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CREDITORS' RIGHTS

*Joseph E. Ulrich**

This article addresses developments in Virginia creditors' rights from April 1988 to April 1989. It is aimed at the non-specialist who nonetheless handles creditors' rights problems in practice. The following will describe the more important holdings and offer some comments about these holdings.

I. Damages for Maliciously Filing a Mechanics Lien

Donohoe Construction Co. v. Mount Vernon Associates[1] raised the question of what theories will support a claim for damages caused by the intentional wrongful filing of a mechanics' lien. The Supreme Court of Virginia answered that the plaintiff has two theories available, but the court tailored these theories so that very few plaintiffs will ever be successful.

Defendant contractor, Donohoe, agreed to build a nursing home for plaintiff. The Department of Housing and Urban Development (HUD) financed the construction. HUD required that the construction contract contain a liquidated damages clause for late completion and a clause granting ultimate authority to HUD to decide all disputes involving construction and payment. Construction lagged behind schedule, and the nursing home was completed so late that the plaintiff was compelled to cancel commitments to patients and staff. Donohoe learned that HUD intended to enforce the liquidated damages clause.[2]

Donohoe filed a memorandum of mechanics' lien for $389,576.11 four days after the project was completed, although Donohoe subsequently revised the claim down to $100,899.00. In the suit to enforce the lien, plaintiff proved it had paid all bills presented to it, that no others were due, and that it had deposited funds with its lender for those to come due in the future. The trial court ruled

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[1] 235 Va. 531, 369 S.E.2d 857 (1988).

[2] *Id.* at 534, 369 S.E.2d at 859.

that Donohoe's mechanics' lien was invalid.[3]

Thereafter, plaintiff sued Donohoe on two theories: that the filing of the mechanics' lien slandered its title, and that the filing constituted an abuse of process. Plaintiff relied on the earlier court's finding that "Donohoe knew or should have known that it was filing its lien improperly."[4] The trial court also cited evidence that Donohoe filed the suit to prevent the assessment of liquidated damages, to force plaintiff to settle, and delay plaintiff's closing on permanent financing.[5] The jury awarded plaintiff substantial damages. The supreme court reversed because the evidence was insufficient to support either theory.[6]

The court had no difficulty holding that the filing of a memorandum of a mechanics' lien is a judicial proceeding entitling the claimant to the defense of absolute privilege in a suit for slander of title. After emphasizing that the absolute privilege applied to words used in "all proceedings of a judicial nature,"[7] the court focused upon the relation of memorandum of lien to the suit to enforce. The court held that "for a claimant to obtain the remedy provided by [the mechanics' lien] statute,[8] he must *perfect* his lien and, thereafter, sue to *enforce* it. The two proceedings are inseparable."[9] Therefore, the filing of the memorandum of mechanics' lien constitutes a judicial proceeding. Of course, the privilege only applies if the words are "relevant and pertinent to the case," but Donohoe's memorandum of lien was relevant and pertinent since his statements followed the mandate of the Mechanics' Lien Act.[10] In sum, the court tells us that a slander of title action will never lie against a mechanics' lienor who has enough sense to follow the forms provided in the act.[11]

[3] *Id.* at 535-36, 369 S.E.2d at 859-60. The plaintiff recovered $19,723.20 on its cross bill for delay.

[4] *Id.* at 536, 369 S.E.2d at 860.

[5] *Id.* Plaintiff financed the construction of its nursing home through two lenders. The "construction lender," HUD, financed the building of the project at a reduced financing rate and an enhanced loan term. *Id.* at 533-34, 369 S.E.2d at 858. Once the project was completed satisfactorily, a "permanent lender" had agreed to purchase the debt and the security from HUD. A permanent lender charges a lower interest rate to the owner than a construction lender. Thus, the owner ordinarily wants to obtain permanent financing as soon as possible.

[6] *See Donohoe*, 235 Va. at 539-41, 369 S.E.2d at 861-63.

[7] *Id.* at 537, 369 S.E.2d at 860.

[8] VA. CODE ANN. §§ 43-1 to -23.2 (Repl. Vol. 1986).

[9] 235 Va. at 539, 369 S.E.2d at 861 (emphasis in original).

[10] *Id.* at 539, 369 S.E.2d at 861.

[11] VA. CODE ANN. §§ 43-5, -8, -10 (Repl. Vol. 1986).

The second issue, whether the plaintiff presented sufficient evidence to support the jury's finding of abuse of process, raised a more difficult question. To win on an abuse of process theory, plaintiff must prove two elements: an ulterior purpose besides that which the procedure was designed to accomplish, and an act in the use of the process not proper in the regular prosecution of the proceedings.[12] Plaintiff offered sufficient evidence of an ulterior purpose — that the mechanics' lien was filed to avoid imposition of the liquidated damages clause or to force a settlement. However, plaintiff's evidence failed to prove that Donohoe committed any act in the use of the process not proper in the regular conduct of the mechanics' lien procedure. Despite clear proof of an improper motive, plaintiff failed to demonstrate an abuse of the process after it was issued.[13]

The court indicated, however, that plaintiff's proof might have supported a claim for a kindred, but distinctly different cause of action, known as malicious prosecution (malicious use of civil process)[14] if it could have established "special injury."[15] Malicious prosecution differs from abuse of process in that the former lies "for 'maliciously causing process to issue,' . . . while abuse of process 'lies for the improper use of process after it has been issued.' "[16] As indicated above, plaintiff offered sufficient proof that Donohoe wrongfully had process issued.[17] To win under this theory, however, a plaintiff must prove in addition either arrest of his person arising out of the civil action, seizure of property, or "special injury."[18] "Special injury" is a term of art, but the word "spe-

[12] 235 Va. at 539-40, 369 S.E.2d at 862; *see generally* 1 F. Harper, F. James & O. Gray, The Law of Torts § 4.9 (2d ed. 1986) [hereinafter Harper] (discussing abuse of process); W. Keeton, D. Dobbs, R. Keeton & D. Owen, Prosser and Keeton on the Law of Torts § 121 (5th ed. 1984) [hereinafter Prosser] (same).

[13] 235 Va. at 541, 369 S.E.2d at 862.

[14] A malicious prosecution suit most commonly is founded upon an underlying criminal proceeding instituted with malice and without probable cause, which terminated in favor of the plaintiff. Pallas v. Zaharopoulos, 219 Va. 751, 250 S.E.2d 357 (1979). A majority of jurisdictions have extended this cause of action to include malicious (wrongful) initiation of civil suits. *See* Harper, *supra* note 12, at §§ 4.1 -4.9; Prosser, *supra* note 12, at §§ 119-121.

