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Annual Survey of Virginia Law: Bankruptcy Law

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BANKRUPTCY LAW

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I. Introduction

This survey article reviews and analyzes legislative and judicial developments that have occurred in bankruptcy law between April 1989 and April 1991. This article intends to alert the general practitioner to significant recent developments in the bankruptcy area. The article focuses on legislative changes that have been made to the Bankruptcy Code and to Virginia statutory law, along with federal bankruptcy decisions issued within the Fourth Circuit. Where appropriate, Virginia state court cases dealing with bankruptcy issues are also addressed.

One of the more significant changes addressed concerns the Virginia General Assembly's redrafting of the property exemptions available to an individual debtor who files bankruptcy in Virginia. In addition, the Fourth Circuit Court of Appeals' decision in *In re Moore*[1] addresses the question of whether a debtor's interest in an ERISA-qualified pension plan is property of his bankruptcy estate.[2] Finally, developments affecting the treatment of a claim of a secured creditor and a debtor's entitlement to a discharge will also be addressed.

II. Virginia Property Exemptions

Section 522 of the Bankruptcy Code authorizes individual debtors to exempt certain property interests from becoming assets of the bankruptcy estate.[3] The Bankruptcy Code allows a state to "opt out" of the federal bankruptcy exemptions[4] and to adopt in

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1. 907 F.2d 1476 (4th Cir. 1990).
2. *See infra* notes 65-71 and accompanying text.
3. 11 U.S.C. § 522 (1988).
4. *Id.* § 522(b)(1).

their stead separate exemptions.[5] Virginia is one of thirty-six states which has opted out of the federal exemption scheme.[6] Although the Virginia exemptions apply to debtors and non-debtors alike, most decisions interpreting the application of the Virginia exemptions have been rendered in connection with bankruptcy cases. This is a result of the importance that exemptions play in effective bankruptcy planning and in the administration of a bankruptcy estate.

During the 1990 General Assembly, two bills were enacted which significantly changed the exemptions available to an individual in Virginia. The changes were intended to clarify and update the existing exemptions. The changes also created two additional exemptions available to a debtor.

The changes adopted expand the rights of debtors at the expense of creditors.[7] However, some of the significant loopholes that had become notorious under the old exemptions have now been closed. This should serve to protect creditors to a greater degree.[8]

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5. VA. CODE ANN. § 34-3.1 (Repl. Vol. 1990). The "opt out" provision of the Bankruptcy Code is limited to excluding only the federal exemptions specified in § 522(d). Bass v. Thacker, 5 Bankr. 592 (Bankr. W.D. Va. 1980). The remaining provisions of § 522 are still applicable to a debtor's bankruptcy proceeding. Farmers & Merchants Bank v. Boyd, 11 Bankr. 690 (Bankr. W.D. Va. 1981). In fact, a Virginia bankruptcy court recently ruled that § 522(f) can be utilized by a debtor in a Chapter 7 case to avoid a judicial lien on his residence when there was no equity in the property. *In re* Gunter, 100 Bankr. 311 (Bankr. E.D. Va. 1989).

6. *Report of the Joint Subcommittee Studying Virginia's Exemption Statutes to the Governor and the General Assembly of Virginia* H. Doc. No. 77 at 8 (1990) [hereinafter REPORT]. The report lists the following states as those which have opted out: Alabama, Alaska, Arizona, Arkansas, California, Colorado, Delaware, Florida, Georgia, Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Louisiana, Maine, Maryland, Missouri, Montana, Nebraska, Nevada, New Hampshire, New York, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, South Carolina, South Dakota, Tennessee, Utah, West Virginia and Wyoming. *Id.*

7. The expansion of a debtor's rights reflects the legislative intent that "[t]he fundamental purpose of property exemption statutes is to protect a debtor and his dependents from absolute poverty and, in doing so, protect the state from assuming the support of debtors and their families." *Id.* at 9.

8. Under the prior exemption scheme, limits were not placed on the value of such exemptible items as "one horse," "rugs," or "necessary wearing apparel of the debtor and his family." The failure to limit the value of such items created the ability to claim excessive exemptions. For example, a $2,500.00 mink coat was found to be within the contemplation of "all necessary wearing apparel of the debtor and his family" since the word "necessary" is not a word of limitation requiring the fixing of a value on the items to be exempt. *In re* Perry, 6 Bankr. 263 (Bankr. W.D. Va. 1980). In addition, a racehorse whose value was thought to be between $50,000.00 and $640,000.00 was found to be exempt under the Code section allowing every household to exempt one horse. *In re* Freedlander, 93 Bankr. 446 (Bankr. E.D. Va. 1988).

Moreover, the potential for abuse that existed under the prior provisions has, for the most part, been remedied by placing monetary limits on the categories of exempt property.

A. *Exemption of Retirement Plans*

A new exemption was created in 1990 for interests arising under certain types of retirement plans.[9] The portion of an individual's interest in a retirement plan that now may be exempted is limited to an amount that will provide the debtor with an annual benefit not to exceed $17,500.00.[10] The statute's definition of retirement plan includes most types of qualified retirement plans and is written broadly to include plans that were "intended" to be qualified.[11]

Two restrictions are interposed on the exemption in order to prevent abuse. First, an exemption is not allowed with respect to funds contributed to a retirement plan in the fiscal year in which the exemption is claimed and for the two preceding fiscal years.[12] As a result, the debtor must have accumulated the monies claimed as exempt at least three years prior to the date the exemption is claimed. This restriction is apparently intended to prevent a debtor from investing substantial amounts of money in a retirement plan just prior to filing bankruptcy in an attempt to avoid creditors. Second, restrictions placed on the exemption prevent married individuals who share an interest in the same retirement plan or plans from claiming two separate exemptions of $17,500.00, to the extent they are jointly liable for any debts incurred during their marriage.[13]

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9. VA. CODE ANN. § 34-34 (Repl. Vol. 1990).

