THINGS THAT GO BUMP IN THE NIGHT

CHAPTER 13 PITFALLS AND TRAPS

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The work is rewarding, but it is becoming more difficult to represent debtors in Chapter 13 proceedings. It seems that there are more problems and potential issues to watch out for than ever before. This paper will cover some of the most deviling:

- Protecting the discharge
- Post confirmation surrenders
- Disclosure, Clarity and Judicial estoppel
- The 6-Month Rule
- Lienholders that will not foreclose

1. PROTECTING THE DISCHARGE

Assume your client miraculously has made it all the way through the maze that is Chapter 13 and has made every single required payment to the Chapter 13 Trustee. Both you and your client are expecting a discharge and an end to the process. But the Chapter 13 Trustee filed a pesky Notice of Final Cure which drew a response from the mortgage lender stating that your client is not current on the post-petition mortgage payments. The mortgage loan was listed as "pay direct" in the plan. Because there is a post-petition arrearage, does your client get his/her discharge? Not in the Fifth Circuit.

In re Heinzle, 511 B. R. 69 (Bankr. W. D. Tex., 2014) – This case kicked off the line of cases denying the discharge when the debtor does not make all required direct post-petition payments on his/her mortgage. The debtors cured a mortgage arrearage through the plan with disbursements made by the Chapter 13 Trustee, but at the time of the Notice of Final Cure, they were roughly thirty months in arrears on the post-petition direct payments. The Trustee filed a motion to deny the discharge and dismiss the case.

The debtors argued that the phrase "all payments under the plan" as used in §1328(a) means only those payments the debtors were required to make to the Trustee, which they made, but does not include direct payments. Judge Gargotta disagreed. He relied on *In re Foster*, 670 F. 2d 478 (5th Cir. 1982) and concluded, "The term 'under the plan' properly refers to any payment made pursuant to the provisions of a Chapter 13 plan, regardless of whether such payment is made through the trustee or by a debtor directly to a creditor." *Heinzle* at 77. Judge Gargotta found that, at least regarding a payment proposal, no further modification of the plan was possible because the debtors were at the end of the allowed five year term.[1]

As Judge Gargotta said, "A denial of discharge places Debtors in the difficult position of potentially seeking further bankruptcy relief and would require creditors to determine the legal effect of a denial of discharge on future bankruptcy filings." *Id.* at 83.

In re Kessler, 09-60247, 2015 WL 4726794 (Bankr. N. D. Tex. June 9, 2015) – As in *Heinzle*, the debtors made the payments to the Trustee, but had not made all of their direct

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[1] Pursuant to §1322(d)(1), "the plan may not provide for payments over a period that is longer than 5 years" and pursuant to §1322(d)(2), "the court may not approve a [payment] period that is longer than 5 years."

mortgage payments. The debtors argued that because long term debt is not discharged under §1328(a)(1) anyway, they should not be deprived of their discharge.[2] Judge Robert Jones rejected that argument. He also spoke to the possibility that debtors could avoid this discharge issue by just not indicating how the ongoing mortgage payments will be paid in the plan, hoping to keep those payments ***outside*** the plan.[3] He concluded that if the debtor cures arrears through the plan, the direct payments to the mortgage lender are "under the plan."

The debtors also argued that the lender's failure to object to their motion for a discharge constituted a waiver, relying on *United Student Aid Funds, Inc. v. Espinoza*, 559 U. S. 260 (2010). Judge Jones made short work of this argument. The debtors' discharges were denied.

The decision was appealed to the United States District Court for the Northern District of Texas which affirmed the bankruptcy court's ruling. *Kessler v. Wilson (In re Kessler), No. 6:15-cv-00040-C,* slip op. at 7 (N.D. Tex. Nov. 19, 2015). The district court picked up on an interesting point raised by the Chapter 13 Trustee who argued that "allowing a discharge of the remaining debt where [Kessler] had the unfettered use of $40,000.00 in disposable income would be unfair and inequitable to [Kessler's] creditors."[4]

The Fifth Circuit affirmed. See *In re Kessler*, __ Fed. Appx. __, 2016 WL 3667575 (5th Cir. July 8, 2016). The court relied on its earlier decision in *Foster, supra.* and reiterated that when the plan provides for the cure of pre-petition arrears, even if the post-petition payments are disbursed by the debtor to the mortgage lender, those post-petition mortgage payments are payments "under the plan".[5]

In re Ramos, 540 B.R. 580 (Bankr. N.D. Tex. 2015) – Prior to the Fifth Circuit's *Kessler* opinion, Judge Jernigan reached the conclusion that "direct" payments are payments under the plan, denying the debtor's discharge when those payments were not made. Much more to come on *Ramos*, discussed below, with regard to post-confirmation modifications.

This issue is most likely to come up when the debtor does not pay post-petition mortgage payments simply because any response to the Notice of Final Cure will bring that default to the attention of the court and the Chapter 13 Trustee. However, the reasoning in the cases is equally applicable to the post-petition non-payment of any debt for which the debtor is the disbursing

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[2] Section 1328(a)(1) excepts from discharge any debt provided for under §1325(b)(5). A mortgage loan is a classic example of this type of debt.

[3] "When a debtor chooses to exclude a secured debt from treatment under the plan, 'the lien securing [such debt] merely passes through the bankruptcy case unaffected'; as a consequence it will not be discharged. (citation omitted)." *Kessler* at p. 5.

[4] *Br. of Appellee* at 12; See also *In re Fomancek*, 534 B. R. 296 (Bankr. D. Colo. 2015). In its response to the Notice of Final Cure Payment, the mortgage lender stated that the debtors were over forty thousand dollars in arrears on the post-petition mortgage payments. If the debtors did not make payments to the mortgage lender, payments that were accounted for in calculating their disposable income, what did they do with the money? It was not dedicated to the repayment of their unsecured debt. The Trustee's point is well-taken.

[5] The Fifth Circuit's opinion was designated as unpublished. So, although it is not binding precedent, it can be cited for persuasive value. And what Texas bankruptcy court is going to ignore a Fifth Circuit decision?

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