[15] 235 Va. at 541, 369 S.E.2d at 863. The court intimates that plaintiff's counsel mistakenly chose the wrong theory, and that the questionable result it reaches is not inevitable if counsel chooses the right theory. This appears to be an attempt to pass the buck. As the text accompanying notes 16-28 indicates, plaintiff could not have proved "special injury." The responsibility for the *Donohoe* result rests with the court.

[16] *Id.* at 540, 369 S.E.2d at 862 (quoting Glidewell v. Murray-Lacy & Co., 124 Va. 563, 567-68, 98 S.E. 665, 667-68 (1919)).

[17] *See supra* text accompanying note 13.

[18] Virginia and a sizeable minority of American states follow the rule that "the malicious

cial" obscures rather than explains the concept.[19] Special injury includes only damages which ordinarily do not stem from suits of the kind filed. *Ayyildiz v. Kidd*[20] illustrates this concept. After plaintiff doctor successfully defended a malpractice suit, he brought a malicious prosecution action against his patient, alleging as damages expenditures to defend the original lawsuit, loss of present and future earnings and profits in the practice of medicine, and injury to his professional reputation. The supreme court held that because all such damages would ordinarily arise in a medical malpractice suit, plaintiff failed to satisfy the special injury requirement.[21] Rather, plaintiff must demonstrate that defendant's suit caused an injury not normally flowing from such lawsuits, or that plaintiff was peculiarly subject to a unique kind of injury. For instance, if Doctor Ayyildiz had been engaged in a new medical specialty, which required him to convince the public of the new technique's merit, and the defendant obtained a temporary injunction preventing Ayyildiz from practicing medicine for the purpose of destroying his present doctor-patient relationships, plaintiff *might* be able to demonstrate special injury because he was uniquely subject to such harm.[22]

prosecution doctrine is not extended to a civil proceeding, even though this proceeding is instituted for an improper purpose and without probable cause, unless there is an arrest of the defendant in that civil action, seizure of his property, or some other special injury to him." Ayyildiz v. Kidd, 220 Va. 1080, 1083, 266 S.E.2d 108, 111 (1980). Such rule is justified by the need to protect losing plaintiffs from retaliatory lawsuits. The rule and its justification have been harshly criticized. *See* HARPER, *supra* note 12, at § 4.8; PROSSER, *supra* note 12, at § 120. The authors argue that the so called English rule is a distortion of the actual English view and would not be followed in England on the same facts. HARPER, *supra* note 12, at § 4.8, at 470-74.

[19] The Supreme Court of Virginia's definition of special damages is not helpful. An Oregon case, O'Toole v. Franklin, 279 Or. 513, 569 P.2d 561 (1977) far better describes the concept.

[20] 220 Va. 1080, 266 S.E.2d 108 (1980).

[21]
> The plaintiff here has suffered no injury that would not stem normally from a medical malpractice suit. A defendant in such a suit usually pays his costs and attorney's fees. The damage to the professional reputation of a physician who prevails in malpractice litigation is debatable; but in any event such damages as may result are common to all malpractice actions. Moreover, plaintiff's allegations of injury to his professional reputation and good name are conclusory with no facts being alleged to support a special injury. The other "special injury" alleged, concerning loss of present and future income, we have observed would fall upon the defending physician in any medical malpractice action.

Id. at 1084-85, 266 S.E.2d at 112.

[22] *But cf. id.* As *Ayyildiz* indicates, the special injury requirement precludes virtually all efforts by physicians to countersue those who instigate baseless malpractice suits. *See generally* Birnbaum, *Physicians Counterattack: Liability of Lawyers for Instituting Unjustified Medical Malpractice Action*, 45 FORDHAM L. REV. 1003 (1977) (overview of phenome-

As noted above, the court in *Donohoe* suggested the plaintiff could have successfully sued for malicious prosecution had it proved special injury. One wonders what kind of harm plaintiff might have alleged. Allegations that the filing of the mechanics' lien[23] prevented a sale or a rental, or increased costs due to the fear of non-payment by materialmen, subcontractors, or laborers would not qualify as a special injury. Possibly, proof that the mechanics' lien interfered with other relations, such as loss of patient commitments or staff, and that Donohoe knew of plaintiff's vulnerability might suffice. If the delay caused by the lien disrupted plaintiff's financial arrangements with its permanent lender, special damages may exist.[24] One cannot be sure.

One assumes the court's suggestion that plaintiff might have stated a cause of action for malicious prosecution was designed to provide leeway for the court in the future. However, such leeway may be very limited. A mechanic whose attorney knew the rules could file "maliciously" while avoiding the risks.[25] In any jurisdiction adopting the special injury requirement, "[t]here is almost no possibility of a malicious prosecution remedy for unjustified initia-

non). In the hypothetical suggested in the text, defendant's malicious effort to obtain an injunction could be regarded as a sufficient interference with plaintiff's person to sustain a malicious prosecution action even by courts following the "English" common law rule. *See, e.g.*, Bank of Lyons v. Schultz, 78 Ill. 2d 235, 399 N.E.2d 1286 (1980).

[23] In Ailstock v. Moore Lime Co., 104 Va. 565, 52 S.E. 213 (1905), it was held that the groundless suing of an attachment of a debt owed by a third party to plaintiff was a seizure of property for which a malicious prosecution will lie. In such action any damages plaintiff suffers may be recovered. The filing of a mechanics' lien, however, ordinarily is not regarded as a seizure of property because the owner is not dispossessed; yet according to the *Donohoe* court, a plaintiff may maintain an action for malicious prosecution of a mechanics' lien if that plaintiff establishes special injury. *Donohoe*, 235 Va. at 541, 369 S.E.2d at 862-63. Such a suit would probably fail because some interference with the plaintiff's property rights is a common burden in all mechanics' lien cases, and therefore would not constitute a special injury. *Cf. Ayyildiz*, 220 Va. at 1084-85, 266 S.E.2d at 111-12 (special injury absent where plaintiff doctor suffered no injury that would not arise normally from a medical malpractice suit).

[24] One of the alleged reasons for Donohoe's filing of the mechanics' lien was that such a lien would prevent closing on permanent financing. *Donohoe*, 235 Va. at 536, 369 S.E.2d at 860. Although the existence of a construction lender and a permanent lender is common in the construction industry, Donohoe's filing may have caused plaintiff to lose its permanent lender rather than merely increase its interest costs.