10. *Id.* § 34-34(C). In order to determine the amount that must be invested in order to annually receive $17,500.00, a graduated factoring table contained in VA. CODE ANN. § 34-34(C) must be examined. This system is intended to allow for an exemption equal to the present value of annuity payments that will commence at age 65. *Id.* § 34-34(A). Based on the graduated increases as calculated into the table, the 65 year old debtor could maintain a retirement plan with a value of $143,426.50 and still qualify for the $17,500.00 exemption.

11. *Id.* § 34-34(A). The statute defines retirement plan to mean "a plan, account or arrangement which is intended to satisfy the requirement of United States Internal Revenue Code §§ 401, 403(a), 403(b), 408, 409 (as in effect prior to repeal by United States P.L. 98-369), or § 457." *Id.* Each of these sections refer to qualified retirement plans. In order for a retirement plan to be considered "qualified" certain requirements set out in the Internal Revenue Code must be met. *See infra* note 60.

12. VA. CODE ANN. § 34-34(D).

13. *Id.* § 34-34(F). The exemption for retirement accounts must be claimed within the time limits prescribed by § 34-17 of the Code of Virginia. Section 34-17 requires that an exemption be taken on or before the fifth day after the date initially set for the meeting of creditors held in the bankruptcy case. *Id.* § 34-34(G).

The reason the Virginia General Assembly established an exemption for retirement plans was to cure an apparent inconsistency in the treatment of qualified retirement plans[14] under Virginia Law.[15] Prior to the Fourth Circuit's decision in *In re Moore*,[16] it was believed that a qualified retirement plan could only be excluded from a debtor's bankruptcy estate if the plan met the requirements of Virginia's spendthrift trust law.[17] Virginia's spendthrift trust law, however, does not allow for the creation of a trust for the benefit of the settlor (self-settling trusts). Therefore, a qualified retirement plan created by an owner-employee or a self-employed individual was thought not to be entitled to the same benefit in bankruptcy that would be available to other employees.[18]

In *Moore*, the Fourth Circuit held that the anti-alienation clause required to be included in all qualified plans[19] was sufficient in and of itself to exclude the plan from the bankruptcy estate.[20] Yet, since *Moore* does not specifically address the issue of whether a self-settling qualified plan is excluded from the debtor's bankruptcy estate, the extent of the application of the court's ruling was left uncertain. In a recent decision expanding on *Moore*, the Fourth Circuit in *Shumate v. Patterson*[21] held that an anti-alienation clause contained in a self-settling qualified plan does in fact allow for the exclusion of the plan from the debtor's bankruptcy estate. Therefore, the Fourth Circuit's decisions arguably make the newly enacted retirement plan exemption irrelevant in a bankruptcy proceeding.[22]

14. *See generally infra* text accompanying notes 58-71.

15. REPORT, *supra* note 6, at 1.

16. 907 F.2d 1476 (4th Cir. 1990); *see infra* text accompanying notes 65-71.

17. REPORT, *supra* note 6, at 6-7; *see infra* note 62.

18. REPORT, *supra* note 6, at 7-8.

19. *See infra* note 60.

20. *See infra* note 68.

21. Shumate v. Patterson, No. 88-2174 (4th Cir. Aug. 12, 1991) (LEXIS, Genfed Library, USAPP file). In *Shumate* the court states that "ERISA requires a plan to have a non-alienation provision, and that provision has been vigorously enforced. [citations omitted] No more inquiry need be made to determine whether the trust is controlled by the settlor or the beneficiary, or whether they are the same person." *Id.*

22. However, because Virginia's retirement plan exception is written broadly to include plans that were "intended" to be qualified, the exemption still has an application in certain instances. VA. CODE ANN. § 34-34(A).

B. *Homestead Exemption*

In addition to creating a new exemption for retirement plans, broad changes were also made to the existing exemption scheme. Specifically, significant changes were made to the homestead exemption.[23] The homestead exemption is one of the principal exemptions available to debtors in Virginia. The homestead exemption gives a debtor the right to claim exempt any property, real or personal, up to $5,000.00 in value.[24] The exemption is still available to all householders, as the term has been redefined,[25] and may only be claimed once in a debtor's life.[26]

In a significant 1990 change to the homestead exemption, a debtor is now allowed to claim an additional $500.00 for each dependent of the householder.[27] The term "dependent" means an "individual who derives support primarily from the householder and who does not maintain sufficient assets to support himself.[28] Additionally, under no circumstance may an individual be treated as a "dependent of more than one householder."[29] Dependency can be established by showing that an individual was claimed as a dependent in a householder's most recent income tax return. Because the term householder has been broadly redefined as "any resident of Virginia," there exists the potential for litigation over the treatment of a dependent as a householder.

In their amendments, the General Assembly addressed the manner in which a homestead exemption can be claimed in connection

23. VA. CODE ANN. § 34-4 (Repl. Vol. 1990).

24. *Id.*

25. "[H]ouseholder" was redefined in 1990 to mean "any resident of Virginia." *Id.* § 34-1. Under the prior definition, "householder" meant "any person, married or unmarried, who maintains a separate residence or living quarters, whether or not others are living with him." *Id.* § 34-1 (Repl. Vol. 1984). The ambiguities contained in this definition raised such questions as whether a child living with his parents qualifies as a householder, Jones v. Kirsch, 93 Bankr. 77 (Bankr. E.D. Va. 1988), or whether a husband and wife, living together, may both be deemed householders, Roberts v. County of Henrico Fed. Credit Union, 709 F.2d 275 (4th Cir. 1983); Cheeseman v. Nachman, 656 F.2d 60 (4th Cir. 1981); *In re* Thompson, 4 Bankr. 823 (Bankr. E.D. Va. 1980). Most recently, it was determined under the prior definition that an independent child living with his parents and contributing to the maintenance of the residence was a householder. *In re* Howell, 106 Bankr. 99 (Bankr. W.D. Va. 1989).

