No. 08-1134

In the
Supreme Court of the United States

UNITED STUDENT AID FUNDS, INC.,
PETITIONER,
v.
FRANCISCO J. ESPINOSA,
RESPONDENT.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF OF THE INTERNATIONAL MUNICIPAL LAWYERS ASSOCIATION AS AMICUS CURIAE SUPPORTING PETITIONER

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STATEMENT OF AMICUS INTEREST[1]

The International Municipal Lawyers Association ("IMLA"), previously known as the National Institute for Municipal Law Officers, is a non-profit, professional organization of over 3000 local government entities, including cities, towns counties, and special district entities, as represented by their chief legal officers, state municipal leagues, and individual attorneys. Since 1935, IMLA has served as a national, and now international, clearinghouse of legal information and cooperation on municipal legal matters. IMLA's mission is to advance the responsible development of municipal law through education and advocacy by providing the collective viewpoint of local governments around the country on legal issues before the United States Supreme Court, the United States Courts of Appeals, and state supreme and appellate courts. IMLA members, and the cities and towns that they represent, have a substantial interest in the treatment of local tax claims with respect to taxpayers who file petitions for relief in U.S. Bankruptcy Courts.[2]

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[1] The parties have consented to the filing of this brief. Pursuant to Supreme Court Rule 37.6, neither party nor their counsel authored this brief in whole or in part. Neither party nor their counsel made a monetary contribution to fund the preparation or submission of this brief. No person other than *amicus curiae* made a monetary contribution to its preparation or submission.

[2] Congress recognized the importance of certain municipal taxes by providing that the creation or perfection of a statutory lien on a debtor's property for *ad valorem* property taxes does not violate the automatic stay provision of the Code (if the tax or

Prior to *In re Espinosa*, 533 F.3d 1193 (9th Cir. 2008), protections for nondischargeable municipal tax claims were self-executing under the United States Bankruptcy Code, 11 U.S.C. § 101 *et seq.* (the "Code"). Municipalities were permitted to rely on the self-executing nature of nondischargeability, absent an adversary proceeding judgment or contested proceedings to the contrary. Should, however, the Ninth Circuit's decision in *Espinosa* be affirmed, the result may well be that the claims of cities and towns in Chapter 13 proceedings will be extinguished by the mere declaration in a Debtor's plan, if no timely objection is filed. As such, this Court's resolution of the "discharge-by-declaration" implications of the Ninth Circuit decision directly impacts the municipality's recovery of nondischargeable tax obligations.

IMLA's member cities and towns rely on tax revenues raised from municipal assessments on real and personal property to fund important municipal services.[3] Congress recognized the importance of

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assessment comes due after the date of the filing of a petition for relief). 11 U.S.C. § 362(18). Municipal taxes (real property and excise) are accorded payment priority under the Code if they are administrative expenses or if they are allowed claims possessing priority within 11 U.S.C. § 507(a)(2) and (8). As IMLA recognizes that not every municipal obligation is treated as nondischargeable in a bankruptcy proceeding, this amicus brief is based only on those debts that would otherwise be deemed as nondischargeable under the Code.

[3] The Lincoln Institute of Land Policy has calculated the nationwide percentage of general revenue from local property taxes, based on 2005 census data, at 27.95% The range is between 8.94% (for Arkansas) to 55.95% for Connecticut, with thirteen states having an average property tax revenue higher

these tax revenues to the fiscal well being of municipalities by granting special priorities, most importantly, the nondischargeable nature of certain municipal taxes.

Municipal taxes are excepted from the discharge provisions of the Code if they fall within 11 U.S.C. § 523(a)(1). In contrast to student loan obligations, municipal tax obligations are not *presumptively* nondischargeable. Rather, municipal tax obligations *are always* nondischargeable if they fall within 11 U.S.C. § 523(a)(1). Many small municipalities[4] do not retain bankruptcy counsel for Chapter 13 proceedings, perhaps believing until *Espinosa* that since Congress established certain tax obligations as nondischargeable that orders confirming plans which contained impermissible provisions affecting nondischargeable tax obligations would be deemed void. Many municipalities simply cannot afford to allocate more resources towards tax recovery activities where the taxpayers have filed bankruptcy. The average American municipality with a population under 10,000 generates almost

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than 33%. *See* "Summary — Local Property Tax Revenue, by State — 2005," available at *http://www.lincolninst.edu/subcenters/significant-features-propertytax/census/ViewTable.aspx?table=3*.

