Chapter 4

ACTIONS HAVE CONSEQUENCES: EXEMPTIONS AND DISCHARGE

Some debtors learn the hard way that crime doesn't (always) pay and that their actions have consequences. In light of increases in home values (and thus increased equity), Michael A. Rogers reminds readers of the limitations on exemptions found in § 522(q) for debtors with felony convictions or with debts for certain wrongful conduct. This basis for objecting to a debtor's claimed exemption is procedurally powerful for trustees and creditors, because such an objection may be raised at any time before the closing of the case. The article is helpful in highlighting important considerations in determining whether the cap even applies.

Similarly considering the effects of a debtor's pre-petition behavior on the bankruptcy case, Robert C. Meyer investigates how a debtor's status as a convicted criminal or criminal tortfeasor may affect the debtor's ability to obtain a discharge or even claim an exemption. Addressing the relevant Bankruptcy Code provisions — 11 U.S.C. §§ 522(q), 707(c)(2), 727(a)(12), 1141(d)(5)(C), 1228 (f) and 1328(h) — the article emphasizes the factual nature of the bankruptcy court inquiry under these provisions.

Michelle H. Bass questions whether Congress, in crafting the statutory framework of chapter 13, inadvertently created a "wide window of opportunity for mischief" for debtors. The article criticizes the relatively short time frame for creditors, who have discovered late in the case the fraudulent activity of a chapter 13 debtor, to take any action to bring the debtor's malfeasance to light. In reviewing notable case law on the issue, the article concludes that the principle of finality seemingly has outweighed the prevention of abuse of the bankruptcy system.

In his second appearance in this chapter, Robert C. Meyer goes over the potential impact on dischargeability of particular claims when debtors shirk their basic duties to give notice to creditors of their bankruptcy petitions. Focusing primarily on the varying interpretations of § 523(a)(3)'s exception to discharge, the article summarizes the conflicting case law out there on the issue while emphasizing the need for clearer, unambiguous language in the Bankruptcy Code.

Based on a review of the ramifications resulting from a debtor's behavior, these articles illustrate that, unless looking for a challenge, the consumer practitioner might want to find an honest-but-unfortunate debtor to represent.

C. Granting a Discharge to the Dishonest and Fortunate Debtor?

Fraud, Fairness and Finality in Chapter 13

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An individual's debt-adjustment plan under chapter 13 can easily be described as the "wild west of bankruptcy proceedings." Picture a rugged and lawless frontier where debtors who survive the battle for confirmation are free to engage in fraud while thriving under the protections of 11 U.S.C. § 1327. At the conclusion of their sojourn, nefarious debtors who complete their plan according to its terms may reap the discharge benefits of 11 U.S.C. § 1328(a), whether their conduct has gone unnoticed, is found to be willful or was merely inadvertent.

With such broad relief at stake, namely, the mandatory granting of discharge of all debts provided for by the plan "as soon as practicable after completion by the debtor of all payments under the plan,"[1] one would think that bankruptcy courts could happily entertain an untimely, but well-supported, objection to discharge. How else can the spirit of the Bankruptcy Code be upheld if plan proponents engage in egregious misconduct to the detriment of their creditors? Why bother having Code provisions and the Federal Rules of Bankruptcy Procedure if deterrence of this type of behavior cannot be achieved? After all, "[c]ourts of bankruptcy are essentially courts of equity, and their proceedings inherently proceedings in equity."[2]

Although this conventional wisdom may seem apparent, it falls by the wayside in chapter 13 cases when fraud is discovered well after confirmation, beyond the expiration of a debtor's plan, or even after entry of the discharge order itself. Unsecured creditors can seek relief against the dishonest debtor by filing a motion to dismiss under § 1307, filing a motion for revocation of the order confirming the plan under § 1330, filing a post-confirmation plan modification under § 1329, filing an objection to the entry of discharge under § 1328, or filing a motion for revocation of the discharge under § 1328(e). The curious timing constraints unique to each remedy suggests that Congress failed to appreciate "that it was creating this wide window of opportunity for mischief"[3] when it drafted chapter 13. Even if Congress intended to place more weight on the overarching principle of providing finality in lengthy reorganization plans, it certainly did not consider how cumbersome and prohibitive the chapter 13 process would be for unsecured creditors, even without the added insult to injury of late-discovered fraud.

