BASIC BANKRUPTCY LAW PRIMER

AUGUST 2011

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1. INTRODUCTION TO BANKRUPTCY LAW

Our bankruptcy law is a body of rules and standards enacted to facilitate the collection of debts, the distribution of the debtor's assets among its creditors in accordance with the priorities embodied in the Bankruptcy Code, and the preservation of the debtor's ability to start anew.[1] Although courts and commentators differ over the primacy of these principles, they are in general agreement with the importance of these principles to modern bankruptcy law.

Like all debtor/creditor law, bankruptcy law is designed to resolve the various legal problems caused by debtors who are unable or unwilling to pay their debts. A creditor has various alternatives under applicable non-bankruptcy law to attempt to satisfy its claim against the debtor. But the applicable non-bankruptcy law remedies, although potent in the right circumstances, contain several acute deficiencies. First, as a general rule, state law procedures reward the creditor who acts first. The general priority rule of "first in time, first in right" applies with vigor. Consequently, a debtor with assets insufficient to pay all its creditors often finds its creditors in a "race to the courthouse" in an attempt to establish priority while at the same time dismantling the debtor through piecemeal liquidation. The second acute deficiency found in state law is the lack of state law's ability to affect a forced discharge of indebtedness. Thus, an honest but unfortunate debtor who happens to be down on luck and can no longer pay creditors can never receive a discharge under state law without the voluntary consent of the creditors.

Modern bankruptcy law attempts to address the two acute deficiencies found under state debt collection law. Bankruptcy law does this by balancing and accommodating a creditor's interest in being paid with the honest, but unfortunate, debtor's interest in paying its creditors what it can and in receiving a "fresh" start in its economic life. The Bankruptcy Code attempts to achieve this uneasy alliance by balancing the three principles discussed above: the efficient collection of debts, the distribution of the debtor's assets among its creditors in accordance with bankruptcy priorities, and the preservation of the debtor's right to discharge (or reorganize).

1.1. History of Bankruptcy Law

Article 1, § 8 of the United States Constitution states: "The Congress shall have the Power to establish uniform Laws on the subject of Bankruptcies throughout the United States." Congress first exercised the power to establish bankruptcy laws in 1800. Congress subsequently enacted bankruptcy statutes in 1841, 1867, 1898, and 1978 with the Bankruptcy Reform Act (Bankruptcy Code). In 2005, Congress enacted substantial amendments to the 1978 Bankruptcy Code . Current law is based upon the Bankruptcy Code as modified by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA or 2005 Act). The Bankruptcy Code is found at Title 11 of the United States Code. Bankruptcy cases are generally reported in West's Bankruptcy Reporter and can also be found on the Internet.

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[1] See generally *Burlingham v. Crouse*, 228 US 459 (1913); see also Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, at 75, 68-83 (1973).

The Bankruptcy Code itself is divided into nine substantive chapters. The chapters are organized as follows:

- Chapter 1: General Provisions
- Chapter 3: Case Administration
- Chapter 5: Creditors, the Debtor and the Estate
- Chapter 7: Liquidation
- Chapter 9: Adjustment of Debts of a Municipality
- Chapter 11: Reorganization
- Chapter 12: Adjustment of Debts of a Family Farmer or Family Fisherman with Regular Annual Income
- Chapter 13: Adjustment of Debts of an Individual with Regular Income
- Chapter 15: Ancillary and Other Cross-Border Cases

Chapters 1, 3, and 5 apply to the general operations of the bankruptcy case and are thus applicable in most instances under Chapters 7, 11, and 13.[2] (The even number chapters have been reserved for amendments and additions to the Bankruptcy Code, for example, Chapter 12.) All bankruptcy cases, other than ancillary and other cross-border cases, are commenced under chapter 7, 9, 11, 12 or 13.[3]

The protection of both debtor and creditor was not always the function of bankruptcy law. Not long ago, bankruptcy was designed solely to protect creditors. In England, a debtor unable or unwilling to pay its debts could be thrown in debtors' prison. Contrary to the popular view, the function of debtors' prison was not to punish the debtor but to hold the debtor for ransom. It was believed that the debtor's friends and relatives would combine what free assets they had and pay off the debtors' creditors, thus freeing the debtor from prison.

True to its historical roots, English and early American bankruptcy law served purely as a debt collection and equal distribution mechanism. Not until 1841 did American bankruptcy law recognize a debtor's right of discharge of indebtedness. At that time, the dualism of protection, so easily taken for granted today, was established.

In 1978, bankruptcy law underwent a substantial revision. With the enactment of the 1978 Bankruptcy Code and its amendment, bankruptcy law has become a vibrant and challenging area of the law. It is no longer an area of law relegated to the small firm; rather, some of the most prestigious and largest firms in the United States have practice areas in bankruptcy and business reorganization. Furthermore, bankruptcy relief is no longer relegated to the fly-by-night operation. Instead, we have seen great firms such as WorldCom/MCI, Enron, Kmart, Adelphia, Texaco, National Gypsum, the Southland Corporation, Delta, United Airlines,

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[2] See 11 U.S.C § 103 (2006).
[3] See 11 U.S.C. §§ 301, 302(a), 303(b) (2006).

Northwest Airlines, Continental Airlines, and Eastern Airlines seek relief under the Bankruptcy Code. No longer is bankruptcy relief relegated to low-income individuals who are down on their luck. Instead, doctors, lawyers, bank presidents, governors, congressmen, and sports figures are seeking relief under the Bankruptcy Code. As one commentator has cogently observed, bankruptcy has reached sort of a celebrity status in the United States.[4]

1.2. Policies Embodied in the Bankruptcy Code

The major purposes of bankruptcy law are to provide for the efficient collection of debts, distribute the debtor's property in accordance with uniform and national priorities, capture going concern value, and establish the debtor's right to discharge or to reorganize. However, in identifying what policies are embodied in the Bankruptcy Code, it is helpful to first identify who the debtor in the bankruptcy proceeding is. The reason for this identification is that the public policy rationales embraced by the Bankruptcy Code often differ based on whether the debtor is an individual or a business.

1.3. Individual Debtors

The paramount public policy rationale embodied in the Bankruptcy Code when the debtor is an individual is what is known as the fresh start policy. Essentially, bankruptcy permits an individual through the use of exemptions of property, the right to a discharge, and the exclusion of future income from the estate, to begin anew her economic life. Thus, certain property that is exempt under the Bankruptcy Code may be put aside by an individual so that there will be a future economic life. Furthermore, the discharge acts like an injunction forever barring enforceability of a prepetition claim against the debtor. However, there is no constitutional right to obtain a bankruptcy discharge.[5]

1.4. Business Debtors

The paramount public policy rationale embraced by the Bankruptcy Code in regard to a debtor business is the reallocation of limited and finite economic resources or the reorganization of the debtor. Here the fresh start policy is of little importance. Rather, the Bankruptcy Code provides a mechanism by which the resources of a business that has gone bad may be reorganized or redistributed to other businesses that may make a better go of it.

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[4] See generally Donald R. Korobkin, Rehabilitating Values: A Jurisprudence of Bankruptcy, 91 Colum. L. Rev. 717 (1991).

[5] See generally United States v. Kras, 409 US 434 (1973).

2. TYPES OF BANKRUPTCIES

Following is an overview of the types of bankruptcies that will be discussed in detail. Because of space limitations, chapter 9 bankruptcies (those involving municipalities) and chapter 12 bankruptcies (those involving family farmers) will be mentioned here, but not discussed in detail later in this chapter. However, many of the principles learned will also be applicable to those chapters.

2.1. Chapter 7

A bankruptcy case under chapter 7 of the Bankruptcy Code is a liquidation. Often, you hear lawyers refer to chapter 7 cases as "straight" bankruptcies. Generally, all of the debtor's non-exempt assets are collected by the chapter 7 trustee (who is always appointed by the U.S. Trustee) who identifies, collects, liquidates, and distributes them. The proceeds from non-exempt assets are distributed to the various creditors who have filed a proof of claim before the deadline known as the bar date.[6] The exempt assets that are claimed exempt by the debtor are retained by the debtor for a fresh start.[7] The case is closed once the estate is fully administered.

For the individual debtor, the ultimate goal of a chapter 7 case is an order of discharge, which discharges the debts that arose before the order for relief owed by the debtor to the creditors and enjoins the creditors from ever collecting on their discharged claims from the debtor.[8] Chapter 7 discharges are reserved for individuals; partnerships and corporations may not receive a chapter 7 discharge.

For the creditors, the ultimate goal of a chapter 7 case is the efficient collection, liquidation, and distribution of estate property in satisfaction of allowed claims. The distribution of estate property to satisfy allowed secured and unsecured claims is made in accordance with the distributional scheme embodies in the Bankruptcy Code.

2.2. Chapter 9

A bankruptcy case under chapter 9 is reserved solely for municipalities that are insolvent.[9] A municipality is a political subdivision of a state.[10] Chapter 9 provides the insolvent municipality a means by which to propose a plan to adjust its debts. Recently, the City of Bridgeport, Connecticut, sought relief unsuccessfully under chapter 9 of the Bankruptcy Code.

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6 See 11 U.S.C. § 726 (2006).
7 See 11 U.S.C. § 522 (2006).
8 See 11 U.S.C. §§ 727, 524 (2006).
9 See 11 U.S.C. § 109(c) (2006).
10 See 11 U.S.C. § 101(40) (2006).

2.3. Chapter 11

Through the commencement of a chapter 11 case, a debtor attempts to reorganize itself either through rehabilitate or orderly liquidation. Generally, the debtor keeps all of its assets, exempt and non-exempt, and remains in business.[11] Here, the debtor remains in control of the bankruptcy estate. The debtor may continue to engage in ordinary course transactions without court supervision; however, court approval through an order is necessary to authorize transactions outside of the ordinary course of business.[12] A trustee may be appointed to operate the debtor's business;[13] however, the typical situation is one in which the debtor itself operates the business as a debtor-in-possession.

In a chapter 11 case, the debtor proposes a plan of reorganization in which it attempts to provide a satisfactory schedule of payments and possibly collateral to its creditors. After approval of the disclosure statement, the debtor solicits affirmative votes from its creditors and equity holders in favor of its proposed plan of reorganization. Ultimately, the debtor hopes the plan is confirmed by the court.[14] Plan confirmation may take two paths: (1) by unanimous consent or (2) by cram down so long as one non-insider impaired class of claim has accepted the plan.

2.4. Chapter 12

Chapter 12 is limited to family farmers and fishermen with annual income.[15] The goal of a chapter 12 case is rehabilitation of the family farmer or fisherman debtor. The debtor retains all assets and attempts to satisfy claims pursuant to a chapter 12 plan. The chapter 12 process borrows heavily from both chapters 11 and 13.

2.5. Chapter 13

Chapter 13 is limited to individuals with regular income who meet certain debt limits.[16] A chapter 13 case is in some ways similar to a chapter 11 case in that the goal of a chapter 13 case is rehabilitation of the debtor and not liquidation. The debtor keeps all the assets, exempt and non-exempt, and attempts to make payments pursuant to a chapter 13 plan or schedule of payments over three to five years. Further, a chapter 13 trustee operates as the disbursing agent, distributing estate property, including disposable income, in accordance with the terms of the chapter 13 plan. Essentially, the debtor makes one payment to the chapter 13 trustee who then divides the one payment by the debtor to many small payments to the creditors. The chapter 13 plan is generally funded through the debtor's disposable income.

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[11] See 11 U.S.C. §§ 1107, 1108 (2006).
[12] See 11 U.S.C. § 363(c)(1) (2006).
[13] See 11 U.S.C. § 1104 (2006).
[14] See 11 U.S.C. § 1129 (2006).
[15] See 11 U.S.C. § 109(f) (2006).
[16] 11 U.S.C. § 109(e) (2006).

3. WHY BANKRUPTCY? - BANKRUPTCY AS A FINANCIAL TOOL

As one commentator noted, "Bankruptcy, like war, is something we have all heard about but unless we've lived through it, can't really appreciate the stress and changes in one's life caused by the experience." Bankruptcy can be a rigorous process where the most personal financial information of a debtor is disclosed and held up to public scrutiny. The debtor's assets and liabilities are painstakingly explored.[17] The motives behind gifts and charitable contributions are analyzed in detail. Transactions as far as two years back from the filing of the petition are routinely investigated. Under these circumstances, why would a debtor ever want to hold himself up to such scrutiny?

Generally, the decision to forego either an out-of-court settlement or to seek relief under the Bankruptcy Code turns in part on whether the debtor is an individual or a business. Typically, a prime candidate for bankruptcy relief is an individual who has a relatively large amount of unsecured debt that he cannot pay. Bankruptcy relief affords the individual an opportunity to voluntarily surrender his non-exempt assets ultimately to his creditors in exchange for a discharge of prepetition claims. This discharge, coupled with, among other things, the right to declare exemptions, fuels the debtor's fresh start. Moreover, an individual with a large amount of judgments against him may decide to seek relief under the Bankruptcy Code to prevent creditors from obtaining a secured claim by reason of a sheriff's levy on the property.

The reasons a business may seek relief under the Bankruptcy Code are as varied as the fish in the sea. Often times, the business will seek relief under the Bankruptcy Code because of a distortion in the right side of its balance sheet, that is, its liabilities. Where a business has a very good asset base but substantial liabilities, bankruptcy may afford the business an attractive alternative to a straight liquidation. Furthermore, bankruptcy permits the business to focus on its efforts to reorganize by staying repossessions, litigation, and foreclosures.[18] Moreover, bankruptcy often provides a business with a new opportunity to obtain credit or funds.[19] Finally, bankruptcy relief affords a means by which the debtor can bind certain minority creditors who dissented from any informal workout efforts through the use of the classification process and class voting.[20]

It is a fair statement that bankruptcy has become the repository of the nation's woes. Aside from becoming an acceptable corporate management tool,[21] bankruptcy courts find

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[17] See 11 U.S.C. § 341 (2006), see also Bankr. R. 2004.
[18] See 11 U.S.C. § 362(a) (2006).
[19] See 11 U.S.C. § 364 (2006).
[20] See 11 U.S.C. § 1126 (2006).
[21] See Kaplan, Bankruptcy as a Corporate Management Tool, A.B.A.J., Jan. 1, 1987, at 64.

themselves picking up the pieces of a failing tort system, a failed pension system, and poor labor relationships.

4. JURISDICTION AND COMMENCEMENT OF A BANKRUPTCY CASE

Bankruptcy jurisdiction rests with the district court under 28 U.S.C. §1334. The district court, however, may assign cases through reference to the bankruptcy court, which, in fact, all district courts have done. *See* 28 U.S.C. §157. The bankruptcy court may hear all core and non-core matters, unless specifically limited by statute. However, the bankruptcy court may only render final judgments in core matters as opposed to non-core matters.

A case under the Bankruptcy Code may be begun by either a voluntary petition filed by the debtor, or, for a chapter 7 or 11 case, by an involuntary petition filed against the debtor by the requisite number of creditors.[22] The petition is filed with the bankruptcy court clerk.

The petition should state the chapter under which it is filed. Along with the petition, the debtor must pay the appropriate filing fee. Although the fee may be paid in installments, it cannot be waived entirely. Section 302 of the Bankruptcy Code permits a husband and wife to file a joint petition, thus saving the cost of one filing fee.

The date of filing of the bankruptcy petition is a critical date in the bankruptcy case. The filing of the petition establishes a line of demarcation. Any payment or satisfaction by the debtor of any claims arising prior to this date is at least temporarily suspended. Generally, these prepetition claims are either satisfied or discharged through a liquidation under chapter 7 or a plan under chapters 11 or 13.[23]

To establish debtor eligibility, one must determine the status of the potential debtor, that is, whether the debtor is an individual, partnership, corporation, etc. This is necessary because a specific entity may be eligible for relief under Title 11, but not eligible for relief under a specific chapter. Second, the debtor must meet the residency or contact requirements with the United States, a sort of minimum contacts test that betrays the historical in rem foundation to bankruptcy jurisdiction. Third, the bankruptcy court must determine if a categorical exclusion applies. For example, banks, credit unions, and insurance companies may not file for relief under the Bankruptcy Code. Watch out here, however. A bank or insurance holding company is a corporation and may seek relief under the Bankruptcy Code. Finally, an individual debtor must have taken an approved counseling session within 180 days before the commencement of the case to be eligible for relief.

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[22] See 11 U.S.C. §§ 301-303 (2006).
[23] 11 U.S.C. § 101(5) (2006) (defining "claim").

4.1. Voluntary Cases

A voluntary case is commenced by the debtor filing a petition under the appropriate chapter of the Bankruptcy Code.[24] The petition is simple and basically states that the debtor has sought the particular relief in question, for example, chapter 7 relief. The petition need not show the debtor has any assets or is insolvent.[25] Many debtors have no assets; and theoretically, a solvent debtor may voluntarily file for bankruptcy protection.[26]

4.2. Involuntary Cases

An involuntary case is commenced pursuant to 11 U.S.C. § 303 under either chapter 7 or chapter 11: chapters 9, 12, or 13 not being a permitted alternative. An involuntary case cannot be commenced against a railroad, farmer, or charitable institution.[27] Additionally, an involuntary petition must be signed by the requisite number of creditors. Generally, three petitioning creditors must possess unsecured, bona fide, non-contingent claims totaling at least $12,300.00 in order to validly file an involuntary petition. If the debtor has less than twelve holders of bona fide, non-contingent claims against it, a single creditor with a single unsecured, bona fide, non-contingent claim of $12,300.00 is sufficient.[28] A single fully-secured creditor can waive its secured status as to a limited amount of its debt to satisfy this requirement or may join two others without waiving its claim.

Upon the filing of an involuntary petition, the debtor is permitted a period of time in which to answer the petition. Only the debtor may respond.[29] If the debtor does not timely answer the petition, the court will enter an order for relief against the debtor. If the debtor does timely answer the petition, the court can grant relief against the debtor only if the creditors can establish one of two grounds. The petitioning creditors must establish that either (i) the debtor is not generally paying its present debts as they become due or (ii) within 120 days of the date of petition, a receiver, assignee, or custodian had taken possession of substantially all the debtor's property.[30]

Between the filing of the petition and the hearing on the involuntary petition, the debtor is permitted to continue to operate its business much like a debtor-in-possession in a voluntary chapter 11 case.[31] Further, the bankruptcy court may require a bond from the debtor.[32] However, upon motion of any creditor or party in interest, the bankruptcy court can restrict the

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[24] See 11 U.S.C. §§ 301-302 (2006).
[25] The sole exception is for municipalities that seek relief under chapter 9. See 11 U.S.C. § 109(c) (2006).
[26] But see 11 U.S.C. § 109(c) (2006).
[27] See 11 U.S.C. § 303(a) (2006).
[28] See 11 U.S.C. § 303(b) (2006); see also Jack F. Williams, Counting Creditors Under Code § 303(b): The Tale of the Ubiquitous "Such," Norton Bankr. L. Advisor 7 (June 1992).
[29] See 11 U.S.C. § 303(d) (2006).
[30] See 11 U.S.C. § 303(h) (2006).
[31] 11 U.S.C. § 303(f) (2006).
[32] See 11 U.S.C. § 303(e) (2006).

debtor's use of property or appoint an interim trustee to take possession of the debtor's property and operate the debtor's business if it is established that such action is necessary to prevent loss or destruction of property of the estate.[33]

If the debtor is successful in establishing that the grounds for involuntary relief have not been satisfied, the court may grant a judgment in favor of the debtor for its costs and attorney fees.[34] Moreover, any petitioning creditor that files an involuntary petition in bad faith may be held liable for compensatory and punitive damages.

4.3. Dismissal or Conversion to Other Chapters

The bankruptcy court may dismiss a bankruptcy case even though all requirements for filing are satisfied. Dismissals may be based on either non-statutory or statutory grounds. Non-statutory grounds for dismissal rest on an implied duty of good faith in filing the petition. Although there is no statutory requirement that a petition be filed in good faith, there is a requirement that any chapter 11 or 13 plan be proposed in good faith. Courts have looked to the good faith confirmation requirement for a basis to imply a good faith filing requirement. In determining whether a debtor has filed its petition in good faith, courts consider a number of factors, including:

- Single asset
- Undeveloped land
- Encumbered land
- No equity
- Little to no employees
- Little cash flow
- No source of income
- Few creditors with small claims
- Secured creditor action forces the filing
- Timing
- Parallel litigation
- New debtor syndrome

Statutory grounds for relief begin with the generally applicable section, §305. That section provides that a bankruptcy case may be dismissed any time if the interests of the creditors and the debtor would best be served by dismissal. Additionally, each chapter has its own conversion section.[35] A chapter 7 case may be dismissed only for cause, including a delay by the debtor that is prejudicial to creditors or failure of the debtor to comply with orders of the court.[36] A chapter 7 debtor can convert its case to a chapter 11 or chapter 13 case if the case had not

[33] 11 U.S.C. § 303(g) (2006).
[34] See 11 U.S.C. § 303(i) (2006).
[35] See 11 U.S.C. § 348 (2006) (dealing with the consequences of conversion).
[36] See 11 U.S.C. § 707(a) (2006).

previously been converted to a chapter 7 case from a chapter 11 or chapter 13 case.[37] The court may convert a chapter 7 case to a chapter 11 case at any time. However, there can be no forced conversion to chapter 13.

Furthermore, through the 2005 Act, Congress substantially modified §707(b) to include a "means test" for relief under chapter 7. The means testing requirement rests on the perception by Congress that individual debtors were abusing the bankruptcy process by filing chapter 7 petitions when they had sufficient postpetition income to support funding payments under a chapter 13 plan. Thus, §707(b) now provides that a case may be dismissed for debtor abuse. A presumption of abuse is created where the debtor has sufficient income, after certain deductions are made, to fund a chapter 13 plan sufficiently to provide a meaningful payment to his creditors. If a debtor fails the means test, then he must convert to a chapter 13 case or suffer dismissal. However, as previously mentioned, the court does not have the authority to force conversion of the case to a case under chapter 13.

A debtor may convert a chapter 11 case to a chapter 7 case at any time, unless the case was originally commenced as an involuntary chapter 11 case.[38] The court may convert a chapter 11 case to a chapter 7 case or dismiss the case for cause, such as the debtor's inability to effectuate a plan, unreasonable delay by the debtor, failure to file income tax returns, or the absence of a reasonable likelihood of rehabilitation.[39] Additionally, by way of answer to an involuntary chapter 7 petition, a debtor may elect to convert the case to a case under chapter 11 and proceed as a debtor-in-possession. The bankruptcy court may not convert a case from chapter 11 to chapter 7 if the debtor is a farmer or a nonprofit.

Under chapter 13, a case may be dismissed or converted by a debtor at anytime (subject to very limited restrictions). A creditor or any other party in interest may seek dismissal or conversion of a chapter 13 case for cause.[40]

5. WHO MAY BE A DEBTOR IN BANKRUPTCY?

Not everyone or everything may be a debtor in bankruptcy. Certain debtors are categorically excluded from bankruptcy relief. These debtors include banks, thrift institutions, and insurance companies.[41] The common element that these entities have which leads to their exemption from the ability to seek relief under the Bankruptcy Code is that they are all in industries that historically have been closely regulated by the government and governed by their own set of insolvency laws. Aside from general categorical exclusion, some debtors may be

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[37] See 11 U.S.C. § 706 (2006).
[38] See 11 U.S.C. § 1112 (2006).
[39] See 11 U.S.C. §§ 1112(b)(1), (b)(2), (b)(5), 1129(a)(3) (2006).
[40] See 11 U.S.C. §§ 1307(b), 1307(c) (2006).
[41] See 11 U.S.C. § 109(b), 109(d) (2006).

eligible for relief under one chapter but not another.[42] Before turning to the requirements under particular chapters, one requirement applicable to all chapters must first be satisfied. "Only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor" under the Bankruptcy Code.[43]

5.1. Under Chapter 7

A debtor under chapter 7 of the Bankruptcy Code may be a person (person is defined as an individual, partnership, or corporation but does not include a governmental unit); railroads may not seek relief under chapter 7.[44] A sole proprietorship is not a person and cannot file as an entity separate from the individual under the Bankruptcy Code.

5.2. Under Chapter 11

A debtor under chapter 11 of the Bankruptcy Code may be any person eligible for relief under chapter 7, plus railroads; however, stock brokers and commodity brokers may not seek relief under chapter 11 of the Bankruptcy Code, their choice being limited to chapter 7.[45]

5.3. Under Chapter 13

Recall that a chapter 13 case, unlike chapter 7 or 11 cases, cannot be commenced through an involuntary petition. Under chapter 13, only an individual with regular income whose debts do not exceed $922,975.00 of secured debt and $307,675.00 of unsecured debt may file a chapter 13 petition.[46]

5.4. Debtor's Duties

A *quid pro quo* exists in bankruptcy. Once the debtor files a petition seeking relief under the Bankruptcy Code, the debtor receives the protection of the automatic stay[47] and ultimately the right to discharge.[48] The disclosure obligations for these bankruptcy protections are outlined at § 521 of the Bankruptcy Code. Under § 521, the Bankruptcy Code requires the debtor to perform a number of duties. The debtor must "file a list of creditors, and unless the court orders otherwise, a schedule of assets and liabilities, a schedule of current income and expenditures, and a statement of the debtor's financial affairs."[49] The debtor must also cooperate with any

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[42] An example is a railroad, which may only seek relief under chapter 11 of the Bankruptcy Code. See 11 U.S.C. § 109(d) (2006).
[43] 11 U.S.C. § 109(a) (2006).
[44] See 11 U.S.C. § 109(b) (2006).
[45] See 11 U.S.C. § 109(d) (2006).
[46] See 11 U.S.C. § 109(e) (2006).
[47] See 11 U.S.C. § 362(a) (2006).
[48] See 11 U.S.C. § 727(a) (2006).
[49] See 11 U.S.C. § 521(a) (2006).

appointed trustee or examiner, including the surrender of property if ordered by the court. The debtor must cooperate in turning over the books and records to the trustee. The debtor must additionally appear at the discharge hearing. Furthermore, the debtor will have to appear and submit to an examination under oath at a meeting of creditors under § 341; provide interested parties notices of amendments to petitions, lists, schedules, and statements; attend and submit to examinations ordered by the bankruptcy court under Bankruptcy Rule 2004; comply with all court orders; and identify and assist in recovery of the property of the estate. Finally, a debtor must file appropriate tax returns. The various lists, schedules, and statements and the time limits in which they must be filed are discussed in detail at Bankruptcy Rule 1007.

Bankruptcy Rule 4002 lists other duties of the debtor, which include:

> In addition to performing other duties prescribed by the Code and the Rules, the debtor shall (1) attend and submit to an examination at the times ordered by the court; (2) attend a hearing on a complaint objecting to discharge and testify, if called as a witness; (3) inform the trustee immediately in writing as to the location of real property in which the debtor has an interest and the name and address of every person holding money or property subject to the debtor's withdrawal or order if the schedule of property has not yet been filed pursuant to Rule 1007; (4) cooperate with the trustee in the preparation of an inventory, the examination of proofs of claim, and the administration of the estate; and (5) file a statement of any change of the debtor's address.

Failure by the debtor to abide by his duties may result in the court dismissing the bankruptcy case and prohibiting the re-filing of the case for 180 days.