[4] Of the 38,967 general purpose local governments (municipalities, towns, townships and counties) in the United States, a little over 19,000 are classified as municipalities, and of those approximately 15,000 have less than 5,000 residents. The same is true for towns and townships; of the 16,504 towns and townships, over 14,000 have fewer than 5,000 people. *See* 2002 Census of Governments, Vol. 1, No. 1, "Government Organization," U.S. Census Bureau, Tables 3 and 7, available at *http://www.census.gov/prod/2003pubs/gc021x1.pdf*.

exactly as much revenue as it expends, and expends just $7.59 per capita on judicial and legal expenses. *See* 2002 Census of Governments, Vol. 4, No. 4, "Government Finances," U.S. Census Bureau, Table 13, available at *http://www.census.gov/prod /2005pubs/gc024x4.pdf*. Requiring a municipality to expend more on legal costs to maintain revenue levels would result in less resources being allocated to other municipal services, such as education ($31.94 per capita for municipalities under 10,000) and fire and police protection (a combined $185.11 per capita for municipalities under 10,000). The net effect would be to employ counsel *ab initio* to keep vigilant for plans which contain impermissible provisions.

The ramifications of the Ninth Circuit's decision have the potential to affect adversely municipalities in two immediate outcome related ways. First, the *Espinosa* decision permits a debtor to treat nondischargeable debts in a way which does not permit the full recovery of an allowed claim, in a Chapter 13 plan. The practical effect of allowing "discharge-by-declaration" may result in a reduction of available municipal income.

Second, the *Espinosa* decision will require municipalities, in light of the potential loss of income, to devote substantial resources to reviewing Chapter 13 plans, and object to plans which will *de facto* contain provisions in conflict with the Code. This will require municipalities to participate in Chapter 13 proceedings to preserve the *status quo*

ante or run the risk that some or all of their otherwise nondischargeable taxes will be discharged.

Congress did not intend for tax obligations to be subordinate to the debtor's need for a fresh start. *Bruning v. United States*, 376 U.S. 358, 361 (1964) (stating the "congressional judgment that certain problems—e.g., those of financing government—override the value of giving the debtor a fresh start."). In the wake of the Ninth Circuit's decision, municipalities face a no win situation – either allocate scarce resources objecting to facially deficient Chapter 13 plans which treat nondischargeable claims as dischargeable, or risk the loss of valuable tax revenue. In either event, one effect of affirming *Espinosa* may be that municipalities may well cumulatively have less resources to address the needs of their citizens. A second effect may be that debtors' counsel will be duty-bound to seek the most aggressive claims treatment, regardless of Congressional mandates to the contrary, to try and "sneak one past" creditors relying on nondischarge Code provisions and on the Federal Rules of Bankruptcy Procedure (the "Rules") which may require an adversary proceeding.

SUMMARY OF THE ARGUMENT

In *Espinosa*, the Ninth Circuit allowed the debtor to discharge his student loan debts without initiating an adversary proceeding to determine affirmatively that his student loans were an undue hardship as required by 11 U.S.C. § 523(a)(8) and Fed. R. Bankr. P. 7001(6). Stated plainly, it would

appear that the Ninth Circuit rewarded a debtor who filed a plan in contravention of the express requirements of the Code and the Rules. This practice, now known as "discharge-by-declaration," affects all creditors possessing nondischargeable debts, including municipalities. *Espinosa* held that all creditors are bound by a confirmed Chapter 13 plan regardless of whether the requisite notice given to the adversely affected creditor complied with the Code or the Rules. The consequence of affirming the Ninth Circuit is therefore that creditors with presumptively nondischargeable debts, including municipal creditors with nondischargeable tax debts, must devote already scant resources to Bankruptcy proceedings, which on a case by case Chapter 13 recovery basis will not justify the allocation.

The Ninth Circuit rejected any alleged violations of due process on the grounds that the creditor received notice, even if that notice did not comply with the Rules. The Ninth Circuit speculated that because the bankruptcy creditor was a "sophisticated" business entity, the failure to object may well be a calculated strategy. *Espinosa*, 553 F.3d at 1205. Such seems a leap and the applicability of this dicta seems quite limited. This proposition surely does not analogously apply to small towns and unincorporated governmental units which may have limited resources to advocate effectively in Bankruptcy Courts.