The Burdens of Being Last in Line

Unsecured creditors with claims in chapter 13 cases are the very last to potentially receive cents on the dollar. Depending on the amount of a claim, unsecured creditors often have little reason to spend time and money litigating the merits of a debtor's reorganization plan, a debtor's pre-petition conduct or the reasonableness of the debtor's personal expenses. Most unsecured creditors file a proof of claim by the bar date and entrust their fate to the scrutiny of the chapter 13 trustee. Smaller unsecured creditors often rely on challenges by larger claim-holders in their class.

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1 11 U.S.C. § 1329(a).

2 *Pepper v. Litton*, 308 U.S. 295, 305, 60 S. Ct. 238, 244 (1939).

3 *In re Frank*, No. 18-12812 EEB, 2022 Bankr. LEXIS 1004, at *10-11 (Bankr. D. Colo. March 30, 2022).

While it is not uncommon for unsecured creditors to play an active role in a plan's pre-confirmation phase, it is not the norm because participation is often economically irrational. Post-confirmation, most general unsecured creditors with claims in typical nominal base plans cease monitoring the docket altogether.

The lack of incentive for unsecured creditors to participate in confirmation is one reason why maleficent debtors move through the process with ease, often emerging unscathed and debt-free. A lot can change over the course of an individual's three-to-five-year debt-adjustment plan, during which time creditors have an interest in the debtor's estate. For example, if an individual debtor's income goes up, this could result in a greater ability to pay into the plan. Thus, general unsecured creditors can be motivated by the ongoing opportunity to monitor the debtor's compliance with § 1325. Unsecured creditors may also call into question plan confirmation or a debtor's right to the entry of a discharge. Indeed, those who must stand at the end of the line would be remiss to ignore the *de facto* statutes of limitations governing their ability to upend a debtor's plan in progress, or after its completion.

The Dishonest Debtor Loophole

Chapter 13 provides several remedies for creditors to challenge a debtor's actions post-confirmation. The provisions governing dismissal under § 1307, modification of a plan under § 1329, the revocation of an order confirming plan under § 1330 and the entry of or revocation of a discharge under § 1328 are powerful tools when fraud is afoot. The problem most creditors have is an ability to use these tools effectively at the time that the fraud is discovered.

Consider a motion for revocation of the order confirming plan, which can only be brought *within 180 days after the date of the entry of an order confirming the plan*.[4] Furthermore, § 1330 permits the court to revoke an order confirming the plan if the order was procured by fraud and a timely request was made. Compare this permissive and discretionary advice with the urgency and specificity of § 1329(a)'s mandate that the court "*shall* grant the debtor a discharge of all debts as soon as practicable *after completion by the debtor of all payments under the plan*."[5] There is also the confusing time frame for bringing an action under § 1328(e) to revoke a discharge: "[O]n request of a party-in-interest *before one year after a discharge is* granted ... the court *may* revoke such discharge only if such discharge was obtained by the debtor through fraud, and the requesting party did not know of such fraud *until after such discharge was granted*."[6] The revocation of a discharge is permissive (rather than mandatory), yet the movant must seek this relief, if at all, within one year after the entry of a debtor's discharge, and the fraud giving rise to the motion must not have been known to the movant at any time prior to the discharge.

These timing restrictions may hamstring an unsecured creditor that learns of misconduct late in the case. What good *is* a post-confirmation motion to dismiss if the order confirming the plan is binding upon the debtor and all creditors to the case? What relief does a creditor really have if fraud is discovered after the initial six months following entry of the confirmation order? Is there no right or remedy for creditors after the initial six months, until after the entry of a discharge? Would a creditor's specific knowledge of a debtor's fraud prior to the discharge defeat its permissive request for revocation of a discharge if it could not bring this motion while the case was still open? Finally, what remedies do creditors have in the period following completion of all payments under the plan, before the court's entry of discharge?