6. FUNDAMENTAL ISSUES IN BANKRUPTCY

Although the Bankruptcy Code is replete with complexities and idiosyncrasies that can drive a seasoned bankruptcy practitioner a little crazy, one can nonetheless grasp the fundamentals of bankruptcy through an understanding of the major concepts embodied in the Bankruptcy Code. The four major concepts discussed in the remainder of this chapter are the automatic stay,[50] the bankruptcy estate,[51] the claims and distribution process,[52] and the discharge.[53]

[50] 11 U.S.C. § 362 (2006).
[51] 11 U.S.C. § 541 (2006).
[52] 11 U.S.C. §§ 501-507, 725, 726 (2006).
[53] 11 U.S.C. §§ 727, 524 (2006).

6.1. Automatic Stay

One of the most fundamental aspects of the Bankruptcy Code is the creation, scope, effect, and duration of the automatic stay found at § 362 of the Bankruptcy Code. It is the most hotly contested issue in bankruptcy practice.

6.2. The Scope of the Automatic Stay

Upon the filing of a voluntary or involuntary petition in bankruptcy, the automatic stay arises under § 362 of the Bankruptcy Code. The automatic stay applies to all entities, including governmental units. The stay is theoretically of infinite duration, continuing until it is terminated by the bankruptcy court under § 362(d) or by the Bankruptcy Code under § 362(c).

The purposes of the automatic stay are to enable the trustee to preserve the estate, to allow the trustee time to marshal the assets of the estate, to allow the trustee time to satisfy the claims of any creditors, and to afford the debtor time to confirm a plan of reorganization in a chapter 11 case.[54] The automatic stay stops the commencement or continuation of almost all civil actions against the debtor and all acts to create liens, collect or enforce claims, recover property, repossess or foreclose, or exercise control over property of the estate. The automatic stay also prevents the enforcement of all judgment, judicial, and consensual liens. The automatic stay also halts the commencement or continuation of a proceeding before the United States Tax Court.[55]

Generally the automatic stay protects only the debtor, the debtor's property, and property of the estate. Further, as "estate" is more broadly defined, the stay will provide greater protection. Third parties, such as guarantors, generally may not reap the benefits of the automatic stay unless they file their own bankruptcy petition.[56] However, certain provisions of the Bankruptcy Code, for example cases brought under chapter 13, may allow for a co-debtor's stay for family members or those closely affiliated with the debtor where the transaction that created the debt was a consumer transaction.[57]

6.3. Acts in Violation of the Automatic Stay

Any act in violation of the automatic stay is void because the stay is self-enforcing. Thus, a repossession or sale of any property that is property of the estate by a creditor in violation of the stay, with or without knowledge of the stay's existence, is void. Moreover, the creditor may be subject to a litany of sanctions ranging anywhere from paying the attorney's fees

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[54] See Interstate Commerce Commission v. Holmes Transportation, Inc., 931 F.2d 984, 987 (1st Cir. 1991); see also In re Richardson Builders, Inc., 123 B.R. 736, 738 (Bankr. W.D. Va. 1990).

[55] See 11 U.S.C. § 362(a) (2006).

[56] Some authorities, however, hold or suggest that the bankruptcy court has the inherent authority under § 105 to issue an injunction to protect insiders of the debtor, such as partners of a debtor partnership, when in the best interests of the estate.

[57] See 11 U.S.C. § 1301 (2006).

of the debtor to punitive damages and ultimately to contempt of court if the stay violation was willful.[58]

6.4. Exceptions to the Automatic Stay

Certain narrowly drawn and strictly construed acts, however, are not stayed. For example, the commencement or continuation of a criminal action or proceeding against a debtor, the collection of alimony, maintenance or support from property that is not property of the estate, the commencement or continuation of an action or proceeding by a governmental unit to enforce such governmental unit's police or regulatory power, and the issuance to the debtor by the governmental unit of a notice of tax deficiency, along with several other limited exceptions, are all excepted from the scope of the automatic stay.[59] In accordance with the 1994 amendments, assessments, request for tax information and filings, and administrative summonses are no longer violations of the automatic stay pursuant to §362(b)(9) (as amended).

6.5. Relief from the Automatic Stay

A secured creditor or other party in interest may file a request with the court seeking relief from the automatic stay.[60] Relief from the automatic stay is an often litigated area of bankruptcy law. Essentially, for a secured creditor to obtain relief from the automatic stay, it must show either cause for the termination of the automatic stay including lack of adequate protection[61] or that the debtor has no equity in the property and the property is not necessary for an effective reorganization.[62] The debtor will often argue that it in fact has equity in the property or that the property is necessary for an effective reorganization. Moreover, the debtor may argue that it can provide adequate protection of the secured creditor's interest without resorting to the termination of the automatic stay. The creditor has the burden of proof on the issue whether the debtor has equity in the property; the debtor bears the burden on the remaining issues.[63]

6.6. Filing Requirements:

Below are the filing requirements regarding stay-relief motions in bankruptcy courts.

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[58] See 11 U.S.C. § 362(k) (2006).
[59] See 11 U.S.C. § 362(b) (2006).
[60] 11 U.S.C. § 362(d) (2006).
[61] 11 U.S.C. § 362(d)(1) (2006).
[62] 11 U.S.C. § 362(d)(2) (2006).
[63] See 11 U.S.C. § 362(g) (2006).

- File motion for relief from stay which commences a contested matter under Bankruptcy Rule 9014.
- Payment of the filing fee, if required.
- File brief in support of the Motion presenting discussion of relevant facts and issues.
- File affidavits setting out the debt owed, secured status, cause, value of the collateral, *etc*.
- Request a hearing date from the court.
- File proposed order granting the Motion with the court.

One must consult local rules and a judges own peculiarities when considering relief from the stay.

6.7. Seeking Relief from the Automatic Stay

Various factors will affect a creditor's decision whether to seek relief from the stay; however, foremost in the majority of creditor's thoughts is the debtor's ability to repay the indebtedness owed and to protect the collateral securing the creditor's loan. In order for a creditor to seek the release of its collateral from the debtor's estate it is necessary to file a motion to terminate or modify the automatic stay. Such action may be brought at any time after the bankruptcy case is filed by a creditor claiming an interest in property or otherwise seeking relief to proceed against the debtor. The Bankruptcy Code requires that a court schedule a preliminary hearing on the motion for relief from the automatic stay within 30 days of filing the motion to consider whether the automatic stay should continue. Depending on the local rules, certain courts will hold a preliminary hearing to determine if the automatic stay should continue for up to 30 days, and then a final hearing will be held within another 30 days. In certain jurisdictions, the preliminary and final hearings are combined.

As briefly stated above, the Bankruptcy Code sets forth four alternatives for requesting relief from the automatic stay: (1) "for cause, including lack of adequate protection of an interest in property"; (2)(a) "lack of equity in such property," <u>and</u> (b) "such property is not necessary to an effective reorganization;" (3) as to an act against single asset real estate the debtor has failed to file a reasonable plan within 90 days from the order for relief or the debtor has failed to commence monthly payments to the secured creditor; or (4) the commencement of the case is determined to be part of a scheme to delay, hinder, or defraud creditors through a general assignment of interests in the specific real property at issue or through multiple bankruptcy filings.[64] The burden of proof is on the debtor on all elements except the issue whether the debtor has equity in the property.[65]

Cause as specified under § 362(d)(1) may include lack of insurance to protect the collateral, bad faith in the filing of the bankruptcy case, or an inability to adequately protect the

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[64] 11 U.S.C. § 362(d) (2006) (emphasis added).
[65] 11 U.S.C. § 362(g) (2006).

collateral securing the creditor's lien. Adequate protection is not defined in the Bankruptcy Code. However, methods of providing adequate protection are set forth in § 361. Adequate protection includes: (1) a cash payment or periodic cash payments; (2) providing of an additional replacement lien to the extent the use, sale, lease, or grant results in a decrease in the value of the property; or (3) granting of such other relief that will result in the realization of the "indubitable equivalent" of the creditor's interest in the property. As one can see, the concept of adequate protection is protean, its form limited by the imagination of counsel and the sensibilities of the court. Although adequate protection may take a multitude of forms, one theme remains constant: The purpose of adequate protection is to protect a creditor's interest in collateral from harm caused by the delays occasioned by the bankruptcy process itself; a creditor is not entitled to adequate protection from <u>all</u> harms. Moreover, adequate protection is not designed to protect a creditor’s benefit of the bargain; rather, adequate protection protects impairment of the value of a creditor’s lien from the delays inherent in the bankruptcy process.

Alternatively, pursuant to § 362(d)(2), a creditor may plead that a debtor does not have equity in the property and the property is not necessary to an effective reorganization. The creditor generally presents testimony regarding the amount of the indebtedness due, and uses expert testimony with respect to the value of the collateral. The creditor has then met its burden with respect to proving lack of equity, that is, that the amount of indebtedness owed is greater than the value of the property. The debtor may then rebut the creditor's evidence regarding lack of equity or must prove that the property is necessary for an effective reorganization. Because stay disputes are generally heard by the court early in the bankruptcy case, courts tend to be lenient in receiving and considering the debtor's evidence on whether property is necessary for an effective reorganization. However, the debtor must still introduce some evidence to show the necessity of the property for an <u>effective reorganization</u>. Obviously, the debtor or trustee cannot show that the property is necessary to an effective reorganization in a chapter 7 case; thus, the only defense under subsection (d)(2) is equity.

The focus of a § 362(d)(3) action in the context of single asset real estate is to ensure prompt compliance with the Bankruptcy Code by the debtor to protect the secured creditor’s interest in the property. This is done either by forcing a debtor to propose a plan with a reasonable prospect of success or by requiring the debtor to make monthly interest payments at the then fair market rate.

Finally, the focus of a § 362(d)(4) action in the context of real property is to prevent a debtor from frustrating legitimate creditor foreclosure efforts by employing the petition filing as part of a scheme to delay, hinder, or defraud its creditors through a transfer of ownership interest in the property or through the use of multiple or successive bankruptcy filings. The intent of this subsection, added by the 2005 Act, is to frustrate illegitimate efforts by a debtor to use a bankruptcy filing or multiple bankruptcy filings as a sword.

6.8. Termination of the Automatic Stay

When does the automatic stay end notwithstanding a creditor's action under § 362(d)? The answer may be found at § 362(c) of the Bankruptcy Code. Section 362(c)(1) provides that the automatic stay ends as to property that is no longer property of the estate. Property no longer is property of the estate when exempted under § 522, when abandoned under § 554, or when sold under § 363. Although the property may no longer be property of the estate, it may remain property of the debtor still protected by the automatic stay.

Section 362(c)(2) further provides that the automatic stay terminates when the bankruptcy case is closed, dismissed, or the debtor receives a discharge under chapters 7, 11, or 13.

Pursuant to the 2005 Act, §362(c)(3) and (c)(4) further provide limited to no stay protection in certain circumstances. These provisions are designed to prevent a debtor who employs successive bankruptcy filings to reap benefits from the stay and to minimize the unfair frustration of a creditor.

6.9. The Bankruptcy Estate

Along with the automatic stay, the definition and role of property of the bankruptcy estate are two of the most important issues in a bankruptcy case. The estate's property and distribution turn on the chapter under which the case is filed. The commencement of the case creates the estate, while the filing of the petition operates as a stay: protecting the estate, the debtor, and the debtor's property.

6.10. Property of the Estate

Under Bankruptcy Code § 541(a), property of the estate includes all of the debtor's legal or equitable interest in property at the time of the filing of the petition wherever located and by whomever held. This is a question of federal law but state law may be consulted. After the § 541 rules have been applied, chapter-specific rules such as § 1115 for chapter 11 and § 1306 for chapter 13 should be applied to determine the full extent of the property of the estate. Property subject to being exempt under § 522 is included in the definition of property of the estate until it is, in fact, set aside as provided in § 522. Further, anti-forfeiture, recapture, and exclusion provisions under § 541(c) should also be applied. Moreover, all the interest of the debtor and the debtor's spouse in community property that is under the sole, equal, or joint management of the debtor is included in property of the estate. Furthermore, inheritances that come to the debtor within 180 days after the filing of the petition, an interest in property as a result of a divorce decree or property settlement agreement with the debtor's spouse, the proceeds of a life insurance policy or death benefit plan, and the proceeds, rents, and profits from property included in the estate are all included in the definition of property of the estate.[66] Additionally, in a chapter 11

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[66] See 11 U.S.C. §§ 541(a)(1)-541(a)(7) (2006).

or 13 case, postpetition earnings are property of the estate and are usually used to fund the plan. It is this property of the estate that is subject to administration under the Bankruptcy Code and is used to satisfy, among other things, prepetition allowed claims.

6.11. Exempt Property in Bankruptcy

Along with the right to discharge, the right to declare exemptions under § 522 helps fuel the individual debtor's fresh start. To buttress this basic fact is the requirement that only an individual may assert exemptions under bankruptcy law. The law of exemptions recognizes a policy decision that creditors of the debtor, and not the public at least in the first instance, must partially fund a debtor's fresh start through the exemption scheme.

6.12. Bankruptcy Exemptions

Section 522(d) provides a complete list of federal exemptions that a debtor may choose if the debtor does not wish to select the exemptions provided by state law. Although § 522(b) permits a state like Georgia and most other states to require its debtors to select state exemptions only and forego the federal list by opting out of § 522(b), some states like Texas provide that a debtor may select either the federal list (§ 522(d)) or the state list of exemptions. The federal exemptions include the following:

- An equity of up to $18,450.00 in real property or personal property that the debtor or a dependent of the debtor uses as a residence (as compared to the unlimited value homestead exemptions under Texas and Florida law);

- An equity of up to $2,950.00 in one motor vehicle;

- Household furnishings, household goods, and personal apparel not to exceed $475.00 in value in any particular item or $9,850.00 in aggregate value;

- Jewelry not to exceed $1,225.00;

- Property, not to exceed in value $975.00 plus up to $9,250.00 of any unused amount of the exemption provided in (i) above (*i.e.*, the federal homestead provision);

- Books and tools of the trade not to exceed $1,850.00;

- Life insurance (with a cap in certain situations);

- Alimony and child support;

- Special assistance benefits;

- Certain rights in pension or profit sharing plans; and

- Awards from personal injury causes of action or criminal restitution.

As you can see from a perusal of the federal list, the fifth item above is a residual exemption. It permits the debtor to apply any part of the residence exemption that is not used up to $9,250.00 plus an additional $975.00 to exempt any type of property, including cash. This may be beneficial to an individual debtor who owns no home but has some cash in a bank account.

6.13. Exemption Procedures

Bankruptcy Rule 4003 requires the debtor to list and file with the court in accordance with Bankruptcy Rule 1007 all property claimed as exempt under § 522 of the Bankruptcy Code. This declaration of exemptions found in the statement of assets and liabilities must be filed with, or within 15 days after the filing of, the bankruptcy petition unless the court extends the time for filing for cause shown. If the debtor fails to claim exemptions, a dependent of the debtor may file the list of exemptions within 30 days after the debtor's initial time limit has run.

6.14. Objections to Declaration of Exemptions

The trustee or any creditor may file objections to the list of exemptions claimed by the debtor. Any objection must be filed within 30 days after the conclusion of the first meeting of creditors under Bankruptcy Code § 341 or the filing of any amendment to the list unless the court grants additional time.[67] Under Rule 4003, the party objecting to the exemptions has the burden of proof. Moreover, any objection filed with the court must be served on the trustee, the party claiming the exemptions (usually the debtor), and that party's attorney.

6.15. The Exemption Avoidance Power

Section 522(f) grants the debtor an avoidance power to avoid judicial liens and non-possessory, non-purchase money security interests in certain household goods, tools of trade, and health aids. Non-possessory is a term that means the collateral is not in the secured party's possession. Non-purchase money is defined by Article 9 of the Uniform Commercial Code. This power is exercised solely for the benefit of the debtor and the debtor's family. Section 522(f) may be used in any personal bankruptcy, even those bankruptcies where the individual debtor selects the state exemptions rather than the federal bankruptcy exemptions under § 522(d).

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[67] Failure to strictly abide by these objection deadlines will result in the inability to pursue the objection even if meritorious.

EXAMPLE:

> Assume an individual debtor owns a stereo in which Sears retained a security interest; a television in which the debtor granted a security interest to secure preexisting debt owed to a creditor; and an automobile in which the debtor granted a security interest to secure repayment of a debt owed a friend. The debtor files a Chapter 7 bankruptcy petition. May the debtor use the § 522(f) power to avoid any of the liens described above? The answer is no as to the lien in the stereo because Sears has retained a purchase money security interest. Section 522(f) cannot be used to avoid a purchase money security interest. As to the lien in the television, the answer is yes. Last, as to the automobile, the answer is no because although the security interest is non-purchase money and non-possessory, an automobile is not the appropriate type of personal property necessary before § 522(f) may apply.

Under Bankruptcy Rule 4003, any avoidance action under § 522(f) is a contested matter (as opposed to an adversary proceeding governed by Part 7 of the Bankruptcy Rules) and proceeds in accordance with Bankruptcy Rule 9014.

Because of the statutory requirements under § 522(d), the provision cannot be used to avoid a tax lien on otherwise exempt property.

6.16. The Debtor's Right to Redeem Tangible Personal Property

Section 722 authorizes an individual debtor to redeem tangible personal property intended primarily for personal, family, or household use from a lien securing a non-purchase money dischargeable consumer debt if the debtor's interest in the property is exempt under § 522(d) or state law or has been abandoned under § 554. In order to exercise the right of redemption under § 722, the debtor must pay to the creditor holding the lien the amount of the allowed secured claim of the holder that is secured by the lien. In other words, the debtor must pay the lessor of the fair market value of the property or the amount of the claim. This payment must be in cash and, absent consent of the creditor holding the lien, cannot be paid in installments. Thus, the § 722 right of redemption is nothing more than a debtor's right of first refusal in consumer goods that might otherwise be repossessed.

Although § 722 can be a potent ally of the individual debtor, it is a power with significant limitations. Section 722 can only be used by an individual debtor. It applies only to the redemption of tangible personal property that is used for personal, family, or household use. The eligible property must be either exempted or abandoned. Last, the lien in the property must secure consumer debt. If any one of these factors are not met, then the debtor cannot employ § 722.

7. THE CHAPTER 11 CASE

A chapter 11 case is commenced in the same manner a Chapter 7 case is commenced. A trustee can be appointed in a chapter 11 case, but the appointment does not occur automatically and requires appropriate motions by creditors or other parties in interest. See generally 11 U.S.C. § 1104. As a general rule, the debtor in a chapter 11 case remains in possession and in control of its property and continues to operate its business in the ordinary course. See 11 U.S.C. §§ 1107, 1108. Generally, only transactions outside the ordinary course of business require approval of the bankruptcy court. See 11 U.S.C. § 363(b)(1).

In a chapter 11 case, the debtor remains in possession of the estate under §§ 1108 and 1101. Under § 1107, the debtor has most of the powers of a chapter 7 trustee. Specifically, the debtor may do the following: reject executory contracts and leases, use a secured party's collateral, borrow money, modify the debt and equity portion of its capital structure, bind dissenting members of a class, cram down a plan over the objection of most classes, and receive certain tax benefits through reorganization.

Although the debtor remains in possession and operates the business in the ordinary course without the necessity of court approval, there are situations where a debtor may be replaced or have its authority severely limited. Under § 1104, a trustee may be appointed for cause if it is in the best interests of the creditors. The appointment of a trustee terminates the period of exclusivity, that is, the time period in which only the debtor had the right to propose a plan and get it confirmed. However, a court may terminate the trustee's appointment and restore the debtor to possession and management of the property of the estate and business according to § 1105.

A debtor-in-possession may make ordinary course transactions without court approval. The court, however, must approve extraordinary course transactions or unauthorized postpetition transfers. The determination of what is or is not in the ordinary course of business is not self-evident. Courts employ both the vertical and horizontal tests to make this determination. The vertical test looks to the history of the debtor and determines whether a creditor could claim unfair surprise when the debtor engages in the transaction at issue. The horizontal test considers comparable companies both in and out of bankruptcy and the types of transactions that a creditor would expect in the industry.

The official committee of unsecured creditors plays a key role in a chapter 11 case. The United States trustee, a Department of Justice official, appoints the creditors committee from the list of the seven largest unsecured creditors, although the trustee has the authority to depart from the top seven creditors to ensure that the committee represents a meaningful cross-section of the creditor class, including ensuring that a creditor with a relatively small claim but large to that creditor finds himself on the committee. The creditors' committee may retain professional counsel with the court's approval. Further, the court may order a change in the committee composition, additional creditor committees, and an equity security committee.

An examiner may be appointed in certain circumstances to investigate the debtor or current management, review potential causes of action, consider offers to purchase where there is a concern of management entrenchment, etc. In some circumstances, the appointment of an examiner may be mandatory. However, an examiner may not displace a debtor-in-possession and is limited to the scope of duties delineated in the order approving her retention.

7.1. Filing a Plan of Reorganization

In a chapter 11 case, the debtor or its creditors formulate a plan or competing plans of reorganization that provide the means by which the claims of creditors, equity security holders (e.g., shareholders), and other parties in interest are satisfied from the assets or otherwise treated and how the future operations of the debtor's business will be conducted. Unless a trustee is appointed, only the debtor may file a plan of reorganization during the 120-day period following the filing of the petition. 11 U.S.C. § 1121(b).

If a debtor files a plan within this 120-day period, no other plan may be filed during the first 180 days following the filing of the bankruptcy petition. 11 U.S.C. § 1121(c). If a trustee has been appointed or if the debtor fails to file the plan within 120 days and to have the plan confirmed by 180 days (unless these deadlines are extended by the bankruptcy court for cause. see 11 U.S.C. § 1121(d)), a creditor or other party in interest may propose a plan of reorganization and eventually solicit votes in favor of its plan.

The 120-day period of exclusivity to propose a plan cannot be extended beyond 18 months from the order for relief. The 180-day period of exclusivity to propose and have a plan confirmed may not be extended beyond 20 months from the order for relief.

7.2. Contents of a Plan and Disclosure Statement

The plan deals with the claims of creditors and interests of equity security holders. The claims and interests are divided into classes based upon the priorities established by the Bankruptcy Code and the specific nature of the claims and interests. See 11 U.S.C. § 1122. Each secured creditor is generally placed in a class by itself. The classes of unsecured creditors are generally divided into priority and general unsecured claims, although other classes may be appropriate in certain cases, such as disputed, contingent, or unliquidated claims. The interests of equity security holders may be divided into classes based on the relative rights and priorities provided in the equity securities that the debtor has issued.

A disclosure statement must be prepared discussing the plan of reorganization before the debtor solicits any acceptances of the plan from parties in interest. See generally 11 U.S.C. § 1125. The court conducts a hearing to review and approve the form and content of the disclosure statement. The disclosure statement must provide information adequate to inform a hypothetical investor about the contents of the plan. 11 U.S.C. § 1125(a). It must explain the treatment of each class of creditors and disclose the method for classification of claims. It must also contain an adequate liquidation analysis so that a claimant may compare its treatment under the plan to its

recovery under chapter 7 liquidation. The disclosure statement must also contain a discussion of the federal tax consequences of the plan. The disclosure statement cannot be misleading. The disclosure statement is similar to a prospectus filed in connection with a public offering of stock under federal securities laws.

7.3. Classification of Claims

Under a chapter 11 plan of reorganization, all creditors need not be treated alike. Rather, the Bankruptcy Code provides that creditors are divided into classes based upon the nature of their legal rights. The Bankruptcy Code also expressly provides that dissimilar claims are not to be placed within the same class of claims. See 11 U.S.C. § 1122(a), see also 11 U.S.C. § 1123(a) and 1322(b)(1). Although classification of claims can be a creative process (and an important one too if the debtor needs an affirmative vote of a non-insider impaired creditor class to set up a cram down of an objecting creditor class under § 1129(b)), there are certain basic tenets that are generally followed in classifying claims.

First, secured claims are generally placed in their own class. For example, the creditor who has a security interest in the equipment will be placed in one class and the creditor who has a lien on real property will be placed in another class. Second, generally the taxing authorities are placed in a separate class. Third, generally the administrative priority expenses are placed in a separate class. Finally, all unsecured creditors are generally placed in one class. Classification is important because all the members of a class receive the same treatment. Further, a majority of the class in number and two-thirds in amount of claims binds the minority of a class if a plan is confirmed. See 11 U.S.C. § 1126(c). Furthermore, in order to invoke the cram down provisions under § 1129(b) of the Bankruptcy Code, the debtor must be able to point to an affirmative vote in favor of the plan cast by a non-insider creditor class. Consequently, the classification of claims has become a hot litigation topic. Debtors, in their attempt to seek confirmation of plans, have engaged in creative classifications in formulating a plan of reorganization. Creditors, on the other hand, vigorously object to what appears to them to be the gerrymandering of classes of claims for the sole purpose of obtaining the consenting vote in order to invoke cram down. At present, the issue of how far a debtor can go in creatively classifying claims under a chapter 11 plan of reorganization is unresolved.

7.4. Funding Alternatives for Plans of Reorganization

Before the bankruptcy court will confirm a plan under chapter 11 of the Bankruptcy Code, the court must find that the plan is feasible. Essentially, feasibility is a reflection of the financial and economic realities of the proposed reorganization. Like railroad cars, for a chapter 11 plan to go anywhere it must have an engine; that engine is some type of funding mechanism. Below are discussed five of the more common funding alternatives that may be available to a debtor in attempting to propose and ultimately confirm chapter 11 reorganization. Bear in mind, however, that whether any of these funding alternatives is available will depend directly on the facts and circumstances of each case.

7.4.1. Sale of Assets

Often times, a debtor's reorganization may be funded through the sale of certain assets of the debtor. For example, a corporate debtor may have various divisions within the corporate structure that the debtor could "spin-off" in efforts to raise funds for the reorganization. Furthermore, a parent corporation may decide to sell stock in certain of its subsidiaries in an effort to raise funds for reorganization. The sale of assets is one of the more traditional funding alternatives discussed.

7.4.2. Avoidance Powers

A debtor may argue that the recovery from certain avoidance powers, such as fraudulent transfer, postpetition transfer, and avoidable preference actions, will be sufficiently large (even discounting the probability that the debtor may not prevail) to fund a plan of reorganization. Nonetheless, a debtor that must rely on recoveries from avoidance powers actions to fund a plan is on very thin ice. Typically, courts will convert a case to a case under chapter 7 and allow the trustee to bring the actions for the benefit of all creditors.

7.4.3. Postpetition Financing

It may seem strange to the novice, but there are creditors who are interested in providing postpetition financing to a debtor in bankruptcy. There are many creditors and the postpetition financing industry is becoming increasingly competitive. Creditors who provide postpetition financing may be entitled to administrative expense priorities discussed above, liens on unencumbered assets, and in some circumstances, super-priority liens that prime the liens of prepetition secured creditors. See generally 11 U.S.C. § 364. Along with the collateral package, postpetition creditors can shore up any prepetition deficiencies through a mechanism known as cross-collateralization if certain requirements are met, may obtain origination fees in large amounts, and may extract a higher rate of interest from the debtor. Moreover, a lender could not envision a more cost effective and more tightly monitored lending situation than that of a debtor-in-possession operating under the Bankruptcy Code. Typically, a lender will require certain promises or covenants in loan documents wherein the debtor will promise not to engage in transactions out of the ordinary course of business or grant further security interests in or liens on collateral. This is merely a promise, the breach of which would result in damages in any action brought by the creditor. However, in a Chapter 11 case, although the debtor who operates as a debtor-in-possession has the right to continue to engage in business in its ordinary course, it must seek prior approval from a bankruptcy court after due notice and hearing before it can engage in transactions out of the ordinary course of business or grant additional security interests or liens. See 11 U.S.C. § 363(b)(1).