IMLA, representing the interests of municipalities and their counsel, asks that this Court hold, in circumstances in which Congress recognizes

a debt is "presumptively nondischargeable" or simply "nondischargeable," that the debtor cannot proceed through "discharge-by-declaration." Instead, a debtor is required to commence an adversary proceeding as provided by Fed. R. Bankr. P. 7001(6). "You snooze, you lose" should not be the watch word of Chapter 13 practice. A better axiom might be that "everyone has to play by the same Rules."

ARGUMENT

The important purpose of bankruptcy is to provide debtors with a fresh start. *Grogan v. Garner*, 498 U.S. 279, 286 (1991). Thus, the finality of a discharge order is typically binding on creditors who did not object to the proposed plan. But Congress did not treat all debts equally. Congress has specifically made some debts nondischargeable in a Chapter 13 bankruptcy, such as student loans, civil judgments for malicious personal injury and certain municipal tax obligations. *See* 11 U.S.C. § 1328. Indeed, if certain tax debts are to be discharged at all, the debtor is required to take affirmative steps to obtain an order that the debt discharged. *See* Fed. R. Bankr. P. 7001(6). Yet the Ninth Circuit's approval of the passive "discharge-by-declaration" practice allows debtors to avoid otherwise presumptively nondischargeable obligations by willfully ignoring the Rules. This Court should not permit "discharge-by-declaration."

I. THE FAILURE TO REQUIRE AN ADVERSARY PROCEEDING VIOLATED THE BANKRUPTCY CODE AND RULES.

In the case presently before this Court, the debtor's plan proposed discharging a student loan without initiating an adversary proceeding to affirmatively establish "undue hardship." As the Courts of Appeal for the Second, Sixth and Tenth Circuits have held, such actions violate the Code and the Rules. *See Whelton v. Educ. Credit. Mgmt. Corp.*, 432 F.3d 150, 154 (2d Cir. 2005), *In re Ruehle*, 412 F.3d 679, 684 (6th Cir. 2005) and *Educ. Credit. Mgmt. Corp. v. Mersmann*, 505 F.3d 1033, 1049 (10th Cir. 2007). The Ninth Circuit's decision should accordingly be reversed, and the adherence to the Code and the Rules as countenanced by the other Courts of Appeals should be followed.

Section 1328 of the Code specifically precludes certain kinds of debt from being discharged in a Chapter 13 action, including student loan debt. "Unless the debtor *affirmatively* secures a hardship determination, the discharge order will not include a student loan debt." *Tennessee Student Assistance Corp. v. Hood*, 541 U.S. 440, 450 (2004) (emphasis added). To secure affirmatively a discharge, the debtor must initiate an adversary proceeding. *Id.* at 451-452. "[A] bankruptcy court lacks authority to confirm a plan provision that seeks to discharge a student loan debt without an adversary proceeding proving 'undue hardship." *Mersmann*, 505 F.3d at 1043. Moreover, a plan in contravention of the Code should not ostensibly be confirmed by the Court on

good faith grounds. 11 U.S.C. § 1325(a)(3) (A bankruptcy court may only confirm a plan if it "has been proposed in good faith and not by any means forbidden by law."). "[T]he inclusion of such a provision in a plan, where it has no legitimacy, constitutes practice by ambush, hardly consistent with the Bankruptcy Court's duty to serve equity." *Whelton*, 432 F.3d at 153 (internal quotation omitted) (holding that "declaration-by-discharge" is inconsistent with the Bankruptcy Code). Any contrary holding "enriches and emboldens those who take what is not theirs and legitimizes it with Court sanction. Those who push past the edge of propriety are rewarded." *Ruehle*, 412 F.3d at 684. Furthermore, upholding "discharge-by-declaration" creates an "ethical conundrum" for the honest practitioner, as debtor's counsel must decide "between (1) zealous advocacy on behalf of their clients and (2) the requirement that they only present good faith, non-frivolous issues." *Mersmann*, 505 F.3d at 1050.