Creditors looking to utilize these safety nets must do so with caution, as the various statutory conflicts among §§ 1307(c), 1329, 1330(a), 1328(a) and 1328(e) often result in a benefit flowing to abusers of the bankruptcy sys-

4 11 U.S.C. § 1330(a).

5 11 U.S.C. § 1328(a) (emphasis added).

6 11 U.S.C. § 1328(e) (emphasis added).

tem. This balancing of the interests of the parties pursuant to the permissive, discretionary and mandatory directives contained in chapter 13 is expertly analyzed in *In re Frank*.[7]

In re Frank involved joint chapter 13 debtors who failed to disclose a pre-petition personal-injury cause of action, despite accurately disclosing a pre-petition wrongful-termination claim against a former employer. The undermedian debtors' 39-month, 0 percent base plan was confirmed without objection. The order confirming the plan provided that the debtors were bound to "report any settlement or judgment as to the wrongful firing claim within 30 days and turn over any non-exempt portion of the proceeds for the benefit of [unsecured] creditors."[8] One year after confirmation, the undisclosed personal-injury suit was settled, resulting in the debtors' receiving a $67,000 windfall. At the time they received the settlement proceeds, the debtors took no action other than continued remittance of their regular plan payments.

In the month prior to the debtors' final payment under the confirmed plan, the trustee inquired about the status of their wrongful-termination claim to ensure plan compliance before recommending the case for discharge. In response, the debtors first disclosed their receipt of the personal-injury settlement. Whether knowingly or inadvertently, the debtors elected not to inform the trustee of the settlement at the time it was received, but they made this disclosure before making their final payment under the plan. The debtors asserted that their initial nondisclosure of the personal-injury claim was due to their assumption that it was exempt. While the trustee and debtors exchanged information concerning the undisclosed asset, the debtors timely made their final payment in early July 2021. The trustee filed a motion to dismiss for the debtors' failure to disclose this asset on July 20, 2021.

A Balancing Act, or an Unfair Advantage?

The initial question before the court in *Frank* was whether § 1307(c) provided grounds for dismissal for the debtors' failure to disclose a pre-petition asset. The trustee argued that had the disclosure been made at the outset of the case, the debtors would have had the opportunity to elect an exemption in the then-unknown value of the cause of action. Any unexempt value would have been the subject of a trustee's plan modification, requiring the debtors to remit any additional disposable income or unexempt equity in an asset in compliance with § 1325(a)(1).

The court began its analysis of the trustee's motion to dismiss under § 1307(c) by qualifying it as a nonexclusive, permissive statutory provision. However, "[o]n request of a party-in-interest after notice and a hearing, the court *may* dismiss a case under this chapter, whichever is in the best interest of creditors and the estate, *for cause*."[9] This section goes on to provide 11 enumerated examples of grounds to dismiss for cause, without stating any exclusions. Thus, the court determined that these grounds were "merely examples of 'cause' and … not … an exclusive list."[10] The court also highlighted that this provision does not prohibit filing such a motion after payments had been made under the plan or after such time that the plan has expired. In essence, there is nothing in the Code that would *prohibit* the trustee's motion to dismiss at the time it was filed, and the court's inquiry could have stopped there, relying on Congress's permissive directive to deny debtors their discharge for the cause of nondisclosure of an asset.

However, the court compared the limitless scope of § 1307 to the limited time for seeking revocation of an order confirming plan under § 1330. Section 1330 provides that an action seeking revocation of an order confirming a plan *may* be granted, but only if the request is made within six months after entry of the confirmation order, and only if such order was procured by fraud. The court noted that the strict six-month deadline for discovery of potential fraud "places a burden on the reporting parties to be diligent."[11]

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7 *In re Frank*, 2022 Bankr. LEXIS 1004.

8 *Id*. at 3.

9 11 U.S.C. § 1307(c) (emphasis added).

10 *In re Frank*, 2022 Bankr. LEXIS 1004, at *6.

