The below described is SIGNED.

(ade)

Dated: March 04, 2005

JUDITH A. BOULDEN
U.S. Bankruptcy Judge

IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF UTAH

In re: MARK JAMES SHAW and KIMBERLY SHAW, Debtor(s).	Bankruptcy Number: 03-30305 Chapter 7

MEMORANDUM DECISION

Following the debtors' receipt of a Chapter 7 discharge in a no-asset case, a creditor filed suit against the debtors in state court seeking to collect damages resulting from the post-petition destruction of a leased vehicle the debtors failed to surrender as specified in their statement of intent. Despite the debtors' efforts to raise discharge in bankruptcy as a defense in the state court action, the creditor continues to prosecute the debtors because, it asserts, the damages to the vehicle occurred post-petition and were not discharged in the debtors' bankruptcy. As a result, the debtors filed the instant motion for sanctions against the creditor for willful violation of the discharge injunction imposed by 11 U.S.C. § 524.[1] After careful review of the evidence presented, including the credibility of the witness, proffered testimony, the arguments of counsel,

[1] Future references are to Title 11 of the United States Code unless otherwise noted.

and having made an independent review of applicable case law, the Court issues the following memorandum decision.

I. FACTS

On October 2, 1999, the debtors, Mark James (Mark) and Kimberly (Kimberly) Shaw (together, the "Debtors"), entered into a Vehicle Lease Agreement (the "Lease") with Towbin Dodge covering a 2000 Dodge Durango (the "Vehicle"). The Lease was subsequently assigned to Falcon Leasing Company, a division of First National Bank of Nevada (the "Bank"). The terms of the Lease set its expiration date as April 1, 2005, barring early termination. Early termination is defined by the terms of the Lease in ¶ 7. Under subsection b, the Bank can terminate the contract if the Debtors are in default. As defined in ¶ 9 of the Lease, a default has occurred when, among other conditions: (a) the Debtors fail to make a payment when due; (b) the Vehicle is the subject of a proceeding in bankruptcy; (c) the Debtors fail to comply with the insurance requirements of the Lease; or (d) the Bank, in good faith, believes the prospect of payment, performance, or realization of interest in the Vehicle is significantly impaired. Upon default, the Lease allows the Bank to take possession of the Vehicle in addition to the damages and other remedies outlined in ¶ 10.

The Debtors filed a joint Chapter 7 bankruptcy petition on June 12, 2003 (the "Petition Date"). In their statement of financial affairs and schedules filed June 18, 2003 the Debtors listed the unexpired Lease.[2] Although the Debtors indicated in their statement of intent filed with

[2] Although the Debtors mistakenly listed the Bank as a secured creditor on Schedule D rather than on Schedule G as an unexpired lease, there appears to be no dispute but that the Lease is a true lease and not a disguised security agreement.

their Schedules that they intended to surrender the Vehicle to the Bank, they failed to do so by August 4, 2003 as required by § 521(2)(B).

The Debtors attended their § 341 Meeting of Creditors; however, despite receiving notice of the bankruptcy, the Bank did not send a representative to question the Debtors or obtain information to assist in retrieving the Vehicle. On August 15, 2003, the Chapter 7 Trustee filed his no-asset report which abandoned the estate's interest in the Vehicle.

As a result of the Debtors' failure to timely surrender the Vehicle, the Bank filed a motion for relief from the automatic stay on August 22, 2003 seeking an order from the Court terminating the stay and instructing the Debtors to surrender the Vehicle. In its motion for relief, the Bank expressed its concern over the decreasing value of the Vehicle with a lack of adequate protection for the Bank. In support of its motion, the Bank stated it "will sustain irreparable harm" if the Debtors are allowed continued use of the Vehicle without any compensation for its use and depreciation.[3] Unbeknownst to this Court or the Bank, the Vehicle was involved in an accident on August 27, 2003 when Mark either had a seizure or fell asleep while driving and struck an object at a high speed. The Vehicle was totaled. In violation of the provisions of the Lease, the Debtors did not have collision insurance in effect on the Vehicle and it was towed to a wrecking yard which later notified the Bank of the accident and of storage charges incurred. The Debtors never notified the Bank of the accident. Since the Debtors did not file a response to the motion for relief, the Court entered an order granting the stay lift motion on September 16, 2003, and one day later, the Debtors received their Chapter 7 discharge.

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[3] M. Relief from Automatic Stay ¶ 11.

Several months after discharge, the Bank filed a complaint against the Debtors in the Third Judicial District Court for Salt Lake County, State of Utah (the "State Court Action") seeking to recover the loss and value of the Vehicle. The complaint alleges breach of contract and default under the Lease and requests a judgment of $13,832 plus towing and storage charges of the Vehicle incurred after the accident, and costs and expenses including attorney's fees incurred by the Bank.[4] The complaint was never served on Mark and was not served on Kimberly until about nine months after filing. Kimberly testified that at the time of the accident she and her husband were separated and have remained separated to the present time but have not yet obtained a final divorce.[5] Despite the fact that only Kimberly was served, an Answer was filed on behalf of both Debtors in the State Court Action defending that the debt was discharged in bankruptcy.

The Debtors[6] filed the instant motion for sanctions for violation of the discharge injunction under § 524(a) shortly after being served with and answering the State Court Action. The Debtors' motion seeks $3,000 in compensatory damages including attorney's fees and costs and emotional distress, as well as a claim for $9,000 in punitive damages. Kimberly testified she has had some stress related to the Bank's collection actions mostly due to the delay in finalizing her divorce. She also testified that she has incurred attorney's fees which her attorney proffered as being approximately $780. After the hearing the matter was taken under advisement.

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[4] State Court Action Compl. at 4.

[5] Kimberly testified that their divorce has been prolonged due to the dispute with the Bank over the issues involved in this motion.

[6] The motion for sanctions has been brought by the Debtors' counsel, presumably on behalf of both Debtors although only Kimberly appeared. Kimberly's testimony implied she was not in contact with Mark regarding his role in this matter.

II. ANALYSIS

The Debtors are seeking sanctions against the Bank for its alleged willful violation of the discharge injunction imposed by § 524. This Court has jurisdiction to adjudicate this dispute under 28 U.S.C. § 157(b)(2)(I) and (O). The Debtors assert the Bank continues to prosecute a lawsuit against both Mark and Kimberly Shaw despite knowledge of the Debtors' discharge and despite having been asked to cease prosecution of a lawsuit which seeks to collect money based upon a pre-petition claim.

A. Was the Bank's Claim Discharged?

The Bank insists the debt at issue was incurred post-petition and is thus not avoided by a discharge, and therefore the State Court Action is not a violation of the Debtors' discharge. The Tenth Circuit has explained "[a] fundamental tenet of bankruptcy law is that a petition for bankruptcy operates as a 'cleavage' in time. Once a petition is filed, debts that arose before the petition may not be satisfied through post-petition transactions."[7] Likewise, pre-petition obligations are discharged and cannot be collected post-petition. Filing creates a dividing line between pre- and post-petition debts.

The Debtors received a discharge under § 727, which states:

> Except as provided in section 523 of this title, a discharge under subsection (a) of this section discharges the debtor from all debts that arose before the date of the order for relief . . . and *any liability on a claim that is determined under section 502 of this title as if such claim had arisen before the commencement of the case*, whether or not a proof of claim based on any such debt or liability is filed . . . and whether or not a claim based on any such debt or liability is allowed . . . .[8]

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[7] *Ashland Petroleum Co. v. Appel* (*In re B&L Oil Co.*), 782 F.2d 155, 158 (10th Cir. 1986).

[8] § 727(b) (emphasis added).

This creates two categories of debts discharged: 1) all debts that arose before the order for relief; and 2) any liability on a claim determined under § 502 to have arisen pre-petition. The question is whether the Bank's claim falls within either of these two categories. The analysis must begin with treatment of the respective interests in the Lease under the Code, for both the estate and the debtor have separate interests in an unterminated lease.

1. The Estate's Interest in the Lease.

In a Chapter 7 case, a lease of personal property is an executory contract that can either be assumed or rejected by the Chapter 7 trustee. "[I]f the trustee does not assume or reject an . . . unexpired lease . . . of personal property of the debtor within 60 days after the order for relief . . . then such . . . lease is deemed rejected."[9] In this case, the Trustee did not file a motion to assume or reject the Lease and on August 15, 2003, the Trustee filed a no-asset report. In accordance with the Code, the Debtors' Lease with the Bank was deemed rejected by operation of law on August 11, 2003, 60 days after the petition date of June 12, 2003.

2. The Debtors' Interest in the Lease.

A trustee's rejection of a lease has "the effect of abandoning the lease back to the debtor."[10] But what is the status of the lease that a debtor receives? When the trustee rejects the unexpired lease, a technical or anticipatory breach occurs. "[T]he rejection of an . . . unexpired lease of the debtor constitutes a breach of such . . . lease."[11] This anticipatory breach alone does not terminate the contract because the debtor retains a continuing interest. The debtor then has

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[9] § 365(d)(1).

[10] 3 COLLIER ON BANKRUPTCY ¶ 365.09[3][b] (15th ed. 2003).

[11] § 365(g).

the choice of continuing to honor his obligations under the unexpired lease, usually to continue lease payments, or the debtor can default and surrender the vehicle, causing a *material* breach which will usually terminate the contract by its terms or by state law. "[I]n the vast majority of cases, the trustee's technical or anticipatory breach of an unexpired lease (by failing to assume it within the statutory period) will be accompanied by an actual breach in the form of nonpayment of rent."[12]

3. Breach of the Contract.

While the Code is relatively clear, under § 365(g), in stating rejection of an unexpired lease is a breach, the Code does not state the type of breach, the effect that breach has on the contract, and which claims arise from the breach. The existing case law focuses primarily on whether or not the breach results in a termination of the contract.[13] One court has commented "[t]he effect of rejection is one of the great mysteries of bankruptcy law."[14] Another summarizes, "[t]he general rule is that rejection constitutes a *breach* of a lease or executory contract, but does not *terminate* the contract."[15] If the breach of a lease does not terminate the underlying contract, at what point, if at all, is the contract terminated? This is a relevant inquiry because if the contract is terminated and debt related to the terminated contract discharged, a cause of action based on the contract cannot emerge following termination.

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[12] *Fed. Realty Inv. Trust v. Park* (*In re Park*), 275 B.R. 253, 256 (Bankr. E.D. Va. 2002) (emphasis in original) (discussing a debtor's interest in a lease rejected by the trustee).

[13] *See e.g., Sullivan v. Norton* (*In re Norton*), 112 B.R. 932, 934-35 (C.D. Ill. 1990) (explaining the "conflict between the cases as to whether a rejection will effectuate an eventual termination of a lease" and citing leading cases explaining the majority and minority reasoning).

[14] *In re Henderson*, 245 B.R. 449, 453 (Bankr. S.D.N.Y. 2000) (discussing the effect of rejection on an unexpired lease).

[15] *Park*, 275 B.R. at 256.

4. Termination of the Contract.

The consequences of the breach are determined by state law.[16] Utah state law, which governs the Lease, supports a finding that non-payment on a lease is a material breach which would terminate the contract. The Utah Court of Appeals has stated "[t]he law is well settled that a material breach by one party to a contract excuses further performance by the nonbreaching party."[17] Further clarifying, the Utah Supreme Court explains "a failure of performance which 'defeats the very object of the contract' or '(is) of such prime importance that the contract would not have been made if default in that particular had been contemplated' is a material failure."[18] Surely failure to make lease payments rises to that level of importance. The Debtors' failure to make payments on the Lease "defeats the very object of the contract." The Bank's action in filing a motion for relief supports a finding that the Lease was materially breached and that the Bank sought relief from the stay so that it could terminate the Lease based on the breach.

Looking to the terms of the Lease bolsters this approach. The Debtors indicated in both their statement of intention and at the § 341 meeting that they would surrender the Vehicle. Section 521 requires a debtor to act on the stated intention within 45 days after filing the notice of intent. The Debtors not only failed to surrender the Vehicle within the time required by the Code, but the Debtors also defaulted under the terms of the Lease by failing to make payments

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[16] *Blackburn v. Sec. Pac. Credit Corp.* (*In re Blackburn*), 88 B.R. 273, 276 (Bankr. S.D. Cal. 1988).

[17] *Holbrook v. Master Prot. Corp.*, 883 P.2d 295, 301 (Utah Ct. App. 1994).

[18] *Polyglycoat Corp. v. Holcomb*, 591 P.2d 449, 451 (Utah 1979) (internal citation omitted).

and by failing to comply with the insurance requirements. Under the terms of the Lease, this conduct constitutes a material breach that terminates the contract.

The Bank was not without a remedy. The Bank was aware, or should have been aware, of the Debtors' intent to surrender the Vehicle. The Bank could have sent a representative to the § 341 meeting, or could have contacted the Debtors' attorney to arrange the logistics of the voluntary surrender of the Vehicle and could have then held the Vehicle pending relief from the stay. Instead, the Bank chose to wait for the expiration of the 45-day period under which the Debtors have to act on their intention before filing a motion for relief from the automatic stay on August 22, 2003. At this point, the Lease had already been deemed rejected by the Trustee as of August 11th and the Vehicle was then totaled August 27th.

5. Damage Claim as a Result of Rejection and Termination of the Contract.

Damages resulting from the rejection of a lease are construed as arising immediately before the date of filing of the petition and the damages are treated as a general unsecured claim under § 502(g).[19] A lease rejection claim falls into the second category of dischargeable claims under § 727(b) as it is a claim determined under § 502. The pivotal issue is whether the debt, which the Bank sued the Debtors to collect, was, under § 502(g), "[a] claim arising from the [trustee's] rejection." If it was, the debt was discharged in the Debtors' Chapter 7 bankruptcy

[19] *See In re Wright*, 256 B.R. 858, 859 (Bankr. W.D. N.Car. 2001) (analyzing the treatment of damages claims under § 365(g)).

under § 727(b) as "a claim that is determined under section 502 . . . as if such claim had arisen before the commencement of the case."[20]

The Bank argues that though an ordinary monetary claim for rejection damages may be included under § 502(g), it cannot be expected to anticipate and include in its claim all the damages that may arise from rejection of the Lease, leaving the creditor in an unjust position without means for recovery. But § 502(g) is clear that "[a] claim arising from the rejection . . . of an . . . unexpired lease . . . shall be allowed . . . the same as if such claim had arisen before the date of the filing of the petition."[21] There is no foreseeability requirement to allowing claims, and if there was, it is not unforeseeable that personal property will be damaged in some way prior to being returned to the creditor. In fact, the Bank stated in support of its motion for relief from automatic stay that it would "sustain irreparable harm" in the Vehicle if the Debtors were allowed continued use without granting the Bank adequate protection.[22] The Bank sought relief from stay specifically to avoid the type of harm and loss sustained by the Vehicle. It is unfortunate that in this case the damage was so extensive, and that the Code leaves a gap by failing to provide an express remedy for creditors when a debtor neglects to act on his stated intention of surrendering personal property. But these circumstances do not change the fact that as of the date the Vehicle was totaled, the Lease had already been rejected, materially breached, and terminated.

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[20] § 727(b). *See also Maupin v. Franklin Equity Leasing Co.* (*In re Maupin*), 165 B.R. 864, 866 (Bankr. M.D. Tenn. 1994) (finding leasing company's state court suit to collect damages resulting from the rejection of a lease discharged under § 727(b)).

[21] § 502(g).

[22] M. Relief from Automatic Stay ¶ 11.

Other courts have wrestled with questions involving similar issues of what claims arise from the rejection of a lease of personal property. In one case, the leasing company sued the debtor in state court to recover funds for the debtor's post-petition use of a leased vehicle. The bankruptcy court concluded that "an allowed damages claim in bankruptcy would include the lessor's damages for the debtor's post-petition use of the vehicle."[23] The court focused on the "broad reach of a Chapter 7 discharge" and ordered the leasing company to pay compensatory damages to the debtor resulting from the filing of the state court action.[24]

Another bankruptcy court was faced with the question of whether a lessor's claim for excess mileage charges under an automobile lease arose as a result of the rejection of the lease and is thus required to be treated as a pre-petition claim under § 502(g) and discharged under § 727(b).[25] The debtors listed an unexpired automobile lease in their bankruptcy and received a Chapter 7 discharge but elected to continue making payments to the lessor. The lessor never sought or obtained a reaffirmation agreement.[26] The debtors continued payments to the end of the lease and at the conclusion of the lease, they returned the vehicle and paid a portion of the excess mileage charges for which the lessor billed them. The lessor subsequently attempted to collect the unpaid portion.[27] The bankruptcy court found "no principled basis to conclude [that] excess mileage charges are not damages upon rejection of the Lease. The fact that the payment

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[23] *Maupin*, 165 B.R. at 866.

[24] *Id.*

[25] *Beck v. Gold Key Lease, Inc.* (*In re Beck*), 272 B.R. 112, 120 (Bankr. E.D. Penn. 2002).

[26] *Id.* at 116.

[27] *Id.*

was not due until the end of the Lease provides no basis for excepting it from the debt to be discharged."[28]

6. Discharge of the Rejection and Termination Damages.

Similarly to courts in other jurisdictions, this Court cannot find any principled basis to determine that the Bank's contract claim was not discharged. The Lease was deemed rejected by the Trustee and under all theories – bankruptcy law, contract, state law – the Lease was terminated prior to the Vehicle being totaled. "[T]he breach caused by rejection excuses the lessee from performance of his personal obligations under a lease, such breach is material and should likewise give the lessor a right to recover its property to mitigate a potential future dischargeable debt."[29] This general principal applies equally to vehicle leases. "When a vehicle lessee files a Chapter 7 bankruptcy petition, in the normal course the lessee/debtor shortly thereafter will obtain a personal discharge from her lease payment obligation. Section 524(a) then enjoins the lessor from any act to collect the lease payments from the debtor."[30] Once the Debtors obtained their discharge, all obligations arising from the contract were included in the Bank's claim and were discharged. The Bank could have moved more aggressively in Court to obtain possession of the property and mitigate its damages but failed to do so. "[W]here the lessor has not exercised [its right to terminate the lease] either with knowledge or ignorance, the dischargeable debt does not ride through bankruptcy in a no-asset case."[31]

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[28] *Id*. at 124.

[29] *Id*. at 124 n.19.

[30] *Id*. at 123.

[31] *Id*. at 124 n.19 (internal reference omitted).

7. Violation of the Discharge Injunction.

The Bank is suing the Debtors under a contract theory of recovery in the State Court Action – which turns on whether or not the Lease survived the Trustee's rejection and whether or not the contractual claims that arose from the rejection and termination were discharged. After discharge, the Bank no longer has an *in personam* claim against the Debtors under the Lease – prosecution of the contract claim is a violation of the discharge injunction.[32] The Bank's only claim pled in the State Court Action complaint was discharged under § 727(b). It does not matter that the damages to the Vehicle occurred post-petition: by the time the damage was incurred, the Lease had already been deemed rejected and all damages arising from the breach under the contract are treated as pre-petition claims.

The injunction that results from a discharge is explained in § 524(a)(2):

> (a) A discharge in a case under this title—
>
> . . . .
>
> (2) operates as an injunction against the commencement or continuation of an action, the employment of process, or an act, to collect, recover or offset any such debt as a personal liability of the debtor, whether or not discharge of such debt is waived . . . .[33]

The Bank is enjoined from commencing or continuing any action to hold the Debtors personally liable on a discharged debt. "The discharge injunction is permanent. It survives the bankruptcy case, and applies forever with respect to every debt that is discharged."[34] The Bank violated the

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[32] This ruling makes no determination as to whether the Debtors' conduct in destroying the Vehicle gives rise to a cause of action in tort.

[33] § 524(a)(2).

[34] *Motley v. Equity Title Co.* (*In re Motley*), 268 B.R. 237, 241 (Bankr. C.D. Cal. 2001) (explaining the effect of a Chapter 7 discharge).

discharge injunction when it commenced the State Court Action. "The intent of this post-discharge injunction is to protect debtors . . . in their financial 'fresh start' following discharge."[35]

If a party wishes to challenge an injunction, the proper procedure is to first request relief from the Bankruptcy Court and "[i]f dissatisfied with the Bankruptcy Court's ultimate decision, respondents can appeal . . . ."[36] Here, the Bank chose to circumvent the authority of this Court and sued the Debtors in state court under a theory of contractual liability to recover damages under the Lease resulting from the destruction of the Vehicle. The damages sought in the State Court Action constituted an allowed damages claim the Bank could have filed in bankruptcy. The Bank sued in state court to collect "[a] claim arising from the rejection . . . of an . . . unexpired lease . . . that has not been assumed."[37] Consequently, the Bank sued to collect a discharged debt.

B. Sanctions

The Tenth Circuit has outlined a three-part test for prosecuting a civil contempt proceeding.[38] The moving party has the burden of proving by clear and convincing evidence "[1] that a valid court order existed, [2] that the defendant had knowledge of the order, and [3] that the defendant disobeyed the order."[39] Each element has been met. The Debtors have clearly demonstrated and the Court can take judicial notice that the Debtors received a discharge order on September 17, 2003. The Bank has admitted to knowledge of the discharge order. As

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35 *Walker v. Wilde* (*In re Walker*), 927 F.2d 1138, 1142 (10th Cir. 1991).

36 *Celotex Corp. v. Edwards*, 514 U.S. 300, 313 (1995).

37 § 502(g). *See also Maupin*, 165 B.R. at 866.

38 *See Reliance Insur. Co. v. Mast Construction Co.*, 159 F.3d 1311, 1315 (10th Cir. 1998).

39 *Id.*

discussed above, because the claim arising from the breach of the Lease is deemed to have arisen pre-petition, the Bank disobeyed the discharge order when it filed the State Court Action. All elements are present for an award of sanctions.

Kimberly Shaw testified that she has suffered a little stress from the Bank's actions, primarily because it has prolonged her divorce from Mark Shaw. She also testified that her monetary damages are the attorney fees she has incurred relating to this matter of approximately $780. Mark did not testify or appear at the hearing. Although the Debtors' motion requests compensatory damages of $3,000 for attorney fees and emotional distress, there is not enough evidence before the Court to warrant such an award. Compensatory damages will be limited to the attorney fees of $780. The request for punitive damages of $9,000 is not supported by the evidence.

III. CONCLUSION

A debt arising from a lease of personal property which is rejected by the Chapter 7 Trustee but the personal property is retained by the debtors, despite material default, is nonetheless discharged under the Code. The Bank's State Court Action is therefore a violation of the discharge injunction. The Debtors are entitled to recover compensatory damages of actual attorney fees and costs incurred in answering the Bank's complaint in the State Court Action and in bringing this motion before the Court in the amount of $780. A separate order consistent with this decision will issue.

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SERVICE LIST

Service of the foregoing **MEMORANDUM DECISION** will be effected through the Bankruptcy Noticing Center to each party listed below.

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