RECENT DEVELOPMENTS

DEBT COLLECTION

BANKRUPTCY COURTS HAVE BROAD AND INHERENT AUTHORITY TO DENY ANY AND ALL COMPENSATION WHERE AN ATTORNEY FAILS TO SATISFY THE REQUIREMENTS OF THE BANKRUPTCY CODE AND THE RULES.

DISGORGEMENT MAY BE PROPER EVEN THOUGH THE FAILURE TO DISCLOSE RESULTED FROM NEGLIGENCE OR INADVERTENCE. .

Schilling. v. Heavrin (In re Triple S Rests., Inc.), 130 Fed. Appx. 766, 768 (6th Cir. 2005).

FACTS: In this Chapter 7 bankruptcy case, the bankruptcy trustee appealed the district court's reversal of the bankruptcy court's order to disgorge part of the fees collected by Donald Heavrin, general counsel for Triple S Restaurants ("Triple S"). Pursuant to a retainer agreement, Triple S paid Heavrin $ 10,000 per month to retain his legal services. During the year preceding Triple S's Chapter 11 petition, most of Heavrin's legal work involved renegotiating finance agreements and defending law suits in an effort to bolster the financial stability of the corporation.

After Triple S filed for bankruptcy protection, Heavrin did not submit a statement of fees paid to him or an accounting of the time he worked for the debtor as required by the Federal Bankruptcy Rules ("FBR"). Instead, a statement reflecting the payments to Heavrin was submitted by the corporation's bankruptcy attorney as part of an accounting of payments to insiders. The trustee then initiated an adversary proceeding to recover all fees paid to Heavrin by Triple S.

The bankruptcy court twice ordered all of the legal fees disgorged, and the district court affirmed the order both times, subject to specific evidentiary findings. After an evidentiary hearing, the bankruptcy court entered a third judgment, but this one substantially reduced the amount of the recovery to the trustee. This order was reversed by the district court, based on its reversal of its own prior determination that the services rendered by Heavrin were performed in connection with the bankruptcy petition. The bankruptcy trustee then appealed the district court's order to the 6th Circuit.

HOLDING: Vacated the district court's judgment and reinstated that of the bankruptcy judge.

REASONING: Under 11 U.S.C.S. § 329, an attorney must disclose any fee arrangements made within a year of filing the bankruptcy petition for "services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation." In the context of § 329, the controlling question is with respect to the state of mind of the debtor and whether the thought of bankruptcy was the impelling cause of the transaction. Negotiations to prevent bankruptcy may demonstrate that the thought of bankruptcy was the impelling cause of payment. Triple S paid Heavrin to take care of the legal problems in relation to the impending bankruptcy. Heavrin did not disclose his fees as required and, therefore, was in violation of §329.

The court held that bankruptcy courts have broad and inherent authority to deny any and all compensation where an attorney fails to satisfy the requirements of the FBR. In re Kisseberth, 273 F.3d 714, 721 (6th Cir. 2001). Disgorgement may be proper even though the failure to disclose resulted from negligence or inadvertence. Triple S paid fees to Heavrin for services in contemplation of bankruptcy which Heavrin was required to report to the bankruptcy court under Section 329. He did not and disgorgement was proper.

A CHAPTER 7 DEBTOR DOESN'T HAVE AN ABSOLUTE RIGHT TO CONVERT HIS CASE TO CHAPTER 13

In re Cooper, 426 F. 3d 810 (6th Cir. 2005).

FACTS: John Franklin Cooper ("Cooper") and his wife, Athena Chen Cooper ("Ms. Cooper) married in 1967 and were divorced in 1993. As a result of the divorce proceedings, Cooper was ordered to pay Ms. Cooper $2,000 per month in alimony *in futuro* and interests in several annuity contracts. Cooper was also ordered to pay Ms. Cooper's parents $70,657.60, representing sums found to be taken from Ms. Cooper's parents, and interest accrued on those amounts. In February 1997, Ms. Cooper learned that Cooper had converted the value of some of those annuity contracts, some $152,211.65, to his own use.