26. In *In re* Hayes, 119 Bankr. 86 (Bankr. E.D. Va. 1990), the bankruptcy court held that a debtor's right to claim a homestead exemption is not compromised by the trustee's establishment of the existence of the debtor's intent to defraud creditors.

27. VA. CODE. ANN. § 34-4 (Repl. Vol. 1990).

28. *Id.*

29. *Id.*

with the conversion of a case from Chapters 11, 12 or 13 of the Bankruptcy Code to a proceeding under Chapter 7 of the Bankruptcy Code. The amendments require that the homestead exemption be claimed "on or before the fifth day after the date initially set for the meeting" of creditors in the converted Chapter 7 case.[30] This change is significant because under the prior statute a debtor who did not claim a homestead exemption in a case originally filed under Chapters 11, 12 or 13 lost the right to subsequently claim the exemption in a case converted to Chapter 7.[31] As a debtor in a Chapter 11, 12 or 13 case has little incentive to be diligent in claiming exemptions at the time the petition is filed, many debtors lost the benefit of the homestead exemption under prior law.[32]

The General Assembly did not specify whether the new exemptions apply to pending bankruptcy cases that were converted to Chapter 7 after the July 1, 1990 effective date of the amendments. However, a Virginia bankruptcy court has recently held that, in accordance with section 522(b)(2)(A) of the Bankruptcy Code, the exemptions in effect at the time of the initial filing of the bankruptcy petition are controlling.[33] Accordingly, a debtor who filed for bankruptcy prior to July 1, 1990, and subsequently converted his case to Chapter 7 after this date would not be entitled to the benefit of the new exemption scheme.

Prior to 1990, a householder was not allowed a homestead exemption against certain types of creditor's claims.[34] Generally, the claims of landlords, mechanics and certain other creditors were preferred over a householder's right to claim a homestead exemption. The new legislation significantly reduces the type of creditors that receive preferred treatment. Currently, the only creditors entitled to defeat a debtor's homestead exemption are those who provide purchase money financing in the acquisition of property[35] and those claiming a spousal or child support obligation.[36]

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30. VA. CODE ANN. § 34-17.
31. *Id.* § 34-17 (Repl. Vol. 1984).
32. A debtor lacks the incentive to diligently claim exemptions in bankruptcy cases under Chapters 11, 12 and 13 of the Bankruptcy Code since he typically remains in possession of his property. After a plan of reorganization is confirmed, the property of the estate vests in the debtor. 11 U.S.C. §§ 1141(b), 1227(b), 1327(b) (1988).
33. *See In re* Stroble, 127 Bankr. 372 (Bankr. W.D. Va. 1991); *see also In re* Williamson, 804 F.2d 1355, 1359 (5th Cir. 1986).
34. VA. CODE ANN. § 34-5(1) (Repl. Vol. 1984).
35. *Id.* § 34-5(1) (Cum. Supp. 1991).
36. *Id.* § 34-5(2).

In 1990, the General Assembly also prescribed a form homestead deed that must be substantially followed in order to claim the exemption.[37] The form adopted to claim a homestead exemption in personal property is slightly different from the real property form.[38] As the provisions allow for forms that are "substantially similar" to those suggested by the General Assembly, it should still be an acceptable practice to use a single homestead deed which claims as exempt both real and personal property.

C. *Poor Debtor's Exemption*

The amendments made to the exemption scheme include major revisions to the poor debtor's exemption contained in section 34-26 of the Code of Virginia ("Code"). In an effort to limit the potential for abuse, the General Assembly placed monetary limits on many of the exemptions that were previously available.[39] In amending the poor debtor's exemption, the Virginia General Assembly relied on the exemption scheme adopted by North Carolina.[40]

The poor debtor's exemption now allows a householder to claim an exemption in property purchased with non-exempt assets in contemplation of bankruptcy.[41] This amendment clarifies a previously unsettled area of the law and allows for greater certainty with respect to pre-bankruptcy planning.

Under the prior poor debtor's exemption, a householder was entitled to claim an exemption for such items as "one cow," "two hoes," "fifty bushels of shelled corn," and "one barrel of flour."[42] The new legislation modernizes the exemption to account for items which are presently necessary to sustain daily life.[43] Under section 34-26 of the Code, the new poor debtor's exemptions include the following:

1. The exemption for the family Bible, wedding and engagement rings and a burial lot have not been changed.[44]

2. The exemption for "family pictures" has been changed to an

37. *Id.* §§ 34-6, -14 (Repl. Vol. 1990).
38. *Id.*
39. *See supra* note 8.
40. REPORT, *supra* note 6, at 10.
41. VA. CODE ANN. § 34-26 (Repl. Vol. 1990).
42. *Id.* § 34-26(5) (Repl. Vol. 1984).
43. REPORT, *supra* note 6, at 10.
44. VA. CODE ANN. § 34-26 (Repl. Vol. 1990).

exemption for family portraits and family heirlooms with a value not to exceed $5,000.00. The General Assembly omitted any definition of the term "family heirloom," therefore it will be left to the courts to decide the kinds of property that qualify for the exemption.[45]

3. The exemption for "all necessary wearing apparel of the debtor and his family" has been limited to the wearing apparel of the householder with a value not to exceed $1,000.00.[46] This change resolves the issue raised in *In re Perry*[47] which held that a fur coat valued at $2,500.00 was necessary apparel and therefore entitled to be exempt.

4. The exemption of specific household items such as "beds," "bedsteads," "carpets," and "rugs" has been replaced with a much broader exemption encompassing all household furnishings with a value not to exceed $5,000.00.[48]

5. Pets are now the only kinds of animals that are exempt under the new poor debtor's exemption.[49] Under the prior exemption, numerous farm animals which were thought to be necessary to sustain a family in an agrarian society were exempt.[50] In *In re Freedlander*,[51] the broad scope of the prior exemptions resulted in exempting a racehorse with a potential value as high as $640,000.00.

