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A CREDITOR WHO PROVIDES A PURCHASE-MONEY MOTOR VEHICLE LOAN WITHIN 910 DAYS BEFORE A CHAPTER 13 DEBTOR FILES BANKRUPTCY DOES NOT LOSE AN UNSECURED CLAIM FOR A DEFICIENCY JUDGMENT WHEN THE DEBTOR SURRENDERS THE VEHICLE

Capital One Auto Finance v. Osborn, No. 07-1726 (8th Cir. Feb. 5, 2008) and AmeriCredit Financial Services, Inc. v. Moore, No. 07-1315 (8th Cir. Feb. 5, 2008) involved the "hanging paragraph" that describes the unnumbered paragraph at the end of Section 1325 of the Bankruptcy Code. The hanging paragraph impacts a lender's position in a Chapter 13 plan regarding a purchase-money security interest in a motor vehicle. The Eighth Circuit reversed the lower courts and concluded that a creditor who provides a purchase-money motor vehicle loan within 910 days before a Chapter 13 debtor files bankruptcy does not lose an unsecured claim for a deficiency judgment when the debtor surrenders the vehicle.

The hanging paragraph provides that Section 506, including its methods of cram-down and bifurcation, no longer applies when the debtor incurs a purchase-money security interest in a motor vehicle within 910 days prior to the bankruptcy. The 8th Circuit addressed how the hanging paragraph operates when the Chapter 13 debtor surrenders an undervalued "910-day vehicle."

In both cases, the debtors argued that surrender eliminates any deficiency claim since surrender under Section 1325 fully satisfies an allowed secured claim for the purpose of Chapter 13 confirmation, and Section 506 no longer applies to provide the creditor with a general unsecured claim through bifurcation.

The Eighth Circuit concluded that since the hanging paragraph eliminates all reference to Section 506, state law must define the nature of the secured creditor's claim. Section 1325 does not define the amount or nature of the creditor's claim when surrender occurs, but only states that the court must confirm the plan if the debtor surrenders the collateral. The hanging paragraph on its own does not bifurcate or cram down the claim. Since the Code elsewhere is silent on the nature and amount of the claim when surrender occurs, the Court applied state law.

The Court found that the applicable state law in both cases permitted deficiency judgments when a creditor regained possession of the vehicle. Further, the loan documents executed by the debtors in both cases permitted deficiency judgments in this scenario. Therefore, the Court permitted the creditors to have general unsecured claims in the amount that their claims exceeded the value of the collateral.

DEBTOR KNOWINGLY AND FRAUDULENTLY FAILED TO TURN OVER HIS TAX REFUND

In the case of In re Robert D. Klages, No 07-6051 SI (B.A.P 8th Cir. Jan. 31, 2008), the Bankruptcy Appellate Panel for the Eighth Circuit held that the evidence supported the Bankruptcy Court's revocation of the debtor's discharge due to the fact that the debtor knowingly and fraudulently failed to deliver his non-exempt tax refund to the trustee.

At the meeting of the creditors, the trustee advised the debtor that any tax refund he receives may be property of the bankruptcy estate, and as such he should not spend any of the refund without contacting the trustee's office, even after receipt of a notice of discharge. In addition to the verbal warning by the trustee, the debtor was also given a written handout containing the same warning further advising that failure to heed this warning could result in the revocation of his bankruptcy discharge.

The debtor ignored directions to appear for examination and turn over $1,556.11 of his tax refund. The trustee then filed a complaint seeking revocation of the debtor's discharge because the debtor knowing and fraudulently failed to deliver his non-exempt refund to the trustee. The debtor testified that he recalled receiving the verbal warning from the trustee at his meeting of the creditors instructing him not to spend his tax refunds, and that he recalled receiving a handout from the trustee, but that he did not read it. He further testified that he understood the trustee's request to mean that he was not to spend any of his refund without first contacting the trustee, but that he believed that once he received his discharge, he did not owe anyone any money and that the trustee was no longer interested in his tax refund.