7.4.4. <u>Equity-for-Debt Swaps</u>

Yet another funding alternative is where the debtor seeks through a plan of reorganization to cancel some or all of the debt held by a class or classes of creditors in exchange for an equity interest in the reorganized entity. Often times, one will encounter this situation in the more consensual chapter 11 reorganization plan; however, the debtor may make such a proposal in other situations and if it otherwise complies with § 1129, the court may confirm the plan of reorganization.

7.4.5. <u>Equity Infusions</u>

Probably the oldest form of funding discussed here is the equity infusion. The typical situation is where either one of the owners of the debtor agrees to infuse money in the reorganized debtor, or a third party binds himself to do so. One of the major limitations of equity infusions, discussed in detail below, is the absolute priority rule.

7.4.6. <u>Future Operations</u>

Although rare by itself, a debtor may propose to fund a reorganization from future income generated by the reorganized enterprise. More commonly, this alternative is coupled with one of the above methods as a combined means of funding a reorganization.

7.5. Acceptance and Confirmation of a Reorganization Plan

To gain approval of the plan, the debtor must receive the acceptance of the plan by each class of claims and interests. A class of claims accepts a plan if creditors holding two-thirds in amount and one-half in number of the allowed claims in the class vote in favor of the plan. A class of interests accepts a plan if holders of two-thirds in amount of the allowed interests of the class vote in favor of the plan. If a class of claims or interests is not "impaired" by the plan, all members of the unimpaired class are deemed to have accepted the plan as a matter of law. (A class is "impaired" if it receives under the plan less than the full amount of its allowed claim.)

Even if all classes of claims vote in favor of the plan, the bankruptcy court may refuse to confirm the plan if it determines that the plan was not proposed in good faith. <u>See</u> 11 U.S.C. § 1129(a)(3). Conversely, under certain "cram down" provisions, a plan may be confirmed, even though most of the impaired classes reject the plan, if at least one class of impaired claims accepts the plan, the plan does not discriminate unfairly, and the plan is "fair and equitable" with respect to each impaired class of claims or interests that rejected the plan. <u>See</u> 11 U.S.C. § 1129(b).

The fair and equitable standard is based on the absolute priority rule. The absolute priority rule requires that no class of claims or interests that is junior to the claims or interests of a non-consenting impaired class may receive anything under the plan until all members of the non-consenting senior class have been fully compensated. The senior class is entitled to full, but not

over, compensation. The absolute priority rule also requires that any secured creditor be allowed to retain its lien on its collateral and receive payments in the amount of the value of its collateral or otherwise realize the indubitable equivalent of its secured claim.

Courts have generally recognized what has been called the new value exception to the absolute priority rule. To fit this exception, there must be a contribution to a reorganized debtor by old equity, that contribution must be in money or money's worth (future services or sweat equity is insufficient), the contribution must be necessary, and substantially equivalent value to the interest retained by the old equity.

7.6. Plan Confirmation

The Bankruptcy Code provides two means by which a chapter 11 plan may be confirmed. First, the debtor must meet all eleven requirements of § 1129(a) of the Bankruptcy Code, including subsection (a)(8) which provides that all impaired classes of claims or interests must accept the plan. Second, absent consent of all impaired classes, the debtor can achieve confirmation pursuant to the so-called cram down provisions of § 1129(b). Section 1129(b) provides that if the plan meets all of the applicable requirements of § 1129(a), except subsection (a)(8), the court, upon request by the debtor, shall confirm the plan if it does not discriminate unfairly and is fair and equitable with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. Thus, a chapter 11 plan of reorganization can be confirmed over the objections of one or more impaired classes of creditors if at least one non-insider impaired class of creditors votes in favor of the plan.

7.6.1. <u>Confirmation Under § 1129(a)</u>

The debtor has 180 days to propose and convince the court to confirm the plan without competing plans in play. Further, the period of exclusivity cannot be extended beyond 18 (time to propose a plan) or 20 months (time to confirm a plan) from the order for relief. Section 1129(a) of the Bankruptcy Code provides that a court shall confirm a plan only if certain statutory requirements are met. These requirements include the following:

- The plan complies with the Bankruptcy Code. This requirements embraces such things like the reasonable classification requirement found in § 1122 and the plan content requirement found in § 1123.

- The plan proponent must comply with the Bankruptcy Code, such as making the required disclosures under § 1125.

- The plan must be proposed in good faith and not by any means forbidden by law.

- Disclosure must be made of any payment made or promised by the proponent, the debtor, or person issuing securities or acquiring property under the plan, for services or

for costs and expenses in, or in connection with the case, or in connection with the plan. Moreover, any pre-confirmation payment must be reasonable and any post-confirmation payment must be approved by the court.

- The plan must disclose the identity and affiliations of any individual proposed to serve, after confirmation, as an officer, director, or voting trustee for the reorganized debtor. Furthermore, the plan must disclose the identity of any insider that will be employed or retained by the reorganized debtor and must disclose the nature of any compensation to be paid to the insider.

- Although the sixth requirement of confirmation is generally not applicable, it nevertheless requires that any regulatory commission having jurisdiction over the reorganized debtor must approve any rate change contained in the plan.

- Each holder of an impaired claim or interest must either accept the plan or, on the effective date of the plan, receive or retain an amount not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7. This is known as the "best interest of the creditors" test.

- Each class must accept the plan (or are unimpaired under the plan.)

- The plan must comply with the absolute priority rule. In short, the absolute priority rule requires that no class of claims or interests junior to a particular class can receive any payment under the plan unless and until the senior class is paid in full. For example, the absolute priority rule prohibits payment to equity security holders unless and until all creditors holding allowable claims have been paid in full.

- At least one class of claims that is impaired under the plan must accept the plan. The class cannot be an insider class.

- The plan must be feasible. In essence this requirement ensures that a plan which is likely to be followed by liquidation or the need for further reorganization will not be confirmed. The feasibility focus is on the future cash flow, amortized principal, and the net earnings needed to restructure. The new capital structure, including the relationship of debt to equity for the reorganized debtor, must also be sound.

- Certain fees must be paid at or before the effective date of the plan. .

- Certain retiree benefits must continue to be paid after the plan's effective date.

If all the requirements under § 1129(a) of the Bankruptcy Code are met, then the court shall confirm the plan of reorganization. However, if the requirement of consent under § 1129(a)(8) is

lacking *but all other confirmation requirements are met*, then the debtor may turn to § 1129(b) of the Bankruptcy Code.

7.6.2. Tax Claims and Issues

The 2005 Act addressed bankruptcy tax issues in a robust fashion by including some 20 new provisions. For example, a closer look at § 507(a)(8) reveals that priority tax claims are allowed on unsecured claims of governmental units to the extent that such claims are for a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition for which a return is last due (including extensions) after three years before the date of the filing of the petition, assessed within 240 days before the date of the filing of the petition. This is exclusive of any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days. Further, this is also exclusive of any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days.

Furthermore, the rate of interest on tax claims is governed by § 511. If there is a requirement to pay the interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest is the rate determined under applicable non-bankruptcy law. However, in the case of taxes paid under a confirmed plan, the rate of interest is determined as of the calendar month in which the plan is confirmed. The non-bankruptcy tax rate is a terrible provision because it is the only case where the creditor may receive more than the value of its claim. The federal rate makes the most sense since it is closest to the market rate. The state rate, however, may be much as 20% higher than market rate.

Additionally, with respect to the periodic payments of taxes as governed in § 1129(a)(9), the claim holder receives regular installment payments in cash. These payments are of a total value, as of the effective date of the plan, equal to the allowed amount of such claim. This is to be taken over a period ending in less than five years after the date of the order for relief. The payment should not be in a manner less favorable than the most favored non-priority unsecured claim provided for by the plan. Further, with respect to a secured claim that would otherwise meet the description of an unsecured claim of a governmental unit, the claim holder receives cash payments in the same manner and over the same period.

Moreover, the standards for tax disclosures are covered in § 1125(a). Here, "adequate information" means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such hypothetical investor of the relevant class to make an informed judgment about the plan. However, adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure

statement provides adequate information. Here, the court considers the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information.

Finally, the Bankruptcy Code provides that there should be no discharge of fraudulent taxes in § 1141(d). Section 1141(d) defines the effect of confirmation of a chapter 11 plan and specifically discharges certain debts that arose before confirmation. There is an exception for tax liabilities from a chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty. Further, this provision also makes a discharge exception for any debt incurred under false pretenses or by making a false statement in writing. Corporations cannot discharge a debt based on fraud owed to a governmental unit arising out of false pretenses, false representations or actual fraud, whether or not based on use of a financial statement in writing. The language of this provision makes it unclear whether these non-dischargeable debts to governmental units must arise from the debtor's own fraudulent dealings with the government, or if this extends to claims or fines the government could impose on account of the debtor's defrauding of investors or creditors. Further, debt owed to an individual on a qui tam claim is also not dischargeable. With regard to individuals filing chapter 11 cases, the discharge may be delayed until full performance absent a chapter 11 hardship discharge.

7.6.3. Cram Down

Nothing conjures up the demons in the deep recesses of a creditor's mind quite like the concept of "cram down." Cram down is a euphemistic term for the process by which a debtor can obtain confirmation of its plan so long as the plan satisfies all the requirements of § 1129(a) except sub-section (a)(8) which requires acceptance of the plan by all classes of claims and interest. Failing unanimous consent, cram down is the only way to "cram" a plan "down the throat of the dissenting class." The debtor accomplishes cram down by proving all confirmation requirements except (a)(8) are met under § 1129(a) and by proving that the plan "does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interest that is impaired under, and has not accepted, the plan."

The concept of fair and equitable treatment turns on whether the class of claims at issue is a secured or unsecured class. Section 1129(b)(2)(A) defines fair and equitable treatment with respect to a class of secured claims. Section 1129(b)(2)(B) defines fair and equitable treatment with respect to a class of unsecured claims. Please read those provisions.

7.6.4. Competing Plans

Suppose competing plans have been filed and they all meet the requirements under § 1129(a) or (b). What is the court to do in that situation? Section 1129(c) expressly provides that the court may confirm only one plan, unless of course the confirmation is revoked. In the situation where more than one plan satisfies § 1129, the Bankruptcy Code requires the court to give due

consideration to the preferences of creditors and equity security holders before confirming a single plan.

7.7. Effect of Confirmation

Confirmation of a plan of reorganization under chapter 11 discharges the corporate debtor from all claims arising before the confirmation of the plan except those claims paid pursuant to the terms of the plan, subject to certain limitations. See 11 U.S.C. § 1141(d). Confirmation of the plan however, does not discharge an individual debtor of any debt excepted from discharge under § 523. Furthermore, confirmation of a plan of reorganization, except as otherwise provided in the plan, vests in the debtor all property of the estate free and clear of all claims and interests of creditors and other parties in interest.

Once a plan has been confirmed, it becomes a final order of the bankruptcy court and binds all creditors, all equity security holders, the debtor, and other parties in interest with notice of the bankruptcy case to the terms, conditions, and contents of the plan. Consequently, a creditor's pre-bankruptcy rights evaporate. Instead of resorting to pre-bankruptcy documents, a creditor who attempts to satisfy its claim against a reorganized debtor merely seeks to enforce the confirmation order. A confirmation order may be revoked by the court only in certain limited circumstances. Under § 1144, the confirmation order can only be revoked for fraud in its procurement and only within 180 days after the entry of the order. These strict exceptions to the general effect of a confirmation order are necessary to promote and ensure finality in the proceedings. Consistent with that view, any entity who relied in good faith on the confirmation order is protected even if it is later revoked under § 1144.

7.8. Modification of the Plan

Because the plan of reorganization is an intensely negotiated document, it is not uncommon for modifications to be proposed by creditors and for some of those modifications to be embraced by the debtor. Therefore, § 1127 of the Bankruptcy Code was enacted to regulate the modification of plans. A plan proponent may modify a plan at any time before confirmation. Of course, the requirements in §§ 1122, 1123, 1125, and 1129 must be met by the modified plan.

The procedure for modification, however, is different if the reorganized debtor or a proponent of the plan seeks to modify the plan after confirmation but before substantial consummation. The plan may nevertheless be modified even after confirmation but before substantial consummation if, after notice and a hearing, the court concludes that circumstances warrant the modification. Again, any modified plan must comply with § 1122, 1123, and 1129. To facilitate plan modifications, § 1127 further provides that "[a]ny holder of a claim or interest that has accepted or rejected a plan is deemed to have accepted or rejected . . . such plan as modified unless, within the time fixed by the court, such holder changes such holder's previous acceptance or rejection."

7.9. Discharge Under Chapter 11

Under § 1141(d) of the Bankruptcy Code, the confirmation of the plan of reorganization discharges the debtor from any debt that arose before the confirmation of the plan. Unlike § 727(a), a partnership or corporation (as well as an individual) may receive a § 1141(d) discharge. The § 1141(d) discharge is broader than the § 727(a) discharge in that the latter discharges any debts that arose before the entry of the order for relief, while the former discharges any debts that arose before the confirmation of the plan.

Nevertheless, there are limits to the § 1141(d) discharge. First, debts excepted from discharge under § 523 are not discharged under § 1141(d) when the debtor is an individual. Second, if the plan provides for liquidation of all or substantially all of the property of the estate, the debtor does not continue in business, and the debtor would be denied a discharge under § 727(a), then confirmation of the plan does not discharge the debtor. These limitations are necessary so that an individual debtor may not employ a chapter 11 liquidation plan to evade the objections to discharge embodied in §§ 523(a) and 727(a).

Section 1141 also excepts tax liabilities from chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty. Moreover, this section also excepts from discharge any debt incurred under false pretenses or by making a false statement.

8. THE CHAPTER 13 CASE

As its title implies, the purpose of the chapter 13 plan is the adjustment of debts of individuals with regular income. The regular income requirement is necessary as a means by which the chapter 13 plan is funded. The funding takes place by the debtor making payments pursuant to the plan to a chapter 13 trustee who then pays the creditors in accordance with the terms and conditions of the plan.

8.1. Elements of the Plan

The first element of a chapter 13 plan can be found in § 1302 which requires that a chapter 13 plan provide for payment through a trustee. Second, a plan must provide for payment of debts from a portion of the debtor's disposable income as defined in § 1325(b)(2). Third, the plan must provide for submission of all or a portion of disposable income to the trustee. Fourth, the plan must provide full payment to priority claims although the claims may be paid throughout the plan term. Fifth, the plan must treat all creditors within a class the same. Sixth, the plan may not stretch out payments for more than three years, or with the court's approval, five years. See generally 11 U.S.C. § 1322.

8.2. Role of the Chapter 13 Trustee

The chapter 13 trustee plays a role quite different from the chapter 7 counterpart. Instead of being charged with the marshalling of assets, the liquidation of assets, and the payment of proceeds from the assets to the creditors, the chapter 13 trustee is entrusted with the duties to pay creditors a portion of the debtor's future earnings or income pursuant to the terms and conditions of a confirmed chapter 13 plan. Thus, the debtor is required to send but one check to the chapter 13 trustee who then divides the proceeds of the monthly check for all creditors in accordance with the confirmed plan. See generally 11 U.S.C. § 1302(b).

8.3. Plan Confirmation

Confirmation of a chapter 13 plan is governed by § 1325 of the Bankruptcy Code. It reads almost like an abbreviated list of plan confirmation requirements under § 1129 for chapter 11 cases. Most importantly, the confirmation requirements of § 1325 provide only a single financial condition for the protection of unsecured creditors. That financial condition requires the court to determine whether an unsecured creditor would receive less under a chapter 13 plan than it would under chapter 7 liquidation. If that be the case, the plan should not be confirmed. Along with the financial condition, which protects unsecured creditors, the court may only confirm a plan if the following are met:

- The plan complies with the provisions of chapter 13 and the remainder of the Bankruptcy Code.
- Certain fees are paid before confirmation.
- The plan is proposed in good faith and not by any means forbidden by law.
- Secured claims must receive certain protections if the holder of such claim has not accepted the plan, including retention of the liens securing the claim or surrender of the collateral to the creditor.
- The plan is feasible, i.e., the debtor will be able to make all payments under the plan and to comply with the plan.

8.4. Effect of Confirmation

Section 1327 provides that the "provisions of a confirmed plan bind the debtor and each creditor whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan." Furthermore, the confirmation of the plan vests all of the property of the estate in the debtor.

8.5. Modification of the Plan

Like its chapter 11 counterpart, the chapter 13 debtor may modify the plan at any time before confirmation, but may not modify the plan in a manner so that it no longer complies with § 1322 which regulates the contents of a plan of reorganization. Furthermore, § 1323 provides that any holder who has previously accepted or rejected the plan is deemed to have rejected or accepted the plan as modified unless "the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder's previous acceptance or rejection."

8.6. Discharge Under Chapter 13

The chapter 13 discharge is slightly broader in scope than either the chapter 7 or chapter 11 discharges. Recall that under chapter 7 or chapter 11 (when the debtor is an individual), a creditor who persuades the court to except its debt under § 523(a) may disregard any discharge order and enforce its claim even after discharge or plan confirmation. Not so in the chapter 13 case. Under § 1328(a), most debts are discharged, even some of those that are non-dischargeable under § 523(a). As a matter of fact, only certain tax claims, certain debts incurred through fraudulent means, unlisted claims, debts incurred through fraud in a fiduciary capacity, alimony and support payments, death or personal injury caused by a debtor under the influence, criminal restitution, restitution or civil action award for willful or malicious injury that resulted in personal injury or death to an individual, and certain long term debts survive the chapter 13 discharge. Consequently, chapter 13 may be a more useful tool for the debtor who may have a substantial amount of debts that a court may find non-dischargeable under § 523(a).

Unlike the chapter 11 discharge, which arises at the time the plan is confirmed, the chapter 13 discharge arises only after the debtor has completed full performance under the chapter 13 plan.[68] What happens to the chapter 13 right to discharge if the debtor is unable to complete performance under the plan? Section 1328(b) answers this question. If the reason the chapter 13 debtor cannot perform under the plan can be traced to reasons beyond the debtor's control, the debtor may receive a "hardship" discharge so long as the debtor has performed sufficiently to have ensured that the creditors have received more under the chapter 13 plan as partially performed than they would have received under a chapter 7 liquidation. Nonetheless, the Bankruptcy Code extracts a price from the chapter 13 debtor who by powers beyond the debtor's control must resort to the hardship discharge. Those § 523(a) debts that are generally non-dischargeable but would have been discharged under chapter 13 remain non-dischargeable if the debtor is granted the hardship discharge.

The 2005 Act included several important chapter 13 changes worth noting in particular. First, a debtor is not eligible for a chapter 13 discharge if he received a discharge in a case under chapters 7, 11, or 12 during the 4-year period preceding the petition date. Further, the debtor is

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[68] Note that in an individual debtor chapter 11 case, the discharge is delayed until performance under the plan, much like the chapter 13 case.

not eligible for a chapter 13 discharge if the debtor received a discharge in a case under chapter 13 during the 2-year period preceding the petition date.

Second, under § 1328(a)(2), there is no discharge available for fraudulent taxes in chapter 13 cases. Chapter 13 "super-discharge" conforms to chapter 7 discharge for individual debtors for purposes of so-called fraud taxes. Tax claims under § 523(a)(1) are also excepted from chapter 13 discharge. Such claims include priority tax claims, claims associated with fraudulent returns, un-filed returns, and willful attempts to evade or defeat a tax.

Third, the debtor must timely file postpetition tax returns or suffer conversion or dismissal of the case. The conversion or dismissal is mandatory if the debtor does not file the returns or obtain an extension within 90 days after the taxing authority files its request. This provision applies in chapters 7, 11, 12, and 13.

9. Cash Collateral and Debtor Transactions

The focus of this chapter is on how a debtor engages in business while in bankruptcy. Implicit in the reorganization model is a viable business to reorganize. To remain viable, a business must continue in business. The Bankruptcy Code recognizes this basic fact.

9.1. Cash Collateral

In order for a business to function it needs cash. This axiom is as true in bankruptcy as it is out. Cash and cash equivalents are the lifeblood of a successful reorganization. Consequently, in order to continue operations in an attempt to successfully reorganize under the Bankruptcy Code, the debtor must be able to gain access to cash and cash equivalents it may have on hand. On the other hand, a creditor may hold a validly perfected security interest in the cash and cash equivalents. Because in most instances once the cash is used the lien evaporates, a creditor can experience significant harm to its secured claim. The Bankruptcy Code recognizes this dilemma and attempts to accommodate the creditor's legitimate concern while providing a means by which the debtor can tap into its cash assets. This mechanism is found neatly in § 363(c)(2) of the Bankruptcy Code.

9.1.1. Definition of Cash Collateral

Before exploring the relationship of a debtor and a creditor who asserts an interest in cash collateral, one must discuss what cash collateral is. Cash collateral is defined in § 363(a). Cash collateral means "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property. . . ." Technical definitions aside, cash collateral means cash or some type of property that can be turned into cash very quickly.

9.1.2. The Debtor's Use of Cash Collateral

Cash collateral is effervescent; when used, it disappears forever. Recognizing that a creditor who has a secured claim is entitled to the protection of its claim at least as to the value of the collateral, how then may the debtor ever use cash collateral? The answer lies in § 363(c)(2).

The rule is straightforward. The debtor is prohibited from using cash collateral except in two circumstances. First, the debtor can use cash collateral if the debtor obtains the consent of the creditor claiming an interest in the cash collateral. If more than one creditor claims an interest in the cash collateral, consents from all creditors would be required. Second, absent consent, the debtor can move the court, after notice and a hearing, to authorize the debtor to use the cash collateral. The price, however, for the debtor to gain access to the cash collateral is the requirement of adequate protection. The court will not permit the debtor to use cash collateral unless the court is convinced that the creditor who claims an interest in the cash collateral is adequately protected.

Previous discussion centered on the role of adequate protection concerning relief from the automatic stay pursuant to § 362(d) of the Bankruptcy Code. Recall that failure to provide adequate protection may constitute one type of cause for relief from the automatic stay under § 362(d)(1).

Adequate protection is a term that is defined under § 361. The definition is non-exhaustive and defines by example. Thus, adequate protection includes periodic cash payments, replacement liens, additional liens, but does not include the granting of an administrative expense priority. It has been suggested that the concept of adequate protection is derived from the protection of property interests by the Fifth Amendment to the United States Constitution. Once the debtor convinces the court that it can adequately protect the creditor's interests, the debtor may use its cash collateral as long as such use is consistent with other provisions of the Bankruptcy Code.

9.2. Transactions with the Debtor

Under § 1108 of the Bankruptcy Code, the debtor-in-possession is authorized to operate its business unless the operation is curtailed by the court. Furthermore, § 363 regulates the debtor's business activities. Both debtors and creditors should be aware of a debtor's ability to, and manner in which it may, conduct its business. If a debtor intends to engage in a transaction in the ordinary course of its business, it may do so under the Bankruptcy Code without prior court authorization. Furthermore, any creditor or third party who participates in an ordinary course transaction will be protected. However, a debtor cannot engage in a transaction outside of its ordinary course of business. Such transaction is an unauthorized postpetition transfer that may be attacked and unwound. Consequently, any creditor or third party that deals with the debtor in a transaction outside the ordinary course of business is not protected.

Thus, the paramount question in this area of bankruptcy law is, "What is an ordinary course transaction?" The determination of this question will depend on the facts and circumstances of each case. The question is a factual one. In resolving the issue, courts will look at the historical operations of the particular debtor and the operations of similar persons in the industry. The court will also consider creditors' expectations concerning what is legitimately an ordinary course transfer by their debtor from their perspective.

As a general rule, when in doubt before engaging in a transaction with a debtor, you should obtain court approval of the transaction. An example may be helpful. Assume Baseball, Inc. has filed a chapter 11 bankruptcy petition. Baseball is in the business of manufacturing baseball bats, gloves, and balls. It operates three plants -- one in Kentucky, one in Japan, and one in Haiti. Elrod Hendricks approaches Baseball and wants to purchase a shipment of bats, balls, and gloves for a sporting goods store outside Baltimore. This is the type of transaction that Baseball is in the business of. It sells bats, balls, and gloves to various businesses for resale. This is clearly an ordinary course transaction and no prior court approval is necessary. Assume, however, that Jim French, a competitor of Elrod, wants to buy every ball manufactured in Haiti. Also assume that Baseball has never entered into a contract of this type. Chances are that a court would conclude that the transaction between Baseball and Jim would be out of the ordinary course of Baseball's business; therefore, the transaction can be avoided under the Bankruptcy Code as an unauthorized postpetition transfer. Further assume that Jim decides that he would rather have the manufacturing plant in Haiti. Clearly, Baseball is not in the business of selling manufacturing plants and any attempt to do so must be authorized by the court before the transaction.

10. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

This section explores the special treatment of executory contracts and unexpired leases. In exploring the treatment of these special relationships, one must become comfortable in identifying them. Further, the consequences of rejection, assumption, or assignment must be determined in addition to the procedures, limitations, and times limits on rejection.

10.1. What is an Executory Contract or Unexpired Lease?

Bankruptcy Code § 365 permits a debtor in possession or a trustee to assume or reject executory contracts and unexpired leases. The Bankruptcy Code does not define the term "executory contract," leaving the determination to the courts. Generally, a contract under which both parties have unfulfilled future obligations other than the mere payment of money is an executory contract. Consequently, repayment of a promissory note is not an executory contract.

If one party has fully performed and the other party has not, the determination whether a contract is executory becomes more difficult. Some courts hold that if one party has fully performed, then the contract cannot be executory, citing the test articulated above. Other courts, instead of employing the traditional test, assess whether the debtor's estate is benefited by

characterizing the contract as executory. If yes, the court will hold that the contract is executory, thus allowing the trustee to assume or reject it.

The Bankruptcy Code also fails to identify unexpired lease. What constitutes an unexpired lease is answered by consulting state law, particularly Chapter 2A of the UCC. Usually, however, unexpired leases will refer to real and personal property leases.

Forfeiture clauses are generally not enforceable in a bankruptcy case if tied to bankruptcy filing, insolvency, *etc.* See 11 U.S.C. §§ 363(1), 365(e), and 541(c). However, if exercised before the bankruptcy filing, then the forfeiture clause may be enforceable. Forfeiture clauses in specified kinds of contracts may be effective to prevent assumption of a contract by the trustee and may actually permit termination by the non-debtor party after the petition filing. Further, these clauses may be enforceable in bankruptcy if the contract is for personal services.

10.2. When Must the Trustee Assume or Reject?

If a trustee in a chapter 7 case does not expressly assume or reject an executory contract or unexpired lease within 60 days following the filing of the petition (or such additional time as the court, for cause, allows), the contract or lease is deemed rejected. See 11 U.S.C. § 365(d)(1). Further, in any nonresidential lease situation, the assumption or rejection must be done within 120 days after the order for relief (with a 90 days extension for cause). In a chapter 11 case, as a general rule, the debtor or trustee (if a trustee has been appointed) may assume or reject an executory contract or unexpired lease at any time prior to confirmation of a plan. See 11 U.S.C. § 365(d)(2). There are several exceptions to this rule discussed below. However, a party to the executory contract or unexpired lease can request the court to require the debtor or trustee to assume or reject the unexpired lease or executory contract within a specified time.

There is a limbo period between the filing of the petition and the time of assumption or rejection. Where the debtor is not in default, the other party must continue to perform. Otherwise, the other party need not perform unless the contract is cured and assumed. If the matter deals with nonresidential real property, performance must be executed.

10.3. The Standard for Assumption

Assumption binds the estate and the non-debtor party. Most contracts and leases may be assumed except personal services and other financial accommodations under § 365(c). The effect is to make the contract an administrative expense of the estate as if the estate had originally entered into the contract. Post-assumption breach gives rise to an administrative expense under § 365(g)(2), but it is limited and capped.

