

UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF )  
 )  
DAVID & HANNAH ARMSTRONG, ) CASE NO. BK86-83714  
 ) CH. 7  
DEBTORS ) Filing No. 329, 331,  
 ) 332, 333, 335, 336

**MEMORANDUM**

Hearing was held on May 3, 1995. on a Motion for Appointment of Special Trustee, or Alternatively, for Removal and Substitution of Trustee Herein filed by the Debtors and various objections. Appearances: Debtors: Michael Helms of Lorance & Thompson, Phoenix, Arizona; Abbott Bank: Douglas Quinn of McGrath, North, Mullin & Kratz, P.C., Omaha, Nebraska, and Jerrold L. Strasheim and Mary Swick of Baird, Holm, McEachen, Pedersen, Hamann & Strasheim, Omaha, Nebraska; Farm Credit Bank: John Ballew of Baylor, Evnen, Curtiss, Grimit & Witt, Lincoln, Nebraska; Trustee: Philip Kelly of Nichols, Douglas, Kelly and Arfman, Scottsbluff, Nebraska; United States Trustee: Jerry Jensen of Omaha, Nebraska. This memorandum contains findings of fact and conclusions of law required by Fed. Bankr. R. 7052 and Fed. R. Civ. P. 52. This is a core proceeding as defined by 28 U.S.C. § 157(b)(2)(A) and (B).

**Background**

The debtors have filed a motion requesting the appointment of a special trustee or, alternatively, for removal and substitution of trustee. Although the debtors have listed several grounds for this motion, it appears that the most significant reason why the debtors believe another trustee should become involved is because the current trustee refuses to file an objection to the claim of the Abbott Bank (Bank).

Earlier in this case the Bank objected to the discharge of the debtors under 11 U.S.C. § 727. This Court found in favor of the Bank and denied the discharge. See Bank of Hemingford v. Armstrong (In re Armstrong) 97 B.R. 565 (Bankr. D. Neb. 1989). That decision was affirmed on appeal to the Eighth Circuit Court of Appeals. See The Abbott Bank v. Armstrong (In re Armstrong) 931 F.2d 1233 (1991). The debtors then objected to the claim of the Bank and this Court found as a fact that after the bankruptcy petition was filed, the Bank took possession of some items of collateral and sold that collateral without giving notice to the debtor as required by the Uniform Commercial Code then in effect in Nebraska. The legal result of the sale without notice to the debtor was that the Bank is denied the right to a deficiency judgment on its claim. Because the Bank, therefore, had no enforceable claim against the debtor under state law, this Court

disallowed the claim against estate. See In re Armstrong, Neb. Bkr. 91:630 (Bankr. D. Neb. Nov. 18, 1991).

Those factual findings and legal conclusions were affirmed by the District Court. See The Abbott Bank v. Armstrong, Neb. Bkr. 93:363 (D.Neb. July 19, 1993). Those factual findings and legal conclusions were left undisturbed by the Eighth Circuit Court of Appeals. See Abbott Bank v. Armstrong, 44 F.3d 665 (8th Cir. 1995). However, the Eighth Circuit found that the debtors were collaterally estopped from bringing the objection to the claim.

The debtors have requested the trustee to object to the Bank's claim, but the trustee has declined. Debtors now request an order appointing a different trustee.

#### Positions of the Parties

The Bank, the trustee, and the United States Trustee have all objected to this motion. The United States Trustee takes the position that the trustee may not be removed, except for cause, and if a trustee is removed for cause, that trustee must be removed from all other pending cases. In addition, the position of the United States Trustee is that not only has there been a failure to allege and prove cause for removal, but that there is no statutory authority for appointment of a special trustee to deal with this issue.

The Bank takes the position that not only is there no authority for appointment of a special trustee and no cause for removal of the current trustee, but that even if there was such cause and such authority, neither the current trustee, a substitute trustee nor any other interested party has a right to object to the claim of the Bank at this time. The Bank suggests that the decision by the Circuit Court of Appeals, Abbott Bank v. Armstrong, 44 F.3d 665 (8th Cir. 1995), which found that the debtors were collaterally estopped from objecting to the claim also precludes any other party from objecting to the Bank's claim.