II. THE FAILURE TO REQUIRE AN ADVERSARY PROCEEDING BEFORE DISCHARGING THE DEBT VIOLATED THE DUE PROCESS CLAUSE.

A. The Due Process Standard.

The due process clause requires "notice and opportunity for hearing appropriate to the nature of the case." *Mullane v. Cent. Hanover Bank & Trust Co.*, 339 U.S. 306, 313 (1950). Moreover, the due process clause requires that notice must be given as,

and to the extent, required by statute. *See City of New York v. New York, New Haven & Hartford R.R.*, 344 U.S. 293, 297 (1953) ("[C]reditors who have knowledge of a reorganization have a right to assume that the statutory 'reasonable notice' will be given them before their claims are forever barred."). "This right to be heard has little reality of worth unless one is informed that the matter is pending and can choose for himself whether to appear or default, acquiesce or consent." *Mullane*, 339 U.S. at 314. "[W]here the Bankruptcy Code and Bankruptcy Rules require a heightened degree of notice, due process entitles a party to receive such notice before an order binding the party will be afforded preclusive effect." *Ruehle*, 412 F.3d at 683, quoting *In re Hanson*, 397 F.3d, 482, 487 (7th Cir. 2005) quoting *Banks v. Sallie Mae Servicing Corp.*, 299 F.3d 296, 302 (4th Cir. 2002).

B. The Discharge Of The Student Loan Debt Without An Adversary Proceeding Violated Due Process.

Congress provided that student loans of the type at issue herein may not be discharged without an affirmative showing of undue hardship. *Hood*, 541 U.S. at 450. The Rules, drafted by the Judicial Conference and approved by the Supreme Court and Congress, prescribe the notice and procedure to be followed to initiate an adversary proceeding in order to discharge student loan debt. *See* Fed. R. Bankr. P. 7004. Here the debtor did not follow that procedure. Instead, the debtor circumvented the notice and adversary procedure and simply declared in his

Chapter 13 plan that a portion of the student loan debt would be discharged. The failure to provide notice as required by the Rules means that the resulting plan confirmation is not entitled to preclusive effect. *See Hanson*, 397 F.3d at 487.

C. The Ninth Circuit Stands Alone.

The Courts of Appeal for the Fourth,[5] Sixth[6] and Seventh[7] Circuits have held that the failure to commence an adversary proceeding to discharge a student loan and give notice as provided by the Rules denies the creditor due process and, therefore, the resulting judgment is not entitled to preclusive effect.[8] The Ninth Circuit stands alone in holding to the contrary.

D. The Factors Considered By The Ninth Circuit Do Not Obviate Congressionally Mandated Notice Provisions.

1. Finality Cannot Trump Due Process.

The Ninth Circuit began its analysis in *Espinosa* by citing to the right to modify a final order as delineated in Fed. R. Civ. P. 60(b)(4) and (6). However, the interests of finality "must yield where

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[5] *Banks*, 299 F.3d at 303.
[6] *Ruehle*, 412 F.3d at 684-685.
[7] *Hanson*, 397 F.3d at 487.
[8] Under the Local Bankruptcy Rules in many U.S. jurisdictions, creditors have until thirty days after the Section 341 Meeting to file an objection to confirmation of a Chapter 13 Plan. *See* Bankr. D. Mass. Local Rules, App. R. 13-8. On many occasions the deadline for filing a proof of claim will be after the confirmation order.

the failure to follow the Code and Rules goes to the heart of the creditor's notice of the bankruptcy plan itself." *In re Mersmann*, 503 F.3d at 1050 (student loan nondischargeable where debtor failed to seek discharge by commencement of an adversary proceeding). Although the finality of a confirmation order should be respected, it cannot trump due process concerns and countenance void orders. *Hanson*, 397 F.3d at 486 ("Although we recognize the strong policy favoring finality of confirmation orders, due process entitles creditors to the heightened notice provided for by the Bankruptcy Code and Rules, and the dictates of due process trump policy arguments about finality."). A debtor should not be able to claim a discharge for a debt through the artifice of including a debt in a Chapter 13 plan even though Congress has stated the debt is presumptively nondischargeable and must be contested only in an adversary proceeding.