A court must approve an assumption. See 11 U.S.C. §§ 365(a), 365(b)(2). A clause which provides for termination of an executory contract or unexpired lease upon bankruptcy or insolvency events is not enforceable under the Bankruptcy Code to prevent the assumption of the executory contract or unexpired lease. See 11 U.S.C. § 365(b). To assume an executory contract or unexpired lease, a debtor must cure any defaults, compensate the other party to the contract or lease for any pecuniary loss resulting from any defaults, and provide adequate assurance of the debtor's future

performance. 11 U.S.C. § 365(b). Prior to assumption of an unexpired lease, the debtor or trustee must pay for any services or supplies furnished after commencement of the case under the lease and, if the lease is a lease of non-residential real property and the debtor is the lessee, perform all obligations of the debtor under the lease.

An unexpired lease or executory contract may be assumed and assigned by the trustee in accordance with the requirements described above and with adequate assurance of future performance by the assignee. Once the executory contract or unexpired lease is assigned, the non-debtor party to the contract no longer has a claim against the estate. Finally, an executory contract to make a loan or extend credit may not be assumed under § 365.

10.4. The Special Cases of Real Property

10.4.1. Unexpired Lease of Non-Residential Real Property Where the Debtor is the Lessee

One exception to the foregoing time periods by which the debtor (or the trustee) must either assume or reject exists with regard to an unexpired lease of non-residential real property in which the debtor is the lessee. If an unexpired lease of non-residential real property in which the debtor is the lessee is neither assumed nor rejected within 60 days of the commencement of a case under either chapter 7 or chapter 11 (or such additional time as the court, for cause, allows), then the unexpired lease is deemed rejected and the property subject to the lease must be surrendered to the lessor. 11 U.S.C. § 365(d)(4).

10.4.2. Unexpired Lease of Real Property Where the Debtor is the Lessor

If a trustee (or debtor in a chapter 11 proceeding in which no trustee has been appointed) rejects an unexpired lease of real property of the debtor where the debtor is the lessor, the lessee under the lease may treat the lease as terminated by the debtor's rejection or, in the alternative, the lessee may remain in possession of the leasehold interest under the lease for the balance of the term of the lease and for any renewal or extension of the term that is enforceable by the lessee under applicable non-bankruptcy law. See 11 U.S.C. § 365(h)(1). If a lessee remains in possession under a lease rejected by the trustee (or debtor in the applicable case) where the debtor is the lessor, the lessee may offset any damages caused by the non-performance of any obligation of the debtor under the lease against the rent reserved under the lease for the balance of the term after the date of rejection of the lease plus any renewal or extension of the lease. The lessee does not have any rights against the debtor's estate for damages arising after the date of the debtor's rejection of the lease, other than the setoff right described above. This power of the lessee to remain in possession under an unexpired lease of real property where the debtor is the lessor essentially makes any rejection by a trustee (or debtor) impractical if the purpose of the debtor's rejection is to terminate the leasehold estate of the lessee in order to regain possession of the leased premises.

11. AVOIDANCE POWERS

Avoidance powers substantially distinguish a bankruptcy case from state debt collection activity. Although some of the avoidance powers have state-law analogues, in bankruptcy, the avoidance powers are the most efficient and successful tool in reassessing the relative rights, powers, and duties between the debtor and its creditors and among creditors. In essence, the avoidance powers authorize a bankruptcy trustee (or a debtor in possession in a chapter 11 case where no trustee has been appointed) to unwind in a bankruptcy forum that which the debtor and creditors have done before the commencement of the bankruptcy case.

A trustee, or a debtor in a chapter 11 case in which no trustee has been appointed, is given extensive powers to avoid pre-petition transactions involving transfers of property by the debtor to the extent such transfers are voidable by creditors under non-bankruptcy laws, are voidable as preferences, or are voidable as fraudulent transfers. A transfer subject to these avoidance powers may be voluntary or involuntary (as by foreclosure), a simple payment through various forms, or an absolute transfer of title or the creation of a lien or security interest. The applicability of these avoidance powers to pre-petition transactions will bring additional assets into the debtor's estate. A debtor should be aware of the existence of the avoidance powers and the duty to examine pre-petition transactions to determine if any are subject to avoidance.

Although not without controversy, the purposes of the avoidance powers are generally well understood. These powers, given to the trustee to exercise on behalf of the bankruptcy estate, allow the trustee to recover for the benefit of the estate certain prepetition transfers of the debtor's property. These powers allow the trustee to enhance the property of the estate for the benefit of all creditors in circumstances where the prepetition transfer resulted in the unjust diminution of the debtor’s property on the verge of bankruptcy or such transfer favored certain creditors at the expense of the general creditor body. The avoidance powers maximize the return to the unsecured creditors by bringing estate assets back into the estate for every one to share in and dissuades creditors from opting out of the collective debt-collection action once bankruptcy is on the horizon.

The avoidance powers help the trustee in protecting the Bankruptcy Code’s distributional scheme, a result that is one of the stated goals of bankruptcy, by avoiding and recovering for the benefit of the estate certain enumerated transfers that frustrate the goal. The avoidance powers can be found in §§ 543-553.

11.1. Trustee’s Strong-Arm Powers Under § 544(a)

One of the most powerful avoidance techniques can be found in § 544(a) of the Bankruptcy Code. Section 544(a), also known as the trustee’s strong-arm power, endows the trustee with the status of a hypothetical judicial lien creditor or a bona fide purchaser of real property (as the case may be) at the time of the filing of the bankruptcy petition. The trustee’s status as a hypothetical judicial lien creditor or a bona fide purchaser of real property at the moment the bankruptcy petition

is filed is merely a status whose substantive affect must spring from some non-bankruptcy law, usually state law that defines the rights and priorities of judicial lien creditors or bona fide purchasers for value.

In those states that have enacted Article 9 of the Uniform Commercial Code, the powers of the trustee as a hypothetical judicial lien creditor are clear. Under UCC Section 9.301(1)(b), a judicial lien creditor who obtains a judicial lien before an Article 9 security interest is perfected has priority over the secured party. Thus, a trustee in bankruptcy under § 544(a) almost always defeats a secured party who has not perfected its security interest as of the filing of the bankruptcy petition. If, however, the secured party perfects its security interest five minutes before the petition in bankruptcy is filed, then the trustee cannot mount a successful attack solely under § 544(a).

Aside from bestowing upon the trustee the status of the hypothetical judicial lien creditor, § 544(a) also gives the trustee as of the date of the bankruptcy petition the status of a hypothetical bona fide purchaser of the debtor's real property. This additional strong-arm power enables the trustee to avoid transfers of real property that were unperfected at the time the bankruptcy petition was filed. Thus, if Gomer sells his gas station to Floyd and Floyd fails to record the transfer in the real property records, Floyd runs the risk that Gomer may file a petition in bankruptcy and his trustee may seek to avoid the transfer as a hypothetical bona fide purchaser under § 544(a)(3).

An example may be helpful. Assume that 86 owes money to 99, the Chief, and Hymie. (recall that Hymie was the robot). Further assume that all three creditors are secured parties under Article 9 of the UCC. However, 99, the Chief, and Hymie have not perfected their security interest in accordance with state law. Smothered by an avalanche of debt, 86 decides to file a bankruptcy petition under chapter 7. Just before the bankruptcy petition is filed, 99 files a financing statement and perfects her security interest in accordance with state law. On the other hand, the Chief, without knowledge of 86's bankruptcy filing, nevertheless files his financing statement in the appropriate place but only after the bankruptcy petition was filed. Unlike the Chief, Hymie has actual knowledge of the bankruptcy filing but nevertheless files a financing statement in an attempt to perfect his security interest in the collateral.

In these circumstances, the trustee will be successful under § 544 in attacking the Chief and Hymie. As to the filing of the petition in bankruptcy, the trustee attains the status of a hypothetical judicial lien creditor. Under Article 9, a judicial lien creditor has priority over any secured party who was unperfected at the time the judgment lien creditor attains its status. Furthermore, both the Chief and Hymie have violated § 362(a) of the Bankruptcy Code. A filing of the financing statement, with or without knowledge of the bankruptcy filing, is a violation of the automatic stay. Moreover, any act in violation of the automatic stay is void. Knowledge or intent to violate the automatic stay is irrelevant; the stay is self-enforcing and operates even if the party allegedly violating the stay had no knowledge of the bankruptcy filing. But because Hymie did have actual knowledge of the bankruptcy filing and nevertheless attempted to perfect the security interest, the trustee may choose to seek sanctions under § 362(h) of the Bankruptcy Code. These sanctions

include actual damages, punitive damages, and possibly contempt of court for willful acts in violation of the automatic stay.

11.2. Trustee's Powers Under § 544(b)

Section 544(b) provides the trustee with yet another weapon in the avoidance powers arsenal. Under § 544(b), the trustee may avoid the debtor's transfers or obligations if any *actual unsecured creditor* with an *allowable claim* could do so under non-bankruptcy law. To invoke this § 544(b) power, the trustee must identify an actual unsecured creditor with an allowable claim that could avoid the transfer under state law. Unlike § 544(a), § 544(b) does not bestow upon the trustee the status of a hypothetical creditor who can attack the transfer. Section 544(b) requires the trustee to find an actual creditor with an allowable claim. Thus, the potency of the trustee's ability to attack a transfer under § 544(b) turns on the substantive effect of applicable state law.

Most often, § 544(b) will be successfully invoked to attack a transfer as fraudulent under applicable state fraudulent transfer laws. Although the Bankruptcy Code under § 548 contains its own fraudulent transfer provisions, the trustee can only avoid a fraudulent transfer that occurred on or within one year of the filing of the bankruptcy petition. Nonetheless, under the Uniform Fraudulent Transfer Act, a creditor can attack fraudulent transfers as far back as four years. Consequently, if a trustee can locate an actual unsecured creditor with an allowable claim who can attack the transfer as fraudulent under the UFTA, the trustee can step into the actual unsecured creditor's shoes and reach back not one year, but four years in attacking a transfer. Furthermore, if one actual unsecured creditor can be found, the trustee can avoid the transfer in its entirety and is not limited in the recovery to the amount of the claim of the creditor on whom the trustee relied. This is the doctrine of Moore v. Bay, 284 U.S. 4 (1931).

11.3. Avoidable Preferences Under § 547(b)

An avoidable preference is (i) any transfer of an interest of the debtor in property; (ii) to or for the benefit of a creditor; (iii) for or on account of an antecedent debt owed by the debtor before the transfer was made; (iv) made while the debtor was insolvent; (v) made on or within ninety days before the date of the filing of the petition (or within one year if the creditor is an insider); and (vi) that enables the creditor to receive more than it would have received under a chapter 7 liquidation. The trustee, or the debtor-in-possession in a chapter 11 case, shoulders the burden of proof on all the elements of an avoidable preference action. However, there is a statutory presumption that the debtor is insolvent on or within ninety days of the filing of the petition in bankruptcy. Furthermore, if the creditor who received the alleged avoidable preference was an insider of the debtor, then the operative period is extended from ninety days to one year before the filing of the petition in bankruptcy.

11.3.1. <u>Elements</u>

The following is a more detailed analysis of the elements that must be satisfied before a transfer constitutes an avoidable preference under § 547(b) of the Bankruptcy Code.

11.3.1.1. A Transfer of the Debtor's Property

Transfer is broadly defined in § 101(54) to include every mode or disposition of an interest in property, voluntary or involuntary, and includes the creation of a lien on the debtor's property and foreclosure under the Real Property Code. Once the triggering transfer has been identified, you must determine whether the transfer is one of the debtor's property. This is usually the case; however, if the debtor acts as a mere conduit of funds or the funds that go from a third party to the debtor to the creditor are earmarked, then the courts have consistently concluded that the transfer is not one of the debtor's property. For example, an owner of the debtor corporation pays off a corporate debt for which the owner was not personally liable. In that situation, there is no transfer of an interest in the debtor's property. Furthermore, assume the owner directs the funds to the creditor through the debtor but that the funds were always earmarked for the creditor. In that case, most courts have held that the debtor has not transferred its property to the creditor. Under both scenarios, even assuming if all other elements of an avoidable preference are met, there is no avoidable preference under § 547(b) because the debtor has not transferred its property.

11.3.1.2. To or For the Benefit of a Creditor

The drafters of the Bankruptcy Code drafted the avoidable preference section in such a way as to not only ensnare transfers to a creditor, but also transfers for the benefit of a creditor. Assume the debtor owes a debt to A and A owes a debt to B. B, however, is not a creditor of the debtor. If the debtor paid A and then A paid B, assuming all other elements are met, the transfer is one between the debtor and its creditor A. However, if on directions from A the debtor pays B, assuming all other elements are met, the transfer is for the benefit of the debtor's creditor A. Either transfer satisfies the second element of an avoidable preference under § 547(b).

11.3.1.3. For or on Account of an Antecedent Debt

Simply, this element requires that the creation of the debt occurred before the transfer was made. Usually, this element requires a straightforward comparison of the date the debt arose to the date of the transfer. Nonetheless, in some circumstances this simple comparison can be deceptive.

The Code under § 547(e) employs an artificial test to establish when the transfer takes place. The general rule is the transfer takes place when the transfer becomes notorious by perfection rather than the actual date of the transfer. Section 547(e) is the drafters' attempt to protect against secret liens.

Section 547(e) provides that as to real estate transfers, a transfer occurs when the transfer is good against a bona fide purchaser of the real estate. As to personal property transfers, the transfer occurs when it becomes perfected as against a judicial lien creditor. Furthermore, a transfer perfected within ten days after it is actually made is deemed to occur when it became effective between the parties as a matter of law under § 547(e)(2). Under the 2005 Act, the 10-day period has been extended to 30 days. The new extended period applies to all preference actions commenced ancillary to any bankruptcy case filed on or after 17 October 2005.

An example should help explain this complex provision. Assume that two years before the debtor files a bankruptcy petition, it enters into a contract to borrow money from Johnny Bench. In return for the loan, the debtor grants a Chapter 9 security interest in all of its inventory and equipment to Johnny. Johnny, busy with his many television appearances and car commercials, forgets to file the financing statement in the appropriate place. One month before the debtor files its bankruptcy petition, Johnny recognizes his mistake and files his financing statement. The filing of a financing statement is a transfer under Code §101(54). The loan and the grant of the security interest occurred on the same date two years prior to the bankruptcy filing. That date is the date the debt was created. The actual transfer occurred on the same date the debt was created. Nevertheless, the "transfer" as defined by §547(e) for avoidable preference purposes only occurs when the transfer is perfected as against a judgment lien creditor. The transfer does not become good against a judgment lien creditor until the security interest is perfected. Recall that an unperfected security interest is junior to a judgment lien creditor. Thus, the transfer for avoidable preference purposes occurred one month before bankruptcy. Consequently, the transfer can be scrutinized to determine whether all the elements of an avoidable preference were met. This is the case even though the transfer actually occurred two years before the bankruptcy.

11.3.1.4. Made Within 90 Days Before Bankruptcy, Or, If the Transferee is an Insider, Within One Year of Bankruptcy

Again, the time of the transfer as determined by § 547(e) will be determinative as to whether the transfer occurred on or within 90 days of the filing of the bankruptcy petition. An insider is defined under § 101(31).

11.3.1.5. The Debtor is Insolvent

Under § 101(32), insolvency is generally defined as the sum of the debtor's debts exceeding the debtor's property at a fair valuation, the balance sheet approach to insolvency. Under § 547(f), the debtor is presumed to be insolvent for the 90 days preceding the filing of the bankruptcy petition. The insolvency presumption is rebuttable.

11.3.1.6. Preferential Effect

The final element of an avoidable preference found at § 547(b)(5) requires that the transfer have the effect of giving the transferee more than it otherwise would receive in a straight chapter 7 liquidation proceeding. This preferential effect is the essence of an avoidable preference action.

The § 547(b)(5) element of an avoidable preference is almost always met if the creditor is an unsecured creditor. Conversely, if the debtor pays a fully secured creditor and the security interest is not avoidable under one of the avoiding powers, the transfer by the debtor is not a preference. A transfer to a fully secured creditor gives the fully secured creditor no more than he would have received under a chapter 7 liquidation.

However, this is not the case with an undersecured creditor. The law presumes that at least absent relinquishment of a portion of the collateral equal to the payment made by the debtor, any payment within the ninety day preference period is a reduction of an undersecured creditor's unsecured claim and therefore amounts to a preferential transfer for the benefit of the undersecured creditor.

The 2005 Act changes to reclamation claims and the like will have an impact on the ability of the trustee to recover on preference actions. If the holder of a potential preference can show that it received no more than it would have been entitle to under a hypothetical chapter 7 case where the transfer had not been made, then there is no preferential effect. That may very well be the case in situations where trade creditors are being sued as recipients of alleged avoidable preferences when they were paid on goods received by the debtor within the 45-day and 20-day periods described below.

Prior to the 2005 Act, Title 11 of the United States Code (the "Bankruptcy Code") provided some level of protection to sellers of goods who delivered those goods to the debtor in the days preceding the filing of the debtor's petition by incorporating state law reclamation rights, as provided by the Uniform Commercial Code ("UCC"), into the Bankruptcy Code in the form of Section 546(c). However, the amendments made by the 2005 Act via amended Section 546(c)[69] and the inclusion of Section 503(b)(9) dramatically change these rights.

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[69] 11 U.S.C.A. § 546(c)(1):

> Except as provided in Subsection (d) of this Section and in Section 507(c), and subject to the prior rights of a holder of a security interest in such goods or the proceeds thereof, the rights and powers of a the trustee under Sections 544(a), 545, 547, and 549 ~~of this title~~ are subject to ~~any statutory or common law~~ the right of a seller of goods that has sold goods to the debtor, in the ordinary course of such seller's business, to reclaim such goods if the debtor has received such goods while insolvent, within 45 days before the date of the commencement of a case under this title, but~~—(1)~~ such a seller may not reclaim ~~any~~ such goods unless such seller demands in writing reclamation of such goods—
>
> (A)~~before 10~~ not later than 45 days after the date of receipt of such goods by the debtor; or
>
> (B) not later than 20 days after the date of commencement of the case, if ~~such 10-day~~ the 45-day period expires after the commencement of the case.~~, before 20 days after receipt of such goods by the debtor; and~~

An example may be in order. In *In re Georgetown Steel Company, LLC*,[70] the seller of goods was disputing the status of its reclamation claim regarding twelve supersacks of silicomanganes ("SMI"). There, the court determined that reclamation was a state law right, and thus, to prevail, the seller must prove up not only the timely written notice requirement contained in Section 546(c), but also the elements of the state law right: (1) that the goods sold to the debtor on credit were of a type within the ordinary course of business of both parties; (2) that the debtor was insolvent pursuant to the bankruptcy code at the time of delivery of the goods; and (3) that the goods were still in the possession of the debtor or that the goods were not in the hands of a good faith purchaser at the time the demand for reclamation was received.[71] In that case, the seller was unable to prove that the debtor had possession of the goods or that they were not in the hands of a good faith purchaser, thus the seller could not prevail.[72] The replacement of the words "any statutory or common law" with the word "the" in Section 546(c)(1) appears to change the outcome of this case by rendering the possession requirement moot.

What if the seller in *Georgetown Steel* had prevailed? Old Section 546(c)(2) gave the court the ability to deny reclamation (i.e. not require the debtor to return the goods) where the elements of reclamation were shown if the court granted the seller either a lien in property to secure its claim or granted a priority claim for the value of the goods. The elimination of old Section 546(c)(2) in its entirety seems to divest the court of any option: If the seller shows that the goods were sold within 45 days of the commencement of the case to an insolvent debtor, and that a written demand was timely made, the seller appears to have an absolute right to reclaim the goods. How this will work with the definition of Property of the Estate as described by Section 541 of the Bankruptcy Code and the Automatic Stay provided by Section 362 is yet to be seen. The first instances of litigation may well come when the debtor seeks to sell the goods as part of a larger parcel of goods free and clear of liens and interests pursuant to Section 363.

The reality is that in most cases, asset based financing provides a prior perfected lien on most goods such that the right of reclamation is rendered moot. Further, where a lien does not act to moot the reclamation rights, many vendors fail to provide the timely written notice.[73] So why all the concern about goods sold in the days immediately before the filing? The fact that the right to reclaim, and thus potentially put a serious dent in the debtor's ability to operate, is one

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(2) If a seller of goods fails to provide notice in the manner described in paragraph (1), the seller still may assert the rights contained in Section 503(b)(9).

~~(2) the court may deny reclamation to a seller with such a right of reclamation that has made such a demand only if the court—~~

~~(A) grants the claim of such a seller priority as a claim of a kind specified in Section 503(b) of this title; or~~

~~(B) secures such claim by a lien.~~

[70] 318 B.R. 336 (Bankr.S.C. 2004).

[71] *Id.*. at 339.

[72] *Id*. At 340.

[73]Query, however, whether the increased time to provide that notice, and the absence of the requirement that the seller show that the goods are in the possession of either the debtor or an entity that is not a good faith purchaser, taken with the absolute right to reclaim, will increase the instances of reclamation demands.

answer. Another answer is found in New Section 546(c)(2) which refers to Section 503(b)(9) which grants administrative expense status for the:

> the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of such debtor's business.[74]

This provision, in essence, appears to deem all vendors delivering goods within 20 days of the petition date "critical." Thus, as a result of this provision, it will become increasingly critical that the debtor not order any goods for product lines or stores that will be shutdown at. or immediately after, the filing of the petition which will require additional planning on the part of the debtor and its advisors to avoid unnecessary administrative expenses.

11.3.2. Defenses

Section 547(c) of the Code provides a number of affirmative defenses that exclude certain transfers otherwise avoidable from the avoidable preference power. Of course, like any other affirmative defense, the § 547(c) affirmative defenses must be asserted and proved by the transferee.[75] Below is a discussion of the § 547(c) affirmative defenses.

11.3.2.1. Contemporaneous Exchange

Under § 547(c)(1), if the debtor and the transferee intended that the transfer be a contemporaneous exchange for new value given to the debtor and the exchange was in fact *substantially contemporaneous*, then the transfer is not an avoidable preference. Under §547(c)(1), if a debtor and transferee *intend* the transfer to be a contemporaneous exchange for *new value* given to the debtor and the exchange is in fact *substantially contemporaneous*, then the transfer is not an avoidable preference. The test under §547(c)(1) is both subjective and objective.

The first hurdle -- the subjective component -- is to determine whether the parties intended a contemporaneous exchange for new value. Without that intent, the fact that a transfer was contemporaneous or substantially contemporaneous does not save the transfer from avoidance under §547(c)(1). Intent is a question of fact and, in this context, will generally be proved by circumstantial objective evidence, including the terms in any documents or memoranda between the parties, form of payment (for example, cash or check), prior relationships, custom in the industry, etc.[76] Additionally, the transfer must be in exchange for new value. New value includes "money or money's worth in goods, services, or new credit or

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[74] 11 U.S.C. §503(b)(9).

[75] 11 U.S.C. §547(g).

[76] See, e.g., In re Arnett, 731 F.2d 358, 362 (6th Cir. 1984); In re Quade, 108 B.R. 681, 683 (Bankr. N.D. Iowa 1989).

release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation."[77] Obviously money or money's worth is new value and generally pose no problems. Forbearance of a right or the substitution of an obligation are not new value and generally pose no problems.[78] Courts have concluded that the release of a lien does constitute new value.[79]

The second hurdle -- the objective component -- is to determine whether an intended contemporaneous transfer was in fact *substantially contemporaneous*. Whether a transfer is substantially contemporaneous is determined by the facts and circumstances of each case.[80] Courts generally hold that a thirty-day delay generally passes muster, that forty-five days begins to push the limit, and that sixty days or more usually does not constitute a substantially contemporaneous exchange.[81] But these guidelines may be misleading. The issue will generally turn on the particular facts and circumstances of each case, reasons for any delays, industry standards, and presence of events beyond the control of the parties.[82]

11.3.2.2. Payment Made in the Ordinary Course of Business

Prior to the 2005 Act, the trustee may not avoid a transfer if it was in payment of a debt that was incurred by the debtor in the ordinary course of a business or financial affairs of both the debtor and the transferee, made in the ordinary course of business, and in accordance with ordinary business terms.[83] These ordinary course transfers are treated similar to cash transfers. This particular exception to the avoidable preference power is the one most often used by those creditors

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[77]11 U.S.C. §547(a)(2).

[78]Although substitution of an obligation does not constitute new value, authority does exist to support a finding of new value where terms of an existing loan have been modified in favor of the debtor, see In re F&S Cent. Mfg. Corp., 53 B.R. 842, 850 (Bankr. E.D.N.Y. 1985), or where the transferee pays a debt to a third party thereby benefiting the debtor, see In re Bellanca Aircraft Corp., 850 F.2d 1275, 1279-1280 (8th Cir. 1988).

[79]See, e.g., In re E.R. Fegert, Inc., 887 F.2d 955, 959 (9th Cir. 1989); In re Fuel Oil Supply & Terminaling, Inc., 837 F.2d 224, 231 (5th Cir. 1988); In re Phoenix Steel Corp., 76 B.R. 373, 376 (Bankr. D. Del. 1987).

[80]See In re Arnett, 731 F.2d 358, 360 (6th Cir. 1984).

[81]See, e.g., In re Bullion Reserve, 836 F.2d 1214, 1219 (9th Cir.), cert. denied sub nom., Bozeck v. Danning, 486 U.S. 1056 (1988); In re Foreman Indus., Inc., 59 B.R. 145, 152 (Bankr. S.D. Ohio 1986).

[82]Recall that application of the earmarking doctrine may in fact be better understood as a special case of the §547(c)(1) defense.

[83]See 11 U.S.C. § 547(c)(2)

who provide valuable goods and services to the debtor on credit and is known commonly as the "Ordinary Course Defense" and is found at §547(c)(2)

Historically, §547(c)(2) had three prongs embodied in its three subsections. The first prong, whether the defendant was in the business of selling the goods sold during the preference period to the debtor, and whether the debtor was in the business of buying such goods, was very rarely at issue. This prong has been folded into the new section itself leaving only two subsections.[84] Further, where historically both of these two remaining subsections had to be met, now for any preference action commenced ancillary to any bankruptcy case filed on or after 17 October 2005, only one of the subsections must be met.

The first of these subsections, §547(c)(2)(A) (historically §547(c)(2)(B)) as amended, also known as the "subjective test" requires that the transfers be "ordinary" as between the debtor and creditor, considering such factors as timing, amount, and manner.[85] Along with time between invoice and payment, other factors that may be analyzed include:

1. The length of time the parties have been engaged in these types of transactions;
2. Whether the payments in question were larger than usual;
3. Whether the payments were made in the usual manner;
4. Whether the debtor or creditor took unusual actions to cause invoices to be paid;
5. Whether the Defendant took any actions within the Preference Period to put itself in a better position in the face of the Debtor's deteriorating financial situation.[86]

The second prong, §547(c)(2)(B) (historically §547(c)(2)(C)) as amended, also known as the "objective test" requires that the transfers be made according to terms consistent with industry norms. An analysis of case law suggests that this prong does not require the determination of a single "industry metric," but rather, that a range of terms used in the industry is a more reasonable and accurate depiction of ordinary course.[87] It is important to note that as

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[84] 11 U.S.C.A. § 547(c)(2) provides:

(c) The trustee may not avoid under this Section a transfer— . . .