The Bankruptcy Court found the debtor's testimony that he believed he could spend his tax refunds was not credible because of the warnings he received to the contrary. Based upon this, the Bankruptcy Court found that he knowingly spent the refunds with the intent to defraud the trustee and the bankruptcy estate. And based upon these findings, the Bankruptcy Court revoked the debtor's discharge and the debtor appealed the revocation.

The sole issue on appeal was whether the debtor knowingly and fraudulently failed to turn over the non-exempt tax refund. The B.A.P. first looked to 11 U.S.C. § 727(d)(2), which states that a debtor's discharge shall be revoked if the debtor knowingly and fraudulently fails to report the acquisition of property, which is property of the estate, or fails to turn over such property. The discharge will only be revoked if the debtor's failure to deliver the property of the estate is done so knowingly and fraudulently.

The B.A.P. found that the debtor did knowingly fail to fulfill his duty to turn over his tax refunds to the trustee based upon the debtor's testimony that he received a verbal, as well as a written, warning from the trustee that he was not to spend any of his tax refund without first contacting the trustee, even after he received notice of his discharge.

The B.A.P. next turned to whether the debtor's failure to turn over his tax refunds to the trustee was also fraudulent. The Court found that the debtor ignored information which was given to him and then claimed ignorance, and that this behavior was so reckless that fraud could be implied.

The B.A.P. gave due deference to the Bankruptcy Court's finding that the debtor's testimony was not credible and concluded that the Bankruptcy Court correctly applied the law. As such, they affirmed the Bankruptcy Court's judgment revoking the debtor's discharge.

TRUSTEE UNABLE TO PROVE PREFERENCE OR FRAUDULENT TRANSFER

In James Killips v. Robert C. Schropp, RCS Sons, Inc. and Leo Dahlke (In re: Prime Realty, Inc.), No. 07-6034NE and 07-6034NE (B.A.P. 8th Cir. Dec. 27, 2007) the B.A.P. upheld the Bankruptcy Court's decision dismissing adversary proceedings against the defendants because the trustee failed to meet his burden of proof on the preference actions and fraudulent conveyance claims.

Prime Realty, Inc. ("Prime") was involved in several joint ventures with Leo Dahlke ("Dahlke") and RCS & Sons, Inc. ("RCS"), the sole shareholder of which is Robert C. Schropp ("Schropp"). The joint ventures consisted of various partnerships for which Prime was the general partner.

In 2000 the partnerships began experiencing financial difficulties. Under a plan to address the partnerships' liquidity problems, RCS and Dahlke agreed to obtain a $2,072,000 loan from Nebraska State Bank, the proceeds of which would be used to fund capital needs of the partnerships and Prime's purchase of RCS's and Dahlke's interests in the partnerships. In turn, Prime agreed to repay the loan directly to Nebraska State Bank.

Following the closing of the loan transaction, Prime paid RCS $313,682.45 and paid Dahlke $293,682.45. Prime, however, failed to make any payments on the Nebraska State Bank loan and, after July 1, 2001, stopped making payments to RCS and Dahlke.

On March 15, 2002, Prime filed a petition for relief under Chapter 11 of the Bankruptcy Code. Following the bankruptcy filing, the trustee filed adversary proceedings against RCS and Dahlke to avoid and recover the transfers they received as either preferential under 547(b) or constructively fraudulent under 548(a)(1)(B).

The Bankruptcy Court consolidated the adversary proceedings and also found that because the defendants were insiders, the one-year look back period applied for purposes of Section 547. However, because the transfers were made outside the 90 day period prior to the petition date, the trustee was not entitled to the presumption of insolvency. The key issue at trial was whether Prime was insolvent at the time it made the transfers or whether it had an unreasonably small amount of capital after making the transfers.

The trustee testified that in early 2003 the market value of Prime's assets was over $2,000,000 less than the values reflected on the balance sheet. However, Prime's balance sheet at the time of the transfers showed it was solvent by approximately $165,000.

