The Intersection of State Law and Bankruptcy

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The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different states that the expediency of it seems not likely to be drawn into question.

James Madison, Federalist Papers, No. 42

History of Bankruptcy

Although most reading this manuscript understand the basic history of bankruptcy, a refresher is in order. An understanding of the relationship between state and federal bankruptcy laws is not complete without a review of bankruptcy's beginnings in the formation of this country. The inclusion of a bankruptcy clause in the Constitution emphasized the framers' intentions to maintain more than simply a loose confederation of several states. The bankruptcy clause showed a commitment to a federal government with limited powers, mostly dedicated to the prevention of fractured governance and improved commerce among the several states.

Although the Articles of Confederation did not contain any provision for uniform bankruptcy laws, The framers debated the idea of a uniform bankruptcy system, and consequently the Constitution included such a provision. Primarily, the framers recognized that the several colonies had their own versions of procedure and practice, which created varying results among them.[1] However, some attribute debt-laden farmers with creating the groundswell for the bankruptcy clause in the Constitution. Shay's Rebellion is a prime example of grassroots support for uniform bankruptcy laws. The rebellion was a response to Massachusetts state legislative inaction to relieve farmers' foreclosures during the economic depression at the end of the Revolutionary War.[2] The legislature, controlled by commercial interests, was not responsive to the farmers' petitions for creation of paper money, stay of foreclosures, and general protective legislation. After their pleas were ignored, bands of rebels shut down local courts and the state legislature. Eventually, the uprising was repelled, and most of the rebels were pardoned immediately. Historians attribute Shays and other protests with the shift from the Articles of Confederation to the Constitution.[3]

It is interesting to note, however, that no immediate bankruptcy legislation resulted from the Constitutional provisions[4]. Over the next century, numerous bankruptcy laws were enacted and repealed. Each time the economy failed or weakened, Congress responded with a primitive form of bankruptcy laws (by today's standards), which were then repealed once the economy improved.[5] Each new derivation of bankruptcy

[1] Vault: A Brief History of Bankruptcy Law; www.vault.com
[2] Shays Rebellion: http://encarta.msn.com/encyclopedia_761552054/shays%E2%80%99_rebellion.html
[3] Id.
[4] The result of this inaction was numerous states implementing their own bankruptcy rules, which created the very problems the Bankruptcy Clause was designed to prevent.
[5] This proves my long held belief that Congress has *always* been a reactive, not a proactive body.

law became more favorable to debtors.[6] With the enactment of the Bankruptcy Act of 1898, however, a uniform structure of bankruptcy laws was finally implemented that lasted almost 80 years. The 1898 Act was the most debtor-friendly legislation enacted up to that time period. Subsequent revisions of the Bankruptcy laws finally culminated in the current Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Of note are the sweeping changes made after the enactment of the 1978 revisions to the Act. Bankruptcy judgeships were actually created via legislation to replace the old referee system, enlarging the powers of the judges to hear matters arising in or related to a bankruptcy case. The legislation creating the judgeships came under attack, and after the *Marathon* decision, Congress was forced to re-work how the judicial structure of the bankruptcy system would function (the Bankruptcy Amendments and Federal Judgeship Act of 1984). This expansion of bankruptcy judges' role in a particular case also led to conflicts with state law and state court proceedings since the definition of "arising in or related to" could arguably cover matters within a state court's jurisdiction.[7]

Since its permanent enactment in 1898, bankruptcy laws have become an integral part of the national economy, whether it is through major corporate Chapter 11 cases, or the millions of consumer cases filed each year. A recurring theme throughout bankruptcy's history is how other areas of the law, particularly areas of law that are recognized as within the power of the states to control[8] are treated in the context of a bankruptcy case. This manuscript, far from an exhaustive review of all areas of intersection, is designed to give the bankruptcy practitioner a general overview of what happens when these two jurisdictions collide.

Collision of State Law and the Bankruptcy Code

I. *Rooker-Feldman* Doctrine

No manuscript or discussion of the interrelationship of state and federal courts is complete without a review of the *Rooker-Feldman* doctrine. *Rooker-Feldman* has been cited and tossed about in a number of cases since the doctrine was established, and in fact, some federal courts have tried to expand the reach of *Rooker-Feldman* to elevate it to "preclusion by another name."[9] However, boiled down, *Rooker-Feldman* simply stands for the proposition that lower federal courts are courts of original, not appellate jurisdiction. North Carolina Federal District and Bankruptcy Courts have also analyzed *Rooker-Feldman* in the context of state court actions and their relationship with subsequent attempts to avoid the particular state court action.

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[6] Of course, this did not take very much when the earliest forms of bankruptcy involved death sentences (see: Rome, and the 1705 Statute of Anne)

[7] Under the 1978 Code, judges were basically granted Article III powers despite being a creature of Article I (not good). The 1984 amendments fixed that problem with the enactment of 28 USC 157.

[8] areas such as domestic relations, torts, contracts, real estate, estate administration, landlord/tenant, and the like

[9] See *Lance v. Dennis*, 546 U.S. 459 (2006)

The United States Supreme Court, in *Lance v. Dennis*, provides an excellent analysis of *Rooker-Feldman* and its limitations. In *Dennis*, the petitioners, citizens of the state of Colorado, sought to require the secretary of state to implement the Colorado legislature's redistricting plan developed after the 2000 census. Prior to the filing, several rounds of state court litigation culminated in the Colorado Supreme Court ruling that the legislature's plan violated the Colorado Constitution.[10] The petitioners claimed, in their federal action, that the Colorado Constitution violated the Elections Clause of the U.S. Constitution.

A three-judge District Court panel ruled it did not have jurisdiction over the case because of *Rooker-Feldman*, reasoning that since the petitioners were in "privity" with the state-court case losers (Colorado legislature), the preclusion principle applied.[11] In its analysis, the District Court panel set forth the three-part test regarding application of *Rooker-Feldman*:

1. The party against whom the doctrine is invoked must have actually been a party to the prior state court judgment or have been in privity with such party;
2. The claim raised in the federal suit must have been actually raised or inextricably intertwined with the state-court judgment; and
3. The federal court claim must not be parallel to the state court claim

The *Dennis* court disagreed with the District Court panel on the application of *Rooker-Feldman.* Citing *Exxon Mobil Corp. v. Saudi Basic Industries Corp.*, 544 U.S. 280 (2005), the Court stated that the *Rooker-Feldman* doctrine specifically prevents the lower federal courts from exercising jurisdiction over cases brought by "state court losers" challenging "state court judgments rendered before the district court proceedings commenced." *Exxon*, at 284. Therefore, in the *Dennis* matter, the *Rooker-Feldman* doctrine does not apply.

