

# Credit Union Attorney Law Letter

A Law Letter for Credit Unions, Financial Institutions, and Attorneys

Vol.14 No.4

April 2002

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## **Judgment Creditor's Lien Avoided Entirely in Bankruptcy Even Though It Was Perfected Before Second Mortgage**

In *Kolich v. Antioch Laurel Veterinary Hospital, Inc., P.C.* ("In re Kolich"), case no. 01-6041 (8th Cir. Feb. 22, 2002), the Eighth Circuit, reviewing a Chapter 7 bankruptcy case, avoided a judgment creditor's lien perfected before the debtors took out a second loan against their home because the value of all three liens (two mortgages and a non-consensual judgment lien) plus the debtors' homestead exemption exceeded the fair market value of the property.

### Facts

In 1992, Dean and Michelle Kolich purchased a veterinary practice for Dean from Antioch Laurel Veterinary Hospital, Inc., P.C. ("Antioch"). Six years later, the Kolichs borrowed from World Savings Bank to purchase a house, and World Bank took a mortgage.

Thereafter, the Kolichs fell behind in their payments to Antioch. Antioch sued and won a judgment of \$133,875. In September 2000, Antioch recorded its judgment against the Kolichs, thereby obtaining a judgment lien that, under applicable state law, was second in priority to the World Bank's mortgage against the Kolichs' house.

Three months later, the Kolichs borrowed \$80,000 against their house from Norbank. It was secured by a second mortgage. Norbank apparently failed to discover Antioch's judgment lien before making the loan. Under state law, Norbank's interest in the Kolichs' house was third in priority behind World Bank and Antioch.

After borrowing the \$80,000, Michelle Kolich took the money to Las Vegas and attempted, unsuccessfully, to gamble the couple out of debt.

### Chapter 7 Bankruptcy Petition

In April 2001, the Kolichs filed a Chapter 7 bankruptcy petition. Everyone affected agreed that the Kolichs house was then worth \$275,000. They owed World Bank \$219,000, Antioch \$133,875, and Norbank \$80,000. Under state law, the Kolichs were entitled to a homestead exemption of \$8,000.

### Avoidance of Judgment Lien Under Bankruptcy Code § 522(f)(2)

After filing their Chapter 7 petition, the Kolichs moved to avoid Antioch's judgment lien under § 522(f) of the Bankruptcy Code. 11 U.S.C. § 522(f). Section 522(f)(1) provides that a debtor can avoid a non-consensual lien that impairs an otherwise valid exemption (in this case a homestead exemption). Since Congress's 1994 Amendments to the Bankruptcy Code, § 522(f)(2) has

contained a mathematical formula for use in determining whether a non-consensual lien impairs an exemption. Under the formula, “[t]he exemption is impaired [if or] to the extent the total of all liens on the property plus the exemption exceed the fair market value of the property.” *Quoting In re Gostian*, 215 B.R. 237, 238 (Bankr. M.D. Ala. 1997).

When the §522(f)(2) formula is applied to the Kolichs’ case it looks like this:

Antioch’s Judgment Lien	\$ 133,875
+World Bank’s first mortgage	219,000
+Norbank’s second mortgage	80,000
+Homestead exemption	+ 8,000
Subtotal	\$ 440,875
- FMV of property	- 275,000
Extent of Impairment	\$ 165,875

Because the extent of impairment is a positive number, strict adherence to the formula set out in § 522(f)(2) requires avoidance of Antioch’s judgment lien in its entirety.

Antioch naturally argued that, in this case, it was unfair to strictly adhere to the mathematical formula in § 522(f)(2) because that would destroy the priority position given by state law to judgment liens perfected before the extension of a consensual loan, like Norbank’s second mortgage in this case. Antioch ultimately argued that fairness required leaving it with a secured lien to the extent its lien did not exceed the combined value of World Bank’s loan (\$219,000) and the homestead exemption (\$8,000), minus the fair market value of the house (\$275,000), i.e. \$48,000.

The bankruptcy court agreed with Antioch and avoided Antioch’s judgment lien only to the extent its value exceeded \$48,000. The Kolichs appealed.

### Appeal

On appeal, the Eighth Circuit Court of Appeals reversed, holding that the bankruptcy court had erred by not strictly applying the formula set out in § 522(f)(2) and avoiding Antioch’s loan in its entirety. The appeals court explained:

“The bankruptcy court’s emphasis on preserving state created priorities for the benefit of prior nonconsensual judicial lien[s] finds no support in

the language of the amendment [to the Bankruptcy Code in 1994] or in the legislative history. Rather, the 1994 amendments have created a federal definition of impairment which no longer looks to or depends upon state law. ....

“....

