



## CHAPTER OUTLINE

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### CHAPTER PREVIEW

The law of bankruptcy provides possible solutions to problems that arise when a person, partnership, limited liability company, corporation, farmer, or municipality is unable, or finds it difficult, to satisfy obligations to creditors. Bankruptcy has its roots in the law of the Roman Empire and has been a part of English jurisprudence since 1542. Article I, Section 8 of the United States Constitution empowers Congress with the responsibility to create a bankruptcy system at the federal level. The bankruptcy laws in the United States have been amended periodically. Today's bankruptcy law is based on the Bankruptcy Reform Act of 1978 (1978 Bankruptcy Act). While this act has been amended several times, the most significant revision to bankruptcy law occurred with the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). The BAPCPA was enacted primarily in response to the fact that personal bankruptcy filings were increasing each year at an alarming rate. The provisions of the BAPCPA, which are so new that few courts have ruled on major aspects of the legislation, generally make it more difficult for individuals to declare bankruptcy (and thus have their debts to business eliminated). Congress observed that bankruptcies were declared in many instances where consumers should be able to pay-off their debts. Also, the BAPCPA mandates that an individual may not be deemed a debtor under any provision of federal bankruptcy law unless the debtor received appropriate credit counseling within 180 days of filing.

The basic concept underlying bankruptcy is to allow a debtor who is in a difficult financial situation a fresh financial start. In other words, the bankruptcy laws permit a deserving debtor the opportunity to come out from under overwhelming financial burdens and to begin life anew. For the large majority of personal bankruptcies, seeking protection under bankruptcy law comes after a catastrophic event has occurred that is beyond the control of the individuals filing for bankruptcy (e.g., death of the principal wage-earner, devastating illness of a family member, or natural disaster).

However, this "fresh start" is not granted without the debtor's paying something for the opportunity. In essence, the bankruptcy laws have always attempted to balance the rights of the debtor with the rights of the creditors. To protect the creditors, the debtor must turn over his or her assets to court supervision in the form of a trust. Loss of every asset would deprive the debtor of the opportunity for a fresh financial start. Therefore, the debtor may exempt certain items from the bankruptcy estate and retain them as the basis for a new beginning.

As you study this chapter, keep in mind that the bankruptcy laws provide an acceptable alternative for debtors in financial difficulty. Filing for bankruptcy is no longer socially unacceptable or an admission of failure. More than ever before, bankruptcy has become an acceptable solution to the financial distress individuals or businesses could not otherwise overcome.

This chapter discusses the types of bankruptcy proceedings, some procedural aspects of a bankruptcy case, and rights and duties of the parties involved in a bankruptcy case.

**BUSINESS MANAGEMENT DECISION**

Your company, which is self-insured, faces thousands of products liability suits. The potential liability could reach hundreds of millions of dollars. Other than these suits, your company is financially sound and profitable. Should your company consider filing for bankruptcy protection?

## TERMINOLOGY

**Debtor**

The party who files a bankruptcy petition or against whom such a petition is filed

**Claim**

A creditor's right to payment in a bankruptcy case

At the outset of your study of this chapter, you should be familiar with some of the more common terms used in bankruptcy proceedings. A **debtor** is the individual, business organization, municipality, or farmer that a bankruptcy proceeding involves. A **claim** is a right to payment from the debtor. Claims are held and asserted by creditors. An **order of relief** is entered by the bankruptcy judge when he or she finds that the debtor is entitled to the protection of the bankruptcy law. A **discharge** is an order by the bankruptcy judge that a debtor is relieved of paying specific debts. Finally, the **trustee** is the person responsible for managing the debtor's assets and for satisfying the creditor's claim to the extent possible.

## TYPES OF PROCEEDINGS

**Order of relief**

The ruling by a bankruptcy judge that a particular case is properly before the bankruptcy court

**Discharge**

An order by a bankruptcy court that a debt is no longer valid—in essence, the debtor's forgiven obligation

**Trustee**

The person named to handle the assets and obligations of the debtor during the bankruptcy proceeding

**Liquidation**

The process of winding up the affairs of a corporation or firm for the purpose of paying its debts and disposing of its assets

### 1. In General

The federal bankruptcy laws have two distinct approaches to the problems of debtors. One approach is to liquidate debts. The liquidation approach recognizes that misfortune and poor judgment often create a situation in which debtors will never be able to pay their debts by their own efforts, or at least it will be very difficult to do so.