Although the U.S. Supreme Court is vested with jurisdiction over appeals from state court judgments through the application of 28 U.S.C. § 1257, lower federal courts are not. *D.C. Court of Appeals v. Feldman* 460 U.S. 462 (1983); *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1923). Generally speaking, classic verbiage that simply explains what the doctrine is can be found in the *Feldman* decision: "[A]n aggrieved litigant cannot be permitted to do indirectly what he can no longer do directly." 263 U.S. at 416. In the *Exxon Mobil* case, the Court stated that lower courts "have at times extended *Rooker-Feldman* "far beyond the contours of the *Rooker* and *Feldman* cases, overriding Congress' conferral of federal-court jurisdiction concurrent with jurisdiction exercised by state courts, and superseding the ordinary application of preclusion law pursuant to 28 U.S.C. § 1738[12]. *Dennis*, at 464. In fact, the *Dennis* court goes on to say that a "more expansive *Rooker-Feldman* rule

[10] Id.
[11] Specifically, the state's citizens are deemed to be in privity with their state government that litigates a matter of public concern, and that preclusion also applies in the Rooker-Feldman context. *Dennis*, at 459.
[12] Also known as the "Full Faith and Credit Act"

would tend to supplant Congress' mandate under the Full Faith and Credit Act", which states that federal courts must "give the same preclusive effect to state court judgments that those judgments would be given in the courts of the State from which the judgments emerged." *Dennis,* at 466, *citing Baker v. GMC*, 522 U.S. 222 (1998). It is important to note, however, that Rooker-Feldman breaks apart somewhat in the context of bankruptcy cases, primarily due to specific bankruptcy code sections that can logically eviscerate state court judgments.

Application of *Rooker-Feldman* in Bankruptcy Cases

Bankruptcy practitioners routinely experience federal lower court review of state court judgments in certain provisions of the Code, and because of the Constitutional mandate for uniform bankruptcy laws and the plenary power of Congress over bankruptcy legislation, state court judgments may be subject to collateral attack. A thorough discussion on this issue is set forth in *Gruntz v. County of Los Angeles,* 202 F.3d 1074 (9th Cir. 2000). In *Gruntz*, the appeals court considered two issues: 1) whether a state court modification of the bankruptcy stay binds federal courts; and 2) whether the automatic stay enjoins prosecution for the willful failure to pay child support. Of particular interest in is the court's analysis of *Rooker-Feldman* and its application in bankruptcy cases. The court properly distinguishes bankruptcy issues as having special application with respect to prior state court judgments. This application harkens back to the historical context within which the manuscript began. The *Gruntz* court stated:

> Congress's plenary power over bankruptcy derives from the constitutional imperative "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. Const., Art. I, § 8. "The Constitution grants Congress exclusive power to regulate bankruptcy and under this power Congress can limit that jurisdiction which courts, State or Federal, can exercise over the person and property of a debtor who duly invokes the bankruptcy law." *Kalb, 308 U.S. at 439*. In furtherance of this charge, jurisdiction and authority over bankruptcies has been vested, from the beginning of the Republic, in the federal district courts. *See, e.g.*, Bankruptcy Act of 1800, § 2, 2 Stat. 19, 21; Bankruptcy Act of 1841, § 6, 5 Stat. 440, 445; Bankruptcy Act of 1867, § 1, 14 Stat. 517, 517; Bankruptcy Act of 1898, § 2, 30 Stat. 544, 545.
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> *Gruntz*, at 1080.[13]

Continuing this application of Congress' plenary power to enact uniform bankruptcy rules, the *Gruntz* court further noted specific statutory references through which the bankruptcy court's power is not restricted by application of *Rooker-Feldman*:

> In apparent contradiction to the *Rooker-Feldman* theory, bankruptcy courts are empowered to avoid state judgments, *see, e.g.*, *11 U.S.C. §§ 544*, *547*, *548*, *549*; to modify them, *see, e.g.*, *11 U.S.C. §§ 1129*, *1325*; and to discharge them, *see*, *e.g.*, *11 U.S.C. §§ 727*, *1141*, *1328*. By statute, a post-petition state judgment is not binding on the bankruptcy court to establish the amount of a debt for bankruptcy purposes. *See 11 U.S.C. §*

[13] Hey, my initial historical review doesn't seem so useless now, huh?

109(e); *Slack v. Wilshire Ins. Co. (In re Slack), 187 F.3d 1070, 1073 (9th Cir. 1999), as amended 99 C.D.O.S. 7463, 1999 WL 694990* (Sept. 9, 1999).

Gruntz, at 1078.

The court goes on to say, however, that state court judgments that do not specifically fall under the definition of a "core" proceeding may be subject to the *Rooker-Feldman* doctrine. In fact, the *Gruntz* court analyzes the 1984 amendments to the bankruptcy code, which, as stated above, was a result of the *Marathon*[14] decision, effectively striking the heart of the 1978 Code. Distinctions between "core" and "non core" proceedings are key in analyzing the applicability of *Rooker-Feldman* in bankruptcy matters. *Marathon*, the court noted, distinguished between the "restructuring of debtor-creditor relations, which is at the core of the federal bankruptcy power," and "the adjudication of state-created private rights." *Marathon*, at 84. Because of the *Marathon* decision, Congress attempted to specifically distinguish between the above conflicting areas. Thus, the discinction was codified in 28 U.S.C. § 157. In general, a "core proceeding" in bankruptcy is one that "invokes a substantive right provided by title 11 or . . . a proceeding that, by its nature, could arise only in the context of a bankruptcy case." *Wood v. Wood (In re Wood), 825 F.2d 90, 97 (5th Cir. 1987)*. "Non-core proceedings" are those not integral to the restructuring of debtor-creditor relations and not involving a cause of action arising under title 11. *See Windsor Communications Group, Inc. v. Grant (In re Windsor Communications Group), 75 B.R. 713, 721 (E.D. Pa. 1985)*. Out of this codification came the distinction between Article I plenary power (core) and Article III (non-core) exclusive jurisdiction.[15]

Automatic Stay

One of the key components of exclusive bankruptcy jurisdiction is the establishment of the automatic stay. This power, codified in 11 U.S.C. § 362, is granted to the bankruptcy courts as a core matter, and the power grants the bankruptcy courts the exclusive right to terminate, annul or modify the stay. 28 U.S.C. § 157(b)(2)(G). The "automatic stay gives the bankruptcy court an opportunity to harmonize the interests of both debtor and creditors while preserving the debtor's assets for repayment and reorganization of his or her obligations." *MacDonald v. MacDonald (In re MacDonald), 755 F.2d 715, 717 (9th Cir. 1985)*. By halting all collection efforts, the stay affords the debtor time to propose a reorganization plan, or simply "to be relieved of the financial pressures that drove him into bankruptcy." *Benedor Corp. v. Conejo Enters., Inc. (In re Conejo Enters.), 96 F.3d 346, 351 (9th Cir. 1996)* (quoting S. Rep. No. 95-989, at 54-55 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5840-41). The automatic stay also "assures creditors that the debtor's other creditors are not racing to various courthouses to pursue independent remedies to drain the debtor's assets." *Dean v. Trans World*

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[14] *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.*, 458 U.S. 50 (1982)

[15] Remember my boring recitation on the history of bankruptcy ?

