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Chapter 13 Plan Cannot Avoid Lien Absent Adversary Proceeding

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Introduction

In *SLW Capital, LLC v. Mansaray-Ruffin (In re Mansaray-Ruffin)*, 530 F.3d 230, 233 (3d Cir. 2008), the Third Circuit considered whether a Chapter 13 confirmation plan has *res judicata* effect with respect to a creditor's lien when no adversary proceeding regarding the lien was brought under the Federal Rules of Bankruptcy Procedure ("the Rules"). The court held that the plan had no *res judicata* effect on such a lien. Accordingly, the lien passed through bankruptcy unaffected and could only be invalidated through an adversary proceeding. In doing so, the court made it clear that the requirements of the Rules outweigh any final, binding effect the Bankruptcy Code ("the Code") might give to a confirmed plan, opining that, while the Code creates the substantive rights of creditors and debtors in bankruptcy proceedings, the Rules define the process by which those rights may be affected. In this instance, the Rules require an adversary proceeding to determine "the validity, priority, or extent of a lien or other interest in property." Fed. R. Bankr. P. 7001(2). Meanwhile, the Code makes the terms of a confirmed plan binding on all parties. 11 U.S.C. § 1327.

In *In re Mansaray-Ruffin*, the debtor submitted a Chapter 13 plan that was confirmed via a confirmation hearing. The plan resolved the creditor's lien for far less than its original value. The creditor, who had not objected to the plan, subsequently moved to maintain its lien despite the confirmed plan because the debtor never initiated the statutorily required adversary

proceeding. The court ruled for the creditor, holding that the need for an adversary proceeding under the Rules outweighs the normal binding effect of a confirmation plan. In doing so, the court relied on the due process requirements of the Fifth Amendment. It stated that due process rights were implicated because an adversary proceeding required procedural protections, such as service of process, that were not available to the creditor in a confirmation hearing. Prior decisions in the Third Circuit and other jurisdictions supported such rationale. Thus, the Third Circuit's decision in *In re Mansaray-Ruffin* reinforced the existing law that confirmation plans do not act as *res judicata* with respect to issues for which the Rules require an adversary proceeding.

The decision, however, was not unanimous. In his dissent, Judge Greenberg argued that the creditor's due process rights were not violated by enforcement of the confirmation plan. He also cited prior decisions by the Third Circuit that made confirmation plans binding while arguing that Congress intended confirmation plans to create finality within the bankruptcy process. He contended that the court should not attempt to abridge that finality as it saw fit.

Despite Judge Greenberg's objections, the decision of the Third Circuit, together with similar decisions in other circuits, leaves debtors filing for relief under Chapter 13 in a precarious position: they must be careful to abide by all the procedural requirements of the Rules and the Code and cannot rely on the apparent finality of a confirmed plan to act as a final resolution to liens any creditors may claim against them.

I. Case Background

The creditor in *In re Mansaray-Ruffin* held a mortgage on the debtor's property, which the debtor contended was rescindable because of material Truth In Lending Act violations. 530 F.3d at 232. After filing Chapter 13, the debtor submitted a plan that listed the creditor as a

disputed secured creditor. *Id.* When the creditor failed to file its own proof of claim, despite being given proper notice of the confirmation hearing, the debtor filed an unsecured claim on the creditor's behalf and considered the mortgage rescinded. *Id.* at 233. Correspondence between the debtor and the creditor indicated that the debtor intended to initiate an adversary proceeding but declined to do so after the creditor failed to amend the proof of claim the debtor had filed on its behalf. *Id.* After the plan was confirmed, the creditor continued to request payments from the debtor and thereafter initiated an adversary proceeding in which it asked the court to rule that its mortgage continued in spite of the plan. *Id.* The creditor contended that the Rules required an adversary proceeding for determination of the status of its lien and that the debtor's confirmed plan could not substitute for this process. *Id.* The debtor moved to dismiss, asserting that the lien was invalid because the Code makes the terms of a confirmed plan binding on all parties. *Id.* She also claimed that the creditor's failure to object to the confirmation plan disposed of any claims it might have had. *Id.*

The court denied the debtor's motion to dismiss and allowed the creditor to retain its mortgage on the debtor's property unaffected by the confirmation plan. *Id.* at 243. It did so in part based on the general rule that a bankruptcy proceeding invalidates only *in personam*, rather than *in rem*, claims against the debtor. *Id.* at 235. The court decided that neither the proof of claim, filed by the debtor on the creditor's behalf, nor the confirmed plan itself was sufficient to avoid the lien. *Id.* at 235–36. Additionally, the court held that the creditor's failure to object to the confirmation plan did not act as a waiver of its right to receive proper notice and an adversary proceeding before judgment was entered with respect to its lien. *Id.* at 237.