“Section 522(f)(2)(A) is a congressionally mandated bright line formula for determining how to calculate the extent to which a judicial lien impairs an exemption. As with all bright line tests, at times it may seem a formulaic application brings unfair results. Yet, ... [this] perceived unfairness was anticipated by Congress. Congress chose clarity over possible unfair results.”

In reaching its decision, the appeals court distinguished a couple of cases from the First and Eleventh Circuits relied upon by Antioch as support for its argument, saying that those cases did not address “the application of the formula, but only how to calculate the debtor’s interest in ... property” jointly owned with a non-debtor.

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## **Creditor Can Require Chapter 7 Debtor to Reaffirm Unsecured Debt as a Condition of Reaffirming Secured Debt**

In *Jamo v. Katahdin Federal Credit Union* (“*In re Jamo*”), case no. 01-9010 (1st Cir. Mar. 26, 2002), the First Circuit has held, in a case of first impression in the U.S. Circuit Court of Appeals, that a creditor who is owed both secured and unsecured debts does not *per se* violate the automatic stay provision of the Bankruptcy Code, 11 U.S.C. § 362(a)(6), by conditioning a Chapter 7 debtor’s reaffirmation of a secured debt on the simultaneous reaffirmance of unsecured debts.

### Facts

Stephen and Lynn Jamo, a husband and wife, filed a Chapter 7 bankruptcy petition. At that time, they owed \$61,000 to Katahdin Federal Credit Union (“the Credit Union”). Of that, \$37,000 was secured by a mortgage on the Jamos’s residence. The rest of the debt was unsecured.

### Reaffirmation Under 11 U.S.C. § 524(c)

In their bankruptcy petition, the Jamos stated their desire to reaffirm the mortgage obligation. Reaffirmance is one of four actions a Chapter 7 debtor may take with

respect to a secured debt after he files for bankruptcy. The other alternatives are: surrendering the collateral, paying off the debt in full, or showing that an exemption is applicable. *See* 11 U.S.C. § 521(2)(A). The reaffirmation process is governed by 11 U.S.C. § 524(c).

When the Jamos's attorney approached the Credit Union about reaffirmation, the Credit Union responded, through counsel, that it would not enter into a reaffirmation agreement with respect to the Jamos's mortgage debt unless they also agreed to reaffirm their unsecured debts.

### **Reaffirmation and the Automatic Stay Provision**

The Jamos's attorney argued to the bankruptcy court that the Credit Union's insistence on reaffirmation of the unsecured debts as a condition of reaffirmation of the mortgage indebtedness violated the automatic stay provision of the Bankruptcy Code, 11 U.S.C. § 362(a)(6). The automatic stay provision springs into effect upon the filing of a bankruptcy petition to bar creditors from engaging in post-petition collections efforts, including foreclosure.

The bankruptcy court agreed with the Jamos's argument that the Credit Union's attempt to link the reaffirmation of secured and unsecured debt was a *per se* violation of the automatic stay provision. The Credit Union appealed. A bankruptcy appeals panel affirmed, so the Credit Union appealed again, to the First Circuit Court of Appeals.

### **Appeal**

The First Circuit reversed, holding that it is possible for a creditor to link the reaffirmation of secured and unsecured debts without violating the automatic stay provision of the Bankruptcy Code. The court held that a violation occurs only if a creditor's conduct during negotiations over reaffirmation constitutes an impermissible threat of foreclosure or repossession.

In reaching its decision, the First Circuit reasoned that 11 U.S.C. § 524(c), governing reaffirmation, "makes manifest that reaffirmation requires a meeting of the minds" and envisions agreements that are the product of "fully voluntary negotiations by all of the parties"; therefore, creditors have the right to reject any and all reaffirmation proposals. That is one feature of Chapter 7 bankruptcies that distinguishes them from Chapter 13. Chapter 13 has a "cram-down" provision, under which a debtor can retain the collateral underlying a debt without

the creditor's approval. *See* 11 U.S.C. § 1325(a)(5)(B). The court pointed out that "a debtor who initially" files under Chapter 7 can "jump midstream to Chapter 13," and "a debtor who persists in traveling the Chapter 7 route knows that reaffirmation depends entirely on his ability to come to terms with the secured creditor."

The court also believed that, even if it adopted a *per se* rule against linking the reaffirmation of secured debts to unsecured debts, creditors would find other ways to get around the rule, like putting cross-collateralization clauses in all loan documents.

### **References to Foreclosure "Unarguably Benign"**

With regard to the conduct of the Credit Union in this case the Court held that, although it had referenced foreclosure on three occasions during the process of negotiating reaffirmation, each of its references to foreclosure, viewed in context, were "unarguably benign." Therefore, the Credit Union's conduct during the reaffirmation process did not violate the automatic stay provision.