Airlines, Inc., 72 F.3d 754, 755-56 (9th Cir. 1995); [**16] *see also* H.R. Rep. No. 95-595, at 340, *reprinted in part in* 1978 U.S.C.C.A.N. 5787, 6297. *Grunz,* at 1081. Because, among other reasons, judicial proceedings in violation of the stay are void *ab initio,* the bankruptcy court is not obligated to extend full faith and credit to such judgments. Infirm judgments are not entitled to full faith and credit in federal courts. *See Kremer v. Chemical Construction Corp., 456 U.S. 461, 482-83, 72 L. Ed. 2d 262, 102 S. Ct. 1883 (1982)*

This accentuates the importance of the automatic stay in bankruptcy proceedings, especially when state actions are ongoing, or recently terminated, and filing occurs prior to final entry of judgment, with all rights of appeal not yet extinguished. There are a number of cases and decisions that illustrate the issues and how the various bankruptcy courts resolved each.

Discharge Injunction – Pending Suit

In re Hitt 2008 Lexis 1162

In this case, the Debtor was sued by a buyer of the Debtor's former residence, based upon allegations that the Debtor had concealed damage to the residence. Prior to the trial, the Debtor filed a Chapter 7 bankruptcy in the Eastern District of North Carolina. The Debtor failed to adequately notice the plaintiff of his filing through the mailing matrix, listing the caption of the case with the county courthouse's address. There was no dispute that the attorney for the buyer had actual notice of the filing within the objection to dischargeability limitation period. *Hitt*, at 2. The buyer failed to attend the creditor's meeting, and also failed to file an adversary proceeding or even request the stay be modified to allow the civil suit to proceed in state court. *Id*., at 2. The civil suit was placed on inactive status, and after the Debtor received his discharge, the buyer's attorney notified the trial court administrator that the matter needed to return to the active docket. The debtor subsequently filed a motion to reopen the Chapter 7 case for a determination that the continuation of the civil suit was a violation of the discharge injunction in 11 U.S.C.§ 524. *Id*., at 3.

The court's analysis begins with a discussion of 11 U.S.C. § 350 and cites *Toussiant*[16] to establish that the bankruptcy court could maintain jurisdiction of this matter. The court noted that if the Debtor had responded to the litigation, presumably through an amended answer or summary judgment motion, with the affirmative defense of discharge in bankruptcy, jurisdiction would rest in the state court. *Id.* Once it was clear that the bankruptcy court would retain jurisdiction of the matter, the issues for the court were:

1) Whether the debt was dischargeable despite 11 U.S.C. § 523(a)(3) which states that when an individual debtor's particular debt "neither listed nor scheduled under *Section 521(a)(1)* . . . with the

[16] *In re Toussiant,* EDNC Case No. 95-01376-8-JRL, has an excellent analysis of bankruptcy court review of state court judgments, and an in-depth analysis of *Rooker-Feldman.*

name, if known to the debtor, of the creditor to whom such debt is owed in time to permit . . . filing of a proof of claim and timely request for a determination of dischargeability of such debt.

2) Whether the "escape valve" exception to 523(a)(3) applies, which states that if a creditor had notice or actual knowledge of the case in time for such timely filing and request, the debt is discharged;

The court concluded that the notice in the initial filing was not sufficient, but that the notice to buyer's attorney was sufficient to trigger the "escape valve" exception, and therefore the debt was discharged. Another interesting case also dealing with violation of the discharge injunction is the Western District case of *In re Bock*, 297 B.R. 22 (W.D.N.C. 2001). *Bock* involved blatant violation of the discharge injunction, precipitated by unscrupulous counsel for the state court plaintiff.

Collateral Estoppel/Default Judgments

***Sartin v. Macik*, 535 F.3d 284 (4th Cir. 2008)**

As recently as July of this year, the Fourth Circuit heard arguments regarding the preclusive effect of a default judgment entered for discovery violations on subsequent bankruptcy litigation. At the outset, the court noted that the issue was one of first impression in North Carolina. In *Sartin*, the defendants were attempting to raise capital to start a multi media website called TeamDriver.com. "They hoped that the TeamDriver.com website would grow to accommodate on-line photo galleries, chat areas, a racing retail store, an on-line auction house, and eventually live video and audio feeds providing behind-the-scenes access to races, including 'helmet/hat cams' and 'wide-angle tool box cams.' They also intended to establish an on-line auction site in partnership with eBay that would allow racing teams to 'liquidate their used and damaged racing parts and one-of-a-kind team items' to eagerly awaiting racing fans. *Sartin*, at 284. The defendants elicited funds from investors through proposals showing projections of capital requirements as well as revenues and operating requirements. *Id.* Based upon their projections, the defendants were able to raise over $200,000 from the plaintiffs.

As could be expected, TeamDriver.com failed before it ever got off the ground. The investors, believing the defendants used the money invested for personal purposes, sued the defendants in state court for a number of claims, including breach of contract, breach of fiduciary duty, constructive fraud, misappropriation, conversion of funds, misrepresentation, and unfair and deceptive trade practices. The defendant Macik filed an answer, but failed to respond to discovery or the state court's order compelling discovery. He subsequently failed to appear at a hearing, and the state court entered judgment against the defendant Macik by default. *Id.* Macik's answer was sticken and judgment was entered, and trebled, for a total judgment against Macik in excess of $600,000.

Subsequently, Macik and his wife filed a Chapter 7, and the plaintiffs from the state suit filed a dischargeability proceeding, alleging that the state court judgment was nondischargeable under 11 U.S.C. § 523(a)(2),(4) & (6). Applying collateral estoppel principles, the bankruptcy court and district court on appeal agreed that the state court default judgment barred the debtor from arguing that 523(a)(2), (4), & (6).[17] However, the Fourth Circuit reversed.

The court's analysis begins with the concept that preclusion (collateral estoppel and res judicata) must be determined under the law of the jurisdiction that rendered the judgment – in this case – North Carolina. The court establishes early that res judicata is not an issue in this case, and that collateral estoppel principles will necessarily be applied to decide this case. In order to assert collateral estoppel under North Carolina law, a party must show that the issue in question was identical to an issue actually litigated and necessary to the judgment, that the prior action resulted in a final judgment on the merits, and that the present parties are the same as, or in privity with, the parties to the earlier action. *Sartin*, at 288.

As to the first requirement, the court noted that the North Carolina Supreme Court has held that parties must satisfy four sub-requirements to satisfy the first element of collateral estoppel. They are:

1) The issues must be the same as those involved in the prior action;
2) The issues must have been raised and actually litigated in the prior action;
3) The issues must have been material and relevant to the disposition of the prior action;
4) The determination of the issues in the prior action must have been necessary and essential to the resulting judgment;

Id., at 288.