6. The former statute provided an exemption for the "tools and utensils" used by a mechanic in his trade, and an additional exemption of a boat and tackle of an oysterman or fisherman, not exceeding $1,500.00, was also available.[52] Considerable litigation occurred with respect to the tools of trade exemption, with the primary area of dispute being the items which constituted tools of a trade.[53] In order to broaden the application of the exemption, the

45. VA. CODE ANN. § 34-26 (Repl. Vol. 1990).
46. *Id.*
47. 6 Bankr. 263 (Bankr. W.D. Va. 1980).
48. VA. CODE ANN. § 34-26 (Repl. Vol. 1990).
49. *Id.*
50. *Id.* § 36-26 (Repl. Vol. 1984).
51. 93 Bankr. 446 (Bankr. E.D. Va. 1988).
52. VA. CODE ANN. § 34-26 (Repl. Vol. 1984).
53. In determining whether or not an item constituted a tool of trade, it was found that the items had to be reasonably necessary, both in kind and quality, for the workman to perform his chosen trade in an efficient and competent manner. *In re* Allen, 52 Bankr. 206 (Bankr. E.D. Va. 1985). A factual determination had to be made on a case by case basis of whether each tool of a mechanic was actually necessary for the particular trade. *In re*

amendments now allow for an expansive range of items that can be claimed exempt in connection with a householder's "occupation or trade."[54] The term "occupation" is defined to include students of almost any kind, and a limit of $10,000.00 has been placed on the value of items that can be claimed exempt.[55]

7. Two new exemption provisions have been added to the former statute. The first allows for the exemption of "medically prescribed health aids;" this exemption is not limited to a monetary amount. The second exemption applies to a motor vehicle and cannot exceed $2,000.00. A perfected security interest on the motor vehicle will have priority over the allowed exemption. These two exemptions broaden the rights of a debtor, and appear to bring Virginia's statute more in line with the exemptions available under the Bankruptcy Code.

D. *Exemption for Personal Injury Claims*

An additional exemption created under the new exemption scheme concerns personal injury claims. Under prior law, the Fourth Circuit held in *Tignor v. Parkinson* that personal injury claims were not exempt based on Virginia's statutory prohibition on the assignment of tort claims.[56] As a result, personal injury claims could only be exempted in accordance with a homestead exemption. The new legislation nullifies the effect of *Tignor* and provides an exemption for personal injury claims without any limitation as to amount.[57]

III. PROPERTY OF THE ESTATE

The Bankruptcy Code broadly defines property of the estate to include "all legal or equitable interests of the debtor in property as of the commencement of the case."[58] Section 541(c)(2) of the Bankruptcy Code excludes as property of the estate a debtor's interest in certain trusts that maintain a restriction on the transfer of an interest. Specifically, this section provides that "[a] restriction on the transfer of a beneficial interest of the debtor in a trust

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Quidley, 39 Bankr. 362, 367 (Bankr. E.D. Va. 1984).

54. VA. CODE ANN. § 34-26 (Repl. Vol. 1990).

55. *Id.*

56. 729 F.2d 977 (4th Cir. 1984) (interpreting VA. CODE ANN. § 8.01-26 (Repl. Vol. 1984)).

57. VA. CODE ANN. § 34-28.1 (Cum. Supp. 1991).

58. 11 U.S.C. § 541(a)(1) (1988).

that is enforceable under *applicable non-bankruptcy* law is enforceable in a case under this title."[59] A significant debate presently exists over the meaning of the phrase "applicable non-bankruptcy law."

If read broadly, "applicable nonbankruptcy law" can be interpreted to include qualified retirement plans[60] governed by the Employee Retirement Income Security Act of 1974, commonly referred to as ERISA.[61] If interpreted narrowly, however, the phrase would apply only to spendthrift trusts[62] created and enforceable in accordance with state law.[63] Because there exists the potential for excluding significant interests contained in a qualified retirement plan from the definition of property of the bankruptcy estate, in bankruptcy planning it is critical to determine the extent to which section 541(c)(2) applies. If the interest in the plan does not become property of the estate, it would not be an asset subject to recovery and administration by a trustee. As a result, there would

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59. *Id.* § 541(c)(2) (emphasis added).

60. "[Q]ualified retirement plan" is defined broadly in the Internal Revenue Code to include pension plans, stock bonus plans, and annuity plans. 12 Fed. Tax Coordinator 2d (Res. Inst. Am.) ¶ H-5101 (1991). There are certain requirements for qualification that all qualified plans must meet. A requirement of particular significance concerns the need for an anti-alienation clause under the plan. With certain exceptions, an anti-alienation clause must provide that benefits under the plan may not be assigned, alienated, garnished, attached or pledged as collateral for a loan. *Id.* ¶ H-8200.

61. 29 U.S.C. §§ 1001 to 1461 (1988). ERISA is very broad and applies to most employee retirement plans. *Id.* §§ 1002(2), 1321. Congress enacted ERISA "to protect and expand the rights of all workers to a pension." 120 CONG. REC. 29,1994 (1974) (statement of Rep. Biaggi). ERISA itself is very complex and allows for a wide range of options for pension and welfare benefit plans. The ERISA provisions "federalize" pension plan law by providing that ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." 29 U.S.C. § 1144(a) (1988).

62. Section 55-19 of the Code recognizes the validity of spendthrift trusts. Under Virginia law, a spendthrift trust has been found to have three defining characteristics. A spendthrift trust must (i) provide for the support and maintenance of its beneficiary; (ii) have been intended, expressly or impliedly, by the settlor to be protected from the beneficiary's creditors; and (iii) have been intended by the settlor to prevent the beneficiary's voluntary or involuntary alienation of the trust property. Levey v. First Va. Bank, 845 F.2d 80, 82-83 (4th Cir. 1988).

