

**Discharge by Declaration:  
So What's Wrong with That?**

**Rebecca B. Connelly  
Standing Chapter 13 Trustee  
Western District of Virginia  
Roanoke, Virginia**

## 21st Annual Winter Leadership Conference

### I. Introduction.

This paper examines the potential traps for debtors who try to obtain a discharge of an otherwise non-dischargeable consumer debt by simply declaring it to be discharged upon completion of a chapter 13 plan. The paper addresses bankruptcy laws and bankruptcy court jurisdiction over these issues.

### II. The Issue.

Can a debtor obtain a discharge of an otherwise non-dischargeable consumer debt by simply “declaring” it to be discharged upon completion of his chapter 13 plan? No; but what if the debtor tries anyway and the creditor fails to object? Maybe; the final answer should come from the United States Supreme Court when it decides *United Student Aid Funds v. Espinosa*<sup>1</sup> later this term.

In *Espinosa*, the debtor filed chapter 13 and included in his plan a provision declaring his student loan debt (United Student Aid Funds) to be discharged upon completion of the plan. He did not institute an adversary proceeding, and the bankruptcy court made no findings of undue hardship. Mr. Espinosa included in his plan the following language: “Any amounts or claims for student loans unpaid by the Plan shall be discharged,” and in a separate paragraph: “Objections, by any creditor, must be filed seven (7) days prior to the hearing on Confirmation of Plan along with a copy to the Trustee and Debtor’s counsel.” The holder of the student loan debt received the plan and did not file an objection to it. The bankruptcy court confirmed the plan. Mr. Espinosa completed his plan and the court granted him a discharge pursuant to the plan.<sup>2</sup>

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<sup>1</sup> United States Supreme Court Case No. 08-1134.

<sup>2</sup> The facts reveal that the discharge order entered in the case excepted the student loan from discharge. The bankruptcy court later concluded that the inclusion of the exception language was a clerical error because it was the clear intent of the bankruptcy court, as reflected in the plan approved by the court, to discharge all student loan related obligations at plan completion.

Several years later, United Student Aid Funds began collection action to collect the unpaid student loan indebtedness.<sup>3</sup> The debtor moved to reopen the bankruptcy case and sought damages against United Funds for violations of the discharge injunction of section 524. United Funds responded by seeking relief from the confirmation order under Rule 60(b) on the ground that the confirmation order was void for lack of due process and for procedural error. Ultimately the case ended up at the Ninth Circuit Court of Appeals. The Ninth Circuit rejected the arguments of United Funds, and in a harshly worded opinion, found that United Funds was not denied due process, notwithstanding the failure of service in accordance with Rule 7004, as it had actual notice of the plan and the deadline for objecting to it, and was more than competent to read and understand its contents. The Ninth Circuit concluded that the confirmation order was not void, and further that the discharge injunction should be enforced. United Funds appealed, and the United States Supreme Court granted certiorari.

The question for the Supreme Court, and for debtors facing similar issues, turns on matters of bankruptcy court jurisdiction as well as bankruptcy law. Specifically, can a bankruptcy court's order have preclusive effect even if it was not supported by bankruptcy law (or as it is sometimes said, can the order have preclusive effect if the order itself is "illegal")? Does the bankruptcy court's jurisdiction as a non-Article III court have any bearing on the answer? What *is* proper notice to a party affected by a Bankruptcy Court order? Taking these questions somewhat out of order, I will address bankruptcy law regarding discharge by declaration in chapter 13, the bankruptcy court's jurisdiction to enter orders binding on parties, and the extent of process necessary to achieve such.

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<sup>3</sup> United Funds filed a proof of claim representing amounts greater than set forth in the plan as the "total amount to be paid" to it. United Funds was paid by the trustee the amounts set forth in the plan, but not the total amount set forth in the proof of claim.

## 21st Annual Winter Leadership Conference

### A. The Law Regarding Discharge of Debts in Chapter 13 and Why a Chapter 13 debtor Cannot Obtain a Discharge by Declaration.