The *Sartin* case presents the question of whether North Carolina courts would hold that issues resolved in a default judgment would have been "actually litigated" for purposes of that judgment so that collateral estoppel principles would apply. This is an issue of first impression in North Carolina, and the court relied on the *Restatement (Second) of Judgments 27*, which North Carolina Supreme Court relied upon when determining

[17] It is interesting to note that the Fourth Circuit stated that this was not a *Rooker-Feldman* case, primarily because Macik did not seek to have the state court judgment overturned, and the bankruptcy court's reference to *Rooker-Feldman* was not accurate because of the *Exxon* decision, making clear that the doctrine only bars collateral attacks on state court judgments; it does not supplant the normal rules of preclusion. Instead, the court noted, the rules of preclusion govern whether a litigant may, in a bankruptcy proceeding, revisit an issue previously addressed in a state court action. Satin, at 287 (footnote 1)

the preclusion principles used in its decisions. The *Restatement* comments that in cases of judgments by confession, consent or default, none of the issues are actually litigated, and therefore collateral estoppel principles do not apply in such cases. *Id.* Therefore, the Fourth Circuit held that the judgment did not have collateral estoppel effect with respect to the subsequent dischargeability proceeding in Macik's bankruptcy case. The dissent was concerned that the ruling regarding this default judgment, being based upon a sanction for refusing to comply with court orders, was providing the debtor a "second bite at the apple" and potentially rewarding the debtor for his bad acts. *Id.*, at 294.

Sartin establishes that in order to give preclusive effect of state court orders, the elements of collateral estoppel or res judicata must be clearly established, but leave open the possibility that in certain circumstances, default judgments entered as sanctions could be viewed differently.

Summary Ejectment/Land Sales Contract/Automatic Stay

***In re Smith*, 08-00452-8-JRL (March 31, 2008)**

The debtor, Tonya Smith, filed a chapter 13 petition on the eve of the enforcement of an ejectment order pursuant to an attempt by a contracting party who alleged that the land sales agreement entered between the parties was in default, which, pursuant to the agreement, triggered an eviction action. The creditor filed the action, an order was entered by the magistrate for ejectment, and the Debtor did not appeal the judgment. Approximately 90 days later, the Debtor filed bankruptcy.

Creditor filed a motion for relief from stay, citing the ejectment order, from which no appeal was taken, requesting the court lift the stay to allow the creditor to take possession of the real estate. The Debtor argued that enforcement of the ejectment order is inappropriate because the order is void since the ejectment order failed to allow Debtor to exercise her right of redemption under state law. According to North Carolina law, parties to a land sales installment contract are treated as mortgagor and mortgagee, *Brannock v. Fletcher* 155 S.E.2d 532, 539 (N.C. 1967), and the mortgagor has an equitable right to redeem its interest under the contract to prevent foreclosure. *Anderson v. Moore*, 63 S.E.2d 641, 644 (N.C. 1951). The court further cited *Lamberth v. McDaniel*, 506 S.E.2d 295 (N.C. App. 1998) which holds that the right of redemption may not be waived by contract.

The court then found that a mortgagor may not be evicted by summary ejectment, even if the land sales installment contract provided for ejectment upon default. Because the debtor could not be evicted by summary judgment, the creditor's motion for relief from stay was denied.[18]

Statutory Liens/Judicial Lien Avoidance

***In re High*, Case No.: 05-02076-5-ATS**

The bankruptcy court held a hearing on the Debtors' motion to avoid a materialmen's lien pursuant to 11 U.S.C. § 522(f)(1)(A). The debtors filed their bankruptcy petition under Chapter 7 on May 19, 2005. Wellbuilt Construction Co. filed a claim of lien, perfecting said claim as required under N.C.G.S. § 44A-1 et seq. The lien, in the amount of $33,234.04, derives from Wellbuilt's providing labor and materials for an addition to the Debtors' home. The Debtors characterize the lien as a judicial lien that impairs their homestead exemption under N.C.G.S. § 1C-1601(a)(1).

The court analyzed the value of the residence, added all mortgages and liens along with the exemptions available and determined that the three mortgage liens exceeded the value of the residence, without even adding in the exemptions or the challenged lien. The court recognized that North Carolina law applied to the court's analysis of the nature and validity of the lien, and further set forth the requirements for affixing a valid materialmen's lien on real estate. After finding that Wellbuilt followed all statutory procedures, including the filing of a suit to perfect the lien. The Highs' bankruptcy filing halted the perfection process, and no judgment was entered.

The issue before the court was to determine whether the lien of Wellbuilt was a judicial lien, since the only liens that can be avoided under 522(f) are judicial liens (other than non-purchase money non-possessory liens on personal property). The court held that the Wellbuilt lien is a statutory lien and not a judicial lien and therefore it could not be avoided. The argument of the Highs revolved around the nature of the process to perfect the lien, in that it required a judicial process to "perfect" the lien. The court held that the "judicial process necessary to enforce the lien does not change the original nature of the lien itself." *Citing, In re Chambers*, 264 B.R. 818, 822 (Bankr. N.D.W. Va. 2001). The definition of a lien "turns on how the lien was created." 2 *Collier on Bankruptcy* ¶ 101.36. *In re Strother*, 2005 WL 1862417 at *1 (10th Cir. BAP 2005)

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[18] It is interesting to note that the court did not discuss preclusion in the context of affording Full Faith and Credit to the state court ejectment order, or that *Toussaint* principles should apply. The question remains whether the bankruptcy should have lifted the stay out of acknowledgement of the order, even if it was erroneously decided; presumably the magistrate did not consider whether the debtor's "equitable right of redemption" was cut off, however, the failure of Debtor to appeal the order or even raise that issue should have eliminated the redemption from consideration. The creditor filed a notice of appeal, as well as a subsequent motion for relief for failure to maintain post-petition payments and for cancellation of insurance due to the poor condition of the property. The case was dismissed in July 2008.

emphasized that statutory liens and judicial liens are mutually exclusive, and "only judicial liens are subject to avoidance under § 522(f)(1)(A)." In dicta, the court in *In re Richardson*, 224 B.R. 804, 809-10 (N.D. Ok. 1998), explained that bankruptcy rather than state law controls what types of liens may be avoided, and that bankruptcy law excludes mortgages, tax liens, and materialmens liens.

DOMESTIC AND FAMILY LAW

There are few areas of state law that are more emotionally charged than those regarding divorce, separation, property settlement and support issues. Of course, because of this, there are a number of areas where a bankruptcy case can cross into the realm of a domestic case, and vice-versa. From claim priorities, to property of the estate determinations, to the status of separation agreements and divorce orders containing property division mandates, the state law regarding domestic matters and federal bankruptcy law can create a number of difficult results. At this point, the manuscript will highlight a number of different statutory provisions in the code that can alter the rights of parties to domestic orders.

It is important to note that the 2005 amendments elevated domestic support obligations to a place of particular importance. A primary example of this is domestic support obligations receiving administrative claim status equal with trustees in 11 U.S.C. § 507(a)(1). Many savvy domestic law practitioners that understand the relationship between bankruptcy and domestic law will adjust language in their documents, whether it is a separation agreement or equitable distribution/support order to be read as domestic support obligations to take advantage of favorable treatment if one of the parties files bankruptcy. More often than not, there is a bankruptcy filing in the midst of a domestic case, complicating the parties' status of their property and rights and responsibilities of each.