The second approach is to postpone the time of payment of debts or to reduce some of them to levels that make repayment possible. This approach is found in the reorganization sections for businesses and in the adjustment of debts provisions for municipalities, farmers, and individuals with regular incomes. The reorganization and adjustment provisions are aimed at rehabilitation of debtors. These procedures, if utilized, prevent harassment of debtors and spare them undue hardship while enabling most creditors eventually to obtain some repayment.

There are three types of bankruptcy proceedings relevant to business, each identified by a chapter of the statute: Chapter 7, Liquidation; Chapter 11, Reorganization; Chapter 13, Adjustment of Debts of an Individual with Regular Income. For the year ending June 30, 2008, there were 967,831 bankruptcy filings, according to the United States Bankruptcy Court. Of those, 63% (615,748) of all bankruptcies filed were for Chapter 7 (liquidation), 36% (344,421) were for Chapter 13 (wage earner), and less than 1% (7,607) were for other chapters. (While not covered in this text, Adjustment of Debts of a Family Farmer under Chapter 12 is treated in a manner somewhat similar to those that file under Chapter 13.)

### 2. Liquidation Proceedings under Chapter 7

**Liquidation** proceedings are used to eliminate most of the debts of a debtor. In exchange for having the debts declared uncollectible, the debtor must allow many, if not most, of his or her assets to

be used to satisfy creditors' claims. Cases under Chapter 7 of the statute may involve individuals, partnerships, limited liability companies, or corporations, but only individuals may receive a *discharge* from the court. A discharge voids any judgment against the debtor to the extent that it creates a personal liability. A discharge covers all scheduled debts that arose before the date of the order for relief. It is irrelevant whether or not a claim was filed or allowed. A discharge also operates as an *injunction* against all attempts to collect the debt—by judicial proceedings, telephone calls, letters, personal contacts, or other efforts. *Under all types of proceedings, once they are commenced, creditors are prohibited from attempting to collect their debts.*

The debts of partnerships, limited liability companies, and corporations that go through liquidation proceedings are not discharged. These businesses are still technically liable for their debts; however, the lack of discharge is immaterial unless the partnership, limited liability company, or corporation acquires assets later. This lack of discharge stops people from using “shell” businesses after bankruptcy for other purposes.

Certain businesses are denied the right to liquidation proceedings. Railroads, insurance companies, banks, savings and loan associations, homestead associations, and credit unions may not be debtors under Chapter 7 of the Bankruptcy Act. These organizations are subject to the jurisdiction of administrative agencies that handle all aspects of such organizations, including problems related to insolvency. Under this arrangement, there are alternative legal provisions for their liquidation.

Also, under the BAPCPA, Congress instituted a mechanism to reduce the abuse of Chapter 7 filings that was being experienced in the 1990s. The new law grants to a bankruptcy judge the power to dismiss a petition of bankruptcy for “substantial abuse” where the debtor’s income fails to meet the “means test.” Substantial abuse will be presumed where the debtor’s family income is greater than that of the median income of a family in the debtor’s state. (Section 707 of the BAPCPA provides a detailed explanation of the means test, including allowed expenses and exceptions)

Chapter 7 has special provisions relating to liquidation proceedings involving stockbrokers and commodity brokers. These special provisions are necessary to protect their customers, because bankruptcies of this kind usually involve large indebtedness and substantial assets. Stockbrokers and commodity brokers are subject only to Chapter 7. Chapter 11 and Chapter 13 proceedings are not available to them.

### 3. Reorganization Proceedings under Chapter 11

Reorganization proceedings are utilized when debtors wish to restructure their finances and attempt to pay creditors over an extended period, as required by a court-approved plan. Such cases almost always involve a business as the debtor. Chapter 11 of the 1978 Bankruptcy Act contains detailed provisions on all aspects of the plan of reorganization and its execution. In addition, the BAPCPA creates a special group of “small business debtors” (with less than \$2 million in debt) that are allowed to function under special rules that expedite the process.