Following the divorce proceedings, Cooper filed a petition for Chapter 7 bankruptcy. Seventeen months after filing the Chapter 7 petition, and just one week before trial, Cooper filed a motion to convert the case to Chapter 13. The United States Bankruptcy Court for the Western District of Tennessee denied Cooper's motion for Chapter 13 conversion. On appeal, the Bankruptcy Appellate Panel of the Sixth Circuit affirmed. Cooper appealed again to the Sixth Circuit.

HOLDING: Affirmed

REASONING: Although the Sixth Circuit had not directly addressed the issue, a denial of a motion to convert for bad faith was consistent with Sixth Circuit precedent. In *Alt v. United States*, 205 F.3d 412, 418-19 (6th Cir. 2002), the Sixth Circuit held that a bankruptcy court may dismiss a Chapter 13 petition that was not filed in good faith. The Sixth Circuit further reasoned that if a Chapter 13 petition could be dismissed for lack of good faith, then it was logical to conclude that "a conversion from Chapter 7 to Chapter 13 may also be denied in the absence of good faith." *In re Brown*, 293 B.R. 865, 870 (Bankr. W.D. Mich. 2003). In determining bad faith, the bankruptcy court looked at Cooper's previous trial demeanor. The court noted that Cooper was a difficult witness and gave many false statements as well as inconsistent testimony. Furthermore, the court proved Cooper had infringed on marital property by secreting accounts in banks and other places and not disclosing the true amount of the marital assets. The Sixth Circuit agreed with the bankruptcy court that these factors supported the finding of bad faith.

Cooper argued that the plain language of 11 U.S.C. section 706(a) gave him the absolute right to convert. Section 706 states that a debtor "may at any time" convert a case under Chapter 7 to a case under Chapter 11, 12, or 13, provided there was not already a prior conversion. Cooper argued that since

he had not made a prior motion for conversion, that he had the absolute right to convert pursuant to the language in section 706. The bankruptcy court rejected Cooper's argument. The court first examined the plain language in the statute. Section 706 used the permissive phrase that the debtor "may convert" rather than "shall." Had Congress intended to leave the bankruptcy courts no discretion, it would have used the more mandatory phrase of "shall be able to convert." Additionally, the court found that the underlying policy behind section 706 was that "the debtor should always be given the opportunity to repay his debts." S. Rep. No. 95-989, at 94 (1978).

In this case however, the court found the motion to convert was motivated solely by Cooper's desire to avoid a determination regarding entitlement of a discharge, and not by a desire to repay his creditors. He never intended to pay his debt and was effectively abusing the bankruptcy process to thwart Ms. Cooper's efforts to collect. The court cited evidence that Cooper had been given the opportunity in the past to make payments based on an installment plan and failed to comply. Allowing Cooper to convert to a Chapter 13 plan would be little different from such installment plans he had already failed to honor. Thus, the Sixth Circuit affirmed the holding of the Bankruptcy Appellate Panel and the bankruptcy court that Cooper did not have an absolute right to convert his Chapter 7 petition to Chapter 13 because he made the motion for conversion in absence of good faith.

IRA IS EXEMPT FROM BANKRUPTCY BY FEDERAL BANKRUPTCY CODE

Rousey v. Jacoway, 125 S.Ct. 1561 (2005).

FACTS: Richard and Betty Jo Rousey ("Rouseys") were formerly employed by Northrup Grumman. Upon termination of employment, they took lump-sum distributions from their employer-sponsored pension plans and deposited the sums into separate Individual Retirement Accounts ("IRAs") under each of their names. Several years later, the Rouseys filed a joint Chapter 7 bankruptcy petition in the United States Bankruptcy Court for the Western District of Arkansas. Jill R. Jacoway was appointed by the court as the Chapter 7 trustee for overseeing the liquidation of the bankruptcy estate.

In the petition, the Rouseys sought to protect portions of their IRAs from creditors by claiming exemptions from the bankruptcy estate pursuant to 11 U.S.C. Section 522(d)(10)(E). Jacoway objected to these claims. The Bankruptcy Court sustained the objection and granted a motion to have the sums turned over to her. The Rouseys appealed to the Bankruptcy Appellate Panel ("BAP"), but the Bankruptcy Court's ruling was upheld. The Rouseys appealed again, and the Court of Appeals for the Eight Circuit affirmed. On a final appeal, the United States Supreme Court granted certiorari.