Property of the Estate 11 U.S.C. § 541

Under North Carolina law, the "rights of the parties to an equitable distribution of marital property and divisible property are a species of common ownership, the rights of the respective parties vesting at the time of the parties' separation." N.C. Gen. Stat. §50-20(k). *See* Brown v. Brown, 136 N.C.App. 331, 524 S.E.2d 89, *reversed and remanded on other grounds*, 539 S.E.2d 621 N.C. 353 N.C. 220 (2000)(equitable distribution rights abate if spouse dies prior to divorce). This provision has been held not to create an interest in specific property as of the date of separation, but only a right to the equitable distribution of the property, whatever a court should determine that property is. Wilson v. Wilson, 73 N.C.App. 96, 325 S.E.2d, *disc. rev. denied*, 314 N.C. 121, 332 S.E.2d 490 (1985). This right to equitable distribution is sufficient to make out an unsecured claim of the nondebtor spouse. *See* Perlow v. Perlow, 128 B.R. 412 (E.D.N.C. 1991). Nonetheless, under N.C. Gen. Stat. §50-20, an equitable distribution agreement or order may be entered prior to divorce.

Therefore, it appears that the debtor's right to an equitable distribution of marital property may be property of the estate if the debtor is separated or separates from his or her spouse within 180 days of the filing date under 11 U.S.C. §541(a)(1). The date of separation is when the right to equitable distribution of marital property vests. N.C.G.S. § 50-20(k). *See* Wilson v. Wilson, 73 N.C.App. 96, 99, 325 S.E.2d 668, 670 (1985). The property in which the debtor has an interest is the chose of action for equitable distribution. Proceeds of the equitable distribution action are the rights in specific marital property. 11 U.S.C. §541(a)(6). This language is nonetheless somewhat contrary to 11 U.S.C. §541(5), which seems to contemplate that entering into a binding agreement or the entry of an interlocutory or final divorce decree is the point of time that triggers the 180 day limitation. 11 U.S.C. §541(a)(5)(B).

A right to property division is troublesome in North Carolina in that state law does not provide for the vesting of rights in any particular property of the spouses at the time of separation, only a vesting of the right to distribution. *See* N.C.G.S. §§ 50-20(b) and (k), Perlow v. Perlow, 128 B.R. 412, 415 (E.D.N.C. 1991), Halverson v. Halverson (In re Halverson), 151 B.R. 358, 362-63 (M.D.N.C. 1993), Hearndon v. Hearndon, 132 N.C.App. 98, 510 S.E.2d 183 (1999), Justice v. Justice, 123 N.C.App. 733, 475 S.E.2d 225 (1996), Hagler v. Hagler , 319 N.C. 287, 290, 354 S.E.2d 228, 232 (1987), Wilson v. Wilson, 73 N.C.App. 96, 99, 325 S.E.2d 668, 670 (1985). Therefore, it is difficult for the nonfiling spouse to assert a property interest in particular marital property when the division has not been effected prior to the bankruptcy filing.

In the Eastern District of North Carolina, it appears that a valid Qualified Domestic Relations Order ("QDRO") is necessary to effectuate a property right of the non-spouse in a retirement plan. Martel v. Zeitler, 213 B.R. 457 (Bankr. E.D.N.C. 1997), *but see* Walston v. Walston, 190 B.R. 66, 67 (E.D.N.C. 1995)(nondebtor spouse has property interest in vested military benefits). A nonfiling spouse may be particularly affected by a bankruptcy that intervenes between the time that a state court has awarded a portion of the debtor's pension benefits to the nonfiling spouse and *before* the order was actually entered. *See* Martel v. Zeitler (In re Zeitler), 213 B.R. 457 (Bankr. E.D.N.C. 1997), Gendreau v. Gendreau (In re Gendreau), 122 F.3d 815 (9th Cir. 1997), Long v. Donahue (In re Long), 148 B.R. 904 (Bankr. W.D. Mo. 1992). Under the court's holding in Martel v. Zeitler, 213 B.R. 457 (Bankr. E.D.N.C. 1997), if a QDRO has not been entered prior to the filing of the bankruptcy case, the nonfiling spouse's right to the division of the retirement will be an unsecured claim against the debtor that can be modified. A distinction will be made, however, between the right to obtain disbursements from the retirement plan pre-petition or the nondebtor spouse's right to obtain payments from the plan post-petition. The prepetition claims are subject to a discharge. The postpetition claims are deemed to be post-petition claims and are not discharged and may be perfected by means of a QDRO.

Some courts have held that the nonfiling spouse has an equitable interest in the right to obtain a QDRO based in the pre-bankruptcy division of the pension, that could not be modified by the bankruptcy filing. *See* Long v. Donahue (In re Long), 148 B.R. 904 (Bankr. W.D. Mo. 1992), Gendreau v. Gendreau (In re Gendreau), 122 F.3d 815 (B.A.P. 9th Cir. 1997) (bankruptcy cannot eradicate right of ex-wife to obtain a QDRO).

Exemption Rights

A debtor is able to "exempt" property from the bankruptcy estate that otherwise would be liquidated by the trustee to pay the allowed claims of creditors. 11 U.S.C. §522(b). North Carolina has opted out of the federal bankruptcy exemptions, such that debtors who are residents of North Carolina are entitled to use exemptions available under North Carolina law to protect their property. N.C.G.S. § 1C-1601(f). *See also* In re McQueen, 196 B.R. 31 (E.D.N.C. 1995), In re Banks, 22 B.R. 891 (Bankr. W.D.N.C. 1982), In re Laues, 90 B.R. 158 (Bankr. E.D.N.C. 1984).

In North Carolina, the general basis for exemptions is found in N.C.G.S. §1C-1601, which is the same basis for exemptions of property from execution in the collection of judgments. This statute also makes reference to exemptions available under the North Carolina Constitution. *See* N.C. Gen. Stat. §1C-1601(c).

Under the North Carolina statute, the exemptions found in N.C.G.S. §1C-1601 do not apply to an execution related to a child support, alimony or, distributive award under N.C.G.S. Chapter 50. N.C.G.S. §1C-1601(e)(9). Therefore, one can argue that a spouse with an order for child support, alimony or distributive award could theoretically object to a debtor's chapter 11, 12, or 13 plan that attempts to pay less that the full amount of his or her claim (especially if the otherwise exempt property would pay the claim in full).

Exemptions are claimed in all cases filed under the Bankruptcy Code, but they are generally only directly applicable to remove property from the estate in Chapter 7 cases, because the debtor will often file a chapter 11, 12 or 13 to retain property of the estate that is not exempt under a confirmed plan by proposing to pay unsecured creditors more than the liquidation value of the property. However, exemptions will apply in the context of Chapter 11, 12, and 13 cases to limit liquidation value. *See, e.g.,* Summerlin v. Summerlin, (In re Summerlin), 26 B.R. 875 (Bankr. E.D.N.C. 1983)(court determined that spouse may pursue exempt property to collect alimony under 11 U.S.C. §362(b)(2)).