63. Proponents of a narrow interpretation of "applicable nonbankruptcy law" cite the legislative history of § 541(c)(2) as authority. *See infra* note 68. A house report notes that § 541(c)(2) of the Bankruptcy Code

> continues over the exclusion from property of the estate of the debtor's interest in a spendthrift trust to the extent the trust is protected from creditors under applicable state law. The bankruptcy of the beneficiary should not be permitted to defeat the legitimate expectations of the settlor of the trust.

H.R. REP. No. 595, 95th Cong., 1st sess. 176 (1977).

be no need to exempt such an interest.[64]

In *In re Moore*, the Fourth Circuit adopted a broad interpretation of the phrase "applicable nonbankruptcy law."[65] In so doing, the court held that a debtor's interest in an ERISA qualified retirement plan was excluded as an asset of the bankruptcy estate pursuant to the anti-alienation clause contained in the plan.[66] This decision extends the Fourth Circuit's prior ruling in *In re McClain.*[67]

In *Moore*, the Fourth Circuit determined that the application of section 541(c)(2) was not limited to state spendthrift trust law as most courts had previously ruled.[68] In holding that the clear language of the statute controls, the Fourth Circuit rejected the reliance by other courts on legislative history as authority for finding that section 541(c)(2) applied only to state spendthrift trusts.[69] The court concluded that the security of employee retirement benefits could only be ensured if there was uniform treatment of retirement plans throughout the country.[70] Because ERISA preempts state law, the Fourth Circuit held that the application of the anti-alienation provisions in conjunction with the Bankruptcy Code operated to provide identical treatment of benefits in all states.

The Fourth Circuit's decision in *Moore* is significant for several

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64. As discussed earlier in this article, an exemption is now available in Virginia for qualified retirement plans. This exemption, however, is subject to a monetary limit. *See supra* text accompanying notes 10-13.

65. 907 F.2d 1676 (4th Cir. 1990).

66. *Id.*

67. 762 F.2d 1204 (4th Cir. 1985). In *In re* McClain, the court found that the language of the qualified plan restricted the transfer of the debtor's interest in the plan under state law. *See also In re* Putman, 110 Bankr. 783 (Bankr. E.D. Va. 1990).

68. The majority of appellate courts have held that the anti-alienation provision of a qualified plan does not in and of itself allow for the exclusion of a debtor's interest in the plan from a bankruptcy estate. *In re* Goff, 706 F.2d 574 (5th Cir. 1983), is the earliest and leading circuit court case on this issue. The court in *Goff* adopted a narrow interpretation of the scope of § 541(c)(2) and found that the section applied only to spendthrift trusts. An analysis of the applicable state law relevant to spendthrift trusts determined that the pension plan in question did not qualify as a spendthrift trust. Other appellate court decisions that have adopted the court's reasoning in *Goff* include *In re* Perkins, 902 F.2d 1254 (7th Cir. 1990); *In re* Lichstrahl, 750 F.2d 1488 (11th Cir. 1985); *In re* Daniel, 771 F.2d 1352 (9th Cir. 1985), *cert. denied*, 475 U.S. 1016 (1986); *In re* Graham, 726 F.2d 1268 (8th Cir. 1984). A substantial majority of lower courts have also followed the *Goff* rationale. *See generally* Note, *ERISA Preemption of State Exemption Laws: The Effects in Bankruptcy*, 7 BANKR. DEV. J. 615, 616-18 (1990).

69. *In re Moore*, 907 F.2d at 1478.

70. The court stated that "[o]ur holding ensures that the security of employee retirement benefits will not depend on the particularities of state spendthrift law." *Id.* at 1480.

reasons. First, it is one of the few decisions which departs from the traditional spendthrift trust analysis in determining whether a retirement plan under section 541(c)(2) is excluded from the bankruptcy estate. Second, it provides debtors with greater certainty in assessing whether a retirement plan will be treated as an asset of their bankruptcy estate. Third, and perhaps most important, the rationale of the Fourth Circuit's decision allows for the exclusion of self-settling qualified plans of closely owned businesses.[71]

IV. Treatment of Secured Claims

Several bankruptcy decisions rendered during the survey period affected the manner in which a secured creditor's claim will be treated in a bankruptcy case. Of particular interest is *In re Townside Partners Ltd.*[72] in which a Virginia bankruptcy court addressed the treatment of an assignment of rents clause contained in a deed of trust. Other decisions addressed such matters as (i) the reduction of a creditor's lien on a debtor's principal residence in a Chapter 13 bankruptcy case;[73] (ii) the right of a secured creditor to recover a deficiency claim against a debtor when notice of a sale of collateral is not given;[74] and (iii) a secured creditor's entitlement to a priority claim when the "adequate protection" it had been afforded proves to be insufficient.[75] The following analysis reviews the developments that have occurred in these areas.

A. *Assignment of Rents*

The treatment of an assignment of rents provision contained in a deed of trust is currently a popular topic in bankruptcy law. In

71. The Fourth Circuit in Shumate v. Patterson, No. 88-2174 (4th Cir. Aug. 12, 1991) (LEXIS, Genfed Library, USAPP file), recently confirmed that self-settling qualified plans of closely owned businesses are in fact excluded from the debtor's bankruptcy estate. Prior to the court's decision in *Shumate*, numerous courts interpreting state spendthrift trust law have relied on the self-settling aspect of a qualified plan as the basis for failing to exclude a plan's interest under § 541(c)(2). *In re Lichstrahl*, 750 F.2d at 1490; *In re Goff*, 706 F.2d at 588-89; *In re* Kerr, 65 Bankr. 739, 740, 745 (Bankr. D. Utah 1986); *In re* O'Brien, 50 Bankr. 67, 77 (Bankr. E.D. Va. 1985); and *In re* DiPiazza, 29 Bankr. 916, 922 (Bankr. N.D. Ill. 1983). In *O'Brien*, a Virginia bankruptcy court found that a qualified pension plan could not be excluded from the bankruptcy estate because of the self-settling nature of the plan. The bankruptcy court found that the plan did not qualify as a traditional spendthrift trust since the settlor was also the beneficiary. *In re O'Brien*, 50 Bankr. at 77.