As soon as practicable after the order for relief, a committee of creditors holding unsecured claims is formed. The committee ordinarily consists of persons with the largest claims, and it may employ attorneys, accountants, or other agents to assist it. Working with the trustee and the debtor concerning the administration of the case, it represents the interests of the creditors. It may investigate the financial condition of the debtor and will assist in the formulation of the reorganization plan.

The court in reorganization cases will usually appoint a trustee before approval of the plan of reorganization. If the court does not appoint a trustee, it will appoint an examiner who conducts an investigation into the affairs of the debtor, including any mismanagement or irregularities.

After the trustee or the examiner conducts the investigation of the acts, conduct, assets, liabilities, financial conditions, and other relevant aspects of the debtor, a written report of this investigation is filed with the court. The trustee may file a plan of reorganization if the debtor does not; or it may recommend conversion of the case to liquidation proceedings. The trustee will also file tax returns for the debtor, file reports with the court, and may even operate the debtor's business unless the court orders otherwise. The debtor may file a *plan of reorganization* with the voluntary petition or later in an attempt to extricate the business from its financial difficulties and help it to survive. The plan will classify claims, and all claims within a class will be treated the same. All unsecured claims for less than a specified amount may be classified together. The plan will designate those classes of claims that are unimpaired under the plan and will specify the treatment to be given claims that are impaired.

The plan must provide a means for its execution. It may provide that the debtor will retain all or part of the property of the estate. It may also propose that property be sold or transferred to creditors or other entities. Mergers and consolidations may be proposed. In short, the plan will deal with all aspects of the organization of the debtor, its property, and its debts. Some debts will be paid in full; some will be partially paid over an extended period of time; and others may not be paid at all. The only limitation is that all claimants must receive as much as they would receive in liquidation proceedings.

Holders of claims or interests in the debtor's property are allowed to vote and to accept or reject the proposed plan of reorganization. A class of claims has accepted a plan if at least two-thirds in amount and more than half in number of claims vote yes. Acceptance by a class of interests, such as equity holders, requires a two-thirds "yes" vote.

A hearing is held on the confirmation of a plan to determine if it is fair and equitable. The statute specifies several conditions, such as good faith, which must be met before the plan is approved. Also before approval, it must be established that each holder of a claim or interest has either accepted the plan or will receive as much under the reorganization plan as would be received in liquidation proceedings. For secured creditors, this means that they will receive the value of their security either by payment or by delivery of the property. Confirmation of the plan makes it binding on the debtor, equity security holders, and creditors. Confirmation vests the property of the estate in the debtor and releases the debtor from any payment not specified in the reorganization plan.

As a general rule, any debtor subject to liquidation under the statute (Chapter 7) is also subject to reorganization (Chapter 11).

#### **4. Adjustment of Individuals' Debts under Chapter 13**

Chapter 13 proceedings are used to adjust the debts of individuals with regular income whose debts are small enough and whose income is significant enough that substantial repayment is feasible. Such persons often seek to avoid the stigma of bankruptcy. Moreover, under the BAPCPA, many Chapter 7 liquidations provisions will be turned into Chapter 13 repayments plans. Unsecured debts of individuals utilizing Chapter 13 proceedings cannot exceed \$336,900, and the secured debts cannot exceed \$1,010,650. Persons utilizing Chapter 13 are usually employees earning a salary, but persons engaged in business also qualify. Self-employed persons who incur trade debts are considered to be engaged in business.

The debtor files a plan that provides for the use of all or a portion of future earnings or income for the payment of debts. The income is under the supervision and control of the trustee. Except as provided in the plan, the debtor keeps possession of his or her property. If the debtor is engaged in business, the debtor continues to operate the business. The plan must provide for

the full payment of all claims entitled to priority unless the creditors with priority agree to a different treatment. If a plan divides unsecured claims into classes, all claims within a class must be given the same treatment.