In In re Hortsman, 276 B.R. 80 (EDNC 2002), Trustee objected to the W use of her wild card exemption for a vehicle titled in H name. The court held that the W debtor could not claim an exemption in H's vehicle. Debtors argued that the vehicle, although titled only in H name, was marital property and cited N.C. Gen Stat. 50-20(2001). The court ruled that claims for equitable distribution of property under N.C. Gen. Stat.

§ 50-20 (2001) were made in a specific, statutory context that could not appropriately provide a basis on which to consider the application of standard bankruptcy exemptions.

If the debtor does not claim exemptions, a dependent of the debtor may claim exemptions on behalf of the debtor to protect property from liquidation by the trustee. 11 U.S.C. §522(l), Fed. R. Bankr. P. 4003(a). "Dependent" includes the debtor's spouse, whether or not the spouse is actually dependent. 11 U.S.C. §522(a)(1). Although it may be somewhat difficult to argue that an ex-spouse qualifies as a dependent unless he or she is receiving alimony or child support, an estranged and not yet divorced spouse does qualify as a dependent. *See* In re Crouch, 33 B.R. 271 (Bankr. E.D.N.C. 1983), Summerlin v. Summerlin (In re Summerlin), 26 B.R. 875, 877-78 (Bankr. E.D.N.C. 1983).

The dependent must file exemptions within thirty (30) days after the expiration of the deadline for the debtor to serve his or her exemptions, Fed.R.Bankr.P. 4003(a), which is the deadline for filing the bankruptcy schedules. *See* Fed. R. Bankr. P. 1007, 4003. The trustee or a creditor may object to the exemptions claimed by the debtor or the debtor's dependent. Fed.R.Bankr.P. 4003(b).

The bankruptcy court for the Eastern District of North Carolina has ruled that the debtor's estranged spouse was entitled to amend the debtor's exemptions to cover six parcels of land owned by the debtor and his spouse as tenants by the entirety. In re Crouch, 33 B.R. 271 (Bankr. E.D.N.C. 1983). The debtor did not exempt any real property on his schedules, and his spouse moved to amend the exemptions to include all the real estate. The objections of the trustee and debtor to the amendment were overruled by the bankruptcy court, which held that the debtor had the first right to file the exemptions but must do so in good faith and without intent to circumvent his obligations of spousal support. When the debtor has not met his support obligations and has claimed inadequate exemptions, the spouse should be allowed to supplement the exemptions as long as the additional exemptions do not unduly prejudice the debtor. In re Crouch, 33 B.R. at 274. *But see* Burman v. Homan (In re Homan), 112 B.R. 356, 359-60 (B.A.P. 9th Cir. 1989)(debtor has exclusive right to claim exemptions in estate property; §522(l) does not allow supplementation of exemption list by dependent and if it did, supplemental exemptions would need to be consistent with those claimed by debtor).

Judicial Liens and Exemptions

In claiming exemptions, the debtor may avoid judicial liens against property, similar to his or her ability to protect property in an execution on a judgment. 11 U.S.C. §522(f). However, the debtor may not avoid judicial liens securing a debt to a spouse, former spouse, or child of the debtor, for alimony to, maintenance for, or support of such spouse or child, in connection with a separation agreement, divorce decree or other order of a court of record, determination made in accordance with State or territorial law by a governmental unit, or property settlement agreement; and

- to the extent that such debt—
  - is not assigned to another entity, voluntarily, by operation of law, or otherwise; and
  - includes a liability designated as alimony, maintenance, or support, unless such liability is actually in the nature of alimony, maintenance or support.

A judicial lien is ordered and entered by the court and is not merely the result of a consensual agreement. The definition of a judicial lien, however, most likely includes a judgment entered by confession or consent and an order incorporating a settlement agreement. *See* In re Wells, 139 B.R. 255 (Bankr. D. N.M. 1992) (lien arising under decree incorporating settlement agreement is a judicial lien). A consensual lien securing a property settlement or division is not avoidable under §522(f). A lien can be avoided under 11 U.S.C. § 522(f)(1) only if the debtor possessed an interest in the property before the lien affixes to it. Where the debtor obtained additional rights in the property at the same time the lien attached to the property, then the lien cannot be avoided. Farrey v. Sanderfoot, 500 U.S. 291, 111 S.Ct. 1825, 114 L.Ed.2d 337 (1991). For instance, a lien in the debtor's residence securing a property division obligation to the nondebtor spouse will not be avoidable if the nondebtor spouse transferred her interest in the residence to the debtor simultaneously with the transfer of the lien.

Furthermore, the debtor cannot avoid a lien to claim an exemption based on the character of the property if the lien was in existence before the property acquired its exemptible character. Owen v. Owen, 500 U.S. 305, 111 S.Ct. 1833, 114 L.Ed.2d 350 (1991). This case involved a judgment lien in favor of the nonfiling spouse in property where the debtor, after receiving the property, used the property as his homestead. The debtor was not permitted to use §522(f) to avoid the lien because the lien attached before the property was eligible for the homestead exemption.

Judicial liens securing debt for property settlements may be avoided by the debtor to the extent necessary to claim his or her exemption. This results in a spiraling conundrum, since the state exemptions are in any case subject to an execution related to a child support, alimony or, distributive award under N.C. Gen. Stat. Chapter 50. N.C. Gen. Stat. §1C-1601(e)(9). However, since N.C. Gen. Stat. §1C-1601(e) also provides other exceptions to the applicability of the exemptions, avoiding a lien securing equitable distribution obligations may allow other "non-exemptable" claims to share in the exempted property.

Secured Claims

Under N.C. Gen. Stat. §50-20(h), a party to an equitable distribution action may file a notice of *lis pendens* against real property alleged to be marital property or divisible property. The *lis pendens* has the effect of putting the world on notice of the spouse's claims in the property.

The Bankruptcy Courts have often seized on the nonfiling spouse's failure to file a *lis pendens* in finding that an equitable distribution claim is an unsecured claim. Although a bankruptcy trustee has certain "strong arm" powers under 11 U.S.C. §544 that enables the trustee to avoid certain transfers, his avoidance powers under that section are limited to those available to a bona fide purchaser of real property. 11 U.S.C. §544(a)(3). Because a *lis pendens* is effective notice as against a *bona fide* purchaser, the trustee's interest in the real property will be subject to the interest of the nonfiling spouse in the property. *See* Walston v. Walston, 190 B.R. 66, 67 (E.D.N.C. 1995)(characterizing the outcome in Perlow v. Perlow, 128 B.R. 412, 415 (E.D.N.C. 1991), as resulting from "Mrs. Perlow's failure to file a *lis pendens* or obtain an execution lien on personal property").

Secured claims in a domestic context may also result from consensual liens, such as liens granted to secure property division or alimony in a separation agreement.

Preference Avoidance

The trustee has the power to avoid prepetition transfers of property or liens that benefited one particular creditor to the detriment of the others under the preference statute, 11 U.S.C. § 547. Among the statutory defenses available to creditors is that "(t)he transfer that is made by the debtor was a bona fide payment to a spouse, former spouse, or child for alimony, maintenance, or support that is in connection with a separation agreement, divorce decree, or court order, but not to the extent that the debt is assigned to another entity, whether voluntarily, by operation of law, or otherwise; or includes a liability designated as alimony, maintenance, or support unless such liability is actually in the nature of alimony, maintenance, or support. 11 U.S.C. §547(c)(7). A transfer made related to a property settlement or division does not receive the special protection afforded to support creditors.