On the question of whether Prime was left with an unreasonably small amount of capital following the transfers, the trustee produced several default notices from Nebraska State Bank as evidence that Prime was having difficulty meeting its financial obligations.

The Bankruptcy Court dismissed the adversary proceedings, holding that the trustee failed to demonstrate that Prime was insolvent at the time of the transfers. Additionally, the Bankruptcy Court noted that the loan transaction by and among RCS, Dahlke, Prime and Nebraska State Bank resulted in a net $1,600,000 cash infusion to Prime, and therefore, the trustee failed to prove that Prime was left with an unreasonably small amount of capital as a result of the transfers.

The trustee appealed to the B.A.P. On the issue of insolvency, the B.A.P. agreed with the Bankruptcy Court, noting that the relevant time frame for determining the solvency of Prime was 2001, at which time Prime's assets exceeded its liabilities by approximately $165,000. According to the B.A.P., the trustee's testimony as to Prime's financial condition in 2003 was not probative as to the question of Prime's insolvency in 2001. The B.A.P. further found that the trustee is not a financial expert, accountant, real estate appraiser or otherwise qualified to proffer an opinion as to the true value of Prime's assets in early 2001.

The B.A.P. rejected the trustee's arguments based on the theory of "retrojection", whereby the plaintiff can establish insolvency by showing that the debtor was insolvent shortly after making the transfers and the debtor's financial condition did not change substantially in the interim. The B.A.P. noted that the trustee failed to offer evidence of when Prime became insolvent and did not establish that Prime's financial condition had not substantially changed between the time of the transfers and when it may have become insolvent.

The B.A.P. also upheld the Bankruptcy Court's dismissal of the trustee's fraudulent conveyance claims. The B.A.P. reiterated the Bankruptcy Court's findings that because the net effect of the loan transaction with Nebraska State Bank and transfers to RCS and Dahlke was a $1,600,000 cash infusion into Prime, the transfers did not make Prime insolvent.

The B.A.P. considered whether the transfers left Prime with an unreasonably small amount of capital to operate its business. The B.A.P. acknowledged that the Prime default notices presented by the trustee supported his position, but ultimately determined that the Bankruptcy Court's finding to the contrary was not clearly erroneous where there was evidence that Prime continued to operate for almost a year after the transfers and where the trustee failed to introduce any evidence as to Prime's capital structure.

The last issue considered by the B.A.P. was whether a finding of fact in a prior order in an unrelated adversary proceeding involving RCS and Dahlke collaterally estopped them from denying Prime's insolvency. The B.A.P. noted that the finding of fact in the prior order was not conclusive as to whether Prime was insolvent or was operating with an unreasonably small amount of capital. Accordingly, such finding did not collaterally estop RCS or Dahlke from denying that Prime was either insolvent or operating with an unreasonably small amount of capital.

HYPOTHETICAL LIQUDATION TEST IS CONDUCTED AS OF THE PETITION DATE

In Falcon Creditor Trust v. First Insurance Funding, No. 07-6036 (B.A.P. 8th Cir. Jan. 28, 2008), the B.A.P. held that the hypothetical liquidation test under 11 U.S.C. § 547 should be conducted as of the petition date, not the date of the alleged preferential transfer.

First Insurance Funding ("First Insurance") entered into a commercial premium finance agreement with debtor whereby the debtor made an initial down payment on the insurance policies and agreed to pay the rest in monthly installments. First Insurance retained a security interest in the unearned premiums under the policies to secure the premiums financed. debtor made two monthly installment payments in the 90 days prior to the filing of the case. At the time of both transfers, the value of the unearned premiums (First Insurance's collateral) exceeded the debt. But on the petition date, the debt exceeded the value of the unsecured premiums. Falcon Creditor Trust commenced an action to recover the transfers as preferential transfers under 11 U.S.C. § 547.