(2) to the extent that such transfer was— ~~(A)~~ in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, ~~;~~ and such transfer was—

(~~B~~A) made in the ordinary course of business or financial affairs of the debtor and the transferee; ~~and~~ or

(~~C~~B) made according to ordinary business terms;

[85] *In re T.B. Home Sewing Enterprises, Inc.*, 173 B.R. 790, 795-6 (Bankr. N.D. Ga. 1993); see also *In re First Jersey Securities*, 180 F.3d 504, 512 (3d Cir. 1999).

[86] *In re T.B. Home Sewing Enterprises, Inc.*, 173 B.R. at 795-6; see also *Global Tissue, LLC v. E.B. Eddy Forest Products, Ltd.*, 302 B.R. 808 (D. Del. 2003), citing *In re Parkline Corp.*, 185 B.R. 164, 169 (Bankr. D.N.J. 1994).

[87] *Miller v. Florida Mining and Materials (In re A.W. Associates, Inc.)*, 136 F.3d 1439, 1443 (11th Cir. 1998); see also *In re First Jersey Securities*, 180 F.3d at 513.

practitioners, we may be caught up in a battle of metrics – timing, manner and method of payment, days past due, etc. – and lose sight of that which is most important in assessing the applicability of this defense; that is, in crafting this defense, Congress sought to leave undisturbed normal business transactions between the debtor and its creditors so long as neither sought to opt-out of the looming bankruptcy process.

The factors to be considered with regard to payments are as follows:

- Character of payment
- Method of payment
- Type of check processing
- Amount of check
- Check invoice dates compared to payment dates
- Term changes
- Timing of payments
- Proof-of-delivery issues
- Lost invoices
- Misplaced invoices
- Returned or nonconforming goods
- Custom goods
- Credit and discount issues
- Exposure
- New preference period account
- One invoice or payment situation
- Stump period
- Deviate from internal procedure
- Horizontal comparison with regard to procedures
- Extraordinary use of third parties
- Meeting with customer
- Classified as distressed credit
- Appropriate model (no distress, distress, or entire market)

The following reveals the methodology involved with determining the ordinary course of business defense:

> 1. At some point, the expert, or someone working under the supervision of the expert (collectively, the "expert"), visits by phone or in person with the employees and/or professionals of the client to discuss the operations and procedures of the defendant and debtor. The expert analyzes the complaint and exhibits thereto filed by the debtor in the preference action to determine the alleged preference payments, including the gross preference amount, net

> discounts, net chargeback, net credits and other adjustment, to arrive at the net alleged preference amount.
>
> 2. Next, the expert assesses the available check posting and clearing (final payment) records to determine the date checks were posted to the defendant's records or cleared the debtor's bank. Further, the expert prepares and/or analyzes preference details, including check amounts and dates, invoice amounts and dates, any charge-backs, discounts, aging of invoices by due date, and other relevant data, including those factors identified above. Moreover, the expert analyzes the historical transactions between the debtor and the defendant to determine the payment experience with the debtor.
>
> 3. Now, the expert explicitly identifies the testing period, that is, the time period of interest to and consideration by the expert. At this stage, the expert will also identify the relevant industry and then study relevant publications, trade journals, and other industry sources to help inform about collection practices and ordinary business terms. With this, the expert, through experience in the relevant industry and/or through an analysis of comparable companies and/or other accounts maintained by the parties, formulates an opinion as to what constitutes ordinary business terms, considering the manner and amount of payment, the stated terms between the parties, the timing of payments, account status, and other common credit management practices and procedures. To the extent practicable, the expert might cross-validate the expert opinion based on a number of sources or methods, including research (preferably published), experience (including third-party experience), proprietary sources, and an assessment of the actual performance between the debtor and the defendant.

11.3.2.3. Enabling Loans

Under § 547(c)(3), the trustee cannot avoid a security interest if it secures new value given by the creditor that is given to enable the debtor to acquire a particular piece of property and is used by the debtor to acquire the property provided that the security interest must be perfected within ten days from the time the debtor receives possession of the collateral. This affirmative defense recognizes a creditor's ability to protect its purchase money security interest status and mirrors protections common under Article 9 of the UCC for purchase money security interests.

11.3.2.4. Subsequent Advancement of Unsecured Credit

Under § 547(c)(4), a trustee cannot avoid the transfer if, after having received the transfer, the creditor extends unsecured credit. The courts are in conflict over whether the new value must remain unpaid at the date of the bankruptcy filing, with the better view being that all prepetition new value be considered.

The policy rationale that supports the new value defense is that by such actions, a creditor has essentially restored the status quo. Section 547(c)(4) is designed to insulate that restoration. Section 547(c)(4) immunizes repeated repayments of debt followed by extensions of credit, viewing the series of transactions as a whole. Section 547(c)(4), however, places two limits on the use of the defense. First, any subsequent advance of new value must be unsecured or secured by an interest that could be avoided in bankruptcy. Second, any subsequent advance must itself be an avoidable transfer, subject to avoidance under the Bankruptcy Code.

11.3.2.5. Floating Liens

Under § 547(c)(5), a trustee cannot attack a validly secured prepetition creditor with an after-acquired inventory[88] or accounts receivable[89] clause except to the extent that the secured creditor improves its position during the applicable preference period. The affirmative defense, by its terms, does not apply to after-acquired equipment. Prior to the enactment of the Bankruptcy Code, debate existed over whether the attachment of a lien to after-acquired property occurred at the time the debtor acquired rights in the property or at some earlier date. Section 547(e)(3) ended the debate and provides that a transfer is not made until a debtor has acquired rights in the property transferred. Nonetheless, §547(e)(5) permits avoidance of a security interest only to the extent that a transfer places the creditor in a better position as of the bankruptcy petition date than it had been on the latter of (1) the first date on which new value had been given under the security agreement or (2) 90 days prior to the bankruptcy petition date (one year if the creditor is an insider). Any improvement in position goes unprotected under §547(c)(5). In other words, any decrease in the deficiency during the preference period may be recaptured by the trustee. "Accommodation of legitimate inventory and receivables financing is the purpose of §547(c)(5)."

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[88]"Inventory" is defined as:

> personal property leased or furnished, held for sale or lease, or to be furnished under a contract for service, raw materials, work in process, or materials used or consumed in a business, including farm products such as crops or livestock, held for sale or lease . . . .

11 U.S.C. §547(a)(1).

[89]"Receivable" "means right to payment, whether or not such right has been earned by performance." 11 U.S.C. §547(a)(3).

11.3.2.6. Statutory Liens

Under §547(c)(6), the fixing of a statutory lien that is not avoidable under §545 is insulated from attack under §547(b). In particular, the fixing of a federal tax lien is generally not subject to preference scrutiny.[90] Statutory liens are governed by §545.

11.3.2.7. Payment of Debt for Domestic Support Obligations

Section 547(c)(7) removes from the scope of the avoidable preference power any transfers to the extent that they are a bona fide payment of a debt for a domestic support obligation. The prior language (before the 2005 Act) included *all transfer* for support, maintenance, or alimony to spouses, former spouses, and children, and did not limit itself to a payment as a form of transfer. Moreover, the 2005 Act injected the requirement that the payments be bona fide, not a controversial addition, and that such payments be of a debt under a *domestic support obligation*. The term "domestic support obligation" is defined in §101(14A) in an expansive manner. This provision is one in a line of provisions designed to alleviate the harsh effects of bankruptcy following a divorce.

11.3.2.8. Small Consumer Debt Payments

Under §547(c)(8), the trustee in a case of an individual debtor whose debts are primarily consumer debts cannot avoid the preferences to any creditor that aggregates less than $600. This is a rule of administrative convenience and efficiency.

11.3.2.9. Small Business Debt Payments

Under §547(c)(9), the trustee in a case filed by a debtor whose debts are not primarily consumer debts cannot avoid a preference to any creditor that aggregates less than $5,000. This rule also appears to be a rule of administrative convenience and efficiency.

11.3.2.10. 2004 Act Changes

There seems to be some debate among bankruptcy professionals about the legitimacy of many of the preference actions currently being pursued. Some liken to blackmail the practice of simply reviewing the debtor's check register and sending a demand letter and/or a complaint to any entity receiving a check within 90 days of the petition date with no consideration to possible defenses. The "ordinary course and new value are affirmative defenses that they have to prove and I'm not going to worry about until then" attitude has given rise to a great deal of irritation on the part of vendors, the people who represent them, and the courts. Several of the amendments in the 2005 Act appear to be Congress' attempt at rectifying at least part of the problem.

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[90] For a detailed treatment of federal tax liens and avoidance powers, see C. Richard McQueen and Jack F. Williams, Tax Aspects of Bankruptcy Law and Practice §16.21 (3d ed. 2006).

First, the change frequently mentioned herein, the grant of administrative expense status for the value of goods delivered within 20 days of the petition date appears to eliminate payments on account of these deliveries from any potential preference action. Unless the debtor is administratively insolvent, any payment on account of these goods would have to be paid in cash to confirm a plan, thus the creditor could not have received more than under the confirmed plan (excluding the time value of money, of course). Thus, the debtor will not be able to make a *prima facie* case against these vendors on account of payments on these goods.
However, questions about these goods do remain. For instances – can the delivery of goods the value of which is protected by an administrative expense constitute new value for the purposes of Section 547(c)(4) or will the administrative expense priority be treated as a payment? And what exactly does "value" mean? If "value" is determined to be the wholesale cost, and the debtor paid retail, then some wiggle room may still remain for a preference action regarding these goods.

Historically, there was no limit on the size of preference the trustee could pursue in cases where the debtors debts were not primarily consumer in nature.[91] The only limitation was a jurisdictional restriction pursuant to 28 U.S.C. §1409(b), which previously required actions to recover a money judgment of, or property worth, less than $1,000 or a consumer debt worth less than $5,000 be brought only in the district where the defendant resides. Thus, as a practical result, while some trustees may have sent demand letters regarding smaller preferences, they generally did not file complaints. Pursuant to the act, these jurisdictional thresholds have been increased. While the $1,000 limit on money judgments and property remains the same, the 2005 Act increased the amount of a consumer debt to $15,000 and added a provision for the collection of any other debt against a non-insider to $10,000.[92] Thus any preference action worth less than $10,000 must be brought in the district in which the defendant resides, which is generally not where the case is proceeding.

Additionally, a new affirmative defense has been added – Section 547(c)(9), which we will refer to as the "why are you bothering me" defense – which prohibits the trustee from recovering transfers that total less than $5,000 where the debtor is a business debtor. Interestingly, this is added as an affirmative defense rather than an element of the trustee's case in chief which means that the defendant will still have to hire an attorney to file an answer if such an action is brought. However, if a trustee does bring a preference action where the total

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[91] In cases where the debts are primarily consumer in nature, 11 U.S.C.A. §547(c)(8) continues to set the threshold amount at $600.

[92] 11 U.S.C.A. § 1409(b) provides:

> Except as provided in Subsection (d) of this Section, a trustee in a case under title 11 may commence a proceeding arising in or related to such case to recover a money judgment of or property worth less than $1,000 or a consumer debt of less than ~~$5,000~~ $15,000, or a debt (excluding a consumer debt) against a noninsider of less than $10,000, only in the district court for the district in which the defendant resides.

Note that Subsection (d) refers to transactions occurring postpetition.

amount demanded is less than $5,000, I suspect that the trustee and the trustee's attorney can reasonably expect a motion under Federal Rule of Bankruptcy Procedure 9011 to be attached to the answer.

Prior to the 2005 Act, when applying the Ordinary Course Defense, where the relationship between the parties was longstanding, conformance with the ordinary practices of the parties gained in significance, as opposed to those of the industry, in reaching a determination regarding the ordinary course of business, as long as the terms between the parties did not deviate from the terms utilized by the relevant industry to an extent that they were clearly not "usual."[93] However, after the 2005 Act, if either provision is met, the challenged transfer is considered within the Ordinary Course of Business Defense, and, thus, not recoverable by the trustee.

In the Bankruptcy Reform Act of 1994 (the "1994 Act"), Congress amended Section 550 in an attempt to overrule *Levit v. Ingersoll Rand Fin. Corp. (In re DePrizio).*[94] However, despite the 1994 Act, the *DePrizio* question lingered on. Therefore, in the 2005 Act, Congress has once again addressed the question.

In *DePrizio*, the law of unintended consequences reached up and smacked the lender in the nose. When making the loan that was the subject of the alleged preference, the lender had asked for and received personal guarantees by an insider. Thus, every payment on the loan reduced the insider's contingent liability, and benefited the insider. The trustee, argued that because the transfers benefited the insider, the reach back period should be one year rather than 90-days. Thus, by attempting to secure a loan with a personal guarantee by an insider, which created contingent liabilities for that insider, the lender became a *de facto* insider for the purposes of preference actions.

In the 1994 Act, Congress amended Section 550 by adding Subsection (c) to prohibit recovering a transfer such as the one in *DePrizio* from the non-insider transferee. However, this did not really solve the problem for some transfers as highlighted by *Roost v. Associates Home Equity Servs., Inc. (In re Williams).*[95] In *Roost*, a lender had perfected a security interest in a mobile home and the land upon which it sat greater than 90 days, but less than one year, before the petition date. There, the trustee argued that since both the debtor and his wife executed the security agreement, the debtor's wife, as an insider benefited from the security interest. The trustee then sought to avoid the security interest arguing that it benefited an insider. When the lender sought protection under Section 550(c), the trustee argued that it was not trying to recover anything, simply trying to avoid the security interest. The court, citing rules of construction and

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[93]*Miller v. Florida Mining and Materials (In re A.W. Associates, Inc.)*, 136 F.3d at 1443.

[94]874 F.2d 1186, 1187 (7th Cir. 1989).

[95]234 B.R. 801 (Bankr. D. Or. 1999).

precedent recognizing the separation of avoidance and recovery, found the security interest avoidable.

To close the loophole highlighted by *Roost*, the 2005 act added subsection (i) which provides:

> If the trustee avoids under Subsection (b) a transfer made between 90 days and 1 year before the date of the filing of the petition, by the debtor to an entity that is not an insider for the benefit of a creditor that is an insider, such transfer shall be considered to be avoided under this Section only with respect to the creditor that is an insider.[96]

While this provision does seem to close the last of *DePrizio*'s substantive issues, a procedural question remains. The 2005 Act provides that the amendment which added Section 547(i) "shall apply to any case that is pending or commenced on or after the date of enactment of this Act."[97] This implies that any preference action commenced after April 20, 2005, is governed by this provision, but does not address the applicability of the provision to *adversary proceedings* pending at the time of enactment.

11.4. Statutory Lien Avoidance Under § 545

Section 545 permits the trustee to invalidate those statutory liens that lack the characteristics of a true property interest and are merely disguised priority provisions enacted by states in an attempt to circumvent the priority provisions embodied in the Bankruptcy Code. As a general principal, the following types of statutory liens are voidable under § 545:

1. Statutory liens that become perfected at the time of certain kinds of deterioration in the debtor's financial condition.

2. Statutory liens that are not perfected at bankruptcy as against a hypothetical bona fide purchaser from the debtor.

3. Statutory liens that are in favor of the debtor's landlord.

Additionally, in liquidation cases under § 724(a), the trustee may avoid any lien, statutory or otherwise, that secures a governmental or private penalty. Furthermore, in liquidation cases under § 724(b), statutory tax liens on either real or personal property, that are otherwise valid, are subordinated to bankruptcy administration expenses particularly chapter 7 expenses and certain unsecured employee and consumer priority claims, although the 2005 Act limits this partial subordination in many common situations.

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[96] 11 U.S.C.A. § 547(i).

[97] Section 1213(b) of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 Pub. L. 109-8, 119 Stat. 23, enacted April 20, 2005.

11.5. Fraudulent Transfers Under § 548(a)

A trustee, or debtor-in-possession under a chapter 11 case, may avoid any fraudulent transfer under § 548(a) of the Code. The Bankruptcy Code recognizes two types of fraudulent transfers. The first type is commonly referred to as an actual fraudulent transfer. An actual fraudulent transfer is a transfer made by the debtor with the actual intent to hinder, delay, or defraud its creditors. With this type of transfer, the court's focus is exclusively on the actual intent of the debtor. The second type is commonly referred to as a constructive fraudulent transfer. In the constructive fraudulent transfer scenario, the debtor's intent is irrelevant. Rather, the focus is on whether the debtor received less than a reasonably equivalent value in exchange for the transfer and whether the debtor was in a precarious financial condition as defined by the Bankruptcy Code.

Sections 548(a) and 544(b) (incorporating state fraudulent transfer law) of the Bankruptcy Code recognize the power of the trustee to challenge transfers or obligations incurred as fraudulent transfers. Section 548(a)(1)(B) provides:[98]

> (a)(1)(B) The trustee may avoid any transfer ***(including any transfer to or for the benefit of an insider under an employment contract)*** of an interest of the debtor in property, or any obligation ***(including any obligation incurred to or for the benefit of an insider under an employment contract)*** incurred by the debtor, that was made or incurred on or within ~~one year~~ ***2 years*** before the date of the filing of the petition, if the debtor voluntarily or involuntarily--
>
> (A) made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made or such obligation was incurred, indebted; or
>
> (B) (i) received less than a reasonably equivalent value in exchange for such transfer or obligation; and
>
> (ii) (I) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation;
>
> (II) was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital; ~~or~~
>
> (III) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured; ***or***
>
> ***(IV) made such transfer to or for the benefit of an***

[98]This outline does not address transfers made or obligations incurred with the actual intent to hinder, delay, or defraud creditors.

insider, or incurred such obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.[99]

Section 544(b)(1) authorizes a trustee to avoid any transfer by the debtor that an unsecured creditor with an allowable claim could avoid under state fraudulent transfer law. Under §544(b)(1), a trustee's cause of action rises and falls under state law; therefore, one must acquaint oneself with the elements of state fraudulent transfer law. Although the UFTA is similar in many respects to §548, some states such as New York still operate under the UFCA, and some states like Texas have adopted nonuniform amendments to the UFTA.

Section 548 grants to the trustee the power to avoid a fraudulent transfer accomplished with either actual or constructive fraudulent intent. The fraudulent transfer is an infringement of the creditor's right to realize upon the available assets of its debtor. The law imposes a substantive prohibition: the debtor may not dispose of its property with the intent, actual or implied by law, of placing the property beyond the reach of its creditors. Although most commentators agree that one of the fundamental thrusts of fraudulent transfer law is to protect the unjust diminution of the debtor's estate, the authorities disagree about where the proper limits of fraudulent transfer law should be drawn.[100]

11.5.1. Constructively fraudulent transfers

To make out a successful §548(a)(1)(B) claim, the trustee must prove (1) a transfer to the defendant of (2) an interest in property of the debtor[101] (3) during the year (for bankruptcy cases

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[99] The "striked" language has been removed from the section but will continue to govern fraudulent transfer actions brought ancillary to all bankruptcy cases filed before 17 October 2005. The bold and italicized language will govern all fraudulent transfer actions brought ancillary to all bankruptcy cases filed on or after 17 October 2005.

[100] See, e.g., Douglas G. Baird & Thomas H. Jackson, Fraudulent Conveyance Law and Its Proper Domain, 38 Vand. L. Rev. 829 (1985); David Gray Carlson, Is Fraudulent Conveyance Law Efficient?, 9 Cardozo L. Rev. 643 (1987); Frank R. Kennedy, The Uniform Fraudulent Transfer Act, 18 U.C.C. L.J. 195 (1986); Jonathan C. Lipson, First Principles and Fair Consideration: The Developing Clash Between the First Amendment and the Constructive Fraudulent Conveyance Laws, 52 U. Miami. L. Rev. 247 (1997); Marie T. Reilly, The Latent Efficiency of Fraudulent Transfer Law, 57 La. L. Rev. 1213 (1997); Emily Sherwin, Creditors' Rights Against Participants in a Leveraged Buyout, 72 Minn. L. Rev. 449 (1988); Kathyrn Smyser, Going Private and Going Under: Leveraged Buyouts and the Fraudulent Conveyance Problem, 63 Ind. L.J. 781 (1988); Paul M. Shupack, Confusion and Policy and Language in the Uniform Fraudulent Transfer Act, 9 Cardozo L. Rev. 811 (1987); Mary Jo Newborn Wiggins, A Statute of Disbelief?: Clashing Ethical Imperatives in Fraudulent Transfer Law, 48 S.C.L. Rev. 771 (1997); Jack F. Williams, Revisiting the Proper Limits of Fraudulent Transfer Law, 8 Bankr. Dev. J. 55 (1991); Jack F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System, 15 Cardozo L. Rev. 1403 (1994); Barry L. Zaretsky, Fraudulent Transfer Law as the Arbiter of Unreasonable Risk, 46 S.C.L. Rev. 1165 (1995); Todd J. Zywicki, Rewrite the Bankruptcy Laws, Not the Scriptures: Protecting a Bankruptcy Debtor's Right to Tithe, 1998 Wis. L. Rev. 1223.

[101] The Bankruptcy Code does not define the phrase "interest of the debtor in property." Although the question of what constitutes an interest of the debtor in property is a question of federal law, the courts will consult state law in determining whether this element is met. 1A BANKR. SERV. L. ED. §§5D:12, at 19 & n.1 (cases cited therein).

filed on or after 17 October 2005, the period is increased to two years) preceding the filing of the petition in bankruptcy[102] (4) without reasonably equivalent value[103] in exchange for such transfer (5) while the debtor was insolvent or left in some other statutorily-defined precarious financial condition.[104]

Transfer is broadly defined in §101(54) of the Bankruptcy Code to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption."[105] A transfer is a protean and embracive term,[106] including a gift,[107] a foreclosure sale,[108] final payment on a check,[109] a filing of a lis

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The property requirement enjoys a broad scope and is generally construed in light of the purposes of fraudulent transfer law. Generally, the transfer must have depleted the debtor's estate. Id. §5D:12, at 19-20 & n.2 (cases cited therein).

[102]It is the filing of the petition in bankruptcy and not any subsequent petition that is used as the timing reference under §548. *See* Bluford v. First Fidelity Mortgage Co. (In re Bluford), 40 Bankr. 640, 644 (Bankr. W.D. Mo. 1984). The appropriate reach-back period is often one of the most hotly contested issues in a fraudulent transfer action. Section 548(a) constitutes a grant of power to the trustee to avoid certain transfers deemed to have been made within one year of the filing (two years for bankruptcy cases filed on or after 17 October 2005) of the bankruptcy petition. The reach-back period is not a statute of limitations. The reach-back requirement cannot be waived; it is not an affirmative defense. It serves as a means by which the trustee's power is limited in time so that §548 does not serve as a form of unlimited insurance for creditors against the debtor's striking a bad deal. Consequently, transfers "deemed" to have taken place outside the one-year period (or for cases filed on or after 17 October 2005, two years) are not subject to attack under §548. However, one must be careful not to be misled by the realities of the transactions. Section 548(d)(1) states a policy and is not a recantation of the actual events. Thus, the law on when a transaction is deemed to have occurred (as opposed to when, in reality, it happened) must be consulted. Finally, all transfers within the applicable time period must be examined by the court.

[103]The analogous phrase was "fair consideration" under the Bankruptcy Act of 1898 and incorporated a requirement of good faith that no longer exists under §548(a)(1)(B) or §§4 and 5 of the UFTA. See Carr v. Demusis (In re Carr), 34 Bankr. 653, 656 (D. Conn. 1983); see also UFCA §3, 7A U.L.A. supra note 53, at 448-49 (employing a "fair consideration" standard).

[104]Murphy v. General Elec. Credit Corp. (In re Rodriguez), 77 B.R. 939, 940 (Bankr. S.D. Fla. 1987), aff'd, 895 F.2d 725 (11th Cir. 1990); In re Ristich, 57 B.R. 568, 574 (Bankr. N.D. Ill. 1986). The corresponding UFTA sections are §§4, 5, 7A U.L.A. supra, at 652-653, 657. Although obvious, it is occasionally overlooked that postpetition (as opposed to prepetition) transfers are not voidable under §548. Nemeti v. Seaway Nat'l Bank (In re Nemeti), 65 B.R. 391, 394 (Bankr. N.D.N.Y. 1986).

[105]11 U.S.C. §101(54).

[106]*See* Venice Western Motel, Ltd. v. Venice Motor Inn, Ltd. (In re Venice Western Motel, Ltd.), 67 B.R. 777, 780 (Bankr. M.D. Fla. 1986).

[107]Schafer v. Hammond, 456 F.2d 15, 17 (10th Cir. 1972).

[108]BFP v. Resolution Trust Corporation, 511 U.S. 531 (1994); Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 204 (5th Cir. 1980) (seminal case holding that a foreclosure sale is a transfer); accord First Fed. Sav. & Loan Ass'n v. Hulm (In re Hulm), 738 F.2d 323, 325 (8th Cir.), cert. denied, 469 U.S. 990 (1984); but cf. Madrid v. Lawyers

pendens for alimony,[110] an execution on a judgment lien,[111] a renewal of a loan and payments thereunder,[112] a pledge of securities and subsequent involuntary sale,[113] a termination of a lease,[114] a settlement agreement,[115] a consignment of goods,[116] a bonus,[117] a planting of crops,[118] a bank's forebearance in collection of indebtedness in exchange for a security interest in livestock,[119] a garnishment of the debtor's bank account,[120] an attachment of a judgment lien,[121] a leveraged buyout,[122] an upstream, downstream, or cross-stream guaranty,[123] a ratification of a

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Title Ins. Corp. (In re Madrid), 725 F.2d 1197, 1198 (9th Cir.), cert. denied, 469 U.S. 833 (1984); In re Winshall Settlor's Trust, 758 F.2d 1136, 1138-39 (6th Cir. 1985).

[109]Barnhill v. Johnson, 503, U.S. 393, 112 S. Ct. 1386 (1992).

[110]In re Ottaviano, 63 B.R. 338, 341 (Bankr. D. Conn. 1986).

[111]Frank v. Berlin (In re Frank), 39 B.R. 166, 167-69 (Bankr. E.D.N.Y. 1984).

[112]B.Z. Corp. v. Continental Bank, N.A. (In re B.Z. Corp.), 34 B.R. 546, 548 (Bankr. E.D. Pa. 1983).

[113]Kelley v. Horner (In re Kelley), 7 B.R. 384, 388-89 (Bankr. D.S.D. 1980).

[114]Eder v. Queen City Grain, Inc. (In re Queen City Grain, Inc.), 51 B.R. 722, 725-26 (Bankr. S.D. Ohio 1985); see also Darby v. Atkinson (In re Ferris), 415 F. Supp. 33, 39 (W.D. Okla. 1976) (lease cancellation because of default is transfer subject to fraudulent transfer analysis); but see UFTA §8(e)(1), 7A U.L.A. supra note 52, at 662 (leases terminated pursuant to their terms excluded from fraudulent transfer liability).

[115]In re Edward Harvey Co., 68 B.R. 851, 858 (Bankr. D. Mass. 1987).

[116]Campbell v. Macartie (In re Factory Tire Distribs., Inc.), 64 B.R. 335, 338 (Bankr. W.D. Pa. 1986).

[117]Id. at 339.

[118]Lemley-Cabbiness Farms v. FDIC (In re Lemley Estate Business Trust), 65 B.R. 185, 189 (Bankr. N.D. Tex. 1986).

[119]In re Bob Schwermer & Assocs., Inc., 27 B.R. 304, 310 (Bankr. N.D. Ill. 1983).

[120]Ellenberg v. DeKalb County, Ga. (In re Maytag Sales and Serv., Inc.), 23 B.R. 384, 388 (Bankr. N.D. Ga. 1982) (case under §547(b)).

[121]Suppa v. Capalbo (In re Suppa), 8 B.R. 720, 722 (Bankr. D.R.I. 1981) (case under §547(b)).