The trustee takes the position that it is the duty of the trustee to exercise judgment and discretion and that such judgment and discretion should not be second guessed by any interested party or by the Court. The trustee asserts that he has dealt with the claim of the Bank on an arm's length basis, has reviewed the claim and the debtors' objections to it, has reviewed this Court's findings of fact and conclusions of law concerning the validity of the claim, and the findings of the District Court, and has determined that there are no legitimate grounds for objecting to the claim. In addition, the trustee takes a position similar to that of the Bank, that he is

precluded from objecting to the claim as a result of the determination by the Court of Appeals.

Claim Discharge v. Claim Allowance

One of the issues presented to the Court of Appeals, and the issue decided by the Court of Appeals, was whether or not the fact that the Bank was a prepetition creditor of the debtors precluded the debtors from asserting that the Bank's claim should be disallowed. The ruling of the Eighth Circuit can be read to suggest that once it has been established that a party is a creditor for the purposes of bringing a Section 727 discharge objection, the party is always a creditor of the debtor and the debtor has no right to suggest otherwise. However, such a reading of that decision ignores the statutory scheme which distinguishes discharge litigation between the debtor and one creditor from claims litigation between the trustee and a party asserting a right to payment from the estate.

The fact that a party is a creditor for discharge litigation is not, under the Code, determinative of whether that party's claim against assets of the estate is allowable. The Bankruptcy Code defines "creditor" as one who has a prepetition claim. 11 U.S.C. § 101(10). Section 101(5) defines a claim as "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured...."

The threshold issue with regard to whether or not a party has any right to participate in the bankruptcy case is whether that party holds a claim against the debtor. If the party does hold a claim against the debtor, that party is, by definition, a creditor. A party with "creditor status" has the right to participate in the case. If the creditor files a proof of claim in the case the creditor has certain participatory rights. Those rights, in an individual Chapter 7 case, include the right to object to the dischargeability of a particular claim under Section 523 of the Bankruptcy Code and the right to object to a discharge of all claims against the debtor under Section 727 of the Bankruptcy Code, in addition to the right in a case with distributable assets to have the claim considered by the trustee of the estate for the purpose of distribution.

However, holding a prepetition claim against the debtor and thereby becoming defined as a creditor in the bankruptcy case is not the equivalent of having a claim allowed for the purpose of distribution of the assets of the bankruptcy estate. According to one of the Commentators, "there is very little, if any, direct relationship between the allowance of a claim and the discharge of a claim. The fact that a claim is or is not allowable in no way relates to its dischargeability." See 1 ROBERT E. GINSBERG &

ROBERT D. MARTIN, BANKR.: TEXT, STATUTES, RULES (P-H) ¶ 10.08(b), at 10-54, (3d ed. 1994).

A prerequisite to the allowability of a claim and, thereafter, distribution of estate assets, is the filing of a proof of claim. By filing a proof of claim, the creditor, in effect, requests the allowance of the claim. Pursuant to 11 U.S.C. § 502(b)(1), a claim that is unenforceable against the debtor under any provision of bankruptcy or nonbankruptcy law is not allowable. The Bankruptcy Code at 11 U.S.C. § 558 provides that the estate receives the benefit of any defense available to the debtor, including statutes of limitation, statute of frauds, usury, and other personal defenses.

It is the duty of the Chapter 7 trustee to investigate and object to claims which are improper, that is, unenforceable against the debtor or the property of the debtor. 11 U.S.C. §§ 704(5), 502(b)(1). In this case, the trustee initially declined to object to the claim of the Bank because the debtors, as a party in interest had objected. See 11 U.S.C. § 502(a).

#### Effect of Circuit Court Decision

The Eighth Circuit Court of Appeals has now determined that the debtors should not have been allowed to bring such an objection because of the earlier litigation. Although the Circuit Court was concentrating on the issue of prepetition creditor status, the court certainly focused and directed its prohibitive language against the debtors alone. It stated:

[T]he heart of the controversy in Armstrong I was whether the Armstrongs had acted with intent to hinder, delay or defraud a creditor, and our holding rests on the conclusion that creditor status was established. The Armstrongs would now have us reexamine the core of our earlier holding...