The court's decision was influenced by the mandatory requirement of an adversary proceeding under the Rules and the heightened protection the creditor is entitled to within such a

proceeding. An adversary proceeding is “a self-contained trial-still within the original bankruptcy case;” comparable to traditional civil litigation. *In re Mansaray-Ruffin*, 530 F.3d at 234. It requires the service of a summons and a copy of the complaint to the creditor. Fed. R. Bankr.P. 7004. It also has the same rules as traditional civil litigation with regard to discovery, dismissal, and final judgment. Fed. R. Bankr.P. 7026–37, 7041, 7055–56. In this way an adversary proceeding provides greater protection than an objection to a confirmation hearing. A confirmation hearing is a court ordered hearing where a debtor lays out the payment particulars of his proposed plan and creditors are allowed to inquire about or object to the proposal prior to the court confirming the plan. 11 U.S.C. § 1324, 1325. Objections within a confirmation hearing are considered contested matters. Contested matters are more informal than adversary proceedings and do not require the filing of a complaint or service of summons. Fed. R. Bankr.P. 9014. Additionally, contested matters, do not require specific notice to the creditor or full disclosure of the effects the plan will have on the creditor’s claim. Fed. R. Bankr.P. 3015(d).

Recognizing the stark difference in the treatment of the creditor between an adversary proceeding and a contested matter, the court found it to be a violation of the creditor’s due process rights for its lien to be invalidated through the more informal procedure. *In re Mansaray-Ruffin*, 530 F.3d at 239–40.

The court’s opinion in *In re Mansaray-Ruffin* is grounded in the requirements of the Due Process Clause of the Constitution. A minimum requirement of the Due Process Clause of the Fifth Amendment is that no one be deprived of “life, liberty, or property through adjudication” without proper notice. *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950). Proper notice is notice reasonably calculated, under all circumstances, to inform interested parties of an action and to give them the option to appear on their own behalf. *Id.* In *In re*

Mansaray-Ruffin, the court held that the creditor's due process rights had been violated because it never received the summons and complaint required for an adversary proceeding. Instead, the creditor's interest in the debtor's property was reduced from a \$40,000 mortgage balance to a \$1,000 unsecured debt without the creditor being given the proper opportunity to make its claim. It could only make a claim within the confines of the confirmation hearing, the subject matter of which need not have been specified in the notice about the confirmation plan. Such a due process violation prevented the court from granting the confirmation plan its usual binding authority over all interested parties. In refusing to grant finality to the confirmation plan because of a due process violation, the court relied on widespread precedent.

II. Precedent Cases

A. The Requirements of the Rules Outweigh the Force of a Confirmation Plan

Several cases in the Third Circuit, as well as in other circuits, have limited the binding authority of confirmation plans based on violations of the Rules or insufficient notice under the Rules. In *In re McKay*, 732 F.2d 44, 48 (3d Cir. 1984), the Third Circuit ruled that a provision in a confirmation plan that the Code permitted could not invalidate a lien if it did not adhere to the Rules. The debtor in that case sought to avoid liens by claiming protection under a provision in the Code within his confirmation plan. The court rejected this claim because, in order to seek protection under the provision in question, the Rules required the debtor to file for an adversary proceeding, which he had not done. In effect the court held that "when an adversary proceeding is required [by the Rules], courts are not free to disregard the Rules." *In re Mansaray-Ruffin*, 530 F.3d at 236. The court in *In re Mansaray-Ruffin* followed this precedent by adhering to the Rules even though doing so infringed on the usual finality of a confirmation plan.