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## **Supreme Court Invalidates Labor Department Regulation 29 C.F.R. § 825.700(a), Prohibiting Employers from Counting Leave As Family- Medical- Leave-Act Leave Unless They Designate It So**

In *Ragsdale v. Wolverine World Wide*, No.00-6029, 112 S. Ct. 1155 (Mar. 19, 2002), the U.S. Supreme Court has invalidated a regulation promulgated by the U.S. Labor Department that required employers covered by the Family Medical Leave Act of 1993, 29 U.S.C. §§ 2601 *et seq.* ("FMLA") to designate leave as FMLA or lose the right to count the time against the employee's FMLA mandated leave.

### **Relevant Provisions of the FMLA and Labor Regulations**

The FMLA requires employers covered thereunder to provide employees with up to 12 weeks of unpaid leave a year following certain events, including disabling health problems, the serious illness of a family member, and the

arrival of a new son or daughter. *See* 29 U.S.C. § 2612(a)(1). During the leave, the employer must maintain the employee's group health coverage. *See* 29 U.S.C. § 2614(c)(1). Upon the employee's timely return, he must be reinstated his former position or its equivalent. *See* 29 U.S.C. § 2614(a)(1). If an employer interferes with, restrains, or denies the exercise of FMLA rights, he is subject to suit for damages and injunctive relief. *See* 29 U.S.C. §§ 2615(a)(1) & 2617(a)(1).

While the FMLA mandates 12 weeks of unpaid leave, Congress, in the FMLA, expressly encouraged employers to be more generous. Some have been, providing longer leave, partially-paid leave, and leave for reasons other than those covered by the FMLA. With one exception (until now), as long as more generous leave policies have met the FMLA's minimum requirements, the employer has been entitled to count the leave it granted toward the 12 weeks required by the FMLA. *See* 60 Fed. Reg. 2230 (1995).

The one exception to the more-generous employers' right to count leave toward FMLA leave has been in Labor Department regulation 29 C.F.R. § 825.700(a) where it states: "If an employee takes paid or unpaid leave and the employer does not designate the leave as FMLA leave, the leave taken does not count against an employee's FMLA entitlement."

### **Facts**

Tracy Ragsdale worked for Wolverine in 1995 and 1996. At that time, Wolverine provided employees with seven months (30 weeks) of unpaid sick leave, annually.

Around the beginning of the calendar year, Ragsdale developed Hodgkins disease. In February, she requested and received a one-month leave of absence. At the end of each of the next six months, Ragsdale asked for and received a 30-day extension of her leave. At the end of the seventh month, when she asked for an additional 30 days of leave, Wolverine informed her that she was not entitled to anymore leave. When she did not return to work, Wolverine terminated her employment.

Wolverine admittedly did nothing to "designate" that Ragsdale's seven months of unpaid leave included her

FMLA leave. For her part, Ragsdale could not show that, even if Wolverine had "designated" her leave as FMLA leave, she would have changed the way in which she took the leave, in any way.

### **Suit**

Ragsdale sued Wolverine arguing that its failure to notify her that she was taking her FMLA leave automatically entitled her to an additional 12 weeks of leave under 29 C.F.R. § 825.700(a).

Wolverine moved for a judgment without a trial, arguing that all FMLA required was that Wolverine grant 12 weeks of leave and it had in fact granted 30. Wolverine further argued that § 825.700(a) was invalid. A federal regulation is invalid if it is "arbitrary, capricious, or manifestly contrary to the statute." *United States v. O'Hagan*, 521 U.S. 642, 673 (1997).

The district court agreed with Wolverine and entered a summary judgment for it. Ragsdale appealed. On appeal, the Eighth Circuit Court of Appeals affirmed. Ragsdale appealed again, to the U.S. Supreme Court.

### **The Supreme Court's Decision**

The Supreme Court granted Ragsdale's appeal to decide the validity of 29 C.F.R. § 825.700(a). After comparing § 825.700(a) to the statutory provisions of the FMLA, the Court concluded that § 825.700(a) was manifestly contrary to the FMLA because it penalized employers regardless of whether an employee could show any real impairment to his rights or prejudice resulting from not being notified that his leave included FMLA leave.

In addition, the Court noted that the severe penalty imposed by § 825.700(a) might have caused employers with leave policies more generous than the FMLA mandates to abandon their policies to avoid having to decide, at the outset of a request for leave, whether it was covered by the FMLA or not. In some cases, answering the FMLA coverage question may not be easy and a decision might require substantial investigation. If making a determination about coverage is expensive, it becomes

easier to administer a policy that meets the minimum required by the FMLA.

Three justices dissented from the majority of the

Court. In an opinion authored by Justice O'Connor, those three would have held that § 825.700(a) was not manifestly contrary to the FMLA, arbitrary, or capricious. Therefore, it was not invalid.