The only element in dispute under section 547 was the hypothetical liquidation test. Specifically, was the test applied as of the date of the transfers or the petition date. The B.A.P. held the test should be conducted as of the petition date. The Court held that this determination was mandated by the Supreme Court's decision in Palmer Clay Products Co. v. Brown, 297 U.S. 227, 229 (1936):

> Whether a creditor has received a preference is to be determined, not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, but by the actual effect of the payment as determined when bankruptcy results.
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> We may not assume that Congress intended to disregard the actual result, and to introduce the impractical rule of requiring the determination, as of the date of each payment, of the hypothetical question: What would have been the financial result if the assets had then been liquidated and the proceeds distributed among the then creditors?

The Court noted this result may seem "illogical" as a payment on a claim fully secured at the time of the transfer might be a preferential transfer. Such a creditor, however, likely has a contemporaneous exchange of new value defense. The payment to the creditor results in a release of an equivalent value of collateral, which would be made available to the bankruptcy estate -- new value. To conduct the hypothetical liquidation test as of the date of the transfer would improperly conflate the preference analysis with the contemporaneous exchange defense.

DEBTORS USE DERIVATIVE AVOIDANCE REMEDY TO RECOVER EXEMPT FUNDS FROM CREDITOR AFTER LEVY

In Rae v. Spruce Financial, LLC, et. al, Adv. No. 06-3037 (Bankr. D. Minn. Jan. 18, 2008), the Bankruptcy Court found a debtor could recover from a creditor the funds that creditor had levied upon from debtor's bank account both pre- and post-petition.

The debtors' voluntary Chapter 7 case was designated "no asset" and a discharge was granted. One month before the case closed, debtors filed an adversary proceeding to recover approximately $1,000 from Spruce Financial using Section 522(g) – (i) as a derivative avoidance remedy.

Spruce Financial had served levies on debtors' bank and received $830 pre-petition and $240 post-petition. In their schedules, debtors claimed certain bank funds were exempt under Section 522(d)(5). In their amended schedules, debtors claimed the funds levied on by Spruce Financial were also exempt. There were no timely objections to the debtors' claimed exemptions.

In considering cross-dispositive motions, the Bankruptcy Court noted that Section 522(g) and (h) allow a Chapter 7 debtor to exercise certain avoidance powers of a trustee where: (1) the property transferred pre-petition would have been exempt in the bankruptcy case; (2) the property was not transferred voluntarily; and (3) the trustee has not brought an action to avoid the transfers.

The Court found the $850 pre-petition transfer avoidable under Section 547 even though Spruce Financial served its levy more than 90 days prior to the petition date because an avoidable transfer occurred on the date the check was honored by debtors' bank. The Court also found the $240 post-petition transfer avoidable under Sections 550 and 362.

The Bankruptcy Court further found that the liens created by the levy were avoidable under Section 522(f)(1)(A) which, unlike Section 547, does not include a 90-day or insolvency requirement. Thus, the fact that one lien attached greater than 90 days prior to the bankruptcy filing was immaterial. The Court concluded that the debtors could recover the value of the transfers from Spruce Financial using Section 550(a) and then assert their right to claim these funds exempt pursuant to their amended schedules and Section 522(i).

The Bankruptcy Court rejected Spruce Financial's time-barred defense, finding that the styling of its complaint contributed to the confusion that required debtors to serve an amended complaint post-case closing. The Court noted that all claims in the amended complaint either directly or via an alternative theory related back to the first complaint.

Finally, the Court denied debtors' claim that Spruce Financial violated the automatic stay and also denied debtors' request for equitable damages in being forced to remedy an unintentional stay violation.

The evidence demonstrated that upon being advised of debtors' bankruptcy filing Spruce Financial had attempted to return the amount of the post-petition levy and ultimately did so prior to the hearing. The Court found there was no willful violation of the stay and the actual undoing of the post-petition transfer was accomplished before the hearing.