11 *Id*. at 7.

Indeed, this burden may be considered entirely unjust, as the prospect of a lengthy and expensive pre-confirmation process is where many unsecured creditors lose interest and hope of recovery under a debtor's chapter 13 plan. Even in cases that are timely confirmed without objection, general unsecured creditors are largely absent at the confirmation hearing, and certainly in the six months thereafter.

Instead of questioning whether § 1330 ignores the possibility that a debtor may commit fraud beyond the initial six months after an order confirming the plan is entered, the *Frank* court reasoned that the time limitation of § 1330 requires a "balancing of the interests" between the competing roles of the debtor on the one hand, and parties-in-interest on the other hand. The opinion then turns to focus on the "countervailing policy of promoting finality," which principles are abundant throughout the statutory scheme of chapter 13.[12]

Ironically, the opinion is silent as to the formalities of § 1327(a), which would have seemingly supported the court's promotion of the concept of finality in chapter 13. Section 1327 governs the effect of confirmation and provides in relevant part that the provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.[13] This provision is heavily relied on by debtors facing mid-plan challenges to their conduct.

Turning from the provisions that govern confirmation issues to the provisions that govern plan modification and entry of the chapter 13 discharge, the *Frank* court highlighted § 1329(a)'s requirement that a plan may be modified, if at all, any time after plan confirmation *but before the completion of payments under the plan*.[14] This invokes "a principle of finality once the debtor has completed all required payments under a confirmed plan. At that point, post-confirmation plan modification is no longer an option."[15]

Finally, in comparing § 1329(a) to the relevant portions of the chapter 13 discharge provision under § 1328, the opinion derives Congress's intent that "the final plan payment heralds a change in status. With the passing of that final payment, entry of the discharge becomes mandatory[16] "as soon as practicable after completion by the debtor of payments under the plan."[17] The *Frank* court concluded its thesis that the overarching scheme of chapter 13 requires finality over the permissive, discretionary and nonexclusionary relief that could be afforded, with the mandatory requirement that "the court *shall* grant the debtor a discharge of all debts provided for by the plan."[18] Although § 1328 also includes subsection (e), which lays out the ability for a party-in-interest to seek revocation of a debtor's discharge based on the debtor's fraud, this relief must be sought "before one year after a discharge is granted"[19] and is only permitted if the party seeking revocation "did not know of such fraud until after the discharge was granted."[20] Thus, the court determined that subsection (e) was inapplicable to the facts of this case.

In re Frank is groundbreaking in that it considered the entirety of the Bankruptcy Code's chapter 13 post-confirmation statutory language on its journey to evaluate the trustee's relief, which was brought only under § 1307. In the court's view, Congress has determined that after a certain period of time, the principle of finality must outweigh the policy of rooting out abusers of the bankruptcy system.[21] Therefore, balancing the equities in favor of unsecured

12 *Id*

13 11 U.S.C. § 1327(a).

14 11 U.S.C. § 1329(a).

15 *In re Frank*, 2022 Bankr. LEXIS 1004, at *8.

16 *Id*. at *9.

17 11 U.S.C. § 1328(a).

18 *Id*

19 11 U.S.C. § 1329(e).

20 11 U.S.C. § 1329(e)(2).

21 *In re Frank*, 2022 Bankr. LEXIS 1004, at *11.

creditors, even in the face of a debtor's palpable misconduct, is beyond the reach of the mandatory timing restraints embedded in the statute.

Conclusion

In re Frank has added to the wealth of case law that permits debtors to receive their discharge after a significant amount of time has passed, despite the presence of alleged fraud. Although this ruling places more burden on those unsecured creditors, claimholders should not resign themselves to the self-fulfilling prophecy of recovering nothing in consumer reorganization cases. The technical and practical difficulties faced by general unsecured creditors left to navigate the uninviting waters of chapter 13 must be matched by well-informed, active participants in the process. Although obstacles abound, creditors are encouraged to know the timelines of their various permissive and mandatory rights at each stage in a debtor's chapter 13 case.