We consider the timing of the Armstrongs' objection to be significant. A preliminary pretrial statement filed by both the parties in August 1988 in the denial of discharge action made no mention of the lack of notice of the sales of the hay or machinery. The records show that the Armstrongs were aware of the sales at that time. The Bankruptcy Court issued its decision denying discharge March 1, 1989, and identified the bank as the main operating lender of the Armstrongs. The District Court entered its order affirming the Bankruptcy Court's denial of discharge on November 27, 1989. The Armstrongs filed their objection to the claim raising the improper notice

of the two sales on June 18, 1990, after the District Court had issued orders denying discharge. Collateral estoppel is thus most appropriate in this case, where the Armstrongs made no effort to raise an issue that could have had a material bearing on whether the bank was a creditor entitled to an order denying discharge.

We therefore refuse to accede to the Armstrongs' eleventh hour attempt to re-try an issue that was a foundation of our decision in Armstrong I.

Abbott Bank v. Armstrong, 44 F.3d 665, 667 (8th Cir. 1995).

The Court of Appeals has denied the Armstrongs the right to challenge the enforceability of the Bank's claim against them. However, the Court of Appeals did not have before it the question of whether the trustee is also precluded from objecting to the claim on any grounds. The Bankruptcy Court and the District Court have previously found, after a full evidentiary hearing, that post-petition actions by the Bank caused the Bank's claim against the debtors or property of the debtors to be unenforceable under Nebraska law. Such findings were not reversed by the Circuit Court.

In the discharge litigation between the Bank and the debtors, the substance of the Bank's prepetition claim was not an issue. There was not then, and there is not now, any question that the Bank held a prepetition claim against the debtors. Neither the amount of that claim nor the enforceability of that claim outside of the bankruptcy court was litigated. No questions were raised in the discharge litigation concerning the amount of the claim, the extent of that claim with regard to the property of the debtors, the validity of the claim, or the enforceability of the claim under state law.

The only question that was decided in the discharge litigation was whether the debtors' prepetition obligations should be discharged or whether they should be required, notwithstanding the filing of a Chapter 7 bankruptcy, to defend, in state court, any claims by creditors which are not satisfied by the trustee distributions from the property of the estate. No monetary judgment was entered on the Bank claim. No request was made by the Bank to determine the amount of the debt or the enforceability of the debt. Those issues were left for the claims litigation process in the bankruptcy case.

The Bank was successful in obtaining an order of this Court denying the discharge of all of the debtors' prepetition debts. If there were no assets in this bankruptcy estate, the order denying discharge would have the effect of permitting the Bank to pursue its state law collection efforts against the debtors in

state court. The debtors would be permitted in state court to raise all issues concerning enforceability of the Bank's claim. Those issues would include, but not be limited to, the right of the Bank to obtain a deficiency judgment even though the Bank had sold collateral of the debtors without giving the appropriate notices under the Uniform Commercial Code which was in effect at the time of the sale.

The state court might enter findings similar to those entered by the bankruptcy court in the claims litigation. That is, the state court might make a factual finding that collateral of the debtors was sold by the Bank or an agent of the Bank without giving the appropriate notice under the Uniform Commercial Code. Such a factual finding mandates a denial of a deficiency judgment.

The Bankruptcy Code, at 11 U.S.C. § 502(b) prohibits the allowance of a claim against property of the bankruptcy estate if that claim is not enforceable outside of bankruptcy. This bankruptcy estate does have assets which can be liquidated and distributed for the benefit of allowed claims. The Bank has filed a claim and desires to share in the distribution of the property of the estate. Its right to do so depends upon the enforceability of its claim under non-bankruptcy law.

The Eighth Circuit Court of Appeals has determined that the debtors were not the proper parties to challenge the enforceability of the Bank's claim against the estate. However, the Bank should not, therefore, win by default, especially since the prior findings by this Court and the affirmance by the District Court can be considered by the trustee as inferring that there is at least a factual question with regard to whether the Bank's claim is enforceable under state law.

#### The Trustee

The trustee suggests that he has exercised his investigatory powers and his discretion and, notwithstanding factual and legal findings by the Bankruptcy Court and the District Court, declines to lodge an objection to the claim of the Bank. The trustee supplies no legal or factual basis for such refusal to object. For example, he does not suggest that post-petition activities by a creditor may be ignored when the trustee determines whether the creditor's claim is valid for distribution purposes. He does not suggest that somehow he would be precluded from objecting to the claim of the Bank if he disagreed with the amount of the claim or if he found that the Bank had been partially paid by another party, such as a guarantor. Nor does he suggest that he has any legal disability with regard to objecting to a claim based upon post-petition activities of the claim holder.