[25] A plaintiff suing for malicious prosecution of a mechanics' lien suit could sue the attorney who filed the original suit only if he alleged special injury. *Ayyildiz*, 220 Va. at 1084, 266 S.E.2d at 111. However, an attorney may be subject to disciplinary action by the Virginia State Bar for bringing a frivolous lawsuit. *See* VA. CODE OF PROFESSIONAL RESPONSIBILITY DR 7-102(A)(1) (1989) (prohibiting a lawyer from filing a suit "when it is obvious that such action would serve merely to harass or maliciously injure another").

tion of civil litigation that would result, if successful, only in a judgment debt."[26]

II. PERFECTING A MECHANICS' LIEN AGAINST THE OWNER[27]

Virginia courts demand strict compliance with the Mechanics' Lien Act before a lien arises.[28] The smallest deviation from the statutory requirements is often fatal. To perfect a lien, the mechanic must file a memorandum of lien[29] and bring a suit to enforce the lien in accordance with the statute.[30] The owner of the property to be charged must be named in both the memorandum of lien and suit to enforce. In both instances, the mechanics' lien may be enforced against the property only to the extent of the interest of the person named as owner.[31] Thus, for example, if the person named as owner holds only a leasehold interest, the lien attaches to the leasehold only.[32] Set out below are two examples of how this rule operates to defeat a mechanics' lien.

In Virginia, spouses commonly hold title to property as tenants by the entirety. Property held as a tenancy by the entirety is subject only to the claims of a joint creditor of both husband and wife.[33] Thus, if the mechanic files a memorandum of lien against only the husband on property held by the spouses as tenants by the entirety, the lien fails. The fact that the wife knew that lien was claimed against the property and that she signed the contract for the improvements does not change the result. The mechanic must check the title to the property and understand the legal implications of what he discovers.[34]

A mechanic must check the land records a second time to determine who holds title to the property on the date the suit to enforce

[26] HARPER, *supra* note 12, at § 4.8, at 467-68.

[27] *See generally* J. ULRICH, VIRGINIA AND WEST VIRGINIA MECHANICS AND MATERIALMEN'S LIENS §§ 2-4, -6, -13 (1985 & Supp. 1988).

[28] Coleman v. Pearman, 159 Va. 72, 165 S.E. 361 (1932).

[29] VA. CODE ANN. § 43-4 (Repl. Vol. 1986) sets forth the requirements for the memorandum of lien, and VA. CODE ANN. § 43-5 (Repl. Vol. 1986) sets forth a legislatively approved form. Use of the form prevents many mistakes, but not the one discussed here.

[30] VA. CODE ANN. §§ 43-17, -22 (Repl. Vol. 1986).

[31] *See* Feuchtenberger v. Williamson, Carroll & Saunders, 137 Va. 578, 583-88, 120 S.E. 257, 259-60 (1923) (construing predecessors of VA. CODE ANN. §§ 43-3, -20 (Repl. Vol. 1986)).

[32] Wallace v. Brumback, 177 Va. 36, 12 S.E.2d 801 (1941). The leasehold will seldom be worth much.

[33] Vasilion v. Vasilion, 192 Va. 735, 66 S.E.2d 599 (1951).

[34] Gunther v. Cantrell, 11 Va. Cir. 255 (1988).

is filed. This is necessary because a mechanics' lien may be enforced only against the party who owned the property at the time the suit to enforce the lien was instituted.[35] For example, suppose General Contractor (*G*) contracts with Owner (*O*) for improvements on Blackacre. *G* subcontracts part of the work to *S*. *O* enters into another contract for improvements on Blackacre with *K*. After *G* completes the project, *G* files a memorandum of lien naming *O* as owner and brings a suit to enforce against *O*. Thereafter, *S* and *K* each file a memorandum of lien naming *O* as owner. *O* sells Blackacre to Buyer *B*, who properly records the deed.[36] Subsequently, *S* and *K* intervene[37] in *G*'s suit to enforce naming *O*, but not *B*, as owner. Assuming all else is proper, *G* obtains a lien enforceable against *B*, but *S*[38] and *K* do not because they failed to name *B*, who owned Blackacre when the suit was filed.

A. *Remedies in Fraudulent Conveyance Cases*

In re Jenkins Landscaping & Excavating, Inc.[39] involved the following facts. Corporation *JLE*, acting under the direction of its controlling stockholder, *J*, transferred all of its assets to another of *J*'s corporations, *X*, for the purpose of defrauding creditor *C*. At *J*'s direction, *X* paid both a debt and a dividend to *J* out of *JLE*'s assets. More than a year after the transfer, *C* recovered a judgment against *JLE*, which immediately filed bankruptcy. The bankruptcy court voided the transfer from *JLE* to *J* under section 55-80 of the Code of Virginia,[40] returning these assets to *JLE*'s bankruptcy estate.[41] *C* and *J* were *JLE*'s only creditors, but *JLE* had insufficient

[35] Burton Lumber Corp. v. Davis Constr. & Dev. Corp., 14 Va. Cir. 503 (1983).

[36] Mechanics may rely on the record. A purchaser under an unrecorded contract or deed is not an owner for the purposes of the mechanics' lien statutes. R. C. Lee Carpet & Tile, Inc. v. Cone Constr. Corp., 12 Va. Cir. 159 (1988).

[37] On the effect of intervention and S & K's alternatives, *see* J. ULRICH, *supra* note 27, at § 2-13 (1985 & Supp. 1988).

[38] Even though *S* does not obtain his own lien, *S* may take advantage of *G*'s lien pursuant to VA. CODE ANN. § 43-18 (Repl. Vol. 1986).

[39] 93 Bankr. 84 (W.D. Va. 1988).

[40] VA. CODE ANN. § 55-80 (Repl. Vol. 1986) becomes applicable in bankruptcy through use of 11 U.S.C. § 544(b), which permits the trustee to avoid any transfer of an interest in the debtor's property that would be avoidable under non-bankruptcy law by an unsecured creditor with a claim against the estate. The trustee could not use the bankruptcy code's fraudulent conveyance section, because the *JLE*-to-*X* transfer occurred more than a year before bankruptcy. 11 U.S.C. § 548(a) (1988).

[41] All transfers voided and property recovered by the trustee under section 544(b) become part of the debtor's bankruptcy estate. 11 U.S.C. §§ 541(a)(3), 550(a) (1988).

assets to pay both.[42]

Is *C* entitled to priority over *J* as to *JLE*'s assets? The bankruptcy court granted *C* priority[43] on the common sense ground that *J*, the perpetrator of actual fraud, should not be allowed to share in the recovered funds with his victim, *C*. The bankruptcy court distinguished *Mills v. Miller Harness Co.*[44] which held that where a preference paid to the controlling director by a liquidating corporation is set aside under section 55-80 of the Code of Virginia, all creditors, including the preferred director, are entitled to a pro rata share of the recovered assets. Judge Krum viewed *Mills* as involving only fraud presumed in law, while *J* acted with actual fraudulent intent. The district court reversed, asserting that the Supreme Court of Virginia had given no indication it would accept such a distinction. Conceding that allowing *J* to share with *C* was "more than passing strange," Judge Michael nevertheless felt compelled to order this result under the controlling Virginia authority.[45]

The strange result in *Jenkins* builds on decisions such as *Mills* that confuse fraudulent conveyances and preferences. Virginia follows the common law rule that a preference is valid, and a creditor may knowingly accept it.[46] The only exception to this rule comes from cases like *Mills* holding that a director in control of a liquidating corporation may not prefer himself. On *Mills'* facts, the Supreme Court of Virginia has consistently characterized the preferential payment to the controlling director as a fraudulent conveyance,[47] asserting that the transferee acted with actual fraudulent intent.[48] While the result in *Mills* seems clearly correct,[49] the

[42] 93 Bankr. at 85.

