#2943

United States Bankruptcy Court

EASTERN DISTRICT OF CALIFORNIA
8308 U.S. COURTHOUSE
650 CAPITOL MALL
SACRAMENTO, CALIFORNIA 95814

97-BK-C

CHRISTOPHER M. KLEIN
JUDGE

916-498-5543

May 13, 1997

Mr. Peter McCabe, Secretary
Committee on Rules of Practice and Procedure
Judicial Conference of the United States
Washington, DC 20544

Re: Proposed Amendment to Federal Rule of Bankruptcy Procedure 9027

Dear Mr. McCabe:

The remand procedure governed by Federal Rule of Bankruptcy Procedure 9027(d) provides no mechanism for transmitting an order of remand to the court whence the claim or cause of action was removed.

In contrast, the basic federal remand statute provides such instructions in the last two sentences of 28 U.S.C. § 1447(c):

> A certified copy of the order of remand shall be mailed by the clerk to the clerk of the State court. The State court may thereupon proceed with such case.

While one might argue that this portion of § 1447(c) applies to bankruptcy remands under the "comfortable coexistence" principle of *Things Remembered, Inc. v. Petrarca*, 116 S.Ct. 494 (1995), such that the clerk of the bankruptcy court is already under a statutory duty to do the same thing the district court clerk would do in a remand by the district court, the applicability of § 1447(c) in that context is not free from doubt.

The fit between § 1447(c) and Rule 9027(d) is imperfect, at best, and does not plainly instruct bankruptcy clerks what to do and, more important, does not give nonbankruptcy courts unambiguous authority to proceed.

Section 1447(c) does not accommodate the fact that the bankruptcy court's order of remand is not final until either the time to appeal to the district court (or bankruptcy appellate panel) has expired or the appellate court has affirmed. Rather, § 1447(c) is drafted in the context of orders of remand issued by

district courts that are, per § 1447(d), not ordinarily subject to review by a court of appeals.[1]

Nor does § 1447(c), which refers only to remands to "State courts", accommodate the fact that § 1452(a) removals can be made from other federal courts, with concomitant remand to such other federal court.

The gap became apparent as I wrote my recent decision in *Billington v. Winograde (In re Hotel Mt. Lassen, Inc.)*, ___ B.R. ___ (Bankr. E.D. Cal. 1997). My solution in that case was to include the following language in the order of remand:

> The Clerk of the court shall, upon the expiration of the time in which a notice of appeal may be filed, mail a certified copy of this order of remand to the Clerk of the Lassen County Municipal Court. The State court may thereupon proceed with the remanded civil actions.

See Billington v. Winograde, slip op. at 17, n.11.

The critical concept is that the nonbankruptcy court and the parties to the remanded claim or cause of action need a bright-line authorization to resume proceedings.

There is a settled procedure for implementing remands that State courts understand well. They are accustomed to receiving certified copies of orders of remand from district courts pursuant to § 1447(c) and have the comfort of a ready

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[1]This aspect of the gap did not exist before the enactment of § 309(c) of the Judicial Improvements Act of 1990, which amended 28 U.S.C. § 1452(b) to permit an appeal under 28 U.S.C. § 158 from a bankruptcy court's order determining a motion to remand. That amendment prompted the 1991 amendment to Rule 9027 that made the motion to remand a contested matter instead of a matter that required a report and recommendation to the district court. *See* Advisory Committee Note to 1991 Amendment to Rule 9027. Under that former regime, the order of remand was an order of the district court that the district court clerk presumably treated like any other order of remand. *See Chambers v. Marathon Home Loans (In re Marathon Home Loans)*, 96 B.R. 296, 297 (E.D. Cal. 1989) (adopting report and recommendation).

reference to that statute to assure themselves that they have authority to proceed. The absence of a parallel procedure for bankruptcy remands invites confusion.

Accordingly, it is suggested that Federal Rule of Bankruptcy Procedure 9027(d) be revised to specify when the parties may resume proceedings in the nonbankruptcy court from which the claim or cause of action was removed.

Two alternatives suggest themselves. The first tracks the syntax and structure of the rest of Rule 9027. The second borrows operative language of § 1447(c) that is well-known to State courts but which suffers from the criticism that it contains an administrative instruction to the clerk that is not appropriate for rules of procedure.

Alternative eliminating administrative instruction to clerk:

> (d) Remand. A motion for remand of the removed claim or cause of action shall be governed by Rule 9014 and served on the parties to the removed claim or cause of action. Upon receipt by the clerk of the court from which the claim or cause of action was removed of a certified copy of the order of remand, the parties may proceed in that court except to the extent that the bankruptcy court has ordered otherwise.
>
> *Comment*: This alternative utilizes the same syntax that appears in Rule 9027(c). The "except clause" is designed to accommodate the possibility that it may be desirable to specify some limitations on what may occur in or in consequence of the nonbankruptcy litigation, as often occurs in situations in which litigation is permitted to proceed against the debtor in a nonbankruptcy court on the condition that there be no effort to collect any judgment as a personal liability of the debtor.

Alternative modeled on § 1447(c):

> (d) Remand. A motion for remand of the removed claim or cause of action shall be governed by Rule 9014 and served on the parties to the removed claim or cause of action. A certified copy of the order of remand shall be mailed by the clerk, following the expiration of the time in which a notice of appeal may be filed for review under 28 U.S.C. § 158 or, if appealed, the expiration of a stay pending appeal, to the clerk of the court from which the claim or cause of action was removed. That court may thereupon proceed with such case.
>
> *Comment*: This alternative has the advantage of tracking well-known language in § 1447(c) and the disadvantage of containing an administrative instruction to the clerk of the bankruptcy court. One might, however, construe the apparent administrative instruction of a rule of procedure that establishes when the litigation may resume in the nonbankruptcy court.

In short, litigants and nonbankruptcy courts need objective, unambiguous criteria for knowing when they can resume proceedings in the original forum following a remand. Rule 9027 is the logical vehicle for such criteria.

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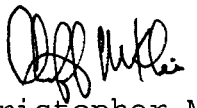
A more general review of Rule 9027 may also be warranted in light of various other issues that have arisen since the rule was last amended in 1991.

For example, Rule 9027(a) does not appear to prescribe a time for removing a civil action that is filed and served after a bankruptcy case is closed (and, hence, not "pending") and before it is reopened for the purposes of enabling litigation regarding the applicability of the discharge. Cf., Lauren A. Helbling & Christopher M. Klein, The Emerging Harmless Innocent Omission Defense to Nondischargeability Under Bankruptcy Code § 523(a)(3)(A): Making Sense of the Confusion Over Reopening

Cases and Amending Schedules to Add Omitted Debts, 69 American Bankr. L.J. 33, 59-63 (1995).

Very truly yours,



Christopher M. Klein

The American BANKRUPTCY LAW JOURNAL

A Quarterly Journal of the National Conference of Bankruptcy Judges

ARTICLE

VOLUME 69 WINTER/DEDICATION, 1995

The Emerging Harmless Innocent Omission Defense To Nondischargeability Under Bankruptcy Code § 523(a)(3)(A): Making Sense Of The Confusion Over Reopening Cases And Amending Schedules To Add Omitted Debts

by

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and
*The Honorable Christopher M. Klein***

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I. INTRODUCTION

The problem of how to apply the bankruptcy discharge to an omitted debt has led debtors to file motions to reopen bankruptcy cases for the purpose of adding debts to schedules on the assumption that the added debts would thereupon be discharged. When presented with motions to reopen, many courts have assumed that the debtor's inadvertence in omitting the debt is relevant to the question of whether the case should be reopened. Debtors and courts, however, have been laboring under false assumptions. A recent line of decisions, explicating what may be called the "ineffectual amendment to schedules approach," has demonstrated that amending schedules is irrelevant to whether the debt is discharged and that inadvertence is a red herring.

The realization that amending schedules has no impact on the discharge of the omitted debt has created a conceptual void that leaves the bench and bar unclear about how to proceed when a debt has been omitted and whether innocent omissions are relevant for other purposes. There is a missing link in existing analysis.

docket. It is appropriate to expect that the debtor would have the burden of proof as to each of these elements in the fashion of the typical affirmative defense.

In contrast, the case for the *nunc pro tunc* amendment has less support. First, Congress has provided § 523(a)(3)(A) as a specific vehicle to determine the parties' rights with respect to omitted debts. Second, the *nunc pro tunc* amendment clashes with the reasoning of *Anderson-Mendiola* and invites divergent jurisprudence separated only by the happenstance of whether a bar date for filing claims was fixed. Third, it is a fiction that, although essential to the court of appeals that decided *Robinson* in the face of, if not in outright defiance of, otherwise controlling Supreme Court precedent, became unnecessary when Congress overruled *Birkett*. Finally, the fiction does violence to the statutory structure of a discharge that is good against the world and not merely against those creditors that were actually listed on the schedules.

It is far preferable to confront the harmless innocent omission head-on in the form of an affirmative defense in a declaratory judgment action than to send the parties on a circuitous journey to an artificial and confusing end.

VII. REOPENING REVISITED

Having in mind the preceding discussion, what should the parties and the court do when an omitted debt comes to light and becomes a problem? The alternatives will be described, in turn, from the perspectives of debtor, creditor, and court.

A. Debtor's Alternatives

The debtor has several choices depending upon the nature of the situation. None of the first three alternatives require that the bankruptcy case be reopened.

First, the debtor may elect to do nothing and rely on the likelihood that the creditor will agree that the debt has been discharged and that litigation would be futile. This choice has its greatest practical appeal when the facts are clear, such as in the case of the otherwise dischargeable debt in a no-asset, no-bar-date case. This "do nothing" strategy is also available when the creditor brings an action on the omitted debt in a nonbankruptcy court. The discharge "voids any judgment *at any time obtained*," to the extent it determines the personal liability of the debtor with respect to a discharged debt "whether or not discharge of such debt is waived."[131] Thus, the debtor can choose to do nothing and see what happens in the post-bankruptcy action in confidence that a collateral attack will still be available and that no waiver of discharge can be implied.

Second, in response to a creditor's action on the omitted debt, the debtor could choose to interpose the affirmative defense of discharge in bankruptcy. As a practical matter, it is the equivalent of a counterclaim for a declaratory judgment that the debt

[131] Section 524(a)(1) provides that a discharge "voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged . . . whether or not discharge of such debt is waived." 11 U.S.C. § 524(a)(1) (1994).

has been discharged because the issues of law are the same. State courts are competent to entertain such a defense or counterclaim and would be applying the same law as the bankruptcy court.

Third, the debtor could file a declaratory judgment action in state court seeking a determination under § 523(a)(3)(A) that the debt has been discharged. State courts have concurrent jurisdiction over such an action,[132] which may be brought "at any time."[133]

If the debtor regards the bankruptcy court as a friendlier forum and is able to persuade the court to reopen the bankruptcy case, the debtor has two basic alternatives. The debtor could file a declaratory judgment action under § 523(a)(3)(A) seeking a determination that the debt has been discharged. This is the primary avenue for relief and could be utilized to make a collateral attack on a nonbankruptcy court's judgment as void pursuant to § 524(a)(1). Moreover, once the case is reopened, the debtor could remove any nonbankruptcy action to the bankruptcy court pursuant to § 1452 of the Judicial Code.

Alternatively, if the omitted debt has unambiguously been discharged, the debtor could attempt to initiate contempt proceedings. One should, however, be cautious and be prepared to demonstrate that a declaratory judgment action is not an appropriate solution. Courts may be reluctant to turn the "legal thumbscrew" of contempt at the request of a debtor who created the problem in the first instance by omitting the debt.

B. Creditor's Alternatives

The creditor's choices parallel the debtor's with the exception that a creditor makes a significant mistake by ignoring the bankruptcy discharge issue and leaving it to the debtor to raise the matter.

The first thing a creditor should do upon learning of a closed bankruptcy case is to inquire into the procedural history of the case. If it was a no-asset, no-bar-date case and if the omitted debt would have been otherwise dischargeable, it should be apparent that collection efforts against the debtor will be futile and contrary to the discharge injunction. If it is not clear that the omitted debt was discharged, the creditor can pursue its rights under nonbankruptcy law.

In any action on the debt in a nonbankruptcy forum, it is logical to expect the debtor to assert a defense of discharge in bankruptcy, to request a declaratory judgment under § 523(a)(3)(A), to attempt to move the dispute into the bankruptcy court, or seek to prosecute a contempt proceeding. But if the debtor does not take such steps, the creditor cannot breathe easy. The debtor's silence can be a trap.

It is not prudent for a creditor to ignore a suggestion that the debt was discharged in bankruptcy. One who succumbs to the temptation to leave it to the debtor to raise discharge in bankruptcy defensively ignores the provisions in § 524(a)(1) that, first,

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[132] 28 U.S.C. § 1334(b) (1994); *see supra* note 48.

[133] Fed. R. Bankr. P. 4007(b); *see supra* note 46.

void a judgment "at any time obtained" and that, second, outlaw waivers, including implied waivers, of discharge. Since there cannot be an implied waiver, a judgment on a discharged debt is subject to collateral attack at any time and could leave the creditor in the unhappy position of having thrown good money after bad.

The better strategy for the creditor who perceives a potential issue regarding discharge is to confront it head-on and obtain a determination that is *res judicata* on the question. If the debtor does not raise the matter by way of formal defense or declaratory judgment action, then the creditor should. This can be accomplished by adding a § 523(a)(3) count to a state court action on the debt[134] or, even, by having the case reopened and bringing a declaratory judgment action in bankruptcy court.[135]

The creditor should recognize that a debtor's motion to reopen the bankruptcy case is fundamentally a procedural matter that involves a choice of forum and that any amendment to the bankruptcy schedules will be irrelevant to the question whether the debt is actually discharged. The creditor who prefers to stay out of the bankruptcy forum should attempt to persuade the bankruptcy court either to abstain in favor of state court, or, if applicable, to remand a removed action to state court, as permitted by §§ 1334(c)(1) and 1452(b) of the Judicial Code.[136]

If the debtor tries to move the dispute over an omitted debt into the bankruptcy forum, the creditor can argue that there are two related disputes—the substantive action under state law and the discharge question—that are better resolved in a single forum. The creditor can suggest that the difficulties regarding the bankruptcy court's jurisdiction over the action on the debt, which probably is not a "core" proceeding, make the state court the more efficient forum. This type of argument gains force in complex multi-party disputes in which the limited jurisdiction of the bankruptcy court offers little prospect for a comprehensive final solution.

In sum, the primary mistake that the creditor can make is to ignore suggestions that the omitted debt was discharged in bankruptcy.

C. Court's Alternatives

The bankruptcy court has fewer options than the debtor or the creditors. Simply, it has to decide whether to reopen the case or not. That decision calls for an exercise of discretion based primarily on its view of whether it is the better forum for resolving the controversy over the omitted debt. If the motion is granted, no particular explanation is needed.[137]

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[134] This includes both § 523(a)(3)(A) and (B). If the omitted debt is nondischargeable for any reason other than § 523(a)(3)(A) or (15), then the creditor is also able to pursue a declaratory judgment action to that effect as well. Thus, actions under § 523(a)(2), (4), or (6) can be prosecuted in a nonbankruptcy court under § 523(a)(3)(B), as well as actions under § 523(a)(1), (5), (7)-(14), and (16). For example, a creditor whose omitted debt was incurred by fraud that would be nondischargeable under § 523(a)(2) could add a § 523(a)(3)(B) count to its state law action on the debt.

[135] The latter course may make sense in districts where bankruptcy courts liberally issue orders to show cause why the debtor should not be held in contempt.

[136] See *infra* notes 140-41 and accompanying text for a discussion of abstention and remand.

[137] If the case is reopened, the likely basis will be "cause" under § 350(b) rather than "to accord relief to the debtor" because the outcome of the dispute is ordinarily in doubt.

Upon reopening, the court should require a formal proceeding within a fixed time to test the dischargeability of the omitted debt.[138] In a declaratory judgment action under § 523(a)(3)(A), the court may need to confront the question of whether there is a cognizable harmless innocent omission defense and whether the facts warrant its application.

Contempt proceedings based on efforts to collect omitted debts should be reserved for egregious circumstances. The court should bear in mind the Supreme Court's admonition that "the exercise of contempt power is 'a delicate one and care is needed to avoid arbitrary or oppressive conclusions' "[139] and that it should exercise the least possible power adequate to the situation. Ordinarily, the availability of a declaratory judgment under § 523(a)(3) will suffice.

Denial of a motion to reopen warrants an explanation from the court. The parties deserve guidance. Appellate courts need to be able to determine whether the trial court's discretion is being abused.

If the refusal to reopen is based on the *Anderson-Mendiola* ineffectual amendment rationale, the court should indicate whether the denial is without prejudice to another motion seeking to have the case reopened for the purpose of prosecuting a formal action to determine whether the omitted debt was discharged or to enforce the discharge. Putting the debtor to the time and expense of a renewed motion that would be granted, however, is not a very satisfying result. The better course of action in such instances would be for the court to grant the motion to reopen; require that a formal proceeding, other than amending the schedules, be initiated within a fixed time after the case is reopened; and order that the case be closed without further order if such a proceeding is not pending as of a specific date.

If the court is declining to reopen the case because it prefers that the question of the discharge of the omitted debt be litigated in a nonbankruptcy court of competent jurisdiction, then it should so indicate. In order to minimize appeals and delay for the parties, it should also either formally abstain or remand a removed action pursuant to §§ 1334(c)(1) or 1452(b) of the Judicial Code.[140] A decision to abstain or remand

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[138]It may be appropriate, as an administrative matter, to require that schedules be amended. *Cf. In re* McKinnon, 165 B.R. 55 (Bankr. D. Me. 1994). It should, however, be made clear that any such amendment would have no impact upon whether the omitted debt is discharged.

[139]Order of April 24, 1973, Adopting and Transmitting Bankruptcy Rules to Congress, 411 U.S. 991 (1973) (Douglas, J., dissenting) (quoting Cooke v. United States, 267 U.S. 517, 539 (1925)).

[140]Statutory abstention in favor of a state court is governed by § 1334(c)(1) of the Judicial Code, which provides:

> Nothing in this section prevents a district [or bankruptcy] court in the interest of justice, or in the interest of comity with State courts or respect for State law, from abstaining from hearing a particular proceeding arising under title 11 or arising in or related to a case under title 11.

28 U.S.C. § 1334(c)(1) (1994).

Remand of an action removed from state court is governed by § 1452(b) of the Judicial Code, which states in pertinent part that the "court to which such claim or cause of action is removed may remand such claim or cause of action on any equitable ground." *Id.* § 1452(b).

can be reviewed only by the district court or bankruptcy appellate panel and not by the court of appeals or Supreme Court.[141]

VIII. CONCLUSION

Decisions holding that bankruptcy cases may be reopened for the purpose of amending schedules to add innocently omitted debts make two key mistakes. First, they erroneously assume that amending schedules will enable the debt to be discharged. The law is that adding a debt to the schedules is irrelevant to discharging the debt and that the determination whether an omitted debt has or has not been discharged ordinarily requires a declaratory judgment under § 523(a)(3). Second, they fail to recognize that the circumstances of omitting the debt are not relevant to reopening the case, but that they are relevant to the innocent omission defense to nondischargeability under § 523(a)(3)(A). Thus, evidence of why the debt was omitted belongs in a declaratory judgment action under § 523(a)(3)(A) in a civil action in state court, or in an adversary proceeding in bankruptcy court. Denial of a motion to reopen for the purpose of establishing the discharge status of an omitted debt amounts to a determination by the bankruptcy court to abstain and should be analyzed accordingly.

It is time to shift the focus from the red herring of amended schedules in reopened cases to the task of defining the parameters of the emerging equitable innocent omission defense to nondischargeability under § 523(a)(3)(A) that applies in cases of omitted debts where a bar date for filing claims has passed. Few decisions focus on appropriate standards to apply. A host of questions need answers. What is harmless? What is innocent? What if the debtor pays the omitted creditor the same dividend as was received by creditors who were not omitted? What if the omitted creditor learned of the bankruptcy in time to file a tardy claim that actually was paid the same dividend as timely claims as permitted by § 726(a)(2)(C)? There is much work to do.

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[141]The restrictions on appellate review of bankruptcy abstentions state, in pertinent part, that:

> Any decision to abstain or not to abstain made under this subsection (other than a decision not to abstain in a proceeding described in subsection (c)(2)) is not reviewable by appeal or otherwise by the court of appeals . . . or by the Supreme Court of the United States . . . . This subsection shall not be construed to limit the applicability of the stay provided for by section 362 of title 11, United States Code, as such section applies to an action affecting the property of the estate in bankruptcy.

28 U.S.C. § 1334(d) (1994).

Similarly, the restrictions on appellate review of remands by bankruptcy courts provide that: "An order entered under this subsection remanding a claim or cause of action, or a decision to not remand, is not reviewable by appeal or otherwise by the court of appeals . . . or by the Supreme Court of the United States . . . ." *Id.* § 1452(d).

COMMITTEE ON RULES OF PRACTICE AND PROCEDURE
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May 21, 1997

Honorable Christopher M. Klein
United States Bankruptcy Court
8308 United States Courthouse
650 Capitol Mall
Sacramento, California 95814

Dear Judge Klein:

Thank you for your suggestion to amend Bankruptcy Rule 9027. A copy of your letter will be sent to the chair and reporter of the Advisory Committee on Bankruptcy Rules for their consideration.

We welcome your suggestion and appreciate your interest in the rulemaking process.

Sincerely,

Peter G. McCabe
Secretary

cc: Honorable Adrian G. Duplantier
Professor Alan N. Resnick