B. Notice of a Confirmation Plan is not a Substitute for Proper Notice of an Adversary

Proceeding

Adherence to the Rules is so important that even creditors who are given notice of confirmation hearings will not see their liens invalidated by the results of those hearings. The Third Circuit, in *In re Harbor Tank Storage Co.*, 385 F.2d 111, 114–15 (3d Cir. 1967), made it clear that a creditor has a right to expect all notices regarding an adversary proceeding to which he is entitled under the Code, and need not be burdened by filing an appearance or claim in a confirmation hearing. There, the court upheld a creditor's right to file a claim after a confirmation plan was in place, despite the fact that the creditor knew of the confirmation hearing. The court based its decision on the debtor's failure, under the Rules, to provide proper notice of the proceeding. The debtor in that case had publicly published notices of the proceedings in local newspapers but had failed to give the creditor the specific notices required by statute. To support his claim that the creditor's lien should be invalidated, the debtor cited the creditor's actual knowledge of the hearings and the apparent finality of the confirmation plan. The court disagreed. It held that the creditor's knowledge of the confirmation hearings created no burden on the creditor to appear at such hearings absent his receipt of proper notice and the debtor's initiation of the proper adversary proceeding. The creditor has the right to wait for the notices to which he is entitled before he has any duty to act.

C. Due Process Requires Proper Notice of an Adversary Proceeding

The right to wait for the proper notice required by statute is an extension of the creditor's due process rights. In *Piedmont Trust Bank v. Linkous (In re Linkous)*, 990 F.2d 160, 162 (4th Cir. 1993), the Fourth Circuit refused to view a confirmation plan as *res judicata* if it resulted in a denial of due process. There, the creditor received a summary and court notice regarding the debtor's confirmation plan. Despite these notices, the creditor failed to take any action with

regard to its claim at the confirmation hearing. After the plan was confirmed the creditor moved to have it revoked. The court granted the creditor's motion because the notice given was not sufficient under the Rules. The Rules required specific notice, a motion, and a hearing for the kind of collateral valuation the debtor had obtained in his confirmation plan. Citing the due process requirements of the Fifth Amendment, the court held that the debtor's failure to give notice in accordance with the requirements of the Rules prevented the confirmation plan from acting as *res judicata* with regard to the creditor's lien.

Later, the Fourth Circuit expanded upon this rationale in *Banks v. Sallie Mae Servicing Corp. (In re Banks)*, 299 F.3d 296, 301 (4th Cir. 2002). That court held that a creditor's knowledge of a confirmation hearing, absent proper filing by the debtor, fulfilled the "notice" requirement but not the "service of process" requirements necessary to give a confirmed plan *res judicata* effect. *Id.* The debtor in that instance sought to discharge a portion of his student loan by providing for such discharge in the language of his confirmation plan. Typically, in order to discharge a student loan, the Rules require an adversary proceeding. The creditor in that case received general notice of the confirmation hearings but was not given specific notice of the effect it would have on his claim, nor was he offered the service of process that accompanies an adversary proceeding. In the absence of such a proceeding, the court held that the confirmation plan could not validly discharge the student's loan debt, even though the creditor failed to bring his claim until five years after the plan was confirmed.

Likewise, in *Ruehle v. Educ. Credit Mgmt. Corp. (In re Ruehle)*, 412 F.3d 679, 684 (6th Cir. 2005), the Sixth Circuit held that discharging a student loan debt through a provision in a confirmation plan without an adversary proceeding violated the creditor's due process rights. In ruling that the debtor's attempt to discharge his debt in such a manner was invalid, the court

noted that “[e]very person and entity is entitled to the prescribed level of notice for the process to be due.” *Id.* at 684–85. In citing each of these cases, the court in *In re Mansaray-Ruffin* asserted that both the creditor’s knowledge of the debtor’s confirmation hearing, and its failure to object to her plan, were inconsequential. The creditor had the right to assume that its lien could not be invalidated unless the debtor initiated an adversary proceeding. As such, the creditor was within its due process rights to wait for the proper notice that went with such a procedure.

D. A Confirmation Plan Does Not Affect a Pending Adversary Proceeding

The Ninth Circuit extended due process protection even further. In *Enewally v. Wash. Mutual Bank (In re Enewally)*, 368 F.3d 1173 (9th Cir. 2004), it held that a plan confirmed while an adversary proceeding was pending did not have preclusive effect over the issues to be litigated in such a proceeding. There, the debtor was able to modify the value of a lien held by the creditor in his confirmation plan. During the pending adversary proceeding, the creditor successfully challenged this modification. The court, in ruling for the creditor, held that any “issue [that] must be raised through an adversary proceeding is not part of the confirmation process.” *Id.* (quoting *Cen-Pen Corp. v. Hanson*, 58 F.3d 89, 93 (4th Cir. 1995)). Because it is not part of the confirmation process, resolution of such an issue in the confirmation plan does not have “preclusive effect” unless it is litigated. *Id.*