#### 1. Student Loan debts

Student loans are not dischargeable in chapter 7 or chapter 13, except upon a finding of undue hardship. This statement is supported by a statutory scheme that is consistent and clear. Bankruptcy Code section 523(a)(8) excepts from discharge a student loan unless it “would impose an undue hardship on the debtor and the debtor’s dependents.”<sup>4</sup> Sections 727 and 1328 exclude from discharge debts that “are provided for in section 523,”<sup>5</sup> or “of the kind specified in . . . paragraph . . . (8) of section 523(a).”<sup>6</sup> To date, no court has found ambiguity or inconsistency to support a statutory basis for discharging a student loan in bankruptcy absent finding undue hardship. As the United States Supreme Court acknowledged in *Tennessee Student Assistance Corp. v. Hood*,<sup>7</sup> “section 523(a)(8) is ‘self-executing,’ . . . . Unless the debtor affirmatively secures a hardship determination, the discharge order will not include a student loan debt.”<sup>8</sup>

Given that the student loan debt is not discharged, some debtors have tried to creatively deal with the obligation by providing for the claim in a chapter 13 plan in a manner that will result in a discharge of the indebtedness at the conclusion of the plan. They do so by: 1) paying the indebtedness in full under the plan plus post petition interest,<sup>9</sup> or 2) paying the principal and pre-petition interest in full and “declaring” the post-petition interest to be discharged, or 3) establishing a claim under the plan to be paid in full by the trustee without interest and “declaring” that any amounts other than the amounts set forth under the plan shall be discharged

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<sup>4</sup> 11 U.S.C. § 523 (a)(8); Student Loan Default Prevention Initiative Act of 1990, Pub.L. 101-508 §§ 3001, 3007 (1990).

<sup>5</sup> 11 U.S.C. § 727(b).

<sup>6</sup> 11 U.S.C. § 1328(a)(2).

<sup>7</sup> 541 U.S. 440, 450 (2004)(internal citations excluded).

<sup>8</sup> *Id.*

<sup>9</sup> 11 U.S.C. § 1322 (a)(10) . This method may have an adverse impact on other unsecured creditors and therefore may be opposed by the chapter 13 trustee or other unsecured creditors. *Groves v. LaBarge (In re Groves)*, 39 B.R. 212 (8<sup>th</sup> Cir. 1994); *McCullough v. Brown*, 162 B.R. 506 (N.D. Ill. 1993); *In re Kolbe*, 199 B.R. 567 (Bankr. D. Md. 1996).

at the conclusion of the plan. Under any of these methods, the debtor has provided for the debt, thereby meeting the first threshold test for discharge of indebtedness in chapter 13.<sup>10</sup> The first option simply concedes the non-dischargeability and attempts to pay the debt through conduit payments even at the risk of a discriminating against other creditors. It is the last two options that creatively discharge the indebtedness and elicit controversy.

If the debtor provides that post-petition interest charged on a non-dischargeable debt will be discharged without payment, and without a showing of undue hardship, the debtor has proposed treatment under his plan contrary to section 523(a)(8). This means, therefore, that the plan does not comply “with the other applicable provisions of this title,”<sup>11</sup> assuming compliance with section 523 is an “other applicable provision” contemplated by section 1325(a). On the other hand, if the debtor proposes that all plan disbursements shall be applied to principal and pre-petition interest only and not to post-petition interest, likewise is impermissible under the Code. The Fourth Circuit considered such plan treatment in *In re Kielisch*,<sup>12</sup> and even though the plan did not attempt to directly discharge post-petition interest, found that it had the effect of prohibiting the student loan holder from charging interest on its non-dischargeable debt, something contrary to section 523(a)(8).<sup>13</sup> Finally, providing for a particular amount to be paid, notwithstanding a proof of claim, and providing that *any* amounts over the proposed amount to be paid shall be discharged upon plan completion is again contrary to the Code. In this method,

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<sup>10</sup> 11 U.S.C. § 1328(a) (the court shall grant the debtor a discharge of all debts provided for by the plan . . .); *see Internal Revenue Service v Hairopolos*, 118 F.3d 1240 (IRS claim not provided for under plan and accordingly not discharged); *compare with In re Leber*, 134 B.R. 911 (Bankr. N.D. Ill. 1991) and *In re Vlavianos*, 71 B.R. 789 (simple provision in plan referencing that section 507 claims will be paid in full sufficient to provide for IRS debt and allow it to be discharged without payment when no proof of claim timely filed).

<sup>11</sup> 11 U.S.C. § 1325(a)(1).