[43] In *Jenkins* the precise question was whether *J*'s fraud precluded him from filing a proof of claim pursuant to BANKR. RULE 3002(c)(3), which permits creditors who received voidable transfers to file proofs of claim within 30 days after the judgment avoiding such transfer has become final. The bankruptcy court did not let *J* file. 93 Bankr. at 89.

[44] 229 Va. 155, 326 S.E.2d 665 (1985); *see also* Cheatle v. Rudd's Swimming Pool Supply Co., 234 Va. 207, 360 S.E.2d 828 (1987); Darden v. George C. Lee Co., 204 Va. 108, 129 S.E.2d 897 (1963).

[45] *In re* Jenkins, 93 Bankr. at 87, 89.

[46] Surratt v. Eskridge, 131 Va. 325, 108 S.E. 677 (1921).

[47] *See* cases cited *supra* note 44. With the exception indicated, a corporation may prefer one creditor over another. Beck v. Semones Adm'r, 145 Va. 429, 134 S.E. 677 (1926); *see also infra* note 52.

[48] Section 55-80 of the Code of Virginia voids all transfers made with the intent to defraud creditors. A fraudulent transfer may not be set aside, however, unless the transferee qualifies as bona fide purchaser. One who knowingly accepts a preference does no wrong under section 55-80 of the Code of Virginia. *See* Irby v. Gardner, 157 Va. 132, 160 S.E. 81

court has never adequately explained how the controlling director's intent differed from that of an ordinary preferee.[50] Once the assets have been returned to the corporation, *Mills* holds that the director may share ratably with other creditors. Such a remedy is appropriate for preferences, which offend, if at all, the collective interests of creditors, but such remedy makes no sense where the transferee is a party to a fraud of those with whom he is permitted to share. Presumably, the *Mills* court did not view the director's conduct as morally evil, but merely refused to let him use his inside position[51] to gain an advantage over those with equal claims.

Jenkins involved more than a preference. The bankruptcy court found the controlling stockholder guilty of an actual intent to defraud the creditor, and on this point the district court affirmed. Thus, the bankruptcy judge's decision to distinguish *Mills* as involving only technical fraud (presumed in law rather than actual) seems sensible. On the other hand, a literal reading of the Virginia cases does not support this distinction. The problem, of course, does not lie with either view. *Jenkins* simply exposes the Virginia court's inept scheme for dealing with corporate manipulations directed by insiders to gain advantages over outside creditors.[52]

(1931). Thus, the preferred director's conduct in *Jenkins* had to be characterized as fraudulent for section 55-80 of the code of Virginia to apply.

[49] Fletcher cites numerous decisions upsetting corporate preferences to or for the benefit of a controlling director. 15A W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 7421 (Rev. Perm. ed. 1973). Most of the decisions rest on the theory that the controlling director, by taking the preference, violates a fiduciary duty to other creditors of the corporation. This rule is not a part of the law of fraudulent conveyances. In bankruptcy such transfers would be subject to challenge as insider preferences. *See* 11 U.S.C. § 547(b) (1988).

[50] This point is considered at length in Ulrich, Fraudulent Conveyances and Preferences in Virginia, 36 WASH. & LEE L. REV. 51, 65-77 (1979).

[51] "[A fraudulent conveyance] is inherently and always vicious; the [preference] innocent and valid, except when made in violation of the express provision of a statute. One is *malum per se* and the other *malum prohibitum* -- and then only to the extent forbidden." Van Iderstine v. National Discount Co., 227 U.S. 575, 582 (1913).

[52] At one time Virginia permitted a controlling director to receive preferential payments from his corporation. Planters Bank of Farmville v. Whittle, 78 Va. 737 (1884). *But see* cases cited *supra* note 44 overruling *Planters Bank*. Yet in Bank of Commerce v. Rosemary & Thyme, Inc., 218 Va. 781, 239 S.E.2d 909 (1978), the question was whether preferential payments made by a corporation to a third party for which the controlling directors were sureties fell within the scope of these cases. Despite the fact that the controlling directors' economic positions in *Bank of Commerce* and *Mills* are functionally identical, the court held that the plaintiff was not entitled to a remedy against the directors under section 55-80 of the Code of Virginia. 218 Va. at 787-89, 239 S.E.2d at 914-15. Of course, the directors in *Bank of Commerce* did not receive a transfer. The problem stems from the court's labelling a preference as a fraudulent conveyance in *Mills*. This has misled the bar. The law would be

Arguably, the Bankruptcy Code resolves the priority problem raised in *Jenkins*.[53] Section 55-80 of the Code of Virginia becomes applicable through one of the trustee's powers, section 544(b)[54] of the Bankruptcy Code. The judges and attorneys involved in *Jenkins* assumed that section 544(b) incorporates the entire state law result. The Bankruptcy Code, however, seems to require a different result. Section 541(a)(3)[55] provides that "[a]ny interest in property that the trustee recovers under Section . . . 550" becomes part of the estate. Section 550(a)[56] provides that "to the extent that a transfer is avoided under section 544" the trustee may recover the property or its value from the initial transferee. Therefore, once the transfer to *J* from *JLE* was set aside, the assets became part of the estate. The Bankruptcy Code decides how the assets of the estate should be distributed. In this setting, the bankruptcy court could have subordinated *J*'s claim to *C*'s under section 510(c)(1) using traditional equitable principles.[57]

III. Virginia Exemptions in Bankruptcy

A. *Interpreting the Virginia Exemption Statutes*

Every bankrupt claims his or her exemptions. Exemptions are a crucial part of a bankrupt's fresh economic start. Of course, bankrupts assert the maximum exemption, and in the process exemption claims are often pushed to the statutory limit. Because Virginia has "opted out" of the federal exemptions, Virginia bankrupts may use only Virginia exemptions.[58] Thus federal judges, especially bankruptcy judges, must decide the outer limits of the Virginia exemption system. This year was no exception.