72. 125 Bankr. 8 (Bankr. W.D. Va. 1991).

73. *See infra* notes 89-97 and accompanying text.

74. *See infra* notes 98-107 and accompanying text.

75. *See infra* notes 108-112 and accompanying text.

Virginia, as is typical in other states, the Uniform Commercial Code does not apply to the "creation or transfer of an interest in or lien on real estate."[76] As a result, a secured creditor's interest in rents received from real estate is created by an assignment of rents clause typically contained in a deed of trust recorded against the property. The point at which a secured creditor becomes entitled to receive the rents from real estate under an assignment of rents clause is determined by state law and has been the subject of much debate and uncertainty.[77]

The issue of when a secured creditor becomes entitled to receive rents from real estate is important in a bankruptcy context since the question determines the debtor's right to use such property in a Chapter 11 reorganization. Section 363(c)(1) of the Bankruptcy Code provides the Chapter 11 debtor with broad authority to use property of the estate in the ordinary course of the debtor's business.[78] However, when a creditor's collateral is in the form of "cash collateral,"[79] the Bankruptcy Code provides the creditor with special protection. Specifically, the Bankruptcy Code prevents the debtor from using cash collateral without first obtaining the creditor's consent or court authority.[80] This protection is afforded to the creditor because allowing the debtor to use cash collateral is, in effect, forcing the creditor to finance a Chapter 11 debtor's post-petition operation.

In *In re Townside Partners, Ltd.*,[81] a Virginia bankruptcy court addressed the issue whether rents should be treated as cash collateral. In *Townside*, the debtor acquired an apartment complex against which a deed of trust containing an assignment of rents clause was executed and properly recorded. The assignment of rents clause stated that a "present and irrevocable" assignment of

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76. VA. CODE ANN. § 8.9-104(j) (Repl. Vol. 1965).

77. *See* Butner v. United States, 440 U.S. 48 (1979).

78. 11 U.S.C. § 363(c)(1) (1988).

79. 11 U.S.C. § 363(a) (1988) of the Bankruptcy Code defines cash collateral broadly to mean

> cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offsprings, rents, or profits of property subject to a security interest as provided in section 552(b), . . . whether existing before or after the commencement of a case under [the Bankruptcy Code] . . . .

Id.

80. *Id.* § 363(c)(2).

81. 125 Bankr. 8 (Bankr. W.D. Va. 1991).

rents was created.[82] Additional language contained in the clause indicated that the assignment of rents provision may be triggered upon an event of default.

The court determined that there were two means by which rents could qualify as cash collateral under Virginia law. The first required that the creditor be in actual possession of the property in order to create an entitlement to the rental income.[83] The second required that the assignment of rents clause contain language that establishes an "absolute" assignment of rents.[84] In the latter case, the court relied on the Fourth Circuit's decision in *Fidelity Bankers Life Insurance Co. v. Williams*[85] which recognizes the validity and enforceability of an absolute assignment of rent clause.

In finding that a clause granting an absolute assignment of rents was present in *Townside*, the court distinguished the facts of *In re Vienna Park Properties*,[86] a New York bankruptcy court decision interpreting Virginia law. In that case, the New York court held that the assignment of rents clause was not absolute since it was granted only "as additional security."[87]

Townside clarifies Virginia state law with respect to the treatment of assignment of rent clauses in bankruptcy cases. To the extent the decision is followed by other Virginia bankruptcy courts, the case will provide guidance in drafting the language contained in future assignment of rent clauses. The decision will also provide practitioners, representing debtors and creditors alike,

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82. *Id.* at 10.

83. Although rents are specifically included within the definition of cash collateral, the definition also requires that they be "property subject to a security interest as provided in § 552(b). . . ." 11 U.S.C. § 363(a) (1988). Section 552(b) requires a creditor to have a present entitlement to rents at the time the petition is filed in order to maintain a right to the rents post-petition. *Id.* § 552(b).

Because Virginia is a "lien theory" state and not a "title theory" state, secured creditor's cases have held that an immediate entitlement to rents is created by the creditor having actual possession of the property. Interstate R.P. Co. v. Roberts, 127 Va. 688, 692, 105 S.E. 463, 464 (1920) ("[t]he essence of a mortgage or deed of trust is that it creates a lien on property to secure a debt"); *In re* Vienna Park Properties, 120 Bankr. 332, 335-36 (Bankr. S.D.N.Y. 1990); Administrator v. Richmond & A.R.R. Co., 81 Va. 388, 391 (1866) ("The law is now well settled that until possession of the mortgage property is taken by the mortgagee, or proper judicial authority, the mortgagor is entitled to the profits. When possession is thus taken, the mortgagee becomes entitled to the profits but only to such as thereafter accrue."); *In re Townside Partners, Ltd.*, 125 Bankr. at 10.

84. *In re Townside*, 125 Bankr. at 10.

85. 506 F.2d 1242 (4th Cir. 1974).

86. 120 Bankr. 332 (Bankr. S.D.N.Y. 1990).

87. *Id.* at 337.

with the certainty needed for effective bankruptcy planning. The holding will also have ramifications with respect to Chapter 7 proceedings in that a secured creditor, without an absolute assignment of rents clause, will not be entitled to recover rents from real estate until after obtaining relief from the automatic stay and taking possession of the property.[88]

B. *Lien Reduction Under Chapter 13*

Several recent Virginia bankruptcy court decisions have addressed the question of whether a homeowner can use Chapter 13 to repay less than the full amount of a home mortgage. In *In re Gadson*,[89] the bankruptcy court held that a homeowner in a Chapter 13 bankruptcy case could reduce a creditor's claim secured by a deed of trust only on the debtor's principal residence to reflect the value of the collateral.[90] The court's decision turned on a comparison of two provisions of the Bankruptcy Code, sections 506 and 1322(b)(2).