Unsecured claims not entitled to priority may be repaid in full or reduced to a level not lower than the amount that would be paid upon liquidation. Since this amount is usually zero, any payment to unsecured creditors will satisfy the law. The secured creditors may be protected by allowing them to retain their lien, by payment of the secured claim in full, or by the surrender of the property to the secured claimant. Under provisions of the BAPCPA, the debtor's median income determines whether the length of the plan is three or five years. A typical plan allocates one-fourth of a person's take-home pay to repay debts.

The plan may modify the rights of holders of secured and unsecured claims, except that the rights of holders of real estate mortgages may not be modified. Claims arising after the filing of the petition may be included in the plan. This is a realistic approach because all the debts of the debtor must be taken into account if the plan is to accomplish its objectives.

When the court conducts a hearing on the confirmation of the plan, if it is satisfied that the debtor will be able to make all payments to comply with it, the plan will be approved. Of course, the plan must be proposed in good faith, be in compliance with the law, and be in the best interest of the creditors.

As soon as the debtor completes all payments under the plan, the court grants the debtor a discharge of all debts unless the debtor waives the discharge or the debts are not legally dischargeable (see Sections 7 and 8).

After a hearing, courts may also grant a discharge, even though all payments have not been made, if the debtor's failure to complete the payments is due to circumstances for which the debtor should not justly be held accountable. In such cases, the payments under the plan must be not less than those that would have been paid on liquidation, and modification must not be practicable.

**TABLE 39-1 ■ Type of Bankruptcy**

<b>Chapter</b>	<b>Type</b>	<b>Debtor</b>	<b>Who may file</b>	<b>Impact</b>
Chapter 7	Liquidation	Individuals, partnerships, corporations, and other business entities	Debtor or creditors	Most or all debts are discharged, economic activity ceases, and debtor may start anew.
Chapter 11	Reorganization	Individuals, partnerships, corporations, and other business entities	Debtor or creditors	Debtor remains in business and debts are liquidated through approved plan
Chapter 13	Adjustment of Debts	Individual	Debtor only	Debt repayment plan is executed.

## GENERAL PRINCIPLES

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### 5. Property of the Estate

The *bankruptcy estate* consists of all legal or equitable interests of the debtor in property, wherever located. The property may be tangible or intangible and includes causes of action. To begin, all property is included in the estate, but the debtor may exempt portions entitled to exemption, as discussed in the next section.

The estate includes property that the trustee recovers by using his or her power to avoid prior transactions. It also includes property inherited by the debtor or received as a beneficiary of life insurance within 180 days of the petition. Proceeds, products, offspring, rents, and profits generated by, or coming from, property in the estate are also part of the estate.

In general, property acquired by the debtor after commencement of the case—including earnings from employment—belongs to the debtors. Property held in trust for the benefit of the debtor under a *spendthrift trust* does not become a part of the estate. In essence, the trustee in bankruptcy acquires the same interest with the same restrictions as the debtor had at the time the bankruptcy petition was filed. However, the trustee can require creditors to turn over possession of assets that were held by the creditors at the time the petition was filed. In return, the trustee must provide adequate protection for these creditors' claims. These concepts apply to the IRS and other government agencies.

### 6. Exemptions

Technically, all property of the debtor becomes property of the bankruptcy estate, but an individual debtor is then permitted to claim some of it as exempt from the proceedings. That property is then returned to the debtor. Exemptions Federal, state, and local laws grant exemptions.

**FEDERAL EXEMPTIONS** Federal bankruptcy law provides for exemptions, adjusted every three years based on the Consumer Price Index, including the following based on April 1, 2007, adjustments:

1. Real property used as a residence, up to \$20,200 in equity
2. The debtor's interest, not to exceed \$3,225, in one motor vehicle
3. The debtor's interest, not to exceed \$525 in any particular item or \$10,775 in aggregate value, in household furnishings, wearing apparel, appliances, books, animals, crops, or musical instruments that are held primarily for the personal family or household use of the debtor and his dependents
4. The debtor's interest in jewelry, not to exceed \$1,350
5. The debtor's interest in other property, not to exceed \$1,075, plus up to \$10,125 of any unused real property exemption
6. The debtor's interest, not to exceed \$2,025, in any implements, professional books, or tools of the trade of the debtor, or the trade of his or her dependents
7. Unmatured life insurance contracts
8. The cash value of life insurance, not to exceed \$10,775
9. Professionally prescribed health aids
10. The debtor's right to receive benefits such as social security, unemployment compensation, public assistance, disability benefits, alimony, child support and separate maintenance reasonably necessary, and current payments of pension, profit sharing, annuity, or similar plans