[122]Kupetz v. Continental Ill. Nat'l Bank & Trust Co., 77 B.R. 754, 759- 60 (C.D. Cal. 1987), aff'd sub nom., Kupetz v. Wolf, 845 F.2d 842 (9th Cir. 1988); see United States v. Tabor Court Realty Corp., 803 F.2d 1288 (3d Cir. 1986), cert. denied, 483 U.S. 1005 (1987); see generally David Gray Carlson, Leveraged Buyouts in Bankruptcy, 20 Ga. L. Rev. 73, at 73 (1985).

[123]Lawrence Paperboard Corp. v. Arlington Trust Co. (In re Lawrence Paperboard Corp.), 76 B.R. 866, 874-76 (Bankr. D. Mass. 1987); see generally Daniel R. Coquillette, Guaranty of and Security for the Debt of a Parent Corporation by a Subsidiary Corporation, 30 CASE W. RES. 433 (1980); Robert J. Rosenberg, Intercorporate Guaranties and the Law of Fraudulent Conveyances: Lender Beware, 125 U. PA. L. REV. 235 (1976).

security interest,[124] a draw on a credit line,[125] a collusive judgment,[126] an encumbrance,[127] a release by a beneficiary of an interest in a trust estate,[128] a change in a beneficiary of a life insurance policy,[129] a divorce or separation agreement,[130] a rescission of a profitable contract,[131] a payment of a dividend,[132] and a payment of usurious interest.[133] This list does not attempt to exhaust all of the possibilities of the term "transfer."[134]

The time when a transfer is deemed made for purposes of fraudulent transfer actions depends on §548(d)(1) and applicable state law. Section 548(d)(1) states:

> For the purposes of this section, a transfer is made when such transfer is so perfected that a bona fide purchaser from the debtor against whom applicable law permits such transfer to be perfected cannot acquire an interest in the property transferred that is superior to the interest in such property of the transferee, but if such transfer is not so perfected before the commencement of the case, such transfer is made immediately before the date of the filing of the petition.

Thus, a fraudulent transfer is deemed to have occurred under §548(d)(1) when the transfer becomes valid against a subsequent bona fide purchaser pursuant to applicable state

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[124]Mitchell v. Travis (In re Jackson Sound Studios, Inc.), 473 F.2d 503, 506 (5th Cir. 1973).

[125]Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 989-91 (2d Cir. 1981).

[126]Petrides v. Park Hill Restaurant, Inc., 265 A.D. 509, 511, 39 N.Y.S.2d 645, 647 (1943).

[127]Service Mortgage Corp. v. Welson, 293 Mass. 410, 412, 200 N.E. 278, 279 (1936).

[128]Schaefer v. Fisher, 137 Misc. 420, 426, 242 N.Y.S. 308, 314 (1930).

[129]Id.

[130]FDIC v. Malin, 802 F.2d 12, 18 (2d Cir. 1986).

[131]Wilson v. Holub, 202 Iowa 549, 552, 210 N.W. 593, 595 (1926).

[132]Mancuso v. Champion (In re Dondi Fin. Corp.), 119 Bankr. 106, 109 (Bankr. N.D. Tex. 1990).

[133]Larrimer v. Feeney, 411 Pa. 604, 607, 192 A.2d 351, 353 (1963).

[134]Because what constitutes a transfer is a question of federal law, state law on the issue is not controlling. See McKenzie v. Irving Trust Co., 323 U.S. 365, 369-70 (1945); First Fed. Sav. & Loan Ass'n v. Hulm (In re Hulm), 738 F.2d 323, 326 (8th Cir.), cert. denied, 469 U.S. 990 (1984); Lovett v. Shuster, 633 F.2d 98, 104 (8th Cir. 1980). For purposes of §548, "transfer" should be construed to include an obligation incurred. See 11 U.S.C. §§101(54), 548(a); see also 1A BANKR. SERV. L. ED. §5D:6, at 13-14 (1990) ("a 'transfer' should be construed as including the incurring of an obligation").

law.[135] If the transfer is not perfected against a bona fide purchaser before the filing of the petition, the transfer is deemed to have occurred immediately before the date of the filing.[136] The purpose of §548(d)(1) is two-fold: first, the time of perfection serves as an objective point in computing the reach-back period of the trustee; and, second, it discourages secret, that is, unperfected liens.[137]

As mentioned, "transfer" is broadly defined in §101(54) to include every mode or disposition of an interest in property, voluntary or involuntary. Once the triggering transfer has been identified, you must determine whether the transfer is one of an interest in the debtor's property. This is usually the case; however, it is important to realize that the estate can only recover that interest which the debtor possessed.

11.5.1.1. Lack of reasonably equivalent value

Under §548(a)(1)(B)(i), receiving less than a reasonably equivalent value for a transfer made or obligation incurred is one of the necessary elements of a constructive fraudulent transfer. The assessment of reasonably equivalent value is objective and is generally a question of fact.[138] Courts have generally employed a case-by-case approach in assessing reasonably equivalent value while observing the unfairness of applying mechanical tests.[139] Reasonably equivalent value is not susceptible to simple formulation. Ideally, it should signify the

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[135]See Sandoz v. Bennett (In re Emerald Oil Co.), 807 F.2d 1234, 1237 (5th Cir. 1987); Madrid v. Lawyers Title Ins. Corp. (In re Madrid), 725 F.2d 1197, 1200 (9th Cir.), cert. denied, 469 U.S. 833 (1984); Lovett, 633 F.2d at 104; Furedy v. Appleman (In re Vodco Volume Dev. Co.), 567 F.2d 967, 970 (10th Cir. 1977), cert. denied, 439 U.S. 806 (1978); Main v. Brim (In re Main), 75 B.R. 322, 326 (Bankr. D. Ariz. 1987); Frank v. Berlin (In re Frank), 39 B.R. 166, 171 (Bankr. E.D.N.Y. 1984); Schatzman v. Campo (In re Oesterle), 2 B.R. 122, 124 (Bankr. S.D. Fla. 1979).

[136]See Oesterle, 2 B.R. at 124 (actual "transfer" made well before one year of the filing of the petition but recorded two days after the filing; held, transfer deemed to have occurred immediately before filing).

[137]In re Madrid, 725 F.2d at 1200; Nemeti v. Seaway Nat'l Bank (In re Nemeti), 65 B.R. 391, 395 (Bankr. N.D.N.Y. 1986); see 4 COLLIER ON BANKRUPTCY ¶548.08, at 548-87 to -88.

[138]See Klein v. Tabatchnick, 610 F.2d 1043, 1047 (2d Cir. 1979); Jacoway v. Anderson Cajun's Wharf (In re Ozark Restaurant Equip. Co.), 74 B.R. 139, 143 (Bankr. W.D. Ark.), remanded, 77 B.R. 686 (W.D. Ark.), on remand, 83 B.R. 591 (Bankr. W.D. Ark. 1987), aff'd in part and rev'd in part, 850 B.R. 342 (8th Cir. 1988); but see BFP v. Resolution Trust Corporation, 511 U.S. 531, 114 S. Ct. 1757 (1994)(bid price held to constitute reasonably equivalent value in noncollusive nonjudicial foreclosure sale); Durrett v. Washington Nat'l Ins. Co., 621 F.2d 201, 203 (5th Cir. 1980) (question of law in mortgage foreclosure context).

[139]See, e.g., Adwar v. Capgro Leasing Corp. (In re Adwar), 55 B.R. 111, 115 (Bankr. E.D.N.Y. 1985); see also Rubin v. Manufacturers Hanover Trust Co., 661 F.2d 979, 994 (2d Cir. 1981) (rejecting any requirement of "mathematical precision" in determining reasonably equivalent value); but see Durrett, 621 F.2d at 203 (observing that a foreclosure bid price of less than 70% of fair market value would not constitute reasonably equivalent value), rejected in, BFP v. Resolution Trust Corporation, 511 U.S. 531, 114 S. Ct. 1757 (1994).

reasonable estimate of what can be realized from the debtor's assets by converting them into cash under possibly guarded (but not forced-sale) conditions. It is wrongheaded to think of reasonably equivalent value as a “number,” or more correctly, a point estimate of value.[140] Rather, data on prices and market fluctuations suggest that a careful analysis of value must begin with an interval estimate of values that captures a more accurate and reliable picture of property, market, and value. Thus, value that falls short of a reasonably equivalent value is value that falls outside the range of values one would expect reasonable parties to reach based on the information available to each at the time of the transfer. The value that is the fruit of ordinary business dealings, that is consistent with the ordinary business practices of others, and that is in the range of values one could reasonably anticipate strongly suggests a reasonably equivalent value. The value that is the product of secret dealings, extraordinary business practices, or falls outside the range of values one could reasonably anticipate strongly suggests a failure of a reasonably equivalent value. Any greater precision comes at the sake of clarity.

"Value" is defined as "property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor."[141] Under the Code, the proper valuation of an asset for purposes of assessing reasonably equivalent value appears to be that "amount which can be realized from the assets within a reasonable time" and not upon immediate liquidation.[142] In addition, where the assets have a greater value as an ongoing business, that value is usually determinative.[143] Although it is clear that payment on an antecedent debt constitutes value, the payment is not dispositive of the issue of reasonably equivalent value.[144] Rather, the debt must be legitimate and bona fide; moreover, the debt must be compared to the value transferred by the debtor to see if reasonably equivalent value is lacking.[145] Unlike the UFTA or the Code, the Texas UFTA[146]

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[140] See David S. Salsburg and Jack F. Williams, A Statistical Approach to Claims Estimation in Bankruptcy, 32 Wake Forest L. Rev. 1119 (1997).

[141] 11 U.S.C. §548(d)(2)(A).

[142] See, e.g., Utility Stationery Stores, Inc. v. American Portfolio (In re Utility Stationery Stores, Inc.), 12 B.R. 170, 176 (Bankr. N.D. Ill. 1981) (§547(b) action).

[143] Danning v. Progressive Pharmaceutical Sys., Inc. (In re Western Adams Hosp. Corp.), 609 F.2d 929, 930 (9th Cir. 1979) (per curiam).

[144] Demusis v. Carr (In re Carr), 40 B.R. 1007, 1008 (D. Conn. 1984). For a discussion of different categories of value, see 1A BANKR. SERV. L. ED. §§5D:34 to :44, at 36-41.

[145] See Plymouth United Sav. Bank v. Lee, 278 Mich. 545, 548, 270 N.W. 781, 782 (1936). How about the situation where a debtor who has borrowed $1 million grants a security interest to its creditor in all of its assets worth $5 million--is the perfection of the security interest a fraudulent transfer? We believe common sense would lead one to conclude no. Regardless of the breadth of the security interest, a creditor is only entitled to satisfaction of the debt. In other words, although $5 million in assets are encumbered, it is only to the extent of the $1 million indebtedness. The UFTA follows this common sense approach. See UFTA, Prefatory Note, 7A U.L.A. 639, 641 (1984). This, however, may not be the case under the UFCA. Bad faith coupled with property securing a present advance or

does provide a noninclusive definition of reasonably equivalent value. Under Texas UFTA Section 24.004(d), reasonably equivalent value includes, without limitation, a "transfer or obligation that is within the range of values for which the transferor would have willfully sold the assets in an [arm's] length transaction."[147] This definition is consistent with the decision in Anderson Industries, Inc. v. Anderson (In re Anderson Industries, Inc.),[148] which analyzed reasonably equivalent value in light of the fact that the bargained for exchange was reached through arm's length negotiations where, presumably, the purchaser was the best informed party as to the value of the asset.[149]

Reasonably equivalent value as commonly understood suggests a comparison of the value transferred by the debtor with the value actually received by the debtor.[150] The bargaining position of the parties, their relationship, the adequacy of the price, the prevailing market conditions, and the marketability of the property transferred are all relevant considerations.[151] Beyond this simple formulation, unfortunately, the case law on reasonably equivalent value is hopelessly confused. Aside from several general rules regarding reasonably equivalent value discussed above, each court seems to address the issue in a subjunctive manner. For example, one court, resigned to the fact that no true market comparison could be made to determine reasonably equivalent value because no such market existed, nevertheless created a hypothetical market to gauge the price paid by the transferee.[152] All in all, the cases on reasonably equivalent value have been deficient in providing a sensible and predictable manner to judge whether a debtor has transferred an asset for less than a reasonably equivalent value.

Based on a careful distillation of the cases, it does appear that a model of reasonably equivalent value may be constructed. The model is a functional one, a process-sensitive

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antecedent debt in an amount disproportionately small as compared with the value of the property may lead a court to find a lack of fair consideration. UFCA §3(b), 7A U.L.A. 427, 449 (1984).

[146]TEX. BUS. & COM. CODE ANN. §24.004(d) (Vernon).

[147]Id.; see Kjeldahl v. United States (In re Kjeldahl), 52 B.R. 926, 934 (Bankr. D. Minn. 1985) (reasonably equivalent value is the amount which reasonable minds would agree is a close or fair exchange given all the circumstances surrounding the transfer).

[148]55 B.R. 922 (Bankr. W.D. Mich. 1985).

[149]Id. at 927-28.

[150]See 1A BANKR. SERV. L. ED. §5D:45, at 42 (1990).

[151]See also Jacoway v. Anderson (In re Ozark Restaurant Equip. Co.), 850 F.2d 342 (8th Cir. 1988) (analysis of reasonably equivalent value in fraudulent transfer context requires consideration of "the entire situation" including market conditions).

[152]See Cooper v. Ashley Communications, Inc. (In re Morris Communications NC, Inc.), 75 B.R. 619, 622-25 (Bankr. W.D.N.C. 1987), rev'd, 914 F.2d 458 (4th Cir. 1990).

approach to assessments of value. The approach suggests that if the process actually employed by the parties to reach a value is reasonable, then the fruits of that process is itself reasonable. Thus, the purchase price of an asset transferred wherein the price was reached by arms' length negotiations will generally approximate reasonably equivalent value.

For example, the Supreme Court addressed the issue of what constituted reasonable equivalent value in the context of a real property foreclosure in *BFP v. Resolution Trust Corporation.*[153] In that case, the Supreme Court put to rest the issue of how to gauge reasonably equivalent value in the context of a real property foreclosure, where it held that the bid price at a noncollusive real property foreclosure sale, conducted in accordance with state law, was per se reasonably equivalent value. Some commentators have chalked the *BFP* case up to the sanctity of certainty of title in real property. Although an important point, the better view, I suggest, is that a reasonable sale's process (that is, a sale process that the legislature has deemed reasonable by its enactment) results in a reasonable sale's price. Thus, at a greater level of abstraction, the Supreme Court case in *BFP* contains a treasure trove of valuable lessons on the general questions of what constitutes a reasonably equivalent value.

Another example of the process-sensitive approach I am suggesting may be found in the context of intercorporate guaranties. Guaranties may also constitute fraudulent obligations in certain circumstances. This is especially the case in the context of intercorporate guaranties. If you were to study the guaranty cases, you would find that three rules may be deduced. First, an upstream guaranty from a subsidiary guaranteeing the debt of a parent is presumptively for less than a reasonably equivalent value unless the guaranties result from an arms' length negotiation where the common enterprise was viable at the time of the incurrence of the guaranty obligations. Courts reach this result under either the identity of interests rubric or the indirect benefits approach. However, the benefits must be demonstrable and supported by the evidence. Likewise, a cross-stream guaranty where one subsidiary guarantees the debt of another subsidiary may presumptively fail the reasonably equivalent value test, according to many opinions, unless demonstrable benefit can be adduced. Finally, a downstream guaranty, wherein a parent guarantees the subsidiary's debt, is presumptively valid.

Thus, fraudulent obligations such as some guaranties may be proscribed under §548.[154] It is, however, incorrect to cast a spell on all guaranties. An emerging trend is developing that embraces a robust, process-sensitive approach[155] to assessing reasonably equivalent value in the context of guaranties, particularly where affiliates are involved. For example, in In re Image Worldwide,[156] the Seventh Circuit observed that any indirect benefits to a guarantor may be

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[153]511 U.S. 531 (1994).

[154]*See* Jack F. Williams, The Fallacies of Contemporary Fraudulent Transfer Models as Applied to Intercorporate Guaranties: Fraudulent Transfer Law as a Fuzzy System, 15 Cardozo L. Rev. 1403 (1994).

[155]For a detailed treatment of robust or fuzzy logic in the nature of fraudulent transfers, see id.

[156]139 F.2d 574 (7th Cir. 1998).

considered in evaluating whether a reasonably equivalent value was received in exchange for the guaranty obligation.[157] While authorities exist to the contrary, recent authority generally rejects the notion that an intercorporate guaranty constitutes a fraudulent obligation per se.

11.5.1.2. Statutorily-defined financial distress

Under fraudulent transfer law, a lack of reasonable equivalent value is necessary but not sufficient before a court condemns a transfer made or obligation incurred as constructively fraudulent. In addition to lack of a reasonably equivalent value, the transfer made or obligation incurred must occur when the debtor is (1) insolvent or rendered insolvent, (2) left with an unreasonably small capital, or (3) left with an inability to pay its debts as they became due.

11.5.1.2.1 Insolvent or rendered insolvent

Although a thorough discussion of the solvency question is beyond the scope of this outline,[158] several additional observations should be made. First, insolvency is a legal term of art. Accounting or finance principles inform the inquiry; they do not constrain it. Thus, the definition of asset or liability, for example, is not a Generally Accepted Accounting Principal ("GAAP") question; it is a legal one. Second, in this context, the question is one of bankruptcy law. Finally, the test for insolvency for fraudulent transfers is the same test used to determine insolvency for preference action with one notable exception. In a fraudulent transfer analysis, you must assess insolvency immediately before and after the transfer made; §548(a)(1)(A) ensnares transfers made by the debtor while insolvent *or that render a debtor insolvent*. However, under §547(b)(3), a preference is avoidable when a debtor makes the transfer while insolvent.

At its most fundamental core, we find that there is no fundamental core to insolvency. Insolvency is no well-understood or universal term of art. To the contrary, it is a content-driven term. If you ask that we define insolvency, we must retort why, for what purpose do you seek the definition? To be sure, classic definitions abound. We often capture the concept by reference to a balance sheet: Solvency is that condition whereby a company's liabilities exceed its assets. Of course, financial statements employ book values, and, in all likelihood, do not reflect assets at fair market value or all liabilities. Thus, insolvency law forced consideration of a company's assets and liabilities at some version of fair value. Adjusted balance sheet formulas also quickly slipped the moors of GAAP, requiring a consideration of additional assets (such as

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[157]Id. at 582.

[158]For a thorough discussion of solvency, including proof issues, see Frank R. Kennedy, Vern Countryman, and Jack F. Williams, KENNEDY, COUNTRYMAN, & WILLIAMS ON PARTNERSHIPS, LIMITED LIABILITY ENTITIES, AND S CORPORATIONS IN BANKRUPTCY, Chapter 6 (2000).

causes of action) and additional liabilities (such as contingent liabilities). GAAP became the handmaiden of insolvency tests and not its jailor.

The Bankruptcy Code applies the adjusted balance sheet approach to determine solvency. Under this approach, a debtor is insolvent when the sum of its debts is greater than its property at a fair valuation. In employing the Bankruptcy Code's adjusted balance sheet test of insolvency, a fair valuation and not the book value or cost of an asset is used.[159] Equitable rights, such as the rights of subrogation and of contribution, are assets that must be quantified.[160] Further, goodwill, other intangible property, and, to the extent not reflected in goodwill or some other asset already accounted for, discounted cash flow constitute assets that should be quantified and considered in assessing insolvency in a going concern analysis only.

The "fair valuation" standard under the Bankruptcy Code is not self-evident. A fair valuation does not mean the amount the property would bring in the worst circumstances or in the best. For example, a forced sale price is not necessarily fair value though it may be used as evidence on the question of fair value, particularly where the debtor is on its financial deathbed as of the transfer date. Likewise, fair market value is not necessarily fair value though it may be used as evidence on the question of fair value, particularly where the debtor is a going concern as of the transfer date.

In the quest of employing reasonable approaches to the determination of a fair valuation, some courts have embraced going concern values for inventory and not for equipment,[161] while others have disregarded illiquid assets in the insolvency calculus altogether.[162] Still other courts have employed a temporal standard in assessing which valuation to use, that is, a presumption that going concern value is applicable unless at the time of transfer the business is in such a precarious financial condition that the liquidation value of the assets is more appropriate.[163] It appears that the present consensus among cases suggests that where at the time of the transfer under scrutiny, if the debtor's business is a going concern and not on its financial deathbed, then a going concern valuation is appropriate. However, where at the time of the transfer or action

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[159]*Euro-Swiss Int'l Corp.*, 33 B.R. at 885-86.

[160]*Join-In Int'l (U.S.A.) Ltd. v. New York Wholesale Distribs. Corp. (In re Join-In Int'l (U.S.A.) Ltd.)*, 56 B.R. 555, 560 (Bankr. S.D.N.Y. 1986); <u>See</u> 1A BANKR. SERV. L. ED. §5D:76, at 60 (1990).

[161]*See, e.g.*, *Ohio Corrugating Co.*, 91 B.R. at 437-38.

[162]*See, e.g.*, *Wieboldt Stores, Inc. v. Schottenstein*, 94 B.R. 488, 505 (N.D. Ill. 1988).

[163]*See, e.g.*, *Vadnais Lumber Supply, Inc. v. Byrne (In re Vadnais Lumber Supply, Inc.)*, 100 B.R. 127, 131 (Bankr. D. Mass. 1989).

under scrutiny, if a debtor's business is in such a financial state as to lead one to conclude that it was more likely than not that the debtor would liquidate in the reasonably foreseeable future, then a fair valuation should more closely approximate orderly liquidation value to liquidation value.[164] Therefore, one must assess the business status of the debtor at the time of the transfers made or obligations incurred.

11.5.1.2.2 Left with unreasonably small capital

In addition to the adjusted balance sheet test for insolvency, the Bankruptcy Code fraudulent transfer provision can also condemn a transfer made for less than a reasonably equivalent value if the debtor was left with unreasonably small capital. While adequate market capitalization may be a relevant indicator in assessing whether the debtor was left with unreasonably small capital, the primary focus by the use of the term "capital" is on current assets, total assets, working capital, and both current and long-term liabilities.

The following factors significantly influence a company's total investment in working capital: (i) type of business; (ii) business cycle; (iii) production cycle; (iv) credit policy; (v) supply/demand conditions; (vi) market conditions; (vii) growth potential; (viii) dividend policy; (ix) inflation; and (x) financing of working capital either through internal or external sources. In addition to these factors, an assessment of unreasonably small capital would include both a horizontal and vertical analysis of the Company's balance sheets and income statements as described above. For example, a trend analysis of the balance sheets would show over time a more robust picture of current assets, total assets, working capital (current assets net current liabilities), and leverage (both current and long-term liabilities). Ratios based on the financial statements calculated over time could include total current liabilities to total assets, current assets to current liabilities (working capital). A trend analysis of the income statements would show over time sales, operating income, interest expense and interest expense, net income before taxes, and EDITDA. Furthermore, a trend analysis of the financial statements should pick up any increase in debt maturities because of transactions, any unforeseeable or unplanned intervening events that arose after the transfer date, and borrowing availability.

In addition to the analysis described above, an expert would routinely undertake a financial ratio analysis to determine whether the debtor was left with unreasonably small capital. Thus, the expert would calculate the key financial ratios of the debtor in an effort to assess its financial position based on its financial statements as reported and as constructed for the testing period. In undertaking this analysis, an expert would employ both a trend analysis (comparison of the debtor's ratios across time) and an analysis of comparable companies in the industry.

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[164]*See* Frank R. Kennedy, Vern Countryman & Jack F. Williams, PARTNERSHIPS, LIMITED LIABILITY ENTITIES & S CORPORATIONS IN BANKRUPTCY, Chapter 6 (2000)

11.5.1.2.3 Left with an inability to pay debts as they become due

A third alternative test for financial distress is where the debtor is left with an inability to pay debts as they become due. Thus, an expert would also investigate and analyze whether a debtor intended to incur debts beyond the debtor's ability to pay those debts as they come due. Employing this test, the expert would assess the existing liquidity ratios and working capital levels discussed above. An expert would also consider the debtor's borrowing availability under any financing arrangement, which would strongly bolster the view that the debtor was able to pay current obligations as they came due. Additional factors would include history of payables performance, violation of financial covenants, actual business operations, the fact that the debtor continued operations and generated profits for some significant time after the transfer (if applicable), that public bondholders invested in the debtor (if a public company), that equity continued to invest in the debtor, and that sophisticated creditors continued to do business with the debtor, including extending credit for goods provided and services performed.

11.6. Changes to fraudulent transfer law

There are several amendments of now under §548. Three are addressed in these materials. Please note that these changes generally apply to all fraudulent transfer actions commenced ancillary to any bankruptcy case filed on or after 17 October 2005.

11.6.1. Two-year reach back period

As mentioned previously, the 2005 Act amended §548 to expand the reach-back period for scrutinizing transfers made and obligations incurred as either actually or constructively fraudulent. The amendment increased the period from one year to two years under general §548(a)(1) attack. The intent was to expand the powers of the trustee, especially in the areas of fraudulent transfer attacks on transactions to insiders, although the language does not limit itself to those special situations. Whether this expansion is significant is subject to debate in light of the much longer periods already embodied in §544(b) as that section incorporates state fraudulent transfer law. Of course, one can surmise that where a situation presents itself outside the one year period but within two years from the petition date, and the trustee cannot find an actual creditor with an allowed unsecured claim who could have avoided the transfer, then the expanded reach back period would be welcome relief.

11.6.2. Insider employment contracts

The 2005 Act also sought to ensure the trustee and the courts that the power to scrutinize insider employment contracts existed and that the standards to avoid such contracts, in the appropriate circumstances, should be loosened. First, the 2005 Act amends the general flush language of §548 to include as a modifier of both "transfer" and "obligation" any transfer or obligation to or for the benefit of an insider under an employment contract. Insider is broadly defined at §101(31) to include, in the situation where the debtor is a corporation, a director; officer; or person in control of the debtor; or an affiliate of the debtor, among others. The term "employment contract," while not directly defined under the Bankruptcy Code, will continue to maintain the meaning that it has under applicable nonbankruptcy law. Whether this amendment is necessary is also subject to debate; it appeared that the existing definitions of "transfer" and "obligation" were sufficiently broad to include both the creation of the employment contract and any payments or transfers thereunder.

Second, the 2005 Act amends the conditions of financial distress that may result in the avoidance of any transfer made or obligation incurred. Specifically, once a court finds a lack of a reasonably equivalent value[165] in exchange for any obligation incurred or transfer made pursuant to an employment contract with an insider, the trustee need only show that the such transfer made or obligation incurred was not in the ordinary course of business. Much is left to imagination under this new replacement for financial distress. For example, is it the transfer made or obligation incurred that must be outside the ordinary course or is it the employment contract in the first instance? I suggest the former, a reading not only consistent with the language of §548(a)(1)(B)(ii)(IV), but also with other provisions in the Code that mandate scrutiny on a transaction by transaction basis.[166] Additionally, when assessing ordinary course, whose ordinary course are we considering? Is it the ordinary course of the debtor? The insider? The industry? Healthy members of the industry only? I would suggest that the proper focus is to borrow from the authorities under §363 and employ both a horizontal and vertical assessment of ordinary course. However, the proper focus should be on whether the creditors may maintain a legitimate claim of unfair surprise based on all the circumstances known or reasonably known to them at the time of the transfer made or obligation incurred under the insider employment contract. Of course, even if the insider employment contract falls within the ordinary course, it may nonetheless fail §548 under the general dictates of financial distress coupled with a lack of a reasonably equivalent value, nothing in that section suggesting otherwise.