HOLDING: Reversed

REASONING: The Rouseys argued that their IRAs are exempt under 11 U.S.C. Section 522(d)(10)(E) of the Bankruptcy Code. Under Section 522(d)(10)(E), an individual's right to receive payment under an IRA must meet certain requirements to be exempt from the bankruptcy estate. Jacoway argued that the Rouseys do not meet the first two requirements of Section 522(d)(10)(E): (1) the right to receive payment must be from a stock bonus, pension, profit-sharing, annuity, or similar plan or contract; and (2) the right to receive payment must be on account of illness, disability, death, age, or length of service.

The Court had interpreted the words "on account of" to mean "because of," thus requiring a causal connection with the factor specified in the statute. *Bank of America Trust and Sav. Assn. v. 203 North LaSalle Street Partnership*, 119 S. Ct. 1411 (1999). Jacoway first argued that the Rouseys' IRAs do not meet the second requirement of Section 522(d)(10)(E) because they could withdraw funds at anytime as long as they were willing to pay the 10 percent tax penalty, and thus, there was no causal connection between their right to receive payment and age. The Court disagreed and emphasized the significance of the tax penalty. The penalty created a deterrent to early withdrawal which suggests Congress intended it to preclude early access to IRAs. Furthermore, the penalty is removed when the accountholder turns 59, and thus the Rouseys' right to the balance of their IRAs was a right to payment "on account of" age.

Jacoway also contended that the Rouseys' IRAs were not plans or contracts similar to stock bonus, pension, profit-sharing, or annuity plans under the first requirement of Section 522(d)(10)(E). Again, the Court disagreed. The common feature of all these plans was providing a substitute for wages. The Court found that IRA distributions were similar to income substituting for wages. Furthermore, Section 522(d)(10)(E) stated that non-exempt plans are such that do not qualify under section 408 of the Internal Revenue code of 1986, which explicitly mentions IRAs. If Congress had not intended IRAs to be exempt, it would not have referred to them here. Because the Rouseys' IRAs fulfilled both of the Section 522(d)(10)(E) exemption requirements at issue, the judgment of the Court of Appeals was reversed.

A DISCHARGE OF A DEBTOR'S STUDENT LOANS COULD BE GRANTED BASED ON THE DETRIMENTAL EFFECT THE LOANS HAD ON HER PRECARIOUS MENTAL HEALTH

In re Reynolds, 425 F.3d 526 (Minn. 2005).

FACTS: Plaintiff was a University of Michigan law school graduate who, according to her psychiatric expert at trial, suffered from severe depression, panic attacks, anxiety and personality disorders. Because of the seriousness of her mental condition, she had to take antidepressant, antipsychotic and mood stabilizer drugs. Even after becoming licensed as an attorney, she was unable to secure employment as an attorney. Because of her inability to secure legal employment and the effects of her mental condition and the drugs she used to treat her mental condition, she was only able to work as a secretary-receptionist. As this job paid only around $30,000/year, both she and her husband (who earned $29,000/year as a bus driver) were not able to make payments on the massive student loan debts estimated at near $142,000. Plaintiff filed for bankruptcy in order to discharge the outstanding student loans. She claimed under 11 U.S.C. Section 523(a)(8) that her student loans should be discharged. Although student loans are generally held not to be dischargeable under that section, there is an exception for a debtor's undue hardship. Plaintiff claimed she met the undue hardship exception because her mental condition prevented her from obtaining employment

as an attorney. In addition, she claimed that extreme stress brought about by the massive debt was aggravating her mental condition and health and reducing the effectiveness of her medical treatment. The United States Bankruptcy Court discharged Plaintiff's student loan debts. It found that forcing the Plaintiff to pay off the student loans presented such a stress on the Plaintiff that she suffered an undue hardship, which would be alleviated by discharge of the indebtedness. The United States District Court affirmed. The student loan creditors appealed to the United States Court of Appeals for the Eighth Circuit claiming that there was not an undue hardship under 11 U.S.C. Section 523(a)(8). They claimed that the Plaintiff and her husband earned enough money after subtracting for living expenses to pay off the debt over several years and that the undue hardship exception was not intended to discharge debts because of the effect on the debtor's mental health.