E. Other Cases Hold that a Confirmation Plan is Binding Even if Its Terms Violate the Rules

In contrast to these decisions, other prior rulings by the Third Circuit have reinforced the notion that a confirmation plan is binding on all parties even if it violates a provision of the Code. In *In re Szostek*, 886 F.2d 1405, 1408 (3d Cir. 1989), the Third Circuit declared a confirmation plan *res judicata* with regard to all payment plan issues that could have been decided at the confirmation hearing. There, the creditor sought revocation of the debtor’s

confirmed plan because it violated § 1325(a)(5)(B)(2) of the Code, which requires calculation of the present value of the creditor's claim. The court refused to revoke the plan, stating that the purpose of bankruptcy law and reorganization provisions would be defeated if debtors could not discharge their debts with absolute finality. It further opined that creditors would have no incentive to participate in bankruptcy proceedings if they knew that confirmed plans were not final.

The debtor in *In re Mansaray-Ruffin* relied on this precedent in arguing that the Code made the terms of a confirmation plan binding on all parties. The court in *In re Mansaray-Ruffin* rejected this argument, noting that *In re Szostek* also stated that a plan could not be confirmed if it did not meet the mandatory requirements of the Code. *In re Mansaray-Ruffin*, 530 F.3d at 239. The section of the Code at issue in *In re Szostek*, § 1325, was not mandatory because it failed to state that a plan could be confirmed "only if" its provisions were met. 886 F.2d at 1411. In this way, the court in *In re Szostek* distinguished § 1325 from mandatory requirements of the Code, which did contain such "only if" conditional language. *Id.* Since § 1325 wasn't mandatory, the court enforced the finality of the confirmation plan. The court in *In re Mansaray-Ruffin* however, ruled that the adversary proceeding requirement in the Rules was mandatory. *In re Mansaray-Ruffin*, 530 F.3d at 238–39. This ruling was based on the constitutional principle of due process. *Id.* Since it found that the adversary proceeding was mandatory, the court reasoned that any finality the confirmed plan carried was outweighed by due process requirements. *Id.*

The Third Circuit again reinforced the importance of finality in bankruptcy law with relation to confirmation plans in *Branchburg Plaza Associates, L.P. v. Fesq (In re Fesq)*, 153 F.3d 113, 113 (3d Cir. 1998). There, the debtor proposed a confirmation plan under which it

would only pay 10% of his debt to the creditor in question. The bankruptcy court approved the confirmation plan due to a lack of any timely objections. The creditor subsequently moved to revoke the confirmation order saying it failed to file an objection due to a computer glitch that led it to believe the deadline for filing such an objection was two months later than it actually was. The court denied the motion holding that a creditor could only revoke a confirmed plan due to fraud by the debtor, which was not present here.

The debtor in *In re Mansaray-Ruffin* relied on this opinion, claiming that since the creditor asserted no fraud in this case, the confirmation plan must be given *res judicata* effect. The court rejected this claim. It distinguished *In re Fesq* from *In re Mansaray-Ruffin*. First, it pointed out that *In re Fesq* did not deal with an issue where an adversary proceeding was necessary. Second it indicated that the creditor in *In re Fesq* sought to revoke a confirmation plan whereas the creditor in *In re Mansaray-Ruffin* simply sought a declaration that the confirmation plan did not invalidate its lien. Due to these differences, the court determined that *In re Fesq* did not raise the same due process concerns as *In re Mansaray-Ruffin*, thus its ruling was not applicable.

Despite some Third Circuit precedent in support of the finality of confirmation plans, the overwhelming majority of relevant precedent in the Third Circuit, as well as in other jurisdictions, supports the court's decision in *In re Mansaray-Ruffin*. Courts around the country limit the binding authority given to confirmation plans if a creditor's due process rights of notice and an adversary proceeding have been violated. While this is the current law, the vigorous dissent posed by Judge Greenberg in *In re Mansaray-Ruffin* may, over time, tilt the law in this area towards a relaxation of strict due process enforcement in favor of reinforced adherence to the finality of confirmation plans.

III. Greenberg's Dissent in *In re Mansaray-Ruffin*

Not all are in agreement that the requirement of an adversary proceeding should nullify the finality of a confirmed plan. In a strongly worded dissent in *In re Mansaray-Ruffin*, Circuit Judge Greenberg argued that the majority had erroneously equated the constitutional requirements of due process with the procedural requirements of the Rules. He argued that the due process requirements were met despite the debtor's violation of the Rules because the Rules and the Code requirements were stricter than the due process requirements. These enhanced requirements result from the fact that the invalidation of a lien is a "matter of great consequence" in bankruptcy law. *In re Mansaray-Ruffin*, 530 F.3d at 243. He further stated that the actual notice the creditor received of the confirmation hearing was sufficient to comply with due process. Accordingly, the confirmation plan should have had *res judicata* effect notwithstanding the debtor's failure to strictly comply with the Rules.