Under section 506 of the Bankruptcy Code, a secured claim can be reduced to reflect the value of the underlying collateral.[91] The language of section 506, however, conflicts with section 1322(b)(2) of the Bankruptcy Code which provides that a Chapter 13 plan may not modify the rights of holders of claims secured only by a debtor's principal residence.[92] In *Gadson*, the court determined that section 1322(b)(2) does not preclude a Chapter 13 debtor from modifying the amount of a secured claim pursuant to section 506.[93]

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88. *In re* Oceanview/Virginia Beach Real Estate Associates, 116 Bankr. 57 (Bankr. E.D. Va. 1990), also analyzes the existence of cash collateral in an assignment of rents context. In *Oceanview*, a Virginia bankruptcy court reviewed the issue of whether hotel receipts could be considered rents under an assignment of rents clause. In finding that hotel receipts could not be considered "rents," the court held that the creditor's lien had to be perfected as personal property in accordance with the Uniform Commercial Code. *Id.*

89. 114 Bankr. 453 (Bankr. E.D. Va. 1990).

90. It should be noted that although this particular issue was not decided, the bankruptcy court in *In re* Schaffer, 84 Bankr. 63 (Bankr. W.D. Va.), *aff'd and remanded sub nom.*, Capital Credit Plan of Tenn., Inc. v. Schaffer, 116 Bankr. 60 (W.D. Va. 1988), *appeal dismissed*, 912 F.2d 749 (4th Cir. 1989), took an even more restrictive view of § 1322(b)(2). In *Capital Credit Plan of Tenn., Inc.*, the court held that "notwithstanding the fact that the value of the real estate may be high enough to make the debt fully secured" a Chapter 13 plan can modify the rights of a creditor secured only by a debtor's principal residence. *Id.* at 61. (quoting *In re* Schaffer, 84 Bankr. 63, 67 (Bankr. W.D. Va. 1988)).

91. *See* United States v. Ron Pear Enter., Inc., 89 U.S. 235 (1989).

92. 11 U.S.C. § 1322(b)(2) (1988).

93. *In re Gadson*, 114 Bankr. at 456.

Since *Gadson*, two other cases, *In re Moore*[94] and *In re McNair*,[95] have adopted the same analysis.

The bankruptcy court's decision in *Gadson* produces a favorable result for unsecured creditors and Chapter 13 debtors alike. Monthly payments to creditors secured only by a debtor's home can now be reduced under a Chapter 13 plan to correspond to the secured portion of the debt. This will have the effect of increasing the debtor's disposable income and will allow for larger payments to unsecured creditors.[96] By increasing the payments to unsecured creditors, a Chapter 13 debtor will be more capable of overcoming any "meaningful" or "substantial" payment requirement that may be considered by a bankruptcy court in confirming the debtor's plan.[97]

C. *Deficiency Claims Under Flawed U.C.C. Sales*

In *In re Parrish*,[98] a Virginia bankruptcy court determined that a secured creditor's failure to provide proper notice of a U.C.C. Article 9 sale does not automatically deny the secured creditor the right to a deficiency claim. Section 8.9-504 of the Code provides that after notice to a debtor,[99] a secured creditor may dispose of collateral after a default and collect any remaining deficiency that may then be owed. Where it is established that a secured creditor has failed to comply with section 8.9-504 of the Code, the debtor has a right to recover any loss caused by such failure.[100] In an earlier decision, the Fourth Circuit had determined that the failure to give notice to the debtor of a secured party's sale was a fatal defect that prevented the recovery of a deficiency claim.[101]

Two diverging views have been adopted by courts that have ad-

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94. 113 Bankr. 239 (Bankr. E.D. Va. 1990).

95. 115 Bankr. 520 (Bankr. E.D. Va. 1990).

96. The term "disposal income" is defined in § 1325(b)(2) of the Bankruptcy Code and generally determines the amount of funds that will be available for unsecured creditors. 11 U.S.C. § 1325(b)(1)(B) (1988).

97. Section 1325 of the Bankruptcy Code presents as a condition of confirmation a requirement that a Chapter 13 plan be proposed in good faith. Although "substantial" or "meaningful" payments is not an absolute requirement in a good faith analysis, it is an element to be considered. *In re* Dean, 692 F.2d 968 (4th Cir. 1982).

98. 110 Bankr. 229 (Bankr. W.D. Va. 1989).

99. The term "debtor" is defined in § 8.9-105 of the Virginia Uniform Commercial Code and refers to the party obligated to make payment under the secured note. The term should not be confused with a debtor as defined by the Bankruptcy Code.

100. VA. CODE ANN. § 8.9-507(1) (1965).

101. *In re* Bishop, 482 F.2d 381 (4th Cir. 1973).

dressed this issue. The first view provides for a "per se" rule that a secured creditor may not recover a deficiency claim where a debtor has not been given notice of the secured party's sale.[102] The second view, which has been characterized as the "no harm no foul" rule, focuses on the actual damage caused to the debtor.[103] Under the "no harm no foul rule," the creditor need only establish that the amount received from the sale of the debtor's collateral is equal to the fair market value of the collateral. If the creditor can make such a showing, then the creditor will be entitled to the full amount of a deficiency claim.[104]

The court in *Parrish* concluded that *Bishop* does not mandate the application of the per se rule in every instance. Instead, the court found that the "facts of each case must be examined in order to determine which rule should be applied."[105] Based on the facts before it, the court held that the debtor had not been damaged by the lack of notice and found that a deficiency claim should therefore be allowed.[106] Since *Parrish* was decided, two Virginia circuit courts have applied the "no harm no foul" rule.[107]

D. *Entitlement to Priority Claim When Adequate Protection is Insufficient*

The filing of a bankruptcy petition imposes an automatic stay which prevents a secured creditor from recovering his collateral without specific court authority.[108] A creditor, however, may seek relief from the automatic stay on the ground that his collateral is not adequately protected.[109] A debtor often defends such an action by providing the creditor with additional protection that is intended to account for any decrease in the collateral that may occur during the time the automatic stay is in effect.[110] In *Grundy Na-*

102. *See In re Parrish*, 110 Bankr. at 231.