11.6.3. <u>Condemnation of certain asset-protection strategies</u>

The 2005 Act adds a new subsection (e) to §548, designed to condemn certain asset protection strategies commonly employed under applicable nonbankruptcy law. Specifically, §548(e)(1) provides:

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[165]One must note that value as defined in §548(d)(2)(A) does not include an unperformed promise to furnish support to the debtor.

[166]*See, e.g.,* 11 U.S.C. §547(c)(2) (ordinary course of business defense on transfer by transfer basis); 11 U.S.C. §363 (transfers made in and out of ordinary course).

(e)(1) In addition to any transfer that the trustee may otherwise avoid, the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if –

(A) such transfer was made to a self-settled trust or similar device;

(B) such transfer was by the debtor;

(C) the debtor is a beneficiary of such trust or similar device; and

(D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

Again, although some may argue that the main thrust of new §548(e) is already covered by existing fraudulent transfer law, one cannot argue with the proposition that the trustee's powers to scrutinize the self-settled trust scenario have expanded greatly. Two key changes include the following: First, the new subsection extends the reach back period to ten years. Second, the new subsection broadens the definition of self-settled trust by including the ambiguous language "similar device." The ramifications of the addition of "similar device" to section 548(e)(1)(A) are presently not well understood. To what extent will the "similar device" language be used to scrutinize favorite asset protection planning devices such as IRAs, retirement funds, or even the limited liability entity. The ambiguity and importance of the language means that bankruptcy courts will be left to interpret the meaning of "similar device." Thus, for example, if one were to identify the primary attributes of the self-settled trust, I suggest it would be that the self-settled trust is simply the alter-ego of the debtor and that the self-settled trust protects assets from the claims of creditors because it acts as a restraint on the alienation of property.. Thus, would a bankruptcy court embrace a definition of "similar device" to include any alter-ego form that restrains alienation? Only time will tell.

11.7. Postpetition Transfers Under § 549(b)

With a couple of enumerated exceptions at §§ 549(b)-549(c), a trustee may avoid a transfer of property of the estate that occurs after the commencement of the case and is not authorized by the Bankruptcy Code or by the bankruptcy court. Recall the discussions about unauthorized transactions with the debtor, such as the transaction outside the ordinary course of the debtor's business. Absent court approval of the outside-the-ordinary-course-of-business transaction, the trustee under § 549(a) may avoid the transaction and recover any transfer of estate property.

11.8. Setoff Under § 553

Pursuant to § 553, any right of setoff that existed under state law is preserved in a bankruptcy. Thus, there is no right to setoff created by bankruptcy law; § 553 merely recognizes a state created right to setoff but only in certain circumstances. Below is a detailed analysis of § 553.

11.8.1. **Right to Setoff**

Setoff is a time-honored creditor's remedy whereby mutual debts may be "netted out." The genesis of the doctrine of setoff can be traced to Roman law and, although not a part of early English common law, has been a part of American common law since the middle Seventeenth Century. As the Supreme Court of the United States cogently observed, the doctrine of setoff is grounded on the absurdity of making A pay B when B owes A.

Because the Bankruptcy Code does not create any independent right of setoff, one must review state law to assess whether a right to setoff exists at all. Traditionally, the right to setoff exists when the following four conditions are met:

- (i.) the fund to be setoff is the property of the debtor;
- (ii.) the fund is deposited without restrictions;
- (iii.) the existing indebtedness is due and owing; and
- (iv.) there is a mutuality of obligation between the debtor and the creditor, and between the debt and the fund on deposit.

Setoff is thus a method to net debts, usually arising out of unrelated transactions.

Although state law is not uniform as to how one affects a right to setoff, generally, the courts have concluded that a creditor must take three steps to effectuate its setoff right.

First, the creditor must decide to exercise the right to setoff. Second, the creditor must take some action that accomplishes the setoff. Third, the creditor must make some record that evidences that the right to setoff has been exercised. Under the majority rule, the mere declaration of intent to setoff is ineffective to accomplish setoff. There are, however, several jurisdictions where no overt act is necessary.

A typical example of the right to setoff often arises in the traditional bank/customer relationship. For example, a customer maintains a deposit account at a bank. This relationship is traditionally viewed as a creditor/debtor relationship. The customer then executes a promissory note, promising to pay the bank a sum of money in return for a car loan. Upon the execution of the note, an additional customer/bank relationship exists. In this relationship the customer is the debtor, the bank is the creditor. If the customer defaults on the promissory note, the bank's right to setoff arises. The customer is the bank's creditor in relation to the deposit account, but is also a debtor in relation to the promissory note. The bank is a creditor as to the promissory note, but is a debtor as to the deposit account. Mutuality of obligation exists. The conditions necessary for the right to setoff are all present.

Only mutual debts may be setoff under § 553(a). A debt is considered mutual when it is between the same parties in the same right or capacity. The debts need not, and usually do not, arise out of the same transaction. Section 553 requires that both the funds and the debt arise prior to the filing of the bankruptcy petition.

11.8.2. **Limitations on a Creditor's Right to Setoff**

Although the Bankruptcy Code does not create any right to setoff, it does delineate the procedure by which a creditor can exercise its non-bankruptcy setoff right. There are several limitations on a creditor's ability to effectuate a setoff.

- If the creditor's claim is disallowed other than under § 502(b)(3), any setoff can be avoided.

- If a creditor effects the setoff within 90 days of bankruptcy, while the debtor is insolvent, and if it can be proved that the deposit was made for the purposes of obtaining a right to setoff, the setoff is voidable by the trustee under § 553(a)(3).

- If a creditor effects a setoff within 90 days of bankruptcy, while the debtor is insolvent, and if it can be proved that the creditor's claim was transferred to it by an entity other than the debtor, the setoff is voidable by the trustee under § 553(a)(2).

The Bankruptcy Code modifies prior law dramatically in granting the trustee power to avoid a setoff exercised within 90 days of bankruptcy, not only where deposits have been built up with an intent to exercise setoff or a claim has been transferred to set up a setoff right, but also where there has been an improvement in position by the creditor within the 90-day period. Under § 553(b), the trustee may void a setoff to the extent that an insufficiency existing at the date of setoff is less than an insufficiency existing on the latter of: (i) the first day of the 90 day period; or (ii) the first day within that period on which an insufficiency existed. The insufficiency relates to the extent to which the amount owed by a debtor exceeds the amount owed to that debtor.

Significantly, the power to recover under § 553(b) is absolute; the power does not hinge on the insolvency of the debtor. Furthermore, of great significance is the fact that the improvement in position test under § 553(b) only applies to the prepetition setoff. Thus, mere improvement of a creditor's position is not voidable by the trustee when the creditor does not setoff prior to bankruptcy. The creditor who rolls the dice and refrains from prepetition setoff can ride the tide of any increase in the debtor's funds.

The dual standard between the treatment by the Bankruptcy Code of prepetition and postpetition setoff reflects a policy to discourage prepetition setoff, thus maintaining a source of working capital for the debtor's reorganization. The following are a few examples to help you understand a trustee's ability to limit a creditor's right to setoff under § 553(b).

11.8.2.1. Calculation of Possible Recovery

In order to calculate the amount the trustee is entitled to recover from the creditor, one must make the following basic calculations:

- Calculate the insufficiency, if any, at the time of the setoff;
- Calculate the insufficiency, if any, as of the ninetieth day preceding the bankruptcy filing;

If the insufficiency at the time of the setoff is greater than the insufficiency at the time of the bankruptcy filing, then calculate the insufficiency for every successive day from the bankruptcy filing date until you reach 90-days back;

The trustee may then recover from the creditor the amount equal to the difference between (i) the set-off date insufficiency and (ii) the "first date insufficiency" (or the insufficiency amount on the first date in the 90-day window when such amount is less than the setoff date insufficiency). This amount is the improvement in position. If the amount subject to setoff is always greater than the debt (i.e., the lender is always oversecured) or the amount of the setoff date insufficiency is always greater than the "first date" insufficiency amount (i.e., no improvement), then there is no insufficiency and no funds can be recovered by the trustee.

11.8.2.2. Additional Analysis and Illustrations

The following three examples illustrate, in a step-by-step fashion, the workings of the recovery provisions of the statute.

(Example 1)

Step 1. Ninetieth day preceding the filing of the petition in bankruptcy, or the first date within the 90-day period on which there was an insufficiency:

- Amount debtor owed $1 million
- Amount subject to setoff $500,000
- Insufficiency $500,000

Step 2. At time of setoff:

- Amount debtor owed $1 million
- Amount subject to setoff $700,000
- Insufficiency $300,000

Step 3. Amount subject to recovery by trustee:

Trustee could recover $200,000. The basis for this conclusion is that the insufficiency on the ninetieth day preceding the date of filing, or on the first date within the 90-day period in which there was an insufficiency, exceeded the insufficiency at the time of setoff by $200,000.

(Example 2)

Step 1. Ninetieth day preceding the filing of the petition in bankruptcy:

- Amount debtor owed $1 million
- Amount subject to setoff $1 million
- Insufficiency None

Step 2. First day within the 90 days preceding the filing on which there was an insufficiency:

At all times during the 90 day period, the amounts on deposit equaled or exceeded the amount owed to creditor.

Step 3. Amount setoff:

Creditor setoff the amount on deposit against the entire amount owed to creditor.

Step 4. Amount subject to recovery by trustee:

Since there was no insufficiency at any time during the 90 days preceding filing of the petition, creditor did not improve its position during that time; consequently, no part of the amount setoff was subject to recovery under § 553.

(Example 3)

Step 1. Ninetieth day preceding the filing:

- Amount debtor owed $1 million

- Amount subject to setoff $1 million
- Insufficiency None

Step 2. The first date within the 90 day period in which there was an insufficiency:

The debtor borrowed an additional $200,000, creating a total debt of $1.2 million. At the same time, the debtor withdrew $100,000, leaving a total amount of $900,000 subject to setoff.

Insufficiency $300,000.

Step 3. At time of setoff:

The debtor had paid down its debt to $400,000. The amount on deposit equaled or exceeded $400,000. The creditor setoff the amount on deposit against the debt owed.

Insufficiency None

Step 4. Amount subject to recovery by the debtor:

The debtor could recover $300,000. The basis for this conclusion is that the first insufficiency within the 90 days prior to the filing exceeded the insufficiency at the time of setoff by $300,000. In the type of factual setting illustrated by Example 3, it is conceivable that the entire setoff amount could be recovered by the trustee. This would be the result if in Step 2 of Example 3, the trustee had withdrawn $200,000. The result would have been an insufficiency of $400,000, which would then be the amount of the improvement in position in Step 3; consequently, the entire $400,000 setoff could be recovered.

11.9. Avoidance Power Liability Under § 550

The liability of a transferee of an avoided transfer is governed by § 550(a). After avoiding a transfer, the trustee may recover the actual property transferred or, if the court orders, the value of the property transferred. The stated policy of preferring return of the property rather than its value is to avoid unnecessary contests over valuation. Any avoidable transfer is automatically preserved for the benefit of the estate under § 551, thus promoting equality of distribution among creditors and honoring priorities established in the Bankruptcy Code.

Not only is the initial transferee or the entity for whose benefit the transfer is made liable under § 550(a), but also any subsequent transferee. Nevertheless, any subsequent transferee from the initial transferee may absolve its liability if it can show it has given value in good faith. Although unable to absolve itself from total liability, any initial transferee is entitled to a credit for any "improvements" made to the property in good faith. Finally, although the trustee may have several legitimate target defendants, the trustee will receive but one satisfaction.

12. CLAIMS AND DISTRIBUTION

The historic core of bankruptcy law is the claims process. Holders of claims[167] participate in the bankruptcy case and ultimately receive a distribution from property of the estate. Moreover, it is the claim that is discharged in bankruptcy, and claims are also subject to the stay. Thus, a broad definition of "claim" enlarges the universe of parties in interest in a bankruptcy case and expands the debtor's right to discharge. The claims process can be highly technical. Although there is commonality existing throughout the Bankruptcy Code, each substantive chapter harbors its own peculiarities regarding the claims process. In general, proofs of claim set out the nature and grounds of the claim and circumstances surrounding it. Proofs of claim also identifies the amount, extent, and status of the claim.

In some situations, when a claim arises is not self-evident. There are three tests to determine when a claim arises. First, the state law test examines whether the holder of the claim has an action under state law. Second, the prepetition relationship test seeks to establish whether there is some prepetition privity, contact, impact, or hidden harm affecting the holder. Lastly, the conduct test looks to the time of the debtor's wrongful conduct in order to establish when the claim arose.

In some situations, a court may need to estimate claims for purposes of voting and plan feasibility. For these purposes, there is an estimation of claims outlined in § 502(c). The methods for estimation include the following: face value, zero value, market theory, forced settlement, discounted value, and summary trial. Ultimately, bankruptcy courts make the determinations and their findings are regularly upheld on appeal. However, reconsiderations for cause are permitted under § 502(j).

12.1. Chapter 7 Case

In a chapter 7 case, all creditors who believe they have a claim against the estate must file a proof of claim before the bar date or their claim will be forever barred and can no longer be satisfied from the property of the estate or enforced against the debtor. The proof of claim must usually be filed within 90 days from the first scheduled date of the first meeting of creditors.

[167] See 11 U.S.C. § 101(5) (2006) (defining "claim").

The government, including the IRS, has 180 days from the order for relief to file its claim.[168] The proof of claim sets out the nature and grounds for the claim, the circumstances surrounding the claim, and the amount, status, and extent of the claim. If the trustee or any party in interest fails to dispute the proof of claim, the claim is deemed allowed and approved.[169] The distribution of estate assets to satisfy claims in a chapter 7 case is made in strict accordance with § 726. Here, the estate agrees to distribute unencumbered estate property to the allowed priority and unsecured claims. The secured creditor generally receives its collateral or the value of the collateral.[170]

12.2. Chapter 11 Case

Although a creditor generally need not file a proof of claim in a chapter 11 case unless the creditor's claim is listed in the debtor's schedules as unliquidated, contingent, or disputed, it is usually a good practice to do so.[171] That way, if the case were later converted from a chapter 11 case to a chapter 7 case, the creditor would be protected. Moreover, the filing of a proof of claim provides notice to the trustee or debtor-in-possession of the status, extent, and circumstances of the claim in question.

The distribution of estate assets and the treatment of claims in a chapter 11 case are accomplished pursuant to a plan of reorganization usually filed by the debtor. The plan of reorganization will set out the various assets of the estate, the classes of creditors, the amounts and distribution creditors are to receive, and the treatment of the claims. Before soliciting votes on approval of the plan, the debtor must file and have the court approve a disclosure statement. The disclosure statement serves as a prospectus, explaining the plan of reorganization and the treatment of classes of claims. After the disclosure statement is approved, the debtor then solicits votes on the plan, hopefully convincing a majority of the creditors and the holders of two-thirds in amount of claims in each designated impaired class that it is in their best interests to approve the plan. If the plan is approved by the creditors and the bankruptcy court, then the plan is the mechanism by which the various creditors are paid. If the plan, however, is not approved by the bankruptcy court, then creditors may file competing plans in which they attempt to obtain a majority approval of the plan, or the debtor or creditors may convert the case to a liquidation case under chapter 7.[172]

12.3. Chapter 13 Case

Generally, a creditor must file a proof of claim in a chapter 13 case within 90 days from the date of the first scheduled meeting of creditors – the bar date. The proof of claim provides

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[168] See 11 U.S.C. § 502(b)(9) (2006).
[169] 11 U.S.C. § 502(a) (2006).
[170] See 11 U.S.C. § 725 (2006).
[171] See 11 U.S.C. § 1111(a) (2006).
[172] 11 U.S.C. § 1112 (2006).

notice to the chapter 13 standing trustee and the debtor of the status, amount, extent, and circumstances of the claim in question.

The distribution of estate assets and the treatment of claims in a chapter 13 case are accomplished pursuant to a plan filed by the debtor. A chapter 13 plan must provide for full payment of all priority claims (although, unlike chapter 11, the payments may be extended over the period of the plan), not discriminate unfairly among claims of the same legal type, and not modify claims that are secured only by the debtor's principal residence, except that a default on such a claim can be cured and any debt that has been accelerated can be reinstated. Furthermore, a chapter 13 plan cannot extend over three years, or up to five years with the court's permission.

Other than the restrictions above, a chapter 13 plan can alter or affect secured or unsecured claims. A chapter 13 plan can provide for extended payments, a composition, or pro rata monthly payments to creditors until the funding for the plan dissipates. Unlike chapter 11 plans of reorganization, creditors do not have a vote on a chapter 13 plan. After notice and a hearing, if the plan meets the requirements of § 1325, the court can confirm the plan even though a creditor objects to the plan.

12.4. Claims and Distribution

The Bankruptcy Code establishes certain rules and priorities with respect to the allowance, treatment, and satisfaction of claims. Filing a proof of claim makes the *prima facie* case for an allowance. Further, the proof of claim is deemed allowed unless there is a timely objection. The grounds for disallowance are set out in §§ 502(b)(1)-(9), which includes unenforceable claims against the debtor, claims on unmatured interests, and claims that are not timely filed.

One of the major modifications of the Bankruptcy Code is the focus on and characterization of claims. State law generally focuses on the status of creditors as secured or unsecured. The Bankruptcy Code, however, focuses on the status of claims. Thus a creditor is said to have a fully secured claim, an undersecured claim, an oversecured claim, or an unsecured claim. For example, a creditor who is owed $100,000 and possesses a lien in collateral worth $75,000 possesses a secured claim for $75,000 (the value of the underlying collateral) and an unsecured claim for $25,000 (the deficiency).[173] Such a creditor is also known as an undersecured creditor. Further, there is no distinction between consensual and nonconsensual creditors.

12.5. Secured Claims

Secured claimants are generally entitled to the collateral or to the value of the collateral securing their claims. Generally, the trustee will surrender the collateral under § 725, abandon

[173] See generally 11 U.S.C. § 506(a) (2006).

the collateral under § 554, sell the collateral and turn over the proceeds under § 363, or allow the creditor to terminate the stay under § 362(d) and repossess and foreclose on the collateral.

A secured claim is allowed for the full amount of the claim, including postpetition interest on the claim and possible attorneys' fees to the extent, but not in excess, of the value of the collateral securing the claim, but only if the creditor is oversecured.[174] Thus, if a creditor is undersecured, it will not be entitled to attorneys' fees or postpetition interest as part of its allowable secured claim.

Property acquired by the debtor's estate after commencement of a case is not subject to any security interest granted under a security agreement executed prior to commencement of the case except to the extent of proceeds, products, offspring, rents, or profits of property if such proceeds, products, offspring, rents, or profits are covered by the security agreement and financing statement. Thus, the Bankruptcy Code extinguishes the effect of after-acquired property clauses contained in the bulk of security agreements.

12.6. Unsecured Claims

Unsecured claims arising prior to the filing of the petition are allowed only to the extent of the amount of the claim as of the date of filing. Except with respect to fully or oversecured secured claims, no postpetition interest is allowed on any claim unless a surplus remains after all creditors' claims are paid in full.[175]

Claims filed by insiders and attorneys for services rendered to the debtor are disallowed to the extent that these claims exceed the reasonable value of services rendered by the parties. An insider of a corporate debtor includes a director, officer, person in control, partnership in which the debtor is a general partner, general partner of the debtor, a relative of a general partner, director, officer or person in control of the debtor, or an affiliate.[176] Claims of landlords for future rents are limited to any unpaid rent due under the lease as of the date of commencement of the case and the rent reserved under the lease for the greater of one year or 15% (not to exceed three years) of the remaining term of the lease.[177]

12.7. Priorities Under the Bankruptcy Code

Distributions in a chapter 7 case are made in accordance with priorities established by the Bankruptcy Code.[178] Unsecured claims are placed in various categories under the following priorities:

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174 See 11 U.S.C. § 506(b) (2006).
175 See 11 U.S.C. §§ 502(b), 726 (2006).
176 See 11 U.S.C. § 101(31) (2006).
177 See 11 U.S.C. § 502(b)(6) (2006).
178 See 11 U.S.C. § 507(a) (2006).

a. Domestic support obligations owed as of the petition date subject to certain trustee fees.
b. Administrative expenses of the case as defined in §§ 507(a) and 503(b). These include postpetition tax claims of the estate for which the debtor may not be liable.
c. Claims arising out of authorized postpetition transactions in involuntary cases as defined in § 502(f).
d. Certain employee claims for wages and attendant payroll taxes accrued within 180 days of the bankruptcy filing (or cessation of business) and up to $10,000.00 per claimant.
e. Certain contributions to employee benefit plans arising out of services rendered within 180 days before the filing of the petition and to the extent of the number of covered employees multiplied by $10,000.00, less the aggregate amount paid to employees in level 4 and by the estate to other benefit plans.
f. Certain farmer and fishermen claims up to $4,925.00 per individual claimant.
g. Certain deposits in connection with consumer transactions up to $2,225.00 per claimant.
h. Certain federal, state, and local tax claims, including income or gross receipts for a taxable year ending on or before the petition filing date incurred within three years[179] of the filing of the petition or assessed within 240 days of the filing, taking into account the still-assessable rule[180]
i. Certain FDIC claims.
j. Wrongful death or personal injury claims as a result of the debtor driving under the influence of alcohol or some other substance.

The claims described in clauses 1 through 10 are defined as priority claims under § 507(a). Priority claims are unsecured claims afforded priority status over other unsecured claims; as a general rule priority claims do not disrupt secured claims. The priority scheme delineated in § 726 and set forth above provides that unsecured claims are paid in the priority established above and no claim in a lower class of priority will be paid prior to payment in full of all claims in a higher class of priority. This concept is known as the absolute priority rule.

A further point is necessary when dealing with priority taxes that hinge on certain time periods. The question is whether a prior bankruptcy case has tolled the time periods. The hanging paragraph after 507(a)(8)(G) describes tolling. Time periods in this subsection are tolled if a taxing authority is prohibited under applicable non-bankruptcy law from collecting a tax as a result of a request of a debtor for a hearing and an appeal of any collection action taken or proposed against the debtor. Further, there must be an automatic stay in effect. Lastly, the

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[179] 11 U.S.C. § 507(a)(8) priority tax rules are designed to give taxing authorities three years to collect taxes before such taxes become non-priority and dischargeable or 240 days after assessment in long-running tax shelter cases.

[180] This subsection applies to certain property taxes incurred before but payable within one year of filing, trust fund taxes, employer employment taxes incurred within 3 years, certain excise taxes where the transaction is within three years, custom duties, and certain penalties for actual pecuniary loss associated with the aforementioned claims.

collection must be precluded by one or more confirmed plans. However, this is a tolling add-on of 90 days if the priority time period is suspended.

Late-filed priority claims may participate in distribution if filed earlier than either 10 days after the mailing to creditors of the summary of the trustee's final report or the date that the trustee commences the final distribution.

12.8. Distribution to Creditors in a Chapter 11 Case

In a chapter 11 case, distribution to creditors is governed by the plan of reorganization. The plan must designate and specify the treatment of the classes of claims. Each member of a class must be treated the same as other members of the class. Holders of priority claims (clauses a through h in the priorities listed above) generally must be paid in full in cash under the plan at the consummation of the plan. One exception is with priority tax claims, which may be paid in full over a six year period.

Each holder of a claim must either accept the plan or receive as much under the plan as the holder would have received in a liquidation under chapter 7.[181] This requirement is known as the best interests of the creditors test. Along with the absolute priority rule, the best interests of the creditors test establishes the parameters of all chapter 11 plans. A creditor, however, can be forced under the "cram down" provisions of chapter 11 to accept a plan notwithstanding rejection of the plan by the creditor's class only if at least one non-insider impaired class votes in favor of the plan, the plan complies with the absolute priority rule, and the plan is in the best interests of the creditors.[182]

12.9. Distribution to Creditors in a Chapter 13 Case

In a chapter 13 case, distribution to creditors is governed by the plan. The chapter 13 plan may designate classes of claims and specify the treatment of the classes.[183] The plan may not discriminate unfairly among claims of the same legal type.[184] The plan must provide for full payment of all priority claims, though the payments may be extended over the period of the plan. Recall that a chapter 13 plan cannot be extended over more than three years, or up to five years with the court's permission. Otherwise, the chapter 13 plan may alter or affect any kind of secured or unsecured debt; provided, the plan cannot modify a claim which is secured only by the debtor's principal residence, except that a default on such a claim can be cured and any debt that has been accelerated can be reinstated.[185] Additionally, a plan can affect secured claims if the lien is left untouched and the stream of payments provided for the secured claim has a present value at confirmation that is at least equal to the value of the secured claim. Nonetheless,

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[181] See 11 U.S.C. § 1129(a)(7) (2006).
[182] See 11 U.S.C. § 1129(b) (2006).
[183] See 11 U.S.C. § 1322(a) (2006).
[184] Id.
[185] 11 U.S.C. § 1322(b) (2006).

if a creditor is fully secured, it must be compensated in full under chapter 13. If, however, a creditor is only partially secured, it is entitled to full compensation to the extent of the value of the collateral. The creditor's unsecured claim, which is represented by the deficiency, may be treated like any other unsecured claim.

Unlike chapter 11 reorganization plans, creditors do not vote on a chapter 13 plan. Rather, the court must determine whether the chapter 13 plan satisfies the confirmation requirements under § 1325. If so, the court can confirm the plan even over the objections of creditors. Section 1325 contains a single financial protection for all unsecured creditors. The court cannot confirm a plan if an unsecured creditor would receive more from a distribution under chapter 7 liquidation than he would under the chapter 13 plan. This is essentially the sole protection for a chapter 13 unsecured creditor. However, under § 1325 the plan must be proposed in good faith.

12.10. Subordination of Claims

Under the Bankruptcy Code, a claim can be subordinated based on contractual, statutory, or equitable subordination agreements.[186] Generally, the creditor whose claim is to be subordinated on equitable grounds must have committed fraud or other inequitable conduct that has resulted in an unfair advantage to the creditor at the expense of some other claimant. Since equitable subordination is remedial in nature, a claim will only be subordinated to the extent necessary to rectify the harm done. Furthermore, any equitable subordination must be consistent with the provisions of the Bankruptcy Code.

What is the effect of equitable subordination? A claim that is subordinated on equitable grounds does not share in distribution of property of the estate with other claims in its class; rather, the subordinated claim will participate in the estate distribution only after those claims it has been subordinated to are paid in full. An IRS claim or federal tax lien may be subordinated under § 510(c) where the IRS has engaged in misconduct.

12.11. Establishing and Protecting Claims

All creditors who intend to share in the assets or participate in the administration of the estate should file a proof of claim within the allowable time. The proof of claim should be served on the debtor and the trustee, if one is appointed, and should be filed with the bankruptcy court. A proof of claim evidences a creditor's claim or interest.

A claim is defined under § 101(5) as:

[186] See 11 U.S.C. § 510(a)-510(c) (2006).

- 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; or

- Right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

There are significant differences and traps for the unwary between the claim rules for a chapter 11 bankruptcy case and for cases in chapters 7 and 13. In a chapter 7 and a chapter 13 case, a proof of claim must be filed within 90 days from the first date set for the first meeting of creditors under § 341.[187] The Bankruptcy Rules contain limited exceptions to the deadline.