In Virginia, only a householder may claim the homestead,[59] poor

improved if the Supreme Court of Virginia would look to the body of law developed by the Fourth Circuit in this area. *See, e.g.*, Regal Ware, Inc. v. Fidelity Corp., 550 F.2d 934 (4th Cir. 1977); Davis v. Woolf, 147 F.2d 629 (4th Cir. 1945); Certain-Teed v. Wallinger, 89 F.2d 42 (4th Cir. 1937).

[53] Doug Rendleman, a fellow law professor at Washington and Lee, suggested this theory.

[54] 11 U.S.C. § 544(b) (1988).

[55] *Id.* § 541(a)(3).

[56] *Id.* § 550(a).

[57] *Id.* § 510(c)(1).

[58] 11 U.S.C. § 522(b)(1)(a) authorizes a state to limit its residents to local exemptions by opting out of the federal exemption. Virginia has opted out. VA. CODE ANN. § 34-3.1 (Repl. Vol. 1984).

[59] VA. CODE ANN. §§ 34-1 to -25 (Repl. Vol. 1984 & Cum. Supp. 1989). Despite its name,

debtor's,[60] and insurance[61] exemptions. Section 34-1 of the Code of Virginia defines householder to include "any person, married or unmarried, who maintains a separate residence or living quarters, whether or not others are living with him." The definition tells us that a householder need not have dependants.[62] Otherwise, the definition is remarkably unhelpful.[63] The federal courts have been forced to refine this definition.

May a person who lives with his parents and earns no separate income qualify as a householder? Judge Hoffman in *Jones v. Kirsch*[64] answered "no," essentially on the ground that to allow this debtor householder status would write the limitation out of the statute. The existence of the definition in section 34-1 of the Code of Virginia strongly implies that the legislature did not intend to extend the homestead exemption to all debtors.[65]

Jones moves toward a workable definition of householder. Debtor Kirsch was the archetypical non-householder, a person living with those who support him. Had Kirsch lived in his own apartment, he apparently would have qualified as a householder because, although dependent, he maintained a residence separate from his parents who supported him; the definition of householder emphasizes living apart, not earning an income.[66] However, suppose Kirsch earned an income and contributed to his own support while living at home. Arguably, contributing to one's support may be enough to obtain householder status. Certainly, this debtor

the homestead is a pure exemption in the amount of $5,000.

[60] VA. CODE ANN. §34-26 (Repl. Vol. 1984). Section 34-27 of the Code of Virginia grants an additional exemption for those engaged in agriculture.

[61] VA. CODE ANN. §§ 38.2-3122 to -3125 (Repl. Vol. 1986).

[62] VA. CODE ANN. § 34-1 (Repl. Vol. 1984). Before 1979 only debtors with a legal or moral obligation to support dependents qualified as householders. *See* M. BURKS, PLEADING AND PRACTICE IN ACTIONS AT COMMON LAW §§ 440-42 (4th ed. 1952). The reasons for the change in definition are discussed in Ulrich, *The Virginia Exemption Statutes — The Need for Reform and a Proposed Revision*, 37 WASH. & LEE L. REV. 127, 131-33 (1980); *see also In re* Doan, 11 Bankr. 704, 705-06 (Bankr. E.D. Va. 1981) (discussing deletion of dependents requirement).

[63] Judge Shelley described it as "vague and ambiguous." *In re* Marsh, 26 Bankr. 94, 95 (Bankr. E.D. Va. 1982).

[64] 93 Bankr. 77 (E.D. Va. 1988).

[65] *Id.* at 81.

[66] *See* VA. CODE ANN. § 34-1 (Repl. Vol. 1984). Judge Hoffman stressed that section 34-1 focused on the householder's living in a separate residence, and that Kirsch *lived with* his parents, not they with him. 93 Bankr. at 79-80. The Fourth Circuit of the Code of Virginia in Chesseman v. Nachman, 656 F.2d 60, 63 (4th Cir. 1981) indicated in dictum that a young couple living together "but apart from either set of parents" would be householders.

could cite the Virginia bankruptcy cases allowing both spouses householder status where each contributes to the support of the family unit.[67] If this analysis is correct, non-householders are a small, easily recognizable class.

In comparison with certain western states, Virginia grants parsimonious exemptions. The generosity` of the federal exemptions served as the primary reason for the legislative decision to opt out. The Virginia homestead and insurance exemptions have lower dollar values than the federal, and the items enumerated in the poor debtor's exemption — clothes, necessary beds and bedding, many common household and kitchen articles, one horse, etc. — ordinarily will not be valuable to creditors at a sale.[68] Note, however, that there is no dollar limit on such items.

Suppose a bankrupt claims a $640,000 racehorse as his poor debtor's horse. May he keep the horse, or is a $640,000 horse "too valuable" to come within the letter and spirit of the exemption. Judge Shelley held for the bankrupt in *In re Freedlander*[69] on the ground that the Virginia legislature, "clearly and unambiguously," had entitled a householder to exempt one horse. He emphasized that the $100.00 cap on the value of an exemptible horse was removed in 1876, and the legislature had not seen fit to restore it.[70] To hold otherwise would require the court to overrule the legislative wisdom on this matter.

Would *Freedlander* have come out differently if the debtor had purchased the $640,000 horse with non-exempt assets on the eve of bankruptcy for the purpose of claiming it as exempt? Judge Shelley stressed that this problem was not before him.[71] Rather, this bankrupt had been sufficiently well heeled to buy this luxury before he fell on hard times, and his lucky choice fortuitously provided him a fresher start than most debtors. Judge Shelly sug-

[67] Where each spouse contributes to the maintenance of the household, both spouses are entitled to claim exemptions. Roberts v. County of Henrico Fed. Credit Union, 709 F.2d 275 (4th Cir. 1983); *Chesseman*, 656 F.2d 60 (4th Cir. 1981); *In re* Gustinis, 16 Bankr. 108 (Bankr. E.D. Va. 1981).

[68] *See* VA. CODE ANN. § 34-26 (Repl. Vol. 1984). Because such items are worth more to the debtor than anyone else, professional creditors often threaten to enforce liens on them to coerce the debtor into payment.

[69] 93 Bankr. 446 (Bankr. E.D. Va. 1988). Had the debtor demonstrated he was a farmer, he would have been entitled to claim a second "too valuable" horse as exempt under the "poor farmer's" exemption. VA. CODE ANN. § 34-27 (Repl. Vol. 1984).

[70] 93 Bankr. at 450 n.2

[71] *Id.* at 448.

gested, however, that if Freedlander had engaged in bankruptcy planning, that is, purchased the horse at the time he was contemplating bankruptcy, not only would this claim of exemption fail but the debtor might lose his discharge.[72] Thus, before one counsels a sinking client to get his bankruptcy house in order by purchasing a Guttenberg Bible, fine oriental rugs, or a racehorse, remember that the stakes are high and the outcome totally unpredictable.