<sup>12</sup> 258 F.3d 315 (4<sup>th</sup> Cir. 2001).

<sup>13</sup> *Id.* at 324 (“the debtors position would, in essence, permit them partially to discharge the interest on their non-dischargeable student loan debts without a showing of undue hardship, as required by section 523(a)(8) . . . allowing the debtors to accomplish indirectly what they could not accomplish directly under the plain language of section 523(a)(8) . . .”).

## 21st Annual Winter Leadership Conference

the debtor is “disallowing” a claim without implementing the process specified by section 502 and Rule 3007.<sup>14</sup> Yet, notwithstanding contravention of Bankruptcy Code provisions, all of these methods are used by debtors routinely in order to deal with the burden of excessive student loan debt and to obtain an effective fresh start.

### 2. The plan and the confirmation order.

Bankruptcy court orders confirming a chapter 13 plan are final orders. The order binds the parties to it even if not provided for under the plan, and even if the party did not accept the plan.<sup>15</sup> In chapter 13, plan confirmation does not require affirmative acceptances from creditors; rather silence or lack of objection can be deemed acceptance and can permit confirmation of a plan and bind the creditor to its terms.

A debtor therefore can provide for a debt and, absent objection, obtain confirmation that will then bind a creditor or other party to the plan treatment. Thus, the debtor could propose treatment, contrary to the Bankruptcy Code or other controlling law, and simply hope he is lucky enough that the affected creditor or party will not file a timely objection to confirmation. In this manner, he achieves through plan confirmation what he may not have been able to otherwise, or at least not without additional costs. What’s wrong with that?

### 3. The order is void “ab initio.”

We know from the Ninth Circuit, as from nearly all of the other Circuits, that the order confirming the debtor’s plan is *res judicata* as to all issues that may have been raised prior to confirmation.<sup>16</sup> Yet, we also know that if the order is “illegal” it does not have *res judicata*

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<sup>14</sup> See *In re Bateman*, 331 F.3d 821, 832 (11<sup>th</sup> Cir. 2003)(plan does not control the amount of a creditor’s claim; a proof of claim pursuant to section 502 controls the amount of a creditor’s claim)(emphasis added); see also *Keilisch, infra*, at 323, admonishing courts not to treat a “claim” as the equivalent of a “debt.”

<sup>15</sup> 11 U.S.C. § 1327.

<sup>16</sup> *In re Pardee*, 193 F.3d 1083 (9<sup>th</sup> Cir. 1999); *In re Harvey*, 213 F.3d 318 (7<sup>th</sup> Cir. 2000); *In re Linkous*, 990 F.2d 160 (4<sup>th</sup> Cir. 1993).

effect;<sup>17</sup> the binding effect of the plan confirmation order that otherwise would establish a new “contract” between the debtor and his creditors is deemed null or “void ab initio.”<sup>18</sup> This means of course that it can’t be enforced, even by the discharge injunction. So, when is a confirmation order illegal? Just because a confirmation order contains provisions contrary to law, it is not *per se* illegal.<sup>19</sup> But what if the order contained provisions contrary to law *and* was obtained without notice to apprise the affected parties of its impact on their rights? Maybe. The analysis seems to turn on just what is sufficient notice to apprise a party of the impact of the order on its rights.

The Ninth Circuit told us in *Espinosa* that notice is adequate as long as it is “reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objection.”<sup>20</sup> The Ninth Circuit explained more specifically,

[i]f a party is adequately notified of a pending lawsuit, it is deemed to know the consequences of responding or failing to respond, even if gaining actual knowledge requires inquiry into court files, hiring a lawyer or conducting legal research. Indeed, it would be virtually impossible to operate a legal system if due process required more than that.<sup>21</sup>

The Ninth Circuit, however, did not address the fact that Mr. Espinosa’s plan language regarding the discharge of the student loan without a finding of undue hardship was an inappropriate plan provision (not permitted as a plan provision under section 1322), and *did* combine with it a lawsuit (the action to determine the student loan as an undue hardship), yet the creditor was not

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<sup>17</sup> *In re Ruehle*, 412 F.3d 679 (6<sup>th</sup> Cir. 2005); *In re Whelton*, 432 F.3d 150 (2<sup>nd</sup> Cir. 2005); *In re Hanson*, 379 F.3d 482 (7<sup>th</sup> Cir. 2005); *In re Banks*, 299 F.3d 296 (4<sup>th</sup> Cir. 2002).