In a chapter 11 case, the rules are more lenient. The filing of a proof of claim is required only when the debtor schedules a creditor's claim as disputed, contingent or unliquidated, fails to schedule the claim at all, or schedules the wrong amount.[188] However, when a chapter 11 case is converted to a case under chapter 7, a proof of claim should be filed. The bankruptcy courts have generally held the "deemed filed" provisions of § 1111(a) are applicable only for the chapter 11 case. Thus, upon a conversion to a chapter 7 case (or a chapter 13 case) the "deemed filed" creditor is out of luck unless it timely files a proof of claim. Further, the debtor may amend its original schedules to alter its treatment or the acknowledged amount of a claim. However, if the debtor lists a claim "disputed" for the first time in an amended schedule, a creditor is entitled by due process to receive sufficient notice and additional time in order to subsequently file a proof of claim.[189]

The proof of claim itself is a relatively simple document, but it must be accurately filled out, that is, signed by the party holding the claim and substantiated by documents (for example: the note, deed of trust, and security agreements). There are substantial criminal penalties for filing a fraudulent or false claim.

In most cases, it is extremely important to timely file a proof of claim in order to protect a creditor's claim in a bankruptcy case. A properly filed claim is prima facie evidence of the validity and the amount of the claim.[190] The proof of claim will then be relied upon by the chapter 7 trustee, or the debtor-in-possession in a chapter 11, as evidence of the amount owed to the creditor and the security held for the claim. Assets of the estate will later be distributed based on the allowed claims filed against the bankruptcy estate. The debtor or the trustee may later object on the basis of the amount, status, or validity of the proof of claim; however, by

[187] Bankr. R. 3002(c).
[188] 11 U.S.C. § 1111(a) (2006), see also Bankr. R. 3003.
[189] See Bankr. R. 1009.
[190] 11 U.S.C. § 501 (2006), see also Bankr. R. 3001(f).

filing a proof of claim prior to the bar date for filing claims, the creditor can shift the burden of proof on issues of allowability to the objecting party.

13. THE DISCHARGE

To an individual debtor the single most important feature of modern bankruptcy law is the discharge.[191] Along with exemptions and the carve-out of future income from property of the estate under § 541(a)(6) for chapter 7 cases, the discharge fuels the fresh start of the debtor, a policy of singular importance in individual bankruptcies. Individual debtors and corporations can also obtain a discharge under chapters 11 and 13 of the Bankruptcy Code, although the chapter 11 discharge for an individual conforms more to the new chapter 13 dishcarge as to timing.[192] The text discusses the discharge right, the effect of discharge, and the denial of discharge.

13.1. Discharge in General

In filing for relief under the Bankruptcy Code, an individual's most important objective is a discharge from his debts. The discharge is the heart of the fresh start policy promoted by the Bankruptcy Code. The discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in certain prohibited conduct, usually some type of fraud or bankruptcy crime.[193] The objecting party has the burden of establishing a ground for the denial of a discharge.

13.2. Prior Denial of Discharge

If a debtor has been denied a discharge in a bankruptcy case, so that all his debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is res judicata as to the obligations existing at that time, which are forever non-dischargeable.

13.3. Effect of Discharge

A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt.[194] The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts,

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[191] See 11 U.S.C. § 727 (2006).
[192] See 11 U.S.C. §§ 1141(d), 1328(a)-1328(b) (2006).
[193] See 11 U.S.C. § 727(a) (2006).
[194] See 11 U.S.C. § 524(a) (2006).

to collect, recover, or offset any discharged debt.[195] In effect, the discharge is a total prohibition on debt collection efforts. Further, under § 524, any attempt to reaffirm a particular debt is void unless the particular provisions of the Bankruptcy Code delineating the requirements of reaffirmation are specifically followed.[196]

13.4. Non-discrimination Provision

To ensure the effectiveness of the discharge, § 525 prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment solely because the person involved was discharged under the Bankruptcy Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. Additionally, under § 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the Bankruptcy Code, or an individual associated with a debtor under the Bankruptcy Code, solely because the debtor is or has been a debtor under the Bankruptcy Code, was insolvent before the commencement of case under the Bankruptcy Code, or has not paid a debt that is dischargeable under the Bankruptcy Code.

13.5. § 727 Discharge

Under § 727(a), the bankruptcy court must grant the individual debtor a discharge of prepetition debts unless one of ten conditions is met. These conditions are discussed below in the section on objections to discharge. Only an individual is eligible for a discharge under chapter 7 pursuant to § 727(a); a partnership or corporation may not receive a discharge under chapter 7. Additionally, § 727(a) applies only in liquidation cases under chapter 7.[197]

The scope of the chapter 7 discharge is quite broad. Any debt that arose prior to the entry of the order for relief is discharged.[198]

13.6. § 1141 Discharge

Under § 1141(d), the confirmation of the plan of reorganization discharges the debtor from any debt that arose before the confirmation of the plan. Unlike § 727(a), a partnership or corporation (as well as an individual) may receive a § 1141(d) discharge. Section 1141(d) discharge is broader than the § 727(a) discharge in that the latter discharges any debts that arose before the entry of the order for relief, while the former discharges any debts that arose before the confirmation of the plan.

Nevertheless, there are limits to the § 1141(d) discharge. First, debts excepted from discharge under § 523 are not discharged under § 1141(d) when the debtor is an individual.

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[195] Id.
[196] See generally 11 U.S.C. § 524(c) (2006).
[197] See 11 U.S.C. § 103 (2006).
[198] See 11 U.S.C. § 727(b) (2006).

Second, if the plan provides for liquidation of all or substantially all of the property of the estate, the debtor does not continue in business, and the debtor would be denied a discharge under § 727(a), then confirmation of the plan does not discharge the debtor. These limitations are necessary so that an individual debtor may not employ a chapter 11 liquidation plan to evade the objections to discharge embodied in §§ 523(a) and 727(a).

Section 1141 also excepts tax liabilities from chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty. Moreover, this section also excepts from discharge any debt incurred under false pretenses or by making a false statement.

13.7. Scope of Discharge

The scope of discharge varies by chapter. In chapter 7 cases, all debts that arose before the order for relief are dischargeable. Under chapter 11, all debts that arose before the confirmation of the plan are dischargeable. Lastly, under chapter 13, all debts provided for in the plan, or disallowed under § 502, are dischargeable.

13.8. Chapter 7 Discharge

Under § 727(a), the bankruptcy court must grant the individual debtor a discharge of all debts that arose before the order for relief unless one of the 12 conditions is met.[199] Here, only individuals are eligible for a discharge; a partnership or corporation may not receive a discharge under this chapter.[200] Additionally, § 727(a) only applies in liquidation cases.

The debtor is not eligible for discharge in chapter 7 case if debtor received a chapter 7 discharge in a case commenced within 8 years of the date of the filing of the petition. Further, the debtor is not eligible for discharge in chapter 7 case if debtor received a chapter 12 or chapter 13 discharge in a case commenced within 6 years of the date of filing of the petition and the payments under the plan totaled less than 70% of the allowed unsecured claims in that case.

Section 727(d) requires the court to revoke a discharge already granted in certain circumstances. There is a revocation if the debtor obtains a discharge through fraud, acquired and concealed property of the estate, or refused to obey a court order to testify. Additionally, § 727(e) permits the trustee, a creditor, or the United States trustee to request revocation of a discharge within one year after the discharge is granted for fraud.

A debtor may waive its right to discharge under § 727(a)(10) of the Bankruptcy Code. The waiver of discharge must be executed in writing by the debtor after the order for relief under chapter 7 has been entered. The waiver is ineffective until approved by the court.

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[199] See 11 U.S.C. § 727(a) (2006).
[200] Id.

13.9. Chapter 13 Discharge

Unlike chapter 11, the chapter 13 discharge is granted not at confirmation but after the debtor has completed performance under the chapter 13 plan. Under § 1328(a), almost all debts of the debtor are discharged, even those that are non-dischargeable under § 523(a). Consequently, the chapter 13 discharge is broadest in scope. As a matter of fact, the only debts that survive the chapter 13 discharge are alimony and support payments, student loans unless failure to discharge would create an undue hardship, criminal fines, claims arising from driving under the influence, criminal restitution, and certain long term debts that the plan purports to pay out after the plan.

Filing under chapter 13 provides a host of other benefits. Chapter 13 cures mortgages arrearages and prevents foreclosures. Moreover, priority/non-dischargeable tax obligations other than trust fund taxes can be paid without incurring postpetition interest. Further, chapter 13 effectively caps the payment to secured creditors on their secured claim at the plan confirmation value and allows the debtor to benefit from post-confirmation appreciation. Lastly, under chapter 13, the debtor retains his tax attributes.

A chapter 13 debtor who fails to complete payments under the chapter 13 plan for reasons beyond the debtor's control may nevertheless be granted a "hardship" discharge. This hardship discharge is granted so long as the creditors have received as much under the plan as they would have under chapter 7 liquidation. In effect, the hardship discharge is nothing but a chapter 7 discharge under a different guise. Thus, all the debts that are non-dischargeable under § 523(a), which could have been discharged pursuant to completion of the chapter 13 plan, will remain in full force and effect like in a chapter 7 case.

The debtor is not eligible for a chapter 13 discharge if he received a discharge in a case under chapters 7, 11, or 12 during the 4-year period preceding the petition date. Further, the debtor is not eligible for a chapter 13 discharge if the debtor received a discharge in a case under chapter 13 during the 2-year period preceding the petition date.

Under § 1328(a)(2), there is no discharge available for fraudulent taxes in chapter 13 cases. Chapter 13 “super-discharge” conforms to chapter 7 discharge for individual debtors for purposes of so-called fraud taxes. Tax claims under § 523(a)(1) are also excepted from chapter 13 discharge. Such claims include priority tax claims, claims associated with fraudulent returns, un-filed returns, and willful attempts to evade or defeat a tax.

The debtor must timely file postpetition tax returns or suffer conversion or dismissal of the case. The conversion or dismissal is mandatory if the debtor does not file the returns or obtain an extension within 90 days after the taxing authority files its request. This provision applies in chapters 7, 11, 12, and 13.

13.10. The Discharge Hearing

Section 524(e) of the Bankruptcy Code requires an individual debtor to appear before the

court to receive the discharge if the court decides to hold a discharge hearing. The discharge hearing gives the court an opportunity to explain the nature of the discharge and to warn the debtor against reaffirming discharged obligations. The discharge hearing is a formal affair that is intended to impress upon the individual debtor the significance of the bankruptcy case. At the discharge hearing, the court will also hear the debtor's attempt to reaffirm any debts.

13.11. Reaffirmation

A reaffirmation agreement is an agreement between the debtor and one of the creditors wherein the debtor agrees to pay an otherwise dischargeable debt. As a general rule, reaffirmation agreements are void. However, the Bankruptcy Code recognizes certain reaffirmation agreements if certain Bankruptcy Code requirements are met. First, the reaffirmation agreement must be entered into before the granting of the discharge. Second, the debtor must have 60 days after approval of the agreement to rescind it. Third, if the individual debtor is seeking to reaffirm a consumer debt that is not secured by the debtor's real property, the court must find that the agreement will not impose an undue hardship on the debtor.

It is difficult to persuade a court to approve reaffirmation agreements. Courts are particularly careful not to allow the debtor, through good intentions, to throttle the fresh start provided by the Bankruptcy Code with otherwise dischargeable debt. This is true because courts recognize that reaffirmations hinder and may even obliterate the debtor's fresh start.

13.12. Redemption

Pursuant to § 722, a redemption gives the debtor a right to buy back collateral from the secured creditor. The property in question must either be exempt or abandoned by the trustee. Further, the strike price is set by the court through a court-imposed valuation. The debtor must pay the entire strike price at the time the right is exercised. This redemption right applies only to consumer goods securing a consumer debt. However, if the property in question is not of the type set forth in § 722, a debtor may always buy it from the trustee through cash that is not property in the estate.

In order to exercise the right of redemption under § 722, the debtor must pay to the creditor holding the lien the amount of the allowed secured claim of the holder that is secured by the lien. In other words, the debtor must pay the lessor of the fair market value of the property or the amount of the claim. This payment must be in cash and, absent consent of the creditor holding the lien, cannot be paid in installments. Thus, the § 722 right of redemption is nothing more than a debtor's right of first refusal in consumer goods that might otherwise be repossessed.

13.13. Exceptions of Debt from Discharge

Notwithstanding the debtor's discharge under the Bankruptcy Code, certain debts are

excepted from discharge as a matter of public policy pursuant to § 523(a). These exceptions to discharge are strictly construed. An exception to discharge should be contrasted with an objection to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, the debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under § 523(a). If successful in asserting § 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a § 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the § 523(a) claims live on.

The burden of proof to assert that the debt is non-dischargeable under § 523(a) falls squarely on the shoulders of the creditor asserting the exception. Among the types of claims that are non-dischargeable are current year taxes and taxes for which the due date falls within three years of the filing of the bankruptcy petition.[201] The following debts are excepted from discharge under § 523(a) as a matter of law:

- Taxes entitled to priority under §§ 507(a)(2) and 507(a)(7).
- Taxes connected with late returns or a failure to file.
- Taxes connected with a fraudulent return or a willful attempt to evade or defeat a tax.
- Debts incurred by fraud or false financial statements.
- Debts arising from fraud or defalcation while acting in a fiduciary capacity.
- Debts arising from embezzlement or larceny.
- Alimony, separate maintenance, or child support (but not a property settlement).
- Claims resulting from willful and malicious injury to a creditor or a creditor's property.
- Governmental fines and penalties to the extent that they are not compensation for actual pecuniary loss. Nonetheless, this category of non-dischargeable debt does not include tax penalties relating to dischargeable taxes or to any transaction or event that occurred more than 3 years before the filing of the bankruptcy petition.
- Student loans provided the non-dischargeability of debt will not impose an undue hardship on the debtor and his dependents.
- Claims associated with death or injury caused by person operating a motor vehicle under the influence.
- Debts that are not scheduled in time for the timely filing of the proof of claim.
- Certain claims owed to federally insured financial institutions that have failed or debts owed to the FDIC.
- Criminal restitution.
- Family law obligations that may cause, on balance, undue hardship.

[201] 11 U.S.C. §§ 523(a)(1), 507(a) (2006).

13.14. Tax Claims

A closer look at § 507(a)(8) reveals that priority tax claims are allowed on unsecured claims of governmental units to the extent that such claims are for a tax on or measured by income or gross receipts for a taxable year ending on or before the date of the filing of the petition for which a return is last due (including extensions) after three years before the date of the filing of the petition, assessed within 240 days before the date of the filing of the petition. This is exclusive of any time during which an offer in compromise with respect to that tax was pending or in effect during that 240-day period, plus 30 days. Further, this is also exclusive of any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days.

Non-priority/non-dischargeable taxes include:

- Taxes connected with fraudulent returns
- Taxes connected with late returns or a failure to file
- Taxes connected with a willful attempt to evade or defeat a tax
- Governmental fines and penalties to the extent that they are not compensation for actual pecuniary loss (This category of non-dischargeable debt does not include tax penalties relating to dischargeable taxes or to any transaction or event that occurred more than 3 years before the filing of the bankruptcy petition).

The Bankruptcy Code provides that there should be no discharge of fraudulent taxes in § 1141(d). Section 1141(d) defines the effect of confirmation of a chapter 11 plan and specifically discharges certain debts that arose before confirmation. There is an exception for tax liabilities from a chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty. Further, this provision also makes a discharge exception for any debt incurred under false pretenses or by making a false statement in writing. Corporations cannot discharge a debt based on fraud owed to a governmental unit arising out of false pretenses, false representations or actual fraud, whether or not based on use of a financial statement in writing. The language of this provision makes it unclear whether these non-dischargeable debts to governmental units must arise from the debtor's own fraudulent dealings with the government, or if this extends to claims or fines the government could impose on account of the debtor's defrauding of investors or creditors. Further, debt owed to an individual on a qui tam claim is also not dischargeable. With regard to individuals filing chapter 11 cases, the discharge may be delayed until full performance absent a chapter 11 hardship discharge.

13.15. Objections to Discharge

Not all debtors are entitled to a discharge under § 727(a). The right to discharge is a right reserved for the honest but unfortunate debtor. Overextending oneself, unforeseen contingencies, the inability to pay debt, or lack of business acumen are not reasons to deny a debtor's discharge. However fraud, criminal activity, and misconduct are grounds for a denial of a debtor's discharge. If a creditor or the trustee is successful in attacking the debtor's discharge

under § 727(a), then <u>all claims</u> survive the bankruptcy case and may be enforced and ultimately satisfied. Grounds for denial of a discharge under chapter 7 include:

- The debtor is not an individual.
- A transfer or concealment of property within one year of bankruptcy by the debtor with the intent to hinder, delay, or defraud its creditors.
- The debtor's failure to keep adequate financial records.
- Debtor misconduct during the bankruptcy case, including perjury, false statements, false oaths, or failure to obey a court order.
- A debtor's inability to satisfactorily explain any losses or deficiencies of assets.
- Insider action and subsequent personal bankruptcy.
- A chapter 7 discharge within eight years of the commencement of the pending case (measured from filing date to filing date).
- A chapter 13 discharge granted within 6 years of the date of filing of the petition and the payments under the plan totaled less than 70% of the allowed unsecured claims in that case.

13.16. Objection to Discharge Proceedings

To object to a debtor's discharge under § 727(a), the creditor must commence an adversary proceeding. An adversary proceeding is the term given to a traditional lawsuit in the bankruptcy context. An adversary proceeding is commenced by the filing of a complaint and the issuance of a summons. Both the summons and complaint are served on the debtor and the debtor's counsel in accordance with the Federal Rules of Civil Procedure as incorporated by Part 7 of the Bankruptcy Rules. The litigation itself, including discovery, motions for summary judgment, and trial procedures, are governed by Part 7 of the Bankruptcy Rules, which most often incorporate the equivalent Federal Rules of Civil Procedure.

Because the Bankruptcy Code presumes the debtor is entitled to a discharge, the creditor objecting to the discharge shoulders the burden of proof. To prevail, the creditor must show one of the grounds for objecting to discharge under § 727(a) by a preponderance of the evidence. Although the question whether the parties are entitled to a jury trial has not yet been completely resolved, it appears likely that the parties do not have a right to a jury trial to hear an objection to discharge proceeding.

13.17. Revocation of Discharge

Section 727(d) requires the court to revoke a discharge already granted in certain circumstances. If the debtor obtained a discharge through fraud, acquired and concealed property of the estate, or refused to obey a court order to testify, the discharge must be revoked. Additionally, § 727(e) permits the trustee, a creditor, or the United States trustee to request revocation of a discharge within one year after the discharge is granted for fraud.

13.18. Waiver of Discharge

A debtor may waive its right to discharge under § 727. The waiver of discharge must be executed in writing by the debtor after the order for relief under chapter 7 has been entered. The waiver is ineffective until approved by the court.

13.19. Substantive Consolidation

Substantive consolidation is not in the Bankruptcy Code. Instead, it is an equitable remedy. As such, there is a fact-intensive inquiry behind substantive consolidation. The following are a list of factors that some courts have considered:

- *Factor 1:* Determine the presence or absence of consolidated financial statements or separate financial statements.
- *Factor 2:* Determine the unity of ownership and interests between and among the various corporate entities.
- *Factor 3:* Determine the existence of parent and inter-company guarantees on loans or any evidence of cross collateralization.
- *Factor 4:* Determine the degree of difficulty in segregating individual corporate assets and liabilities.
- *Factor 5:* Determine if transfers of assets have occurred without the observance of corporate formalities.
- *Factor 6:* Determine the existence and extent of any commingling of assets and business functions and an indication as to whether any such commingling occurred prepetition or postpetition.
- *Factor 7:* Determine the profitability of consolidation at a single physical location or as a single entity regardless of location.
- *Factor 8:* Determine the assumption by the parent of contractual obligations of its subsidiaries.
- *Factor 9:* The sharing of overhead, management, accounting and other related expenses among the different corporate entities.
- *Factor 10:* The existence of inter-company guarantees on loans.
- *Factor 11:* The failure to distinguish between properties of each entity.
- *Factor 12:* The shifting of funds from one company to another without observing corporate formalities.
- *Factor 13:* Determine if the parent company was paying salaries to employees of subsidiaries.
- *Factor 14:* Determine if the subsidiary has grossly inadequate capital.
- *Factor 15:* The degree of difficulty in segregating and ascertaining individual assets and liabilities.
- *Factor 16:* The presence of consolidated financial statements.
- *Factor 17:* The parent owning all or a majority of the capital stock of the subsidiary.
- *Factor 18:* The parent, its affiliates, and subsidiaries having common directors or officers.
- *Factor 19:* The parent or its affiliates financing of the subsidiaries.

- *Factor 20:* The parent shifting people on and off the subsidiaries' board of directors.
- *Factor 21:* The subsidiaries having substantially no business except that with the parent or its affiliates or no assets except those conveyed to it by the parent or the affiliate.
- *Factor 22:* The parent referring to the subsidiary as a department or division.
- *Factor 23:* The directors of the subsidiary not acting independently in the interest of the subsidiary, but taking direction from the parent.
- *Factor 24:* The parent, its affiliates, and the subsidiary acting in the same business location.
- *Factor 25:* Whether prejudice resulting from consolidation is outweighed by greater prejudice posed by continued separation of the bankruptcy estates.

14. SOURCES OF INFORMATION

As you may have gathered, bankruptcy from a creditor's perspective can be quite different from bankruptcy from a debtor's perspective. To the creditor, reorganization is a legitimate goal only because creditors will receive more through the plan of reorganization than they would through chapter 7 liquidation.[202] Moreover, although the creditor may recognize the debtor's dilemmas (the fact that the debtor is unable (not refusing) to pay creditors, and the hardship a bankruptcy case may have on a debtor), the creditor's primary concern is to satisfy as much of its claim as possible.

Although, under a chapter 11 case, the exclusivity period ensures that the bankruptcy case is the debtor's show at least in the first instance, the creditor does have many parts to play. Informally, a creditor can and often does negotiate terms of the plan of reorganization. Formally, a creditor can take numerous steps to protect its interest, to defeat the debtor's proposed plan, to propose its own plan, or to convert the case to a case under chapter 7.

However, the fuel that turns these creditor protection gears is information about the debtor, about the debtor's transfers before bankruptcy, and about the debtor's financial condition. Debtors usually know when they are about to file a petition in bankruptcy. Sometimes creditors know when their debtor is about to file a bankruptcy petition; but, most often, the creditor is caught off guard at least as to current information on the debtor. Thus, from a creditor's perspective the first concern is to obtain as much relevant information as practicable so as to allow it to transverse the bankruptcy maze without blinders.

Since much contact with the debtor may be essentially halted by the operation of the automatic stay, readily available sources of information must be identified by creditors to find out what is going on, how and when they will be repaid, and when, if ever, they will be able to pursue their rights and remedies under state law. Typical sources of information include the following: notice to creditors, the first meeting of creditors, schedule and statements filed with

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[202] See 11 U.S.C. § 1129(a)(7) (2006).

the court, and Rule 2004 examinations. Bear in mind it is the wise creditor who reaps as much benefit as possible from these sources.

14.1. Notices to Creditors

The first and most readily available source of information is the notice to creditors served by the bankruptcy court clerk. Creditors who receive the notice are those who are listed by the debtor in the schedules filed with the bankruptcy court. The notice generally includes the following information:

- The date of filing of the bankruptcy petition.
- The chapter under which the petition was filed.
- The date and time of the first meeting of creditors.
- The bar date for filing proofs of claim, and time periods for objections to discharge of the debts or indebtedness of the debtor.
- Notification of the automatic stay.

If a creditor does not receive a notice from the bankruptcy clerk's office, the creditor may have been incorrectly excluded from the petition filed by the debtor or the address stated therein may be incorrect. Creditors who do not receive notification of the bankruptcy case and do not have actual knowledge of the case in time for filing a proof of claim may not have their claims discharged in a bankruptcy proceeding. Discharge of the debtor's liability in bankruptcy extends only to those claims that are properly scheduled and not excepted from discharge under § 523 of the Bankruptcy Code.

However, if a creditor is aware of the bankruptcy case and has not formally received any notification from the clerk's office, the creditor should contact the debtor's counsel. It is generally in the creditor's best interest to determine the status of the case and the disposition of any collateral securing the creditor's claim during the bankruptcy case.

14.2. The § 341 Meeting of Creditors

The Bankruptcy Code establishes a forum for creditors to obtain information from the debtor or its representative under oath. The Bankruptcy Code provides that within a reasonable time after an order for relief is entered (the date of the voluntary filing of a bankruptcy petition or the date that an involuntary petition is granted), the United States Trustee shall convene and preside at a meeting of creditors and equity security holders.[203] The bankruptcy court does not preside at or attend the creditors' meeting.

Pursuant to Bankruptcy Rule 2003, the creditors' meeting will be held not less than 20 or more than 40 days after the order for relief is entered. The main purpose of the creditors' meeting is to provide a mechanism for creditors to elect a trustee and to examine the debtor.

[203] 11 U.S.C. § 341 (2006).

Generally, the chapter 7 trustee, or in a chapter 11 case the United States trustee, presides over the creditors' meeting, unless there are specific objections to the United States trustee in a chapter 11 case or the chapter 7 trustee presiding over the meeting or the creditors desire to elect their own trustee at the meeting.

The first meeting of creditors under § 341 involves creditors propounding questions concerning the debtor's affairs, assets, liabilities, transfers, exemptions, reorganization plans; the list of topics can go on and on. The scope of the meeting is broad. Some debtors liken it to the inquisition. Because of the overwhelming number of bankruptcy cases filed, the trustees in certain districts have limited the questioning and the length of meetings to approximately 15 to 30 minutes. The trustee may reset the creditors' meeting in order to allow for more time for questioning or to allow the debtor to supplement the information provided to creditors. If not, the meeting is adjourned.

The creditors' meeting is one forum for gathering information. However, in-depth examination of the debtor for an extended period of time does not generally occur at the creditors' meeting.

14.3. Schedules and Statements Filed with the Court

The debtor is required to file a detailed schedule of all its assets and liabilities and a statement of affairs. There are two types of statements of affairs -- one for those engaged in business and a simpler form for those not engaged in business. The statement of affairs provides information concerning the debtor's actions prior to bankruptcy, transfers of property, and the location of the debtor's assets. The statement of affairs and schedules of assets and liabilities are filed with the petition in a voluntary case or, if certain requirements are met, within 15 days after the commencement of the case. Both documents are signed under oath by the debtor. Extensions of the 15-day time period may be allowed by filing a motion and obtaining an order from the bankruptcy court upon cause shown.

A creditor should examine the schedule of liabilities in order to determine if the debtor has listed its claim properly in terms of amount, collateral securing the claim, and the nature of the property in the individual debtor's estate, that is, is the property listed as exempt property under state or federal law. Further, the creditor can ascertain whether the debtor listed the claim on its schedules as contingent, unliquidated, or disputed.

14.4. Rule 2004 Examinations

Bankruptcy Rule 2004 provides that by motion, a party in interest, which is defined to include the debtor, the trustee, creditors and creditors committee and/or equity security holders, may request the examination under oath of "any entity." The scope of the examination is broadly defined and generally relates to "the acts, conduct, or property or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge." Further, the examination may also relate "to the operation of any business and the desirability of its continuance, the source of any money or

property acquired or to be acquired by the debtor for purposes of consummating a plan and the consideration given or offered therefore, any other matter relevant to the case or to the formulation of a plan." The motion for the examination may include the production of documents by the witness. A creditor's attorney can then conduct an extensive examination of the debtor and fully develop facts. This type of examination may take place without a pending action of any kind. Because the 2004 examination is broader in scope than a typical deposition, the sworn testimony may be used only for impeachment purposes.