2. The Misplaced Focus On The Minimum Requirements Of Due Process.

The *Espinosa* decision suggests, in essence, that the plan sufficiently noticed the creditor of the potential loss of an otherwise presumptively nondischargeable claim and that the inquiry ends there. However, the Ninth Circuit's focus on the minimal requirement of due process is misplaced.[9]

[9] The Ninth Circuit states "we find it both wrong and dangerous to hold that the standard for what amounts to constitutionally adequate notice can be changed by legislation." *Espinosa*, 553 F.3d at 1204. Clearly, Congress may not legislate notice that

Such a limited analysis is appropriate only where Congress has not specifically spoken on the issue of process. Here, Congress has provided more than the constitutional minimum and such additional process cannot be discarded. *Banks*, 299 F.3d at 303, n.4 ("where the Bankruptcy Court and Rules require a heightened degree of notice, due process entitles a party to receive such notice before an order binding the party will be afforded preclusive effect."). *See also City of New York*, 344 U.S. at 297 (1953) ("creditors who have knowledge of a reorganization have a right to assume that statutory 'reasonable notice' will be given them before their claims are forever barred").

3. The Relative "Sophistication" Of The Creditor Does Not Obviate Compliance With Congressionally Mandated Notice.

The Ninth Circuit's emphasis on the creditor's "sophistication" is misplaced. This Court has previously stated that "a party's ability to take steps to safeguard its interests does not relieve [the notifying party] of its constitutional obligation." *Mennonite Board of Missions v. Adams*, 462 U.S. 791, 799 (1983) (holding that due process required more than notice by publication "even though sophisticated creditors have means at their disposal to discover" that their rights had been implicated).

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falls below the constitutional minimum. However, where Congress legislates notice that exceeds the constitutional minimum, the failure to comply with such notice is a denial of due process. *City of New York*, 344 U.S. at 297.

The rationale of *Mennonite Board* has equal application here. Yet in stating that Espinosa's actions did not violate due process, the Ninth Circuit disregarded that maxim:

> We find it highly unlikely that a creditor ***whose business it is to administer student loans*** will be misled by the customary bankruptcy procedures or somehow be bamboozled into giving up its rights by crafty student debtors. If the creditor is notified and fails to object, ***it is doubtless the result of a careful calculation that this course is the one most likely to yield repayment*** of at least a portion of the debt.

Espinosa, 553 F.3d at 1205 (emphasis added). The business sophistication of the creditor should not have played a role in the Ninth Circuit's decision.

Further, the Ninth Circuit's interpretation of the creditor's silence as a calculated business decision is both misplaced and troublesome when applied in different contexts. The viability of the rationale behind ignoring the resources at the creditor's disposal is clearer when the creditor is not, as the Ninth Circuit stated, in the business of administering student loans. When the creditor is not a lender but rather a small town with fewer

resources, the limitations of a "sophistication" argument come to light.[10]

4. The Ninth Circuit's Suggestion That The Creditor Made A "Calculated" Choice Is Not Supported.

The Ninth Circuit suggests several reasons why a creditor would not object to a Chapter 13 that would have the effect of discharging an otherwise nondischargeable student loan. However, the Ninth Circuit fails to address other obvious reasons that a creditor may not object to a Chapter 13 plan. Most notably, a creditor may acquiesce to a Chapter 13 plan based on the statutory requirement that student loans may not be discharged absent an affirmative showing of undue hardship and the provisions of the Rules that such showing be made in an adversary proceeding. Indeed, the official website of the U.S. Courts states that government funded or guaranteed educational loans not fully paid under a Chapter 13 plan are not discharged. *See* U.S. Court Website, Public Information Series, "Bankruptcy Basics: Chapter 13" (April 2006), *http://www.uscourts.gov/bankruptcycourts/bankruptcybasics/chapter13.html.* Silence is thus not always the result of a calculated decision.

[10] For example, Fed. R. Civ. P. 4(j)(2) requires service on a municipality be made only on its chief executive officer or as otherwise provided by state law and is made applicable to bankruptcy proceedings by Fed. R. Bankr. P. 7004(a)(1).

CONCLUSION

The requirement of an affirmative showing of undue hardship in an adversary proceeding serves to protect the integrity of the student loan program. The procedural safeguards adopted by Congress cannot and should not be overridden. For the foregoing reasons, the judgment of the Court of Appeal should be reversed and the case remanded with instructions to affirm the judgment of the district court.

Respectfully submitted,

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