B. *Incorporating the Virginia Exemptions into Bankruptcy*[73]

In re Snow[74] raises a crucial issue: Is the entire Virginia exemption system incorporated into bankruptcy? After Green recovered a judgment against Snow for rent and levied on certain items of personal property, Snow filed a homestead deed claiming such

[72] *See id.* Converting non-exempt property into exempt property on the eve of bankruptcy offends judicial sensibilities despite Congress' statement that the "practice is not fraudulent as to creditors, and permits the debtor to make full use of the exemption to which he is entitled under law." S. REP. No. 989, 95 Cong., 2d Sess. 76, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5862; H.R. REP. No. 595, 95th Cong., 1st Sess. 361, *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6317. In Ford v. Poston, 773 F.2d 52 (4th Cir. 1985), the court held that whether the debtor's conversion of non-exempt to exempt property demonstrated an intent to defraud creditors so as to preclude *a discharge* under 11 U.S.C. § 727(a)(2) presented a factual question for the bankruptcy court. When a debtor claims property as exempt, he necessarily intends to deny creditors the right to use such property to satisfy their claims. Exemptions can be viewed as legalized frauds on creditors. When a failing debtor uses assets to buy a race horse to claim as exempt under VA. CODE ANN. § 34-26, his intent is to put it beyond creditors' reach. *Ford v. Poston* does not indicate what facts demonstrate actual fraud. Rather, it focuses on the debtor's subjective intent to fraudulently prevent creditors from using this property. Thus, conversions from non-exempt to exempt become risky.

[73] VA. CODE ANN. § 34-17 (Cum. Supp. 1989), sets forth the time limit for claiming the homestead. A voluntary bankrupt must file a homestead deed before six days after the first creditors meeting, an event which should occur between 20 and 40 days after the petition, according to BANKR. R. 2003(a). Two recent cases flesh out the meaning of section 34-17 of the Code of Virginia.

Suppose debtor files a Chapter 13 that is subsequently converted to a Chapter 7. May the debtor claim a homestead after the conversion? *In re* Freedlander, 93 Bankr. 446 (Bankr. E.D. Va. 1988), indicates that the answer generally will be no. If the first creditors meeting occurred after the original filing, no homestead may be filed more than five days after the meeting. The conversion from Chapter 13 to Chapter 7 does not constitute a new or separate case even if a second first creditor's meeting is convened. *Id.* at 448-49. Suppose debtor merely wishes to increase the amount of his homestead claim after the section 34-17 period has run. While ordinarily new property may not be added or the value of the exemption increased more than five days after the first creditors' meeting, this general rule does not apply to property that did not belong to debtor at the time the exemption had to be asserted. *In re* Custis, 87 Bankr. 415 (Bankr. E.D. Va. 1988).

[74] 92 Bankr. 154 (W.D. Va. 1988), *rev'g* 71 Bankr. 186 (Bankr. W.D. Va. 1987). *In re* Godfrey, 93 Bankr. 451 (Bankr. E.D. Va. 1988) reaches the same result.

items exempt. Subsequently, Snow filed bankruptcy.[75] Pointing to section 34-5(5) of the Code of Virginia,[76] which provides that the homestead cannot be claimed against a debt for rent, Green asserted that his lien was not affected by Snow's homestead claim or bankruptcy petition. Conceding that Green's position would be correct outside of bankruptcy, Snow argued that section 522(f)(1)[77] of the Bankruptcy Code, which voids liens that impair an exemption, overrode the section 34-5(5) exceptions and could be used to avoid Green's lien. Green responded that the Bankruptcy Code incorporates the state exemption scheme in its entirety, that section 34-5(5) means that debtor Snow acquires no homestead exemption as against rent claimant Green, and thus, no exemption existed on which section 522(f)(1) could operate. The district court agreed with Green. The court's metaphor comparing the homestead to a wedge of Swiss cheese captures the essence of the holding:

> Just as the entirety of the wedge is composed of both the cheese and the holes, the entirety of the Virginia homestead exemption is composed both of the substantive provision allowing a debtor to exempt certain property and the exceptions to that exemption which, in this court's metaphor, constitute the holes. Properly understood, the holes are a part of the wedge of cheese and one takes that wedge subject to the holes.[78]

In sum, the debtor receives only what the state exemption system gives him, and bankruptcy provisions, such as section 522(f) do not change this.

Snow is not an example of a hard case making bad law; rather, it is an example of a "poorly crafted legislative scheme" mandating a poor result.[79]

C. *Dischargeability of Debts*

Individuals file for bankruptcy to obtain a discharge of pre-petition debts. The discharge, in conjunction with exemptions, constitutes the bankruptcy fresh start. Not all debts are dischargeable.

[75] *In re* Snow, 92 Bankr. at 155.

[76] VA. CODE ANN. § 34-5(5) (Repl. Vol. 1984).

[77] 11 U.S.C. § 522(f)(1) (1988).

[78] *In re* Snow, 92 Bankr. at 158.

[79] *Id.* at 161 (quoting Dominion Bank of Cumberland v. Nuckolls, 780 F.2d 408, 414-417 (4th Cir. 1985) (Hoffman, J., concurring)). Judge Hoffman cogently states the case against the current bankruptcy exemption scheme.

The Bankruptcy Code lists ten categories of obligations that survive a discharge.[80] Although dischargeability issues present federal questions, state law often has an important role to play.

Section 523(a)(5) of the Code of Virginia provides that obligations for alimony or child support arising out of a separation agreement or a court decree are not dischargeable, but obligations arising from a property settlement are dischargeable.[81] Often, the separation agreement or court decree fails to make clear whether an obligation is for alimony or part of a property settlement. How the parties label the debt is not determinative. Rather, the bankruptcy court must decide its character for discharge purposes.[82] *In re West*[83] well illustrates the difficulty of the characterization problem.

In a hotly contested divorce case, the divorce court ordered the husband to pay all of the couple's joint obligations and the wife's attorneys' fees but denied the wife "spousal support."[84] The record also contained the court's observation that the husband could not afford to pay more.[85] At the dischargeability hearing, the question was whether the husband's obligations were dischargeable. The task of the bankruptcy court at the dischargeability hearing is to determine whether the trier of fact intended such obligations as alimony or as part of a property settlement.[86] If there had been no more evidence available in *West*, the bankruptcy court would have found the obligations dischargeable, because the order denying "spousal support" and the finding that the husband could not pay support strongly implied that the husband's obligations were part of a property settlement and not in lieu of alimony.[87]

[80] 11 U.S.C. § 523 (1988).

[81] *See* 11 U.S.C. § 523(a)(5) (1988).

[82] Because divorce so often leads to bankruptcy — "a clean up bankruptcy" — this kind of dischargeability problem should be anticipated.