However, at least one court has found that property transferred under a divorce judgment cannot be a preference because it is not "on account of antecedent debt"; transfers in consideration for marital rights do not give rise to a "right of payment" or equitable remedy for "breach of performance". In re Haskell, 1998 W.L. 809520 (Bankr. N.D. Ill. 1998), *see* 11 U.S.C. §101(5); *accord, see* In re Hope, 231 B.R. 403 (Bankr. D. Dist.Col. 1999)(entireties property).

In In re Wallace, 66 B.R. 834 (Bankr. E.D.Mo. 1986), the Bankruptcy Court held that the division of pension plans that would not have been property of the estate cannot be preferential transfers of fraudulent transfers under the Bankruptcy Code.

Settlement Agreement as an Executory Contract

Where performance is still required under a property settlement agreement, debtors have attempted to reject the settlement agreement to avoid obligations under the agreement under 11 U.S.C. §365. This attempt at rejection may not be allowed, particularly if it will not be of benefit to the bankruptcy estate. *See* In the Matter of Gardner, 26 B.R. 65 (Bankr. W.D.N.C. 1982) (Chapter 11 context).

In Gardner, the Bankruptcy Court first addressed the extent of the performance remaining under the terms of the separation agreement. Finding that substantial performance remained for both parties and the separation agreement was an "executory contract" under 11 U.S.C. § 365, the court then addressed the benefit to the estate should rejection be allowed. The court did not allow rejection in that it would not: (1) benefit the creditors through a return of property not otherwise attainable to the debtor or trustee; (2) reduce the alimony or support payments due under the contract that accrued through the date of rejection; or (3) achieve anything other than confusion and delay of issues pending in the state court.

Dischargeability and Domestic Claims

Collateral estoppel principles apply in discharge exception proceedings under 11 U.S.C. § 523(a). Grogan v. Garner, 498 U.S. 279, 111 S.Ct. 654, 112 L.Ed.2d 755 (1991). A dischargeability action can also be supported and won using the collateral estoppel. *See* Tavella v. Edwards (In re Edwards), 172 B.R. 505 (Bankr. D. Conn. 1994). In Tavella v. Edwards, during the dissolution hearing at the state court the wife testified that the husband often threatened to file bankruptcy. At the wife's request, the divorce decree specify that the indemnification of debts ordered against the husband be in the nature of support and not dischargeable in bankruptcy. Subsequently, the husband filed a Chapter 7 bankruptcy. The bankruptcy court held that collateral estoppel applied to bar relitigation of the nature of the obligation in bankruptcy court for dischargeability purposes.

Revised § 523(a)(5) now states that a "domestic support obligation," as defined above, is excepted from discharge under chapters 7, 11, and 12, and is excepted from the hardship discharge under chapters 12 and 13. The concept of support obligations being excepted from discharge is a familiar concept from the existing code. However, revised § 523(a)(15) now makes obligations to a spouse, former spouse, or child of the debtor arising in connection with a divorce or separation agreement, and which are not domestic support obligations (i.e., property division debts) non-dischargeable as well.

Together, these two revised sections seem to cover any and all economic obligations that arise by law or by court order relating to the dissolution of marriage or to the support of dependants. Thus, it is no longer as important to distinguish "support" obligations from "property division" obligations in many cases, since property division obligations are no longer subject to discharge (although they may still be discharged in a chapter 13 case, as discussed below).

While the old § 523(a)(15) required the filing of an adversary proceeding and a determination of the debtor's ability to pay a property division debt, and may have required an equitable balancing test between the debtor and non-debtor spouse, the new § 523(a)(15) automatically excepts property division obligations from discharge whenever this section applies. Furthermore, the removal from § 523(c)(1) of any reference to the types of debts specified in § 523(a)(15) indicates that an adversary proceeding is no longer necessary.

The practitioner should bear in mind, however, that the dischargeability of property division debts survives in chapter 13. Section 523(a)(15) obligations are not among the exceptions to a chapter 13 discharge under 11 USC § 1328(a). Therefore, the support vs. property division dichotomy still exists in these cases. As under the old § 523(a)(15), if the obligor is able to have a plan confirmed and to make all payments under the plan, the family obligation that is not in the nature of support will be discharged to the extent it is not paid. However, the requirements for confirming a chapter 13 plan have changed with respect to family obligations, as have the requirements for discharge.

While there are a number of other "intersections" on the path of domestic relations and bankruptcy, the above is merely to illustrate how almost every facet of bankruptcy adjusts and alters domestic clients' rights and expectations concerning final resolution of their particular case.

REGULATION Z AMENDMENTS TO BEDEVIL MORTGAGE LENDERS

(12 CFR §226)

Introduction: In an effort to curb "abusive" lending practices by some sub-prime lenders which strip equity out of consumers' homes, the FRB recently adopted new rules significantly amending Reg. Z requirements. They are effective for mortgage loan applications received after 10/1/09, for all consumer mortgage lenders including CUs. Comply or become a lawsuit target.

I. "Higher Priced Mortgage Loans" secured by consumer's principal dwelling, whether 1st or 2d, but specifically excludes HELOCs.. 12 CFR § 226.35(a).

A. For CU's there are some particularly relevant limitations of scope:

1. Reverse mortgages, construction only loans & temporary bridge loans (*e.g.,* were consumer plans to sell a current dwelling within 12 months) are excluded.

2. HELOC's are excluded., because

a.. Fed concludes he locks are typically retained by original lenders

b. HELOC lenders are concentrated in banking & thrift industries so l regulators can use supervisory authority to protect borrowers.

c. Lenders may be tempted to structure transactions as open-end, to avoid application of the new rules, but 12 C.F.R. §226.35 prohibits structuring for the purpose of evasion.

3. Second homes, vacation homes & investment property are EXcluded, *unless* they are secured by a mortgage on a consumer's principal dwelling.

B. Nontraditional mortgages, with non-amortizing payments were negatively amortizing payments are included, since they are commonly viewed as an example of abusive mortgage lending. 12 CFR § 226.35. Also jumbo loans, portfolio loans & government-guaranteed loans are included.

C. FRB's initial aim was to reach the subprime market, even if regulations also extended to the Alt-A market, and in effort to bring order out of the chaos. HPMLs = subprimes.

D. Definition will be calculated from a new "average prime offer rate" based on Freddie Mac Primary Mortgage Market Survey ("PMMS").

1. First mortgages with an APR of 1.5% or more above PMMS are HPML's.

2. Junior mortgages on an APR of 3.5% or more above PMMS are HPML's.

3. Applicable comparison is calculated as of "rate lock date," *i.e.,* the date the rate is set for the final time befor loan closing, rather than the loan application date. That makes effective prediction of determining whether loan is an HPML more difficult, but increases the accuracy.