HOLDING: Affirmed.

REASONING: The court first applied the rule from 11 U.S.C. Section 523(a)(8) that there is no discharge in bankruptcy for educational loans or loans funded or secured by governmental or nonprofit units "unless excepting such debt from discharge… will impose an undue hardship on the debtor." The court determined that the decision to discharge indebtedness as a result of undue hardship is a question of law. Where the evidence shows financial obligations likely to harm health, and in turn affect the debtor's financial outlook, it was ruled proper to take such facts and circumstances into account. The court went on to state that "we will not adopt an interpretation of "undue hardship" that causes the courts to shut their eyes to factors that may lead to disaster, both personal and financial, for a suffering debtor." The court then determined that undue hardship would be determined based on the "totality of the circumstances" test from *In re Long*, 322 F.3d 549, 554 (8th Cir. 2003).

The court will determine, from the "totality of the circumstances," if there is undue hardship based on 1) the debtor's past, present and reasonably reliable future financial resources; 2) calculation of the debtor and dependent's reasonably necessary living expenses; and 3) other relevant facts and circumstances of case. The court determined that the Bankruptcy Court's finding that there was undue hardship was not clearly erroneous. They found that the harmful effect of the debt on Plaintiff's fragile mental health was supported by facts that showed continuing debt would cause Plaintiff to be voluntarily or involuntarily terminated from her employment. Another factor the court found as support was the diagnosis of both the Plaintiff's and Defendant's medical experts that the Plaintiff had major recurrent depression and dysthymia, a depression-type disorder. Finally, the court found additional support from the fact that her mental health has, does, and will continue to hamper her financial situation (past, present and future earnings).

The court found additional support from the fact that her mental health has, does, and will continue to hamper her financial situation.

CONSUMER CREDIT

TAX-EXEMPT DESIGNATION BY IRS CAN'T SHIELD COMPANY FROM CREDIT REPAIR ACT SUIT

Zimmerman v. Cambridge Credit Counseling Corp., 409 F.3d 473 (1st Cir. 2005).

FACTS: Kelly and Andrew Zimmerman ("Consumers") entered into a contract with Cambridge Credit Counseling Corporation ("Cambridge") for credit counseling services. Prior to entering into the contract, the Consumers saw Cambridge advertising that they were a nonprofit organization helping debtors to manage their debt by obtaining lower interest rates, eliminating fees and re-aging debt. Therefore, the Consumers believed that Cambridge would charge lower fees for their services and hired them.

Cambridge is organized as a charitable organization under Massachusetts law. The company has obtained an Internal Revenue Service's ("IRS") determination that it is tax exempt under I.R.S. § 501(c)(3). This section specifies that charitable and educational organizations whose net earnings do not benefit either shareholders or individuals are exempt from federal taxation.

A few months after enrollment with Cambridge, being dissatisfied with their services, the Consumers decided to cancel the contract. Then, they sued Cambridge and other related entities alleging violations of the Credit Repair Organizations Act ("CROA"). The CROA creates a cause of action for consumers harmed by the unscrupulous business and advertising practices on the part of credit repair organizations. 15 U.S.C. § 1679 *et seq.* However, the CROA does not permit lawsuits against any nonprofit organization which is exempt from taxation under section 501(c)(3) of the IRS.

Cambridge moved to dismiss the complaint. The trial court granted the motion on the grounds that Cambridge was excluded from CROA under 15 U.S.C § 1679a(3)(B)(i). Consumers appealed.

HOLDING: Vacated and remanded.

REASONING: The Consumers contended that the trial court erred in applying the CROA exclusion in this case because Cambridge was not operating as a nonprofit organization. In order to be excluded from the CROA under 15 U.S.C. § 1679a(3)(B)(i), a credit repair organization must actually operate as a nonprofit organization and be exempt from taxation under section 501(c)(3).

The court addressed Cambridge's arguments that a credit repair organization must only have received section 501(c)(3) designation from the IRS to qualify for the exclusion and that the phrase "exempt from taxation under 501(c)(3)" defines "nonprofit organization." The court held that the IRS's classification of the organization as tax-exempt entity was not dispositive of whether organization came within exemption from CROA for tax-exempt nonprofit entities; the entity was required to show that it was