest on the refinance

Shortly after beginning this process, Robert Holmes was arrested on a probation violation and taken into the custody of the Minnesota Department of Corrections. He was incarcerated for nine months. Julie Holmes continued the loan application process while her husband was incarcerated with his knowledge and consent. The Ameriquest representative who the Debtors were working with knew of Robert Holmes's incarceration within a month of the date he was arrested.

However, Ameriquest hired a "mobile closer" to come to the Debtors' home in Duluth in order to obtain their signatures on the loan documents. When she arrived, she learned that Robert Holmes was incarcerated. She did not know this before she arrived at their home. She proceeded to obtain only Julie Holmes's signature on the appropriate documents.

When the documents arrived at the St. Louis County recorder's office they bore a hand-written signature and initials purporting to be those of Robert Holmes. However, Robert Holmes could not have signed the documents because he was incarcerated at the time. Furthermore, there was no record of any visits while he was incarcerated from anyone besides his wife and an attorney. Robert Holmes testified that he never received the documents in the mail while incarcerated. All the evidence on record led the Court to determine that the signature had been forged and most likely had been forged by someone at Ameriquest.

The Court first looked to Minnesota Statute § 507.02 which states:

> If the owner is married, no conveyance of the homestead, except a mortgage for purchase of money …shall be valid without the signature of both spouses. A spouse's signature may be made by the spouse's duly appointed attorney-in-fact.

Upon review of this statute, and in conjunction with the facts of the case, the Court concluded, "[b]ecause it did not bear the signatures of both of the two spouses who owned the subject real estate as their homestead, the…instrument was ineffective to convey a mortgage to Ameriquest," and as such was void.

The Court next looked to the validity of the affirmative defenses raised, the first of which consisted of the argument that "the Debtors ratified the attachment of the mortgage by their conduct after the closing, and therefore are estopped from denying it." However, a court of equity can only apply the doctrine of estoppel so long as it would not result in an utter disregard of statutory law or grant any relief which would be contrary to statutory law. Since Minnesota Statute §507.02 is clear that both spouses' signatures are required for non-purchase money mortgages, any holding estopping the non-signing spouse from asserting the protection of that statute would obviously be contrary to statutory law. Thus, the first affirmative defense put forth by Deutsche Bank failed.

The second affirmative defense asserted by Deutsche Bank was that they should be equitably subrogated to Ocwen's secured position, because the loan proceeds were used to pay the Debtors' debt to Ocwen. However, in order to be able to succeed in substitution to the rights and position of the secured creditor, Deutsche Bank must have "'acted under a justifiable or excusable mistake of fact' in enabling the satisfaction of the Ocwen debt; and, it must establish that it was an 'innocent party' that otherwise would be injured."

Based on evidence which proved that Ameriquest knew that Robert Holmes was incarcerated and could not have signed the documents at the same time as Julie Holmes and because no measures were taken by any employees of Ameriquest to take the proper measures to obtain Robert Holmes's signature, it was clear that there could have been no justifiable or excusable mistake of fact on the part of Ameriquest. And certainly, they are not an innocent party since Ameriquest's employees were "grossly reckless at best, and overtly fraudulent at the extreme." Thus, the second affirmative defense also fails for Deutsche Bank.

Based upon the facts on the record and the applicable legal authority, the court found the mortgage against the Debtors homestead to be null and void.