E. An HPML lender & lender of any HOEPA loan must be able to demonstrate it assessed member's ability to repay from income and assets other than the home's value. 12 CFR § 226.34 (a)(4)(ii)(C) & §226.35(b)(1).

1. This creates a new affirmative duty. No longer is its absence merely a presumption of violation..

2. Independent verification of current income from third-party sources and consideration of reasonably expected income, employment, assets other than the collateral, as well as current obligations, & mortgage related obligations (*e.g.* taxes & insurance). Reliance on current income alone is not necessary.

a. Assessment of repayment ability must include the highest schedule payment in the first seven years of loan.

b. Debtors claiming violation no longer have to prove a lender's "pattern & practice" of disregarding such an assessment, making Reg. Z violation suits more appealing to file and easier to win. This change is a very big deal.

3. If lender can demonstrate that its failure to verify did not cause it to grant a loan it otherwise would not have granted without verification, it may claim "no harm, no foul."

F. Prepayment penalties are banned if the payment can change during:

1. The initial four years of an HPML following loan closing (12 CFR §226.35(b)(3)); and

2. The initial two years of a non-HPML following loan closing (12 CFR § 226.32(d)(7)). Also, prepayment penalty cannot apply if the original lender is making the refinancing loan.

G. First-mortgage lenders must establish escrow accounts for payment of property taxes & homeowners insurance. No more direct payments by consumers.

1. Deadline for establish escrow accounts for stick-built houses is 4/1/10 and four loans secured by manufactured homes, 10/1/10.
2. Lenders can offer consumers the opportunity canceling escrow account after the first year of a loan.

2. Beware that some states have adopted local statutes requiring escrow account use for payment of taxes and insurance even if accounts are in default or in bankruptcy.

3. There is a partial exemption for cooperatives and condominiums, if the cooperative association pays property taxes & insurance premiums.

II. All closed-end mortgages secured by consumers principal dwelling are within the following new rules:

A. Specific servicing practices now forbidden per 12 CFR § 226.36(c):

1. Failing to credit a consumer's account with payment as of the date the payment was received. Crediting now must occur as of receipt date, not posting date.

2. "Pyramiding" late fees, *i.e.*, imposing a late fee on a consumer for making a timely payment that is the full amount due except for a previously assessed late fee.

3. Failing to provide "within a reasonable time after request" and accurate payoff statement. 12 CFR § 226.36(c)(1)(iii). (The example given is 5 business days following receipt). <u>This requirement does not apply to HELOCs.</u> 12 CFR § 226.36(d).

B. Lenders are explicitly forbidden to coerce or encourage an appraiser into misrepresenting the value of a home. 12 CFR § 226.36(b).

1. Lenders are prohibited from extending credit if they know an appraiser has been coerced or pressured into an appraisal amount before the loan closing.

2. Loans may be in violation may be void under state law, but are not necessarily void under regulations the amendments.

C. Lenders must provide good-faith estimates of loan costs, including payment schedules, within three days after a consumer application for a mortgage loan.

1. Includes home improvement loans for her consumer's principal dwelling

2. Includes refinancing an existing loan.

3. Currently, early cost estimates are only required for home purchase loans.

4. Applicants cannot be charged any fee until after the receipt the early disclosures, except a fee for obtaining their credit history.

III. All mortgages, regardless of type, are within the scope of the following new requirements:

A. New advertising requirements now applied to both open and home equity plans and closed-end credit. These become effective for as occurring on or after 10/1/09.

1. Home-equity plan advertising requirements. 12 CFR § 226.16

a. New "clear and conspicuous" standards applied to ads.

b. If the initially advertised rate states an APR not based on the index and margin used to make later readjustments, and must include the period of time the initial rate will be in effect & reasonably current APR that would have been in effect using the index and margin.

c. Required disclosures regarding balloon payments must be equally prominent and closely proximate to minimum periodic payment.

d. Additional tax implication disclosures now required where credit to be extended is greater than the collateral's fair market value.

e. Promotional rates must use the term "introductory" or "intro" next to each mention of the promotional rates, unless the ad is on radio or TV. 12 CFR § 226.249(f)(1).

2. Closed-end credit advertising rules. The following are now prohibited, according to 12 CFR § 226.24(i):

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a. Use of the term “fixed” to refer to rates of closed-end home loans when the rate can change.

b. Comparison advertisements between actual and hypothetical rates and payments, unless certain conditions are satisfied.

c. Falsely advertising alone as Government supported or endorsed.

d. Display in the name of the consumer’s current lender without disclosing that the advertising lender is not affiliated with the current lender.

e. Claiming debt elimination when one debt merely replaces another.

f. Use of the term “counselor” or “financial adviser”. (This one applies only to for-profit brokers or lenders, and presumably excludes credit unions.)

g. Foreign language added to provide required disclosures only in English.

B. Proposed requirements pertaining to “yield spread premiums” were not adopted, because no one could contrive regulations for disclosures that consumers could understand.

IV. Penalty for violation are draconian, and they can be sought by consumers in private civil actions.

A. Primary penalty contains three elements, one of which guarantees the interest of “consumer’s rights” lawyers:

1. Any actual damages suffered by the consumer (*e.g.*, loss of a lower APR more favorable repayment terms on a refinancing loan for the lack of a timely payoff statement), PLUS

2. An amount equal to twice the entire finance charge due on the life of the loan; PLUS

3. The consumer’s actual court costs and reasonable attorney fees. This last provision frequently causes attorney fee awards to be greater than 1 + 2 above.

B. One-year statute of limitation remained, but rigs the violations can still be asserted after SOL expiration, as a defense or counterclaim to a suit for enforcement of a contract which violates Reg Z.

C. Under limited exceptions, consumers can also rescind the entire loan well after the usual rescission period expires.

1. Ordinarily, consumers must return loan proceeds, but chapter 7 bankruptcy scan bar that requirement.

2. Nevertheless, the rescission operates to void the mortgage or deed of trust. The subsequent bankruptcy discharge and the liability for the debt and defeats the mortgage that would otherwise survive.

3. Reg Z. violation claims are routinely used to avoid voluntary liens in bankruptcy that otherwise would be unavoidable, even though the underlying debt is dischargeable.

a. Format is a simple Adversary Proceeding filed by the debtor in his bankruptcy prior to discharge, or even afterwards if he reopened the bankruptcy.

b. Bankruptcy debtors are not required to pay filing fees for Adversary Proceedings, unlike lenders.

c. Even after discharge, lenders to commence foreclosures can find themselves confronted with debtors who file Reg Z counterclaims, sufficient to defeat their mortgage entirely, by exercise of delayed rescission rights.

Conclusion

As one can see, the intersection of state law and bankruptcy can alter parties' rights in a number of ways, often to the detriment of one who is satisfied with a state court result, only to find that bankruptcy can drastically change that result. This manuscript's intent was to introduce the concepts of preclusion, elaborate on the Rooker-Feldman doctrine and wade into a few cases that put those concepts into practice. Also, understanding Reg Z and its application to the Bankruptcy Code is imperative in representing clients in bankruptcy matters.