<sup>18</sup> This Latin legal term literally translated means “a contract null from the beginning if it seriously offends law or public policy, in contrast to one that is merely ‘voidable.’” *See* Black’s Law Dictionary. It is because the order confirming the debtor’s “contract” (plan) has been declared “null from the beginning” or void, that appellate courts have been willing to excuse creditors for violating the bankruptcy court discharge injunction, and invoke Rule 60(b)(4) or (b)(6) to grant relief from the discharge order (and confirmation order). *See also* Fed R. Bankr. P. 9024.

<sup>19</sup> *Bateman*, 331 F.3d at 825 (11<sup>th</sup> Cir. 2003).

<sup>20</sup> *Espinosa*, 553 F.3d at 1202.

<sup>21</sup> *Id.*, at 1203.

## 21st Annual Winter Leadership Conference

advised of the pendency of *this* action (the undue hardship complaint). If the plan provided terms consistent with section 1322 and had been noticed to creditors pursuant to Rule 2002, the creditor, with actual notice of that plan, could hardly argue with a straight fact that it was denied due process. It is the fact that the plan deviated from what a plan can do, without any greater notice than required for plan confirmation, that the *res judicata* status and binding effect of the order becomes less certain. It is true that a confirmation order is binding even if the bankruptcy court made an error regarding the *confirmation* findings; although it is not clear whether the order is binding when the bankruptcy court's confirmation order approved something other than *plan confirmation* absent notice that the plan combined with it other actions (motions or contested matters). As the Second Circuit put it in *Whelton*, *res judicata* can only be invoked where . . . the claims involved were or could have been raised in the previous action. . . .<sup>22</sup> The Fourth Circuit was more direct in *Cen-Pen v. Hanson*,<sup>23</sup>

“Because confirmation of a [c]hapter 13 plan is *res judicata* only as to issues that can be raised in the less formal procedure for contested matters . . . confirmation generally cannot have preclusive effect as to [matters] which must be resolved in an adversary proceeding. In other words, ‘if an issue must be raised through an adversary proceeding it is not part of the confirmation process and, unless it is actually litigated, confirmation will not have a preclusive effect . . .’<sup>24</sup>

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<sup>22</sup> *Whelton*, 432 F.3d 150, 155 (2<sup>nd</sup> Cir. 2005).

<sup>23</sup> 58 F3d 89, 93 (4<sup>th</sup> Cir. 1995).

<sup>24</sup> *Id.* citing *In re Beard*, 112 B.R. 951 at 956.

Once Mr. Espinosa’s plan deviated from section 1322 and inserted something that would otherwise have required proceeding under Rule 7001 (as an adversary proceeding) or Rule 9014 (a contested matter or contested motion), why is it that only notice under Rule 2002 is sufficient to adequately apprise the creditor of the impact on its rights? Didn’t the order confirming Mr. Espinosa’s plan affect United Funds’ right to its “day in court” to be heard over whether its debt imposed an undue hardship on the debtor?

In order to answer what level of notice is appropriate to bind the parties to the confirmation order, don’t we first have to determine what rights are affected by the plan and the confirmation process? If the holder of the student loan debt has a right to his “day in court” to be heard on whether a student loan imposes an undue hardship, this isn’t that the right that has been affected by the plan confirmation process? If the confirmation order and the discharge order have the effect of finding the student loan is an undue hardship and is accordingly discharged, then why is the creditor entitled to less service than he would if the undue hardship ruling had been sought under any other process? Isn’t it *service* that matters not necessarily *notice* of the plan?

**B. Bankruptcy Court Jurisdiction.**

Bankruptcy Courts have concurrent jurisdiction with the district courts over bankruptcy matters; these matters have been referred to the bankruptcy judges through the standing reference.<sup>25</sup> This means, of course, that a party could seek to withdraw the reference regarding a proceeding or matter within a bankruptcy case. The district court certainly will not grant a withdrawal of the reference if the matter pertains to a core bankruptcy proceeding and no

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<sup>25</sup> Under Title 28, the district court has original and exclusive jurisdiction of all cases under Title 11, and original but not exclusive jurisdiction of all civil proceedings arising under Title 11 or arising in or related to cases under Title 11. 28 U.S.C. § 1334. The district courts refer all bankruptcy cases and proceedings arising in or related to these cases to the bankruptcy courts, yet parties have an option to request withdrawal of the reference if a proceeding involves consideration of bankruptcy law, and other federal laws or matters affecting interstate commerce. 28 U.S.C. § 157.

## 21st Annual Winter Leadership Conference

additional matters involving non-bankruptcy law. But what if the proceeding involves a matter over which a party believes he has the right to be heard by an Article III judge? The United States Supreme Court in *Granfinanciera v. Nordberg*,<sup>26</sup> considered a bankruptcy court's jurisdiction over core bankruptcy proceedings that are contested matters at common law. *Granfinanciera* was defendant in a core proceeding to recover a fraudulent conveyance by a bankruptcy trustee, and it wanted to be heard in the district court (it wanted a jury trial). It was the right to this option that was hindered by the bankruptcy court's process and resulted in the United States Supreme Court's reversal.

Generally the matters specified in Rule 7001 as "adversary proceedings" are matters involving core bankruptcy matters, yet the determination of these proceedings may require considerations of non-bankruptcy law or matters. The bankruptcy judge has jurisdiction to hear and issue a final ruling, but the non-debtor party may nonetheless seek (at least has the right to ask) to have the matter heard by the district court instead of the bankruptcy court. Query whether our reaction to the outcome in *Espinosa* would be different if the debt that the debtor declared to be discharged under his plan was not a student loan but rather a debt for damages arising out of a suit for wrongful death or a personal injury as a result of willful and malicious conduct.<sup>27</sup>

If the matter is identified as an adversary proceeding in Rule 7001, it must be *served* in accordance with Rule 7004. Likewise, even if not an adversary proceeding, if the matter is deemed a contested matter, it too must be served pursuant to Rule 7004.<sup>28</sup> Once served, if the

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<sup>26</sup> 492 U.S. 33 (1989).

<sup>27</sup> The Bankruptcy Code excludes from chapter 13 discharge debts for "damages awarded in a civil action against the debtor as a result of willful or malicious injury by the debtor that caused personal injury to an individual or the death of an individual." 11 U.S.C. § 1328(a)(4). If the claim had not been reduced to judgment, the matter may have to heard at the district court. 28 U.S.C. § 157(b)(5)(wrongful death claims and personal injury claims may need to be tried in the district court and not the bankruptcy court).

<sup>28</sup> Fed. R. Bankr. P. 9014.

respondent or defendant does not wish to be heard in bankruptcy court, he must file the appropriate request to withdraw the reference; otherwise he consents to the jurisdiction of the bankruptcy court. Once served, his failure to answer allows the movant or plaintiff the opportunity to seek a default judgment. It's rare if not unheard of for a district court to enter a default order unless or until the plaintiff had proven service. Maybe we shouldn't be surprised therefore when an appellate court questions the effect of orders entered by default in a bankruptcy context when service does not comport with Rule 4 of the Federal Rules of Civil Procedure.

**C. The Good News.**

So what can a debtor do? First, the debtor should be confident that as long as the plan provides for terms permissible under section 1322, once that plan is confirmed, it is binding and any issues of its confirmation cannot be raised again. If the debtor is proposing under his plan, terms or treatment to a creditor beyond what section 1322 contemplates or specifically authorizes, the debtor should consider if additional notice should be made, with clear and unambiguous language, and, more importantly, whether the plan should be served as a contested matter. Perhaps had Mr. Espinosa served his plan upon the agent authorized to receive service for the student loan holder, he would have a stronger argument before the Supreme Court.

**III. Conclusion**

Discharge by declaration is a creative, yet risky tool. Debtors have employed it to discharge student loan debts. Some courts have found the confirmation order approving such discharge to be void simply because the debtor seeking this discharge did not follow Rule 7001 and initiate an adversary proceeding and serve the summons upon the respondent. Other courts have found that such confirmation order not have a binding *res judicata* effect because the

## 21st Annual Winter Leadership Conference

creditor was deprived due process by the failure of the debtor serve the creditor with a summons that provided specific notice of the proceeding to declare the debt an undue hardship. This paper concludes that the failure of service is a defect sufficient to sever the otherwise binding effect of the confirmation order. Therefore, “discharge by declaration” doesn’t work.