Judge Greenberg contended that the debtor's failure to comply with the rules would have made his confirmation plan susceptible to attack had the creditor objected during the hearing. Once the creditor failed to respond to the confirmation hearing, however, it waived any right to an adversary proceeding. Judge Greenberg asserted a general rule that "acceptance of [a] plan by a secured creditor can be inferred from the absence of an objection" by that creditor. *In re Szostek*, 886 F.2d at 1413. He also cited *In re Fili*, 257 B.R. 635, 639 (1st Cir. BAP 2001), declaring that the creditor cannot freely forego fair opportunity to object to a confirmation plan's terms even if the issues he would raise cannot be finally resolved by the plan. Finally, he quoted *In re Fili* declaring a creditor "ignore[s] the confirmation process, and his opportunity to object to confirmation, at his own peril." *Id.*

Judge Greenberg further relied on the precedent of *In re Fesq*, which established that a

showing of fraud is the only way to invalidate the *res judicata* effect of a confirmation plan. He dismissed the majority's distinction of *In re Fesq* from *In re Mansaray-Ruffin*. According to Judge Greenberg, both cases involved a debtor attempting to invalidate a creditor's lien. Both cases raised due process issues because they involved property interests. Due to these similarities, he deemed *In re Fesq* relevant precedent that the court should have followed.

Judge Greenberg also pointed to apparent Congressional intent in contending that the finality of confirmation plans should be enforced. He asserted that if Congress intended for the finality language of 11 U.S.C. 1327 to be usurped by conflicting provisions in the Code or the Rules, they would amend it to declare as much. Absent such action by Congress, the courts are not in a position to legislate by restricting the application of Congressional law.

In conclusion, Judge Greenberg felt that enforcing the finality of the confirmation plan was necessary to further the goals of bankruptcy law and encourage creditors to be active in the bankruptcy process. Citing *In re Szostek*, he suggested that prior to confirmation, the court should enforce compliance with the Code. After confirmation, finality of the plan should be favored over strict compliance with the Code's provisions.

Conclusion

The result of *In re Mansaray-Ruffin*, and of the other similar cases mentioned here, is to place a greater burden on consumers filing for bankruptcy relief under Chapter 13. When filing for such relief, a debtor must be diligent in following the requirements of the Rules. Where an adversary proceeding is required, the procedure for arranging such a proceeding and giving the creditor notice, must be followed exactly. Debtors cannot rely on notices regarding a confirmation hearing to alleviate or resolve disputes for which the Rules require an adversary proceeding. Reliance on such notices is misplaced because creditors are free to ignore them and

wait for the specific notice requirements associated with adversary proceedings.

The obvious danger here is that consumer debtors will believe they have resolved various issues through their confirmed plans only to find out that the order of confirmation was not a final determination of the issue in question. This will put consumers who are already in a precarious financial position in even more peril.

To avoid this danger, attorneys representing debtors must be diligent in providing creditors with all the required notices in a timely manner. Proceeding with a confirmation hearing when required adversary proceedings are pending or unscheduled is a fruitless endeavor. Debtors may find that the bankruptcy process takes more time due to the notice requirements of the Rules. This extended process is a small price to pay for the more definitive finality that will be obtained by following the Rules exactly.

Creditors will find the detailed enforcement of the Rules very advantageous. They can sit back and survey a debtor's proceedings while waiting for all the necessary and required notices before taking any action. There would seem to be little incentive for creditors to engage in confirmation hearings if such hearings have no final authority over their claims. Attorneys representing creditors would be best served by taking no action until the debtor has strictly complied with all the requirements of the Rules.

If Judge Greenberg's dissent resonates with other judges around the country, eventually creditors may be forced to take more active roles in the bankruptcy process. The relaxed due process requirement and simplified notice to creditors that he promotes would help restore the finality Congress intended the bankruptcy process to provide.

Until then, there is no doubt that the current interpretation of the Rules in relation to the due process requirements of the Fifth Amendment is a pro-creditor and anti-debtor approach that

will serve to make filing for bankruptcy an even more disheartening process for those who must go through it.