[83] 95 Bankr. 395 (Bankr. E.D. Va. 1989); *see also In re* Corrigan, 93 Bankr. 81 (Bankr. E.D. Va. 1988), which sets forth Judge Bonney's approach.

[84] "Adjudged, Ordered, and Decreed that the Defendant's request for spousal support is hereby denied on the basis of insufficient funds on the part of the Complainant." 95 Bankr. at 396. The decree was drafted by counsel for the plaintiff. *Id.*

[85] *See id.* at 397.

[86] *Id.* at 398-99 (citing *In re* Long, 794 F.2d 928 (4th Cir. 1986)). If a property settlement is involved, the intent of the parties on the dischargeability question as expressed in the agreement must control. *See id.* at 398 (citing Tilley v. Jessee, 789 F.2d 1074 (4th Cir. 1986)).

[87] Generally, the plaintiff has the burden of proof in dischargeability cases. BANKR. R. 4007; *In re* West, 95 Bankr. at 398.

The parties did offer more evidence. Indeed, they stipulated that the divorce court's order was based on the assumption that the husband's obligations were non-dischargeable, and that had the judge understood the bankruptcy implications, his order would have denied the wife "additional spousal support."[88] This stipulation resolved the dischargeability issue. Although the judge's opinion that dischargeability is a federal question was irrelevant, the phrase "additional spousal support" clearly implies the obligations imposed were in lieu of alimony.[89]

In re West accents the need for attorneys in divorce matters to draft the separation agreement or the court decree carefully so that the potential dischargeability question does not arise. Despite this admonition, it is difficult to state concrete rules on how to accomplish this goal. For example, when payments terminate with death or remarriage, when the debt is one for alimony, but if the payments continue after death, they are part of the property settlement. This much is clear.[90] In a situation like *West*, in which the husband is ordered to pay joint obligations, the decree itself should resolve the dischargeability question. *West* is helpful in this regard. While labels can never control, the attorney, especially the wife's attorney, must build a record showing why the debt took this particular form and was intended as alimony.[91]

Section 523(a)(4) of the Bankruptcy Code declares that defalcations by fiduciaries create non-dischargeable debts.[92] Quite often the issue under this section turns on the definition of a fiduciary. For example, is a partner a fiduciary? Section 50-21 of the Code of Virginia[93] provides that a partner owes fiduciary duties to the partnership. *In re Lewis*[94] holds, however, that the definition of fiduci-

[88] The trial judge speculated that the pertinent part of the decree should have read "Adjudged, Ordered, and Decreed that the Defendant's request for *additional* spousal support is hereby denied on the basis of insufficient funds on the part of the Complainant." *In re* West, 95 Bankr. at 397.

[89] Judge Bostetter's reasoning in *Snow* is instructive. *See id.* at 400.

[90] *See, e.g., In re* Carrig, 5 Collier Bankr. Cas. 2d (MB) 446 (Bankr. D.S.C. 1981). Beyond this case, the outcome is unpredictable. 4 Collier Bankruptcy Practice Guide ¶ 76.08 (1986). For example, attorney fees are often considered alimony, but not always. *Compare In re* Spong, 1 Collier Bankr. Cas. 2d (MB) 1104 (Bankr. W.D.N.Y. 1980), *rev'd*, 5 Collier Bankr. Cas. 2d (MB) 242 (2d Cir. 1981) *with In re* Chrisman, 6 Bankr. 339 (W.D. Okla. 1978).

[91] *See, e.g., In re* West, 95 Bankr. at 398-400.

[92] 11 U.S.C. § 523(a) (1988).

[93] VA. CODE ANN. § 50-21 (Repl. Vol. 1989).

[94] 94 Bankr. 406 (Bankr. E.D. Va. 1988).

ary presents a federal question, and that partners are not fiduciaries for section 523(a)(4) purposes despite the Virginia statute. *In re Lewis* narrowly defines fiduciary to include only "trustees of specific written declaration of trust, guardians, administrators, executors, or public officers and, absent special considerations, does not extend to the more general class of fiduciaries such as agents, bailees, brokers, factors and partners."[95]

Sections 524(c) and (d) limit a debtor's capacity to reaffirm prepetition debts.[96] These limitations were imposed to safeguard the debtor's fresh start. Reaffirmations convert dischargeable debts into non-dischargeable debts. If the debtor reaffirms too many prepetition obligations, his discharge will be of little value. To protect the debtor against himself, sections 524(c) and (d) mandate that the debtor's attorney and the bankruptcy judge oversee the decision to reaffirm. Unless these procedures are followed, the debt remains dischargeable despite a post- petition agreement to repay.[97]

The Court of Appeals for the Fourth Circuit emphasized this last point in *Arnhold v. Kyrus*.[98] After filing his bankruptcy petition, debtor signed a new note and made several payments to creditor. At the discharge hearing, however, debtor did not mention the new note, and the court did not approve the reaffirmation. Subsequently, debtor defaulted on the new note. When creditor sued in state court, debtor asked the bankruptcy court to enjoin creditor's attempt to collect a pre-petition debt, and the bankruptcy court refused. The Fourth Circuit upheld debtor's position, ruling that any reaffirmation not expressly approved by the bankruptcy court is a nullity. Debtor, moreover, never acts in bad faith by merely failing to advise the bankruptcy court of reaffirmation.[99] Creditor,

[95] *Id.* at 410; *cf. In re* Dahlin, 94 Bankr. 79 (Bankr. E.D. Va. 1988). The divorce court in *Dahlin* awarded a woman one-half of her husband's military retirement as alimony. The retirement pay was paid directly to husband. Wife asserted that husband had not paid her half to her, and that this debt was non-dischargeable under section 523(a)(4) of the Bankruptcy Code. *Dahlin*, 94 Bankr. at 80-81. The bankruptcy court agreed, holding that the divorce decree created an express trust in favor of the wife on which the husband had defaulted, such default was a defalcation by a fiduciary within the meaning of section 523(a)(4). The court also held that the debtor owed non-dischargeable alimony under 11 U.S.C. § 523(a)(5). *Id.* at 81-82.

[96] *See generally* Morris & Ulrich, *Reaffirmation under the Consumer Bankruptcy Amendments of 1984: A Loser for All Concerned*, 43 WASH. & LEE L. REV. 111 (1986).

[97] *Id.* at 111-16.

[98] 851 F.2d 738 (4th Cir 1988).

[99] The bankruptcy court held that the debtor was estopped to assert his discharge because he had not brought the reaffirmation to the court's attention at the discharge hearing. The district court reversed. It held that ordinarily a reaffirmation not approved at the dis-

however, could have appeared at the discharge hearing and brought the matter to the court's attention.[100]

In re Brown[101] presents the case of a debtor who asked the court for permission to reaffirm a debt in an effort to obtain her fresh start. The debt was to her credit union. The credit union had a firm policy that it would refuse to deal with anyone who used bankruptcy to discharge a debt to it. Ignoring her attorney's advice,[102] the debtor asked to reaffirm. Finding that repayment was not in her best interest, the court refused to permit the reaffirmation but enjoined the credit union from discriminatorily refusing to deal with Ms. Brown *solely* because she had discharged a debt owed to it. Such a policy discriminated against a bankrupt contrary to section 525 of the Bankruptcy Code.[103] There is contrary circuit court authority.[104]

V. Bankruptcy's Impact on Foreclosure of a Residence

The filing of a bankruptcy petition automatically stays[105] a pending foreclosure on the family home. Chapter 7, however, offers no method to save the home.[106] In contrast, Chapter 13 permits the debtor to develop a method to save the home. Section 1322[107] provides that the debtor may cure pre-petition defaults and reinstate the original mortgage contract by successfully completing an approved Chapter 13 plan.

charged hearing was void, but remanded the case to the bankruptcy court to determine if the debtor had acted in bad faith by not advising the court of the reaffirmation. *Id.* at 739.

[100] *Arnhold* overrules *In re* Newsome, 1 Collier Bankr. Cas. 2d (MB) 1000 (Bankr. W.D. Va. 1980), which held that only the debtor may seek court approval of a reaffirmation. One wonders, however, whether the creditor's right to appear is of any importance. Even if the debtor admits the agreement to reaffirm, he can always change his mind. *See* 11 U.S.C. § 524(c)(4) (1988).

[101] 95 Bankr. 35 (Bankr. E.D. Va. 1989).

[102] Ms. Brown's lawyer refused to sign the affidavit required by § 524(c)(3) which requires the debtor's attorney to state that the reaffirmation would not impose an undue hardship upon the debtor. *See id.* at 36.

[103] *Id.* at 37; *see* Rendleman, *The Bankruptcy Discharge: Toward a Fresher Start*, 58 N.C.L. Rev. 723 (1980) (discusses the ultimate scope of section 525).

[104] See Brown v. Pennsylvania State Employees Credit Union, 851 F.2d 181 (3d Cir. 1988), and cases cited therein.

[105] *See* 11 U.S.C. § 362 (1988).

[106] A Chapter 7 filing may be helpful to the debtor. See Ulrich, *Creditors' Rights: Annual Survey of Virginia Law*, 22 U. Rich. L. Rev. 517 (1988), for some of the possibilities.

[107] 11 U.S.C. § 1322(b)(5) (1988).

Timing is very important. If the foreclosure process is completed under non-bankruptcy law before the petition is filed, the debtor's interest in the property terminates, the property does not become part of the bankruptcy estate, and the automatic stay has no effect.[108] When is the foreclosure process completed? *In re Cole* holds that the process is completed when "the hammer falls," that is, when the trustee of the deed of trust accepts the buyer's bid and payment.[109] *Cole* rejects the view that the trustee must also have completed the deed of sale to the buyer.[110]

Assuming that the debtor files a bankruptcy petition before the foreclosure is completed, under what circumstances may the mortgagee foreclose? *In re Sensabaugh*[111] presents one clear situation — the failure to make several payments under the Chapter 13 plan. The debtor's material breach of her own plan entitled the creditor to dismiss the Chapter 13, thereby terminating the stay. The debtor did not challenge the mortgagee's motion directly; instead she filed a subsequent motion to modify her plan post-confirmation. The court responded that it would decide the creditor's motion first.[112] "To do otherwise would allow a circumvention of section 1307(c)(6) by allowing a debtor to thwart a motion to dismiss for a material default by modifying [the] plan post-confirmation."[113]

In *Sensabaugh*, the court dismissed the Chapter 13 petition, permitting foreclosure in state court to proceed. In most situations, the creditor will seek an order modifying the automatic stay to permit foreclosure during the continuation of the bankruptcy case.

[108] *See, e.g.*, Abdelhaq v. Pflug, 82 Bankr. 807 (E.D. Va. 1988).

[109] 88 Bankr. 763 (Bankr. E.D. Va. 1988).

[110] *In re* Rolen, 39 Bankr. 260 (W.D. Va. 1983). *Cole* also states that the buyer or mortgagee's knowledge that the mortgagor's bankruptcy is imminent has no impact on the validity of the sale. *See* 88 Bankr. at 764.

[111] 88 Bankr. 95 (Bankr. E.D. Va. 1988).

[112] *Id.* at 96. Once the cases were dismissed, the debtor's motion became meaningless.

[113] *Id.* In the alternative the court held that the debtor's proposed modification altered the mortgage contract in a manner not permitted by the Bankruptcy Code. *Id.* (construing 11 U.S.C. § 1322(b)(2)).

Section 1322(b)(2) of the Bankruptcy Code was enacted to prevent debtors from altering the contract terms of home mortgages in Chapter 13. *In re* Brown, 91 Bankr. 19 (Bankr. E.D. Va. 1988) presents a case in which the court used this provision against a creditor. Debtor filed a Chapter 13 plan for the purpose of curing pre-petition defaults on her residential mortgage. The plan restored the parties to their position under the mortgage. Although the mortgage did not provide for interest on late payments, the mortgagee claimed it was entitled to interest on the arrearages. The bankruptcy court responded that awarding interest would be an alteration of the mortgage contract under § 1322(b)(2), and could not be awarded. 91 Bankr. at 22-23.

Automatic stay modification orders are commonly issued. Because the debtor's residence remains part of bankruptcy estate until the debtor is divested of all interest in the property, the bankruptcy court retains jurisdiction to set aside the sale.[114]

When, if ever, should a bankruptcy court upset a state foreclosure sale following the entry of an order modifying the bankruptcy automatic stay? In *In re Hood*,[115] the debtor challenged the foreclosure sale on the sole ground that the price obtained was less than the appraised fair market value. The debtor argued that the rationale of the well-known *Durrett*[116] decision, which held that a pre-petition forced sale for less than 70% of the optimum fair market value should be set aside as a fraudulent conveyance, should be extended to this situation. The court refused to extend[117] *Durrett*, holding that a foreclosure sale properly conducted under state law would be affirmed despite the low price and consequent harm to the estate.[118]

[114] *See* 11 U.S.C. § 105(a) (1988).

[115] 92 Bankr. 648 (Bankr. E.D. Va. 1988).

[116] Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201 (5th Cir. 1980). The 1984 amendments to the Bankruptcy Code seemingly codify *Durrett*. *See* 11 U.S.C. § 548 (Supp. II 1984).

[117] *Durrett* involved a pre-petition sale, while *Hood* involved a post-petition sale to which section 548 clearly does not apply.

[118] 92 Bankr. at 656.