He simply suggests that he does not agree with the factual and legal findings of the Bankruptcy Court and the District Court and, even if he is not precluded as a matter of law by the decision of the Eighth Circuit Court of Appeals, he is not

inclined to file such an objection. He also suggests, with support of all of the other objecting parties, that this Court has no authority to order him to do so or to remove him if he fails to do so.

#### Conclusion

There is significant evidence in this case that the Bank's claim is unenforceable under Nebraska law against the debtors or property of the debtors. The trustee is not precluded by the decision of the Court of Appeals from objecting to the allowability of the claim. The debtors have standing to bring this matter before the Court because if the claim is disallowed in whole or in part, it is likely that the debtors' pecuniary interest will be affected.

The trustee is granted until August 1, 1995, to reconsider his position with regard to filing an objection to the claim of the Bank. If the trustee files such an objection by August 1, 1995, the clerk shall immediately bring the matter to the attention of this judge. If the trustee does not file an objection to the claim by that date, or files any other document in this case which appears to reassert the position of the trustee that he will decline to file such an objection, the clerk should immediately bring the matter to the attention of this judge. Under either scenario, an order will be entered. That order will, if necessary, make specific findings with regard to the authority of the Court.

If an objection to the claim of the Bank is lodged by the trustee, the Bank is not precluded from raising the same legal arguments concerning collateral estoppel and res judicata which have been raised in response to this motion. Those legal arguments are more appropriately dealt with if, and when, an objection to claim is actually filed.

Separate journal entry to be filed.

DATED: May 31, 1995.

BY THE COURT:

/s/ Timothy J. Mahoney  
Timothy J. Mahoney  
Chief Judge

Copies faxed by the Court to:

*HELMS, MICHAEL	8-602-224-4098
QUINN, DOUGLAS	341-0216
STRASHEIM, JERROLD/SWICK, MARY	344-0588
BALLEW, JOHN JR.	8-402-475-9515
KELLY, PHILIP	8-308-635-1387

Copies mailed by the Court to:

United States Trustee  
Law Clerk

Movant (\*) is responsible for giving notice of this journal entry to all other parties (that are not listed above) if required by rule or statute.

UNITED STATES BANKRUPTCY COURT  
FOR THE DISTRICT OF NEBRASKA

IN THE MATTER OF	)	
	)	
DAVID & HANNAH ARMSTRONG,	)	CASE NO. BK86-83714
	)	A
<u>DEBTOR(S)</u>	)	
	)	CH. 7
	)	Filing No. 329, 331,
	)	332, 333, 335, 336
Plaintiff(s)	)	
vs.	)	<u>JOURNAL ENTRY</u>
	)	
	)	
<u>Defendant(s)</u>	)	DATE: May 31, 1995
	)	HEARING DATE: May 3,
	)	1995

Before a United States Bankruptcy Judge for the District of Nebraska regarding Motion for Appointment of Special Trustee, or Alternatively, for Removal and Substitution of Trustee Herein and various objections.

APPEARANCES

Debtors: Michael Helms of Lorance & Thompson  
Abbott Bank: Douglas Quinn, Jerrold L. Strasheim and Mary Swick  
Farm Credit Bank: John Ballew  
Trustee: Philip Kelly  
United States Trustee: Jerry Jensen of Omaha, Nebraska.

IT IS ORDERED:

The trustee is granted until August 1, 1995, to reconsider his position with regard to filing an objection to the claim of the Bank. If the trustee files such an objection by August 1, 1995, the clerk shall immediately bring the matter to the attention of this judge. If the trustee does not file an objection to the claim by that date, or files any other document in this case which appears to reassert the position of the trustee that he will decline to file such an objection, the clerk should immediately bring the matter to the attention of this judge. Under either scenario, an order will be entered. That order will, if necessary, make specific findings with regard to the authority of the Court.

If an objection to the claim of the Abbott Bank is lodged by the trustee, the Bank is not precluded from raising the same legal arguments concerning collateral estoppel and res judicata which have been raised in response to this motion. Those legal

arguments are more appropriately dealt with if, and when, an objection to claim is actually filed.

BY THE COURT:

/s/ Timothy J. Mahoney  
Timothy J. Mahoney  
Chief Judge

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