11. The debtor's right to receive payment traceable to the wrongful death of an individual on whom the debtor was dependent or to life insurance on the life of such a person or to payments for personal injury, not to exceed \$20,200
12. Retirement funds and pensions up to \$1,000,000, along with education savings accounts, which are exempt from taxation under the Internal Revenue Code.

**STATE EXEMPTIONS** Every state has enacted statutes granting exemptions to debtors domiciled there, but these exemptions vary greatly from state to state. For example, some state exemptions exceed those provided by the federal bankruptcy laws. Other state exemptions are too small to give a debtor a real chance at a fresh financial start. To encourage some states to raise their exemptions, the 1978 Act provides that the federal exemptions will be available to debtors unless the state specifically passes a law denying its residents the federal exemptions. Debtors may claim the larger exemptions offered by their state if it is to their advantage to do so. Over half the states have adopted laws denying debtors the use of the federal exemptions; however, these states have substantially increased their own exemptions.

One of the most popular exemptions provided by state law is the *homestead exemption*. In prior years, some states allowed debtors to shield an unlimited amount of equity in their homes through the use of the homestead exemption. However, the BAPCPA now restricts the maximum equity exempted to no more than \$136,875 and provides other restrictions to those who wish to use a state homestead exemption.

**STATUS OF EXEMPT PROPERTY** As a general rule, exempt property is not subject to any debts that arise before the commencement of the case. Exceptions to the general rule apply to tax claims, alimony, child support, and separate maintenance. Exempt property can be used to collect such debts after the proceeding. The discharge in bankruptcy does not prevent enforcement of valid liens against exempt property; however, judicial liens and non-possessory, non-purchase money, security interests in household goods, wearing apparel, professional books, tools, and professionally prescribed health aids may be avoided. A debtor may redeem such tangible personal property from a lien securing a dischargeable consumer debt by paying the lienholder the amount of the secured claim. Exempt property is free of such liens after the proceedings. Waivers of exemptions are unenforceable, to prevent creditors from attempting to deny debtors the necessary property to gain a fresh start.

## 7. Debts that Are Not Discharged

A debt is a liability on a claim. A claim may be based on the right to payment that could be enforced in a proceeding at law, or it may be based on the right to an equitable remedy for breach of performance if the breach gives a right to payment. Claims based on equitable remedies may be dischargeable the same as those based on legal remedies.

Not all debts are discharged in Chapter 7 cases. A discharge in bankruptcy does not discharge an individual debtor from the following debts:

1. Certain taxes and customs duties accruing within two years of bankruptcy
2. Debts for obtaining money, property, services, or credit by false pretenses, false representations, or actual fraud
3. Consumer debts over \$500 for luxury goods and services incurred within ninety days of the order of relief

4. Cash advances over \$750 that are extensions of consumer credit under an open-end credit plan within seventy days of the order of relief
5. Unscheduled debts
6. Debts for fraud or defalcation while acting in a fiduciary capacity and debts created by embezzlement or larceny
7. Alimony, child support, and separate maintenance
8. Liability for willful and malicious torts
9. Tax penalties if the tax is not dischargeable
10. Student loans less than five years old, unless payment creates an undue hardship.
11. Debts incurred as a result of an accident caused by driving while intoxicated
12. Debts owed before a previous bankruptcy
13. Fines and penalties payable to and for the benefit of governmental units that are not compensation for actual pecuniary losses

The taxes that are not discharged are the same ones that receive priority under the second, third, and seventh categories discussed in Section 23 of this chapter. If debtors fail to file a return, file it beyond its last due date, or file a fraudulent return, those taxes are not discharged