103. *See id.*

104. *Id.* at 232.

105. *Id.* at 231.

106. *Id.* at 232.

107. *See generally* Tazewell Oil Co. v. Miners & Merchants Bank, 19 Va. Cir. 245 (County of Buchanan Cir. Ct. 1990); Smith v. Paige, 19 Va. Cir. 359 (City of Richmond Cir. Ct. 1990).

108. 11 U.S.C. § 362(a) (1988).

109. *Id.* § 362(d)(1). Examples of a lack of adequate protection include situations where the creditor's collateral is depreciating as a result of continued use or declining market values.

110. Section 361 of the Bankruptcy Code sets forth different methods by which adequate protection may be provided. 11 U.S.C. § 361 (1988).

tional Bank v. Rife,[111] the Fourth Circuit determined the relief a secured creditor gets when the additional protection the creditor has been given in connection with a relief from stay action proves to be inadequate.

In *Rife*, the court held that a creditor is entitled to be treated as a priority creditor to the extent a debtor fails to make adequate protection payments. In this case, the debtor was ordered to make adequate protection payments as a condition to continuing the automatic stay. The debtor failed to make the necessary payments and the creditor was unable to obtain the immediate possession of its collateral. After finally obtaining relief from the automatic stay, the creditor sought to recover as an administrative priority claim the payments the debtor failed to make, or, in the alternative, the depreciation that had occurred to the collateral.[112]

The Fourth Circuit analyzed the issue in light of the benefit the bankruptcy estate received from the use of the creditor's collateral. Since it was determined that the estate did in fact benefit from the use of the collateral, the court held that the claim was entitled to an administrative expense priority equal to the unpaid adequate protection payments.[113] In the alternative, the court found that the creditor could recover the value of the diminution to the collateral.

V. Objections to the Dischargeability of Debts

A. *Standard of Proof in Dischargeability Actions*

Prior to the United States Supreme Court's recent decision in *Grogan v. Garner*,[114] a split existed among the courts of appeal over the standard of proof to be applied in connection with an action brought by a creditor to prevent a claim from being discharged in the debtor's bankruptcy case. In *Grogan*, the Supreme Court held that the preponderance of the evidence standard, and not the clear and convincing evidence standard, should be applied in determining all instances where a claim can be excepted from a

111. 876 F.2d 361 (4th Cir. 1989).

112. *Id.* at 364.

113. The court relied on §§ 507(b) and 503(a) of the Bankruptcy Code as authority for granting the creditor a priority claim. These Code sections set forth the administrative expenses and the priority claims available in a bankruptcy proceeding. *Id.* at 363-64.

114. 111 S. Ct. 654 (1991). Section 523(a) of the Bankruptcy Code sets forth the situations in which a creditor can seek to have his claim determined not to be discharged in a debtor's bankruptcy case. 11 U.S.C. § 523(a) (1988).

debtor's discharge.[115] The Supreme Court's decision effectively affirms the Fourth Circuit's prior rulings in this area.[116] Although *Grogan* does not specifically address the standard of proof to be used in connection with an action objecting to a debtor's general discharge,[117] bankruptcy courts in Virginia have traditionally applied the same standard used in an action objecting to the discharge of an individual claim.[118]

B. *Dischargeability of Claims Resulting from a Debtor Driving While Intoxicated*

Section 523(a)(9) of the Bankruptcy Code provides that a claim resulting from the operation of a vehicle by a debtor while intoxicated can be excepted from discharge.[119] Previously under this statute it was unclear whether a claimant had to obtain a judgment or decree against a debtor before the filing of the bankruptcy petition to preserve the right to object to the dischargeability of the claim. In 1990, Congress amended the statute to clarify its application. As amended, the section now excepts from discharge any debt "for death or personal injury caused by the debtor's operation of a motor vehicle if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug or another substance."[120] As a result of the amendment, the statute now expressly includes drug induced intoxication and limits the scope of the exception to claims arising from death or personal injury.[121] A separate amendment to the Bankruptcy Code has also been adopted that applies this exception from discharge to a Chapter 13 debtor.[122]

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115. 111 S. Ct. at 660.

116. *See generally* Whitson v. Middleton, 898 F.2d 950 (4th Cir. 1990); Combs v. Richardson, 838 F.2d 112 (4th Cir. 1988).

117. An action objecting to a debtor's discharge is distinguishable from an action objecting to the discharge of an individual debt. An action objecting to a debtor's discharge is brought under § 727 of the Bankruptcy Code and it affects all debts of the debtor. In contrast, an action objecting to an individual debt is raised under § 523(a) of the Bankruptcy Code and is limited to a specific claim. 11 U.S.C. §§ 523(a), 727 (1988).

118. *In re* Harlow, 107 Bankr. 528, 531 (Bankr. W.D. Va. 1989); *In re* Parker, 85 Bankr. 384, 387 (Bankr. E.D. Va. 1988).

119. 11 U.S.C. § 523(a)(9) (1988).

120. *Id.*

121. *Id.*

122. *Id.* § 1328(a)(2).

C. *Dischargeability of Student Loans*

The definition of student loans under section 523(a)(8) of the Bankruptcy Code has been broadened to include "an educational benefit over payment" and "an obligation to repay funds received as a educational benefit, scholarship, or stipend."[123] The time period in which the loan must have first become due in order to be excepted from a discharge has also been extended from five to seven years.[124] A further amendment to the Bankruptcy Code provides that for the first time the student loan exception to a debtor's discharge will apply to the discharge received by a Chapter 13 debtor.[125]

123. 11 U.S.C. § 523(a)(8).
124. *Id.* § 523(a)(8)(A).
125. *Id.* § 1328(a)(2).