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1990]

**BANKRUPTCY LAW—PENNSYLVANIA HOUSING FINANCE AGENCY MAY
DISCONTINUE EMERGENCY MORTGAGE ASSISTANCE PAYMENTS TO
RECIPIENTS WHO FILE FOR BANKRUPTCY**

Watts v. Pennsylvania Housing Finance Co. (1989)

I. INTRODUCTION

In 1983, the Pennsylvania General Assembly enacted the Homeowner's Emergency Mortgage Assistance Program (HEMAP) in order to provide "emergency mortgage assistance payments, prevent widespread mortgage foreclosures and distress sales of homes which result from default caused by circumstances beyond a homeowner's control."¹ HEMAP authorizes the Pennsylvania Housing Finance Agency (PHFA) to pay directly to an eligible homeowner's mortgagee both the full amount of any accrued arrearages as well as monthly payments to keep the mortgage current.² This mortgage assistance is intended to be temporary,³ and is made in the form of a loan to the eligible homeowner, secured by a mortgage lien on the home and repayable with interest.⁴

A homeowner must satisfy a number of eligibility requirements in order to obtain assistance under HEMAP.⁵ One significant requirement is that the "mortgagee has indicated to the mortgagor its intention to foreclose"⁶ and that "[t]he mortgagee is not prevented by law from foreclosing upon the mortgage."⁷

This creates an interesting interplay with bankruptcy law. Under section 362(a)(3) of the Bankruptcy Code, the automatic stay prevents a mortgagee from foreclosing against a mortgagor who has filed for bankruptcy.⁸ Therefore, a homeowner who has filed for bankruptcy will not

1. PA. STAT. ANN. tit. 35, § 1680.401c note (Purdon Supp. 1990) (Findings and Purpose). HEMAP, in its entirety, is codified in PA. STAT. ANN. tit. 35, §§ 1680.401c-411c (Purdon Supp. 1990). HEMAP will expire on December 23, 1992. *Id.* § 1680.411c.

2. *Id.* § 1680.405c(a)-(b).

3. The statute provides that HEMAP assistance "shall be provided for a period not to exceed thirty-six (36) months, either consecutively or nonconsecutively." *Id.* § 1680.405c(f). It also provides that PHFA may terminate payments at any point where PHFA "determines that, because of the changes in the mortgagor's financial circumstances, the payments are no longer necessary . . ." *Id.*

4. *Id.* §§ 1680.405c(g), .406c.

5. *See id.* § 1680.404c(a).

6. *Id.* § 1680.404c(a)(2)(i).

7. *Id.* § 1680.404c(a)(7).

8. 11 U.S.C. § 362(a)(3) (1988). Section 362(a)(3) provides that the filing of a bankruptcy petition operates as a stay of "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate." *Id.* A mortgage foreclosure action falls within this section, and thus is an act that is stayed. *See In re Penfil*, 40 Bankr. 474 (Bankr. E.D.

be eligible for HEMAP assistance because the mortgagee is prevented by law from foreclosing.⁹

A difficult situation arises where a homeowner who is already receiving HEMAP assistance files for bankruptcy. Under this scenario, the homeowner was able to satisfy HEMAP's eligibility requirements at the time of the application for assistance, but subsequently fails the requirements during the period in which she is receiving assistance. In such a case, may the PHFA lawfully discontinue the assistance payments once the homeowner files for bankruptcy, because the homeowner no longer satisfies the requirements for HEMAP assistance? The United States Court of Appeals for the Third Circuit answered this question in the affirmative in *Watts v. Pennsylvania Housing Finance Co.*¹⁰

In *Watts*, three named plaintiffs,¹¹ Dorothy Watts, Robert Bratton and Mr. and Mrs. John Pizzileo, applied for and were determined eligible to receive HEMAP assistance.¹² PHFA cured Watts's and Bratton's arrearages and temporarily provided them with monthly payments to help keep their mortgages current.¹³ Once Watts and Bratton filed for bankruptcy, however, PHFA suspended their monthly payments.¹⁴ Although PHFA approved the Pizzileos' application, it never provided any mortgage assistance because the Pizzileos filed for bankruptcy shortly after their application was approved.¹⁵ PHFA notified Watts and Bratton of the termination of their assistance in a form letter which read in part, "the Agency is discontinuing your monthly assistance under [HEMAP] due to your filing for bankruptcy."¹⁶

Mich. 1984) (recording of sheriff's deed after foreclosure sale is violation of automatic stay); *In re Scott*, 24 Bankr. 738 (Bankr. M.D. Ala. 1982) (foreclosure sale is null and void when held in violation of automatic stay); see also 16 PA. CODE § 40.202(e) (1987) (if homeowner in bankruptcy at time of application for PHFA mortgage assistance, such assistance is contingent upon, *inter alia*, lifting of stay).

9. See 16 PA. CODE § 40.202(e) (1987). Of course, if the automatic stay did not apply or was lifted, then the HEMAP requirement that the mortgagee not be prevented by law from foreclosing would be satisfied.

10. 876 F.2d 1090 (3d Cir. 1989).

11. The action was brought as a class action suit, in which the plaintiff class consisted of all individuals who have applied for or will in the future apply for, or have been awarded HEMAP benefits and thereafter become debtors under the Bankruptcy Code. *Id.* at 1092. Plaintiffs' motion to maintain the action as a class action was granted by the bankruptcy court. *In re Watts*, 76 Bankr. 390, 400-01 (Bankr. E.D. Pa. 1987).

12. *Watts*, 876 F.2d at 1091.

13. *Id.*

14. *Id.*

15. *Id.* The Pizzileos were informed by the PHFA that their application had been "reevaluated," and that no assistance would be provided. *Id.*

16. *Id.* at 1091-92 (emphasis added). The form letter further provided:

Pursuant to [HEMAP], a homeowner is ineligible for assistance when the mortgagee is prevented by law from foreclosing upon the mortgage. As long as the automatic stay of the Bankruptcy Court remains in effect, the mortgagee is prohibited from instituting foreclo-

The plaintiffs filed suit against PHFA, alleging that PHFA's suspension of monthly payments following the filing of their bankruptcy petitions violated the anti-discrimination provision of the Bankruptcy Code,¹⁷ the automatic stay provision of the Code,¹⁸ as well as 42 U.S.C. section 1983.¹⁹ The bankruptcy court held that each of these three provisions had been violated and granted summary judgment in favor of the plaintiffs.²⁰ On appeal, the United States District Court for the Eastern District of Pennsylvania affirmed the bankruptcy court's decision.²¹ The Third Circuit reversed, holding that PHFA's practice of suspending assistance upon the filing of a bankruptcy petition violated neither the anti-discrimination provision nor the automatic stay provision of the Bankruptcy Code.²² Because the court found no violation of the Bankruptcy Code, it held that 42 U.S.C. section 1983 could not have been violated.²³

Additionally, the court held that the Code's anti-discrimination provision, contained in section 525, did not apply to a HEMAP loan.²⁴ Section 525 provides, in pertinent part, that "a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or *other similar grant* to, condition such a grant to, [or] discriminate with respect to such a grant against . . . [a bankruptcy debtor] . . . solely because" of the bankruptcy filing.²⁵ PHFA did not dispute that it

sure proceedings against you. Accordingly, you presently fail to satisfy this eligibility requirement.

Id. at 1092 (citation omitted).

17. *Id.*; see 11 U.S.C. § 525(a) (1988). For a discussion of this provision, see *infra* notes 24-32, 42-67, 97-102 and accompanying text.

18. *Watts*, 876 F.2d at 1092; see 11 U.S.C. § 362(a)(3) (1988). For a discussion of this provision, see *infra* notes 33-41, 68-89, 103-05 and accompanying text.

19. *Watts*, 876 F.2d at 1092; see 42 U.S.C. § 1983 (1988). For a discussion of the court's treatment of the section 1983 claim, see *infra* note 23.

20. *In re Watts*, 76 Bankr. 390, 410 (Bankr. E.D. Pa. 1987).

21. *In re Watts*, 93 Bankr. 350 (E.D. Pa. 1988).

22. *Watts*, 876 F.2d at 1097.

23. *Id.* The court stated that "[b]ecause the plaintiffs' 42 U.S.C. § 1983 claim is dependent upon a finding of a [Bankruptcy] Code violation, it also must fail." *Id.* All of the courts involved in this case recognized that a claim under 42 U.S.C. § 1983 depends entirely upon the success or failure of the claims under the Bankruptcy Code. See *id.*; *Watts*, 76 Bankr. at 408-09; *Watts*, 93 Bankr. at 357. That is, in order to set forth a valid section 1983 claim, one need only to establish that rights under the Constitution or any federal law have been violated. See *Maine v. Thiboutot*, 448 U.S. 1 (1980) (section 1983 encompasses claims based on violations of federal statutory law). Since the Bankruptcy Code is a federal statute, any violation of the Code gives rise to a valid 42 U.S.C. § 1983 claim. *Higgins v. Philadelphia Gas Works*, 54 Bankr. 928, 933-34 (E.D. Pa. 1985).

Because the plaintiffs' section 1983 claim is collateral to the central issues considered in the case, as well as in this piece, it is not discussed further.

24. *Watts*, 876 F.2d at 1093-94.

25. 11 U.S.C. § 525(a) (1988) (emphasis added).

was a "governmental unit."²⁶ Rather, PHFA urged, and the Third Circuit adopted, the reasoning that, in enacting section 525, Congress did not intend "to prohibit the sort of temporary suspension of mortgage financing involved in this case."²⁷

The basis of the court's decision on this issue was that "a HEMAP loan simply is not a 'license, permit, charter, franchise, or other similar grant.'" ²⁸ The court reasoned that the statute's catch-all term, "other similar grant," referred only to items similar to those listed immediately before it.²⁹ Therefore, "other similar grant" referred to "items . . . in the nature of indicia of authority from a governmental unit to the authorized person to pursue some endeavor."³⁰ Since a loan does not authorize a person to pursue some endeavor, it is not a grant within the context of section 525.³¹ Furthermore, the court held that suspension of HEMAP assistance did not violate the "fresh start" policy of the Bankruptcy Code.³²

In the second part of its opinion, the court ruled that PHFA did not violate the automatic stay provision in section 362 of the Bankruptcy Code.³³ Section 362(a)(3) provides that the filing of a bankruptcy petition operates as a stay of "any act to obtain possession of property of the estate or of property from the estate or to exercise control over property of the estate."³⁴ Specifically, the court held that the automatic stay of section 362 did not apply because another Code section, section 365(e)(2)(B), expressly permitted termination of the type of contract in which PHFA and the plaintiffs had engaged.³⁵

26. *Watts*, 876 F.2d at 1092.

27. *Id.* at 1093. PHFA argued alternatively that it did not suspend HEMAP payments "solely because" of the bankruptcy filings. *Id.* at 1094 n.5. The court found it unnecessary to address this argument. *Id.*

28. *Id.* at 1093 (quoting 11 U.S.C. § 525(a) (1988)).

29. *Id.*

30. *Id.*

31. *Id.* In reaching this conclusion, the court relied heavily upon *In re Goldrich*, in which the Second Circuit applied a similar literal approach to section 525 in holding that a credit guarantee was not a "similar grant." *Id.* at 1093 (citing 771 F.2d 28, 30 (2d Cir. 1985)). For a further discussion of *Goldrich*, see *infra* notes 58-64, 97-100 and accompanying text.

32. *Watts*, 876 F.2d at 1094. It has long been held that one of the primary purposes of the Bankruptcy Code is to provide the debtor with a "fresh start." See *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). The *Watts* court perceived no violation of this "fresh start" policy in the present case because mortgage assistance could be "reinstated once the stay [was] lifted if foreclosure [was] still threatened . . ." *Watts*, 876 F.2d at 1094. In fact, the record reflects that each of the named plaintiffs was determined to be re-eligible for assistance benefits once the stay was lifted. *Id.* at 1094 n.4.

33. *Watts*, 876 F.2d at 1095.

34. 11 U.S.C. § 362(a)(3) (1988).

35. *Watts*, 876 F.2d at 1095-96. PHFA did not raise the issue of the applicability of section 365 in the initial bankruptcy court proceeding. Consequently, when PHFA attempted to raise the issue on appeal in the district court, the court refused to consider the issue, applying the general rule that a federal appellate

Section 365(e)(2)(B) provides that an executory contract to make a loan or to extend other financial accommodations to or for the benefit of the debtor is an exception from the general rule prohibiting the termination of contracts because of a bankruptcy filing.³⁶ A contract is executory when "performance remains due to some extent on both sides."³⁷ The *Watts* court held that performance was due on both sides of PHFA's contract with the plaintiffs when the assistance was terminated³⁸ and, therefore, under section 365(e)(2)(B) PHFA was not barred from terminating its performance under its contract with the plaintiffs.³⁹ Although the automatic stay provision of the Code—specifically, section 362(a)(3)—could be interpreted as forbidding PHFA from withholding the plaintiffs' mortgage payments after the bankruptcy petitions were filed,⁴⁰ the Third Circuit did not accept this interpretation. Rather, it

court may not consider an issue not passed on below. *In re Watts*, 93 Bankr. 350, 357 (E.D. Pa. 1988); *see also* Singleton v. Wulff, 428 U.S. 106, 120 (1976). The Third Circuit noted this refusal by the district court, but decided that it was proper to consider the issue "because the purely legal question of section 365's applicability is inextricably intertwined with the issue of whether the automatic stay was violated in this case" *Watts*, 876 F.2d at 1095 n.8.

36. 11 U.S.C. § 365(e)(2)(B) (1988). The general rule prohibiting the termination of executory contracts because of a bankruptcy filing is stated in section 365(e)(1) which provides:

Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified, and any right or obligation under such contract or lease may not be terminated or modified, at any time after the commencement of the case solely because of a provision in such a contract or lease that is conditioned on—

(A) the insolvency or financial condition of the debtor at any time before the closing of the case;

(B) the commencement of a case under this title; or

(C) the appointment of or taking possession by a trustee in a case under this title or a custodian before such commencement.

Id. § 365(e)(1) (citations omitted). Subsection (2)(B) reads:

Paragraph (1) of this subsection does not apply to an executory contract or unexpired lease of the debtor, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties, if— . . . (B) such contract is a contract to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

Id. § 365(e)(2)(B).

37. *In re* National Sugar Ref. Co., 26 Bankr. 765, 767 (Bankr. S.D.N.Y. 1983); *accord In re* Pennsylvania Tire Co., 26 Bankr. 663, 674 (Bankr. N.D. Ohio 1982) ("[t]o fall within the ambit of Section 365, a contract must be one, 'on which performance remains due to some extent on both sides.'") (quoting H.R. REP. NO. 595, 95th Cong., 2d Sess. 347 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6303-04).

38. *Watts*, 876 F.2d at 1096 n.9. The court reasoned that because "PHFA was to have advanced payments to plaintiffs' mortgagees, and plaintiffs were obligated to repay PHFA," the contract was executory. *Id.*

39. *Id.* at 1096.

40. Both the district court and the bankruptcy court below held that section 362(a)(3) was violated by PHFA when it withheld the payments. *In re Watts*, 93

relied on the specific exception for executory contracts and stated that it was “unwilling to grant ‘a protection or benefit pursuant to [section 362] when the [contrary] intent of Congress appears clear at [section 365].’”⁴¹

II. DISCUSSION

A. *Anti-Discrimination Provision*

The legislative history of section 525 of the Bankruptcy Code indicates that the section was passed for the express purpose of codifying the result of the Supreme Court’s decision in *Perez v. Campbell*.⁴² In *Perez*, an Arizona state law which required the suspension of a driver’s license until satisfaction of an accident-related judgment, even where the judgment was discharged in bankruptcy, was declared unconstitutional.⁴³ The Supreme Court held that the statute was in conflict with the “fresh start” policy of the Bankruptcy Code and was thus invalid under the Supremacy Clause of the United States Constitution.⁴⁴

Although *Perez* dealt solely with a judgment in tort,⁴⁵ Congress’s codification of *Perez* purposely went much further. The legislative history provides that section 525’s list of various forms of discrimination against former bankrupts is “not exhaustive” and “is not intended to permit other forms of discrimination.”⁴⁶ This language appears to indicate that discrimination in any form against a debtor by a governmental unit is impermissible under section 525.⁴⁷ In the same paragraph, how-

Bankr. 350, 356-57 (E.D. Pa. 1988); *In re Watts*, 76 Bankr. 390, 408 (Bankr. E.D. Pa. 1987). In order to hold that PHFA violated section 362(a)(3), it was first necessary to determine, as both the lower courts did, that the prospective HEMAP payments were “property of the estate.” See *Watts*, 93 Bankr. at 356; *Watts*, 76 Bankr. at 407. The Third Circuit found it “unnecessary” to rule on this “property of the estate” issue because it held that section 362(a)(3) was inapplicable to this case. *Watts*, 876 F.2d at 1095. In a footnote, however, the court did cite authority which indicates that the court might have ruled that the HEMAP payments were not property of the estate. *Watts*, 876 F.2d at 1095 n.7 (citing *Creative Data Forms, Inc. v. Pennsylvania Minority Business Dev.*, 72 Bankr. 619 (E.D. Pa. 1985), *aff’d*, 800 F.2d 1132 (3d Cir. 1986)). For a further discussion of the “property of the estate” issue, see *infra* notes 69-88 and accompanying text.

41. *Watts*, 876 F.2d at 1096 (quoting *In re New Town Mall*, 17 Bankr. 326, 329 (Bankr. D.S.D. 1982)).

42. 402 U.S. 637 (1971); see S. REP. NO. 989, 95th Cong., 2d Sess. 81, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5867.

43. *Perez*, 402 U.S. at 656.

44. *Id.* at 648-52.

45. The Court stated that “[t]here can be no doubt . . . that Congress intended [the “fresh start”] to include freedom from most kinds of pre-existing tort judgments.” *Id.* at 648.

46. S. REP. NO. 989, *supra* note 42, at 5867.

47. This was the position taken by both lower courts. See *In re Watts*, 93 Bankr. 350, 354-55 (E.D. Pa. 1988); *In re Watts*, 76 Bankr. 390, 402-06 (Bankr. E.D. Pa. 1987). One commentator has stated her belief that the case law on

ever, the Senate Report goes on to say that “[t]his section permits further development to prohibit actions by governmental or quasi-governmental organizations *that perform licensing functions*, such as a State bar association or a medical society, *or by other organizations* that can seriously affect the debtors’ livelihood or fresh start”⁴⁸ The specific reference to “organizations that perform licensing functions” implies that section 525 is targeted exclusively at licensing boards and similar agencies that grant authoritative, enabling documents.⁴⁹ Yet, the catch-all phrase “or by other organizations,” and the reference to the effect on the debtor’s “fresh start,” permits the inference that the section is designed to forbid *any* governmental discrimination which impedes the debtor’s “fresh start.”⁵⁰

It is this inherently contradictory language within the legislative history that has given rise to the issue of the extent of section 525’s applicability. Pro-debtor courts, including many of the bankruptcy courts across the country, have read the language and legislative history of section 525 to condemn virtually all forms of discrimination against a debtor.⁵¹ Other courts, particularly federal appellate courts, have taken a more conservative stance, reading section 525 literally.⁵² In *Watts*, the Third Circuit adopted the latter approach by ruling that PHFA’s suspension of mortgage assistance did not fall within the scope of section

section 525 “implicitly or explicitly support[s] the view that where a governmental entity treats a debtor differently from everyone else discrimination [under section 525] occurs.” Annotation, *Protection of Debtor from Acts of Discrimination by Governmental Units Under § 525 of Bankruptcy Code of 1978*, 68 A.L.R. FED. 137, 141 (1984).

48. S. REP. NO. 989, *supra* note 42, at 5867 (emphasis added).

49. This was the reasoning of the Third Circuit in *Watts*. See *Watts*, 876 F.2d at 1093-94.

50. The district court adopted this approach, stating that “[t]he legislative history of § 525 indicates that Congress sought to attack, in a broad manner, discriminatory practices by governmental entities that would prevent a debtor from taking advantage of . . . a financial ‘fresh start.’” *Watts*, 93 Bankr. at 355.

51. See *Watts*, 76 Bankr. at 403; see also *In re Son-Shine Grading, Inc.*, 27 Bankr. 693 (Bankr. E.D.N.C. 1983) (state department of transportation’s disqualification of debtor from bidding on contracts for department because of debtor’s pending bankruptcy petition violated section 525); *In re Gibbs*, 9 Bankr. 758, 764 (Bankr. D. Conn. 1981) (eviction of debtor by public housing authority solely because debtor filed for bankruptcy violated section 525), *aff’d in part*, *Gibbs v. Housing Auth. of New Haven*, 76 Bankr. 257, 263 (D. Conn. 1983); *In re Heath*, 3 Bankr. 351 (Bankr. N.D. Ill. 1980) (state university’s refusal to issue transcript to Chapter 13 debtor until debtor paid pre-petition debt owed to university violated section 525).

52. See *In re Goldrich*, 771 F.2d 28 (2d Cir. 1985) (section 525 does not prevent government denial of student loan based upon default in repayment of discharged loan); *Johnson v. Edinboro State College*, 728 F.2d 163 (3d Cir. 1984) (college transcript may be withheld to collect student loan not discharged by debtor’s Chapter 7 bankruptcy); *In re Rees*, 61 Bankr. 114 (Bankr. D. Utah 1986) (imposition by state agency of higher tax rate on employer-debtor due to debtor’s failure to pay prior taxes not within scope of section 525).

525.⁵³

The literal approach is based on a long-standing rule of statutory construction which provides that where the language of a statute is unambiguous, the court's inquiry stops.⁵⁴ The *Watts* court read the language of section 525 as unambiguous.⁵⁵ Therefore, the court found that, regardless of Congress's intent that section 525 be further developed, the language of section 525 could not be extended to encompass a loan.⁵⁶

In support of its narrow reading of section 525,⁵⁷ the court relied heavily upon the Second Circuit's decision in *In re Goldrich*.⁵⁸ In *Goldrich*, a former debtor was denied a guaranteed student loan because he had never repaid a prior guaranteed student loan.⁵⁹ The debt owed under the prior loan had been discharged in a bankruptcy proceeding, but a New York statute provided that "[a]ny student who is in default in the repayment of any guaranteed student loan . . . shall not be eligible for any . . . student loan so long as such default status . . . continues."⁶⁰ Accordingly, the New York state agency authorized to guarantee student loans refused to do so.⁶¹

The *Goldrich* court held that the New York law did not violate section 525 because "section 525 does not promise protection against consideration of the prior bankruptcy in post-discharge credit arrangements."⁶² In reaching its decision, the Second Circuit adopted the literal approach and held that the language of section 525 did not cover credit guarantees.⁶³ The *Goldrich* court stated, "Had Congress intended to extend [section 525] to cover loans or other forms of credit, it could have included some term that would have supported such an

53. *Watts*, 876 F.2d at 1093-94.

54. See *Garcia v. United States*, 469 U.S. 70, 75 (1984) ("[w]hen . . . terms of a statute are unambiguous, judicial inquiry is complete"); *United States v. Oregon*, 366 U.S. 643, 648 (1961) (no need to resort to legislative history if statute is clear and unequivocal on its face).

55. *Watts*, 876 F.2d at 1093.

56. *Id.* at 1093-94.

57. Actually, the court did not consider its interpretation of section 525 to be narrow. Rather, the court stated "that when an unambiguous statute is interpreted to mean what it says, the interpretation is not narrow." *Id.* at 1093. Despite this assertion, there are a number of bankruptcy courts that apply section 525 broadly, which supports the proposition that the *Watts* court's reading of section 525 is indeed narrow. For examples of courts which have interpreted section 525 broadly, see *infra* note 101.

58. 771 F.2d 28 (2d Cir. 1985).

59. *Id.* at 29.

60. *Id.* (quoting N.Y. EDUC. LAW § 661(6)(b) (McKinney 1988)).

61. *Id.*

62. *Id.* at 30.

63. *Id.* The court demonstrated its application of the literal approach by noting its "reluctan[ce] to probe behind the plain language of the statute." *Id.*

extension."⁶⁴

The *Watts* court relied on this dicta of *Goldrich* in ruling that PHFA had not violated section 525.⁶⁵ The *Watts* court compared the HEMAP mortgage assistance with the credit guarantees in *Goldrich* and reasoned that if the credit guarantees fell outside of section 525, then HEMAP assistance did as well.⁶⁶ The court further explained that it was reluctant to extend section 525 in this case because PHFA's suspension of mortgage assistance did not offend the "fresh start" policy of the Bankruptcy Code.⁶⁷

B. Automatic Stay Provision

Both the bankruptcy court and the district court in *Watts* held that PHFA violated the automatic stay provision of the Bankruptcy Code by discontinuing the plaintiffs' HEMAP assistance payments.⁶⁸ In order to reach this conclusion it was first necessary to determine that prospective HEMAP loan payments constituted "property of the estate."⁶⁹ Both lower courts made such a determination, relying primarily upon cases in which a debtor's interest in receiving energy assistance grants was held to be property of the estate.⁷⁰

In *Morris v. Philadelphia Electric Co.*⁷¹ and *In re Maya*,⁷² the courts held that assistance payments from a governmental agency were property of the estate.⁷³ *Watts* is similar to these two cases to the extent that

64. *Id.*

65. *See Watts*, 876 F.2d at 1093-94.

66. *Id.*

67. *Id.* at 1094. For a further discussion of the "fresh start" policy as applied to the facts of *Watts*, see *supra* note 32 and accompanying text.

68. *Watts*, 876 F.2d at 1095; *see In re Watts*, 93 Bankr. 350, 356-57 (E.D. Pa. 1988); *In re Watts*, 76 Bankr. 390, 407-08 (Bankr. E.D. Pa. 1987). In particular, the lower courts held that section 362(a)(3) had been violated by PHFA. *See Watts*, 93 Bankr. at 356-57; *Watts*, 76 Bankr. at 407-08; *see also* 11 U.S.C. § 362 (1988). For a further discussion of section 362(a)(3), see *supra* notes 8, 33-34 and accompanying text.

69. Section 362(a)(3) stays only those acts to obtain possession or otherwise control property of the estate. *See* 11 U.S.C. § 362(a)(3) (1988). Section 541 defines "property of the estate" as "all legal or equitable interests of the debtor in property as of the commencement of the case." *Id.* § 541(a)(1). The United States Supreme Court has held that "property of the estate" should be interpreted broadly. *See United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204-05 (1983). *Whiting Pools* was a Chapter 11 case, however, and thus its discussion regarding property of the estate may not apply in a Chapter 7 case. *See A. COHEN & L. FORMAN, BANKRUPTCY, ARTICLE 9, AND CREDITOR'S REMEDIES* 563 (2d ed. 1989) (explaining that *Whiting Pools* interpretation of section 541 may not apply to Chapter 7 cases).

70. *See Watts*, 93 Bankr. at 356; *Watts*, 76 Bankr. at 407.

71. 45 Bankr. 350 (E.D. Pa. 1984).

72. 8 Bankr. 202 (Bankr. E.D. Pa. 1981).

73. *Morris*, 45 Bankr. at 351; *Maya*, 8 Bankr. at 207.

the payments at issue were assistance payments from a state agency.⁷⁴ There is, however, a crucial factual distinction between *Watts* and *Morris* and *Maya*. In *Watts*, the assistance payments at issue were withheld, while in *Morris* and *Maya*, the payments were actually made to the debtors' creditors.⁷⁵ Accordingly, in *Morris* and *Maya*, the actions were brought against the utility-creditors, which had applied the post-petition payments to offset pre-petition debts.⁷⁶

Where post-petition payments have been made to the debtor's creditor and that creditor has applied the payments to a pre-petition debt, policy considerations mandate holding against the creditor-defendant. The *Morris* court summarized:

Once plaintiffs filed for bankruptcy they were no longer under a legal obligation to pay [their creditor] the prepetition debt they had incurred. By applying plaintiffs' [assistance] payments to plaintiffs' dischargeable utility bills, [their creditor] defeated the underlying purpose of the [assistance program]. Instead of [the assistance] funds being used to pay postpetition debts which plaintiffs still have an obligation to satisfy, the funds were used to offset debts plaintiffs had no legal obligation to pay. [Their creditor] collected on an otherwise uncollectable debt⁷⁷

This analysis focused on the actions of the creditor. By using the payment to settle an "otherwise uncollectible debt," the creditor had completely circumvented the primary purpose of the automatic stay. It is not surprising, therefore, that the *Morris* court ruled that the payments were property of the plaintiffs' estate because otherwise it would have been unable to hold that the creditor had violated the Bankruptcy Code.⁷⁸

The Third Circuit in *Watts* did not directly address the applicability of *Morris* and *Maya*, other than to note briefly that both were distinguishable because they involved actions against creditors.⁷⁹ Further, the

74. Both lower courts in *Watts* drew this analogy. See *Watts*, 93 Bankr. 350, 356 (E.D. Pa. 1988); *Watts*, 76 Bankr. 390, 407 (Bankr. E.D. Pa. 1987). The district court noted that HEMAP assistance, much like energy assistance, is designed primarily to "provide economic assistance for vital human needs." *Watts*, 93 Bankr. at 356.

75. *Watts*, 876 F.2d at 1095 n.6.

76. *Id.* Although the *Watts* court noted this distinction, it did not discuss it. See *id.*

77. *Morris*, 45 Bankr. at 354.

78. The lower court in *Morris*, however, held that the payments were not property of the estate. *Morris*, 45 Bankr. at 351; see *In re Morris*, 32 Bankr. 635 (Bankr. E.D. Pa. 1983). Because each of the plaintiffs' causes of action were "predicated on a finding that the grant was property of the estate," the court denied all requested relief and granted the creditor-defendant's motion to dismiss. *Morris*, 32 Bankr. at 638.

79. See *Watts*, 876 F.2d at 1095 n.6. For an explanation of why *Morris* and

court ambiguously noted that it would not have adopted the holdings of *Morris* and *Maya* had it addressed the property of the estate issue,⁸⁰ citing *Creative Data Forms, Inc. v. Pennsylvania Minority Business Development Authority*.⁸¹

In *Creative Data Forms*, a debtor sued a state agency seeking turnover of escrowed loan proceeds which the agency had refused to disburse to the debtor under a previously executed loan agreement between the agency and the debtor.⁸² The agency had disbursed slightly less than fifty percent of the loan proceeds prior to the debtor's Chapter 11 filing, but refused to disburse the balance of the loan funds after the bankruptcy filing.⁸³ Both the bankruptcy court and the district court rejected the debtor's turnover request, holding that turnover was not required because the undisbursed funds were not property of the estate.⁸⁴ The district court reasoned that because the debtor never had possession of the undisbursed funds and could not exercise any legal or equitable rights that would grant it possession, the escrowed loan funds did not fall within the definition of property of the estate.⁸⁵

Although the *Watts* court sidestepped the property of the estate issue by holding that section 365(e)(2)(B) of the Code rendered section 362 inapplicable,⁸⁶ it did recognize that *Creative Data Forms* held that the unpaid balance of an escrowed loan provided by a state agency to a minority business was not property of the estate.⁸⁷ This reference to *Creative Data Forms* demonstrates a reluctance on the part of the court to summarily abide by the lower courts' holdings that the prospective HEMAP payments were property of the plaintiffs' estate.⁸⁸ Moreover, the court noted that the "fresh start" policy of the Bankruptcy Code

Maya are distinguishable from *Watts*, see *supra* notes 75-76 and accompanying text.

80. *Watts*, 876 F.2d at 1095 n.7.

81. 72 Bankr. 619 (E.D. Pa. 1985), *aff'd*, 800 F.2d 1132 (3d Cir. 1986).

82. *Creative Data Forms*, 72 Bankr. at 620-21.

83. *Id.* at 621. The borrower-debtor, Creative Data Forms, Inc. (Creative), was a minority business. *Id.* at 620. The state agency, Pennsylvania Minority Business Development Authority (PMBDA), had approved a \$100,000 loan to Creative and had disbursed \$46,535 of that amount prior to Creative's bankruptcy filing. *Id.* at 620-21. Shortly after the filing, Creative requested a lump-sum disbursement of the entire \$54,454 balance that was being held in escrow. *Id.* at 621. PMBDA refused this request. *Id.*

84. *In re Creative Data Forms, Inc.*, 41 Bankr. 334, 337 (Bankr. E.D. Pa. 1984); *Creative Data Forms*, 72 Bankr. at 624.

85. *Id.* at 622-24.

86. See *Watts*, 876 F.2d at 1095-96. For the reasoning of the *Watts* court as to why section 362 was inapplicable, see *supra* note 35 and accompanying text.

87. *Watts*, 876 F.2d at 1095 n.7.

88. It appears that by using the "but cf." signal immediately before citing *Creative Data Forms* the Third Circuit intended for the case to be compared with, rather than contrasted with, the lower courts' property of the estate holdings. *Id.*; see A UNIFORM SYSTEM OF CITATION 9 (14th ed. 1986). *Creative Data Forms* was not cited as authority contrary to the lower courts' holdings. This may be an

would not be affected by holding the automatic stay inapplicable to the HEMAP payments, since mortgagees were precluded from foreclosing on the debtor while the stay was in effect.⁸⁹

C. Executory Contract Provision

Section 365(e)(1)(B) of the Bankruptcy Code prohibits termination or modification of an executory contract of the debtor solely because of the filing of the bankruptcy petition.⁹⁰ Section 365(e)(2)(B) exempts from this general rule executory contracts “to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor”⁹¹ The *Watts* court held that PHFA’s commitment to provide mortgage assistance “plainly constitute[d]” an executory contract that fell within section 365(e)(2)(B) and, therefore, PHFA had a statutory right to terminate the assistance under section 365(e)(2)(B).⁹²

Therefore, the crucial issue was whether the automatic stay provision of section 362 would apply even though section 365(e)(2)(B) expressly permitted termination of the PHFA contract.⁹³ The *Watts* court held that it did not apply.⁹⁴ The reasoning of the court was that section 365 specifically permitted termination by PHFA and, thus, section 362 should not be interpreted to conflict with such a specific grant by Congress.⁹⁵ Further, the court ruled that the lending, nondebtor party, such as PHFA, need not seek relief from the automatic stay before acting uni-

acknowledgement by the *Watts* court that the lower courts’ holdings are more strongly supported by existing case law.

89. *Watts*, 876 F.2d at 1096. Because foreclosure is prohibited during the stay, the court stated that the bankruptcy court’s assertion that the continuation of HEMAP assistance was “vital to Plaintiffs to retain their shelter” was simply untrue. *Id.* (quoting *In re Watts*, 76 Bankr. 390, 407 (Bankr. E.D. Pa. 1987)).

90. 11 U.S.C. § 365(e)(1)(B) (1988).

91. *Id.* § 365(e)(2)(B).

92. *Watts*, 876 F.2d at 1095-96. The court’s ruling that the PHFA contract was executory appears to be well-supported in the case law because an “executory contract” is generally defined as one in which performance is due on both sides. *See supra* note 37 and accompanying text. The court pointed out that performance was due on both sides in *Watts*: PHFA was obligated to advance payments and the plaintiffs were obligated to repay PHFA. *See supra* note 38 and accompanying text. If the only performance that remained was repayment by the plaintiffs, the contract would not have been held to be executory. *Watts*, 876 F.2d at 1096 n.9; *see In re Pennsylvania Tire Co.*, 26 Bankr. 663, 674 (Bankr. N.D. Ohio 1982), *In re Kash & Karry Wholesale, Inc.*, 28 Bankr. 66, 69 (Bankr. D.S.C. 1982).

93. *Watts*, 876 F.2d at 1096.

94. *Id.*

95. *Id.* This reasoning comports with the Supreme Court’s ruling that sections of a statute must be read in “the context of the whole Act,” therefore, where one section explicitly governs an issue, another section should not be interpreted to cause an irreconcilable conflict. *See Richards v. United States*, 369 U.S. 1, 11 (1962); *accord In re New Town Mall*, 17 Bankr. 326, 329 (Bankr. D.S.D. 1982) (refusing to grant protection under section 362 when intent of Congress appears clear at section 365).

laterally and terminating the executory loan contract.⁹⁶

III. ANALYSIS

A. *Anti-Discrimination Provision*

The *Watts* court relied heavily upon *In re Goldrich* in holding that section 525 was not violated by PHFA.⁹⁷ Reliance on the dicta of *Goldrich*, specifically that regarding Congress's failure to include loans or other forms of credit in the lists of grants in section 525, was clearly appropriate. *Goldrich*, however, is factually distinguishable from *Watts*. *Goldrich* involved a post-discharge denial of credit, while *Watts* involved a termination of credit due to the filing of a bankruptcy petition.⁹⁸ In short, *Goldrich* was not a case in which credit was denied solely because of a bankruptcy filing. Instead, the denial of credit in *Goldrich* was due primarily to the failure of the credit applicant to have paid a prior similar debt. That fact alone would seemingly take the *Goldrich* case outside of section 525.⁹⁹

Therefore, in a factual sense, reliance on *Goldrich* may be misplaced. Yet, from the standpoint of statutory construction, *Goldrich* is persuasive authority. The *Goldrich* court highlighted the major flaw in the theory that section 525 should be read broadly to cover loans when it stated:

Although the exact scope of the items [in section 525] may be undefined, the fact that the list is composed solely of benefits conferred by the state that are unrelated to credit is unambiguous. Congress' failure to manifest any intention to include items of a distinctly different character is also unambiguous. In the absence of ambiguity, no further inquiry is required.¹⁰⁰

The inference to be drawn from this statement from the *Goldrich* court is that had Congress intended for section 525 to be so broad, it

96. *Watts*, 876 F.2d at 1096. The court noted, however, that "the nondebtor party acting unilaterally may want to make a motion for relief from the automatic stay in a doubtful case in order to avoid liability for *ex parte* action which is later determined to be unlawful." *Id.* at 1096 n.11.

97. For a discussion of *In re Goldrich* and the *Watts* court's reliance upon it, see *supra* notes 57-67 and accompanying text.

98. In fact, in *Watts*, the mortgage assistance was reinstated after the plaintiffs had received a discharge in bankruptcy. *Watts*, 876 F.2d at 1092.

99. One of the requirements of section 525 is that the negative action taken against the person be done "solely because" the person is or has been under the Bankruptcy Code. 11 U.S.C. § 525(a) (1988). The facts of *Goldrich* indicate that this requirement was not met.

100. *Goldrich*, 771 F.2d at 30; see also *In re Exquisito Servs., Inc.*, 823 F.2d 151, 153 (5th Cir. 1987) ("better approach" is to focus on specified language of section, read legislative history more narrowly, and apply section "only to situations analogous to those enumerated in the statute"); *In re Rees*, 61 Bankr. 114, 124 (Bankr. D. Utah 1986) (government entity's conduct does not fall within purview of section 525(a) where entity does not have power to grant or deny licenses, permits, charters, franchises or any similar grant).

would have explicitly said so. This argument has considerable appeal, especially considering the detailed list of items contained in the section. Indeed, if Congress truly intended for section 525 to apply to various forms of governmental discrimination, why did it not list various unrelated items in the section? Or why did it not just set forth a *per se* rule prohibiting discrimination by governmental units on the basis of bankruptcy filings? The fact that it did not exercise either of these two broader options evidences an implicit desire to limit section 525 to only those cases similar to the facts in *Perez*.

While sympathetic bankruptcy courts across the country have chosen to interpret section 525 broadly in an effort to help unfortunate debtors,¹⁰¹ the support for such an interpretation is tenuous at best. Perhaps the most conclusive evidence that these courts have interpreted section 525 too broadly is that nearly every circuit court of appeals that has addressed section 525 has done so by applying the literal approach.¹⁰² By adopting the literal approach and finding no policy reasons to extend section 525, the *Watts* decision is thus consistent with the prevailing authority on the issue.

B. Automatic Stay Provision

Even if the HEMAP assistance payments were considered to be property of the estate, there were no policy considerations in *Watts* similar to those in the energy assistance cases that would mandate a holding that the automatic stay should apply. The creditor in *Watts* never received the payments at issue. Therefore, there was no equitable policy consideration involving a creditor that has collected an otherwise uncollectable debt as there was in both *Morris* and *Maya*.

Moreover, as the *Watts* court stated, the policy of the automatic stay—to give the debtor a “breathing spell”—was not affected by holding that the stay was inapplicable under the facts of *Watts*, for while the stay was in effect mortgagees were precluded from foreclosing.¹⁰³ Thus, the continuation of HEMAP assistance was not essential to the plaintiffs’ efforts to retain their homes. Additionally, the record reflected that PHFA reinstated the plaintiffs’ assistance and cured their

101. It should be noted that the majority of bankruptcy courts that have had occasion to interpret section 525 have done so broadly in alleged compliance with the “fresh start” policy of the Bankruptcy Code. See *In re Watts*, 76 Bankr. 390, 405-06 (Bankr. E.D. Pa. 1987); *In re Sudler*, 71 Bankr. 780, 786-87 (Bankr. E.D. Pa. 1987); *In re Hopkins*, 66 Bankr. 828, 833-34 (Bankr. W.D. Ark. 1986); *In re Elsinore Shore Assocs.*, 66 Bankr. 723, 740-43 (Bankr. D.N.J. 1986). See generally Annotation, *supra* note 47.

102. See *In re Exquisito Servs., Inc.*, 823 F.2d 151, 153-54 (5th Cir. 1987); *In re Goodrich*, 771 F.2d 28, 30 (2d Cir. 1985); see also *Laracuenta v. Chase Manhattan Bank*, 891 F.2d 17, 23 (1st Cir. 1989) (applying literal approach to section 525(b)); cf. *Duffey v. Dollison*, 734 F.2d 265 (6th Cir. 1984) (acknowledging “fresh start” policy of Code, but limiting applicability of section 525).

103. *Watts*, 876 F.2d at 1096.

mortgage defaults after the plaintiffs received a discharge in bankruptcy.¹⁰⁴

With respect to the issue of whether prospective assistance payments constitute property of the estate, until the Supreme Court rules directly on the issue, it is likely that lower courts will continue to take a somewhat ad hoc approach to the issue, focusing more on the needs of the debtor than on the statutory definition of property of the estate. Therefore, it would appear that in cases like *Watts*, where the plaintiff-debtors were much less in need of the protection of the automatic stay, courts may be more willing to narrowly construe the definition of property of the estate.¹⁰⁵

C. Executory Contract Provision

From a practical standpoint, the portion of the *Watts* decision that addresses the executory contract provision is potentially devastating to the debtor. Once it is decided that section 365(e) controls, the lender in an executory loan contract with a debtor is free to walk away from the contract obligations at any time. Further, in the event that the lender decides not to reinstate the loan assistance after the debtor receives a discharge in bankruptcy, the debtor would then be faced with mortgage default and imminent foreclosure with no immediate help in sight. Such a result seems to violate the "fresh start" policy of the Bankruptcy Code.¹⁰⁶

On the other hand, it is inequitable to force the nondebtor party to continue to make assistance payments to a creditor of a liquidating debtor. Yet, this would be the result if the automatic stay provision controlled in a case like *Watts*. One of the purposes of the automatic stay is to fix the rights and priorities of creditors as of the time of the filing of the bankruptcy petition.¹⁰⁷ Forcing the nondebtor to continue to make payments, and allowing the creditor to receive those payments while other creditors of the debtor were no longer receiving payments, would be contrary to that objective.

The *Watts* opinion correctly applies the tenets of statutory construction. Section 365(e)(2)(B) is specific and applies directly to the facts of *Watts*. It should prevail over the more general automatic stay provi-

104. *Id.* at 1092.

105. For a discussion of property of the estate as defined under section 541 of the Code, see *supra* note 69 and accompanying text.

106. For a discussion of the "fresh start" policy of the Bankruptcy Code, see *supra* note 32 and accompanying text. The "fresh start" policy is violated when the debtor no longer receives *mortgage* assistance because the debtor is then faced with the prospect of being evicted from his home.

107. See *In re Paul*, 67 Bankr. 342, 345 (Bankr. D. Mass. 1986). Further, the legislative history of section 362 states that "[b]ankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally." H.R. REP. NO. 595, 95th Cong., 1st Sess. 340 (1977), reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6297.

sion.¹⁰⁸ Therefore, even where section 362 applies to the types of contracts described in section 365(e)(2), “the effect of the [automatic] stay should be simply to preserve the status quo rather than to compel performance by the nondebtor party.”¹⁰⁹ Where both sections are applicable, the stay should be vacated.¹¹⁰

IV. CONCLUSION

In holding that PHFA did not violate the Bankruptcy Code when it discontinued mortgage assistance payments to the plaintiffs’ creditors, the Third Circuit in *Watts* joined the majority of circuit courts in adopting the literal interpretation of section 525 of the Code and refusing to extend its protection beyond the language of the statute. Simultaneously, the court held that section 362 was rendered inapplicable by section 365. This holding not only represented a novel approach to the issue, but also enabled the court to avoid ruling on whether the HEMAP payments constituted property of the debtor’s estate. Further, the court found no policy or equitable grounds which entitled the plaintiffs to protection since there existed no fear of imminent foreclosure. Thus, the *Watts* decision maintains the objectives of the Bankruptcy Code, without sacrificing the underlying policy.

Richard Ruffee

108. *But see In re Computer Communications, Inc.*, 824 F.2d 725, 730 (9th Cir. 1987) (even if section 365(e)(2) permits termination of executory contract, section 362 automatically stayed termination).

109. 2 COLLIER ON BANKRUPTCY ¶ 365.06 (15th ed. 1989).

110. *Id.*