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Supreme Court Reaffirms Final Bankruptcy Court Orders are Enforceable Even if Erroneous Under the Law

A notice of filing bankruptcy is a far too common occurrence in today's economic environment. It is easy to ignore such notice, as bankruptcy cases can involve dozens of parties and all too often result in no recovery to creditors. A recent United States Supreme Court case sends a clear warning to creditors and other parties involved in bankruptcy proceedings: When you receive actual notice of something objectionable—object!

In *United Student Aid Funds, Inc. v. Espinosa*, No. 08-1134 (March 23, 2010), the debtor filed a restructuring plan wherein he proposed to repay a portion of his student loans and to discharge the remaining amount. Under the Bankruptcy Code, student loans may be included in a restructuring plan and discharged only after the debtor shows "undue hardship" in an adversary proceeding. An "adversary proceeding" is a separate lawsuit filed in the Bankruptcy Court and commenced by serving a summons on the affected parties. In *Espinosa*, the debtor failed to initiate an adversary proceeding and the Bankruptcy Court made no specific findings of undue hardship.

Even so, the creditor, United, failed to object either to the restructuring plan or to the debtor's failure to initiate the adversary proceeding, despite having received actual notice of the plan. United may have believed that because an adversary proceeding had not been initiated, the plan provisions would be ineffective. Or, United may have decided at the time, that the amount in controversy did not warrant an objection. Or, perhaps the failure to object was oversight. In any event, the Bankruptcy Court confirmed the plan without requiring an adversary proceeding and without making a specific finding of undue hardship.

Three years later, after the debtor paid the full *plan* amount on his student loans, United began intercepting the debtor's income tax refunds (as permitted for student loans) to satisfy the unpaid portion of the student loan. The debtor petitioned the Bankruptcy Court for a contempt order, claiming that United had violated the discharge injunction which forbids collection of a debt other than as provided by the terms of the confirmed plan.

United argued that the Bankruptcy Court's confirmation of the restructuring plan was void because the plan provision authorizing discharge of Espinosa's remaining student loan was inconsistent with the Bankruptcy Code. Additionally, United argued that its due process rights were violated when Espinosa failed to serve it with a summons and complaint to modify the student loan. The Supreme Court ruled for the debtor, Espinosa, reasoning that United failed to timely object to the inclusion of student loans in the restructuring plan after having received actual notice of the plan provisions.

This result is hardly surprising and the case plows no new ground. Rather, this holding confirms that the rules relating to the finality of judgments also apply to Bankruptcy Courts. *Espinosa* reaffirms a prior Supreme Court case, *Stoll v. Gottlieb*, 305 U.S. 165 (1938), in which a Bankruptcy Court confirmed a debtor's reorganization plan that included a release of third-party guarantors of the debt.

Gottlieb, one of the creditors holding a third-party guarantee, had notice of the plan provisions before confirmation and did not object. The plan was confirmed over objections of other similarly situated creditors, but no one appealed the confirmation order. Gottlieb then filed a motion with the Bankruptcy Court to reconsider its decision. The Bankruptcy Court overruled the motion but Gottlieb did not appeal. Instead, Gottlieb instituted a new action against the guarantors in the Illinois state court system, and argued the Bankruptcy Court's confirmation order releasing them was void since the Bankruptcy Court did not have jurisdiction to cancel the guarantees.

The Bankruptcy Act clearly prohibited the release of third-party guarantors (as does the Bankruptcy Code today). Nonetheless, the Bankruptcy Court decision was conclusive. The Supreme Court reasoned that "[a]fter a party has his day in court, with opportunity to present his evidence and his view of the law, a collateral attack upon the decision as to jurisdiction there rendered merely retries the issue previously determined."

These two cases, one just decided, and the other over 60 years ago in 1938, remind us that if a party has notice and an opportunity to object in a bankruptcy proceeding but fails to do so, that party is bound by the final Bankruptcy Court decision even if it is erroneous under the law. Creditors and interested parties ignore bankruptcy notices at their peril.

For more information about bankruptcy issues, please call Brown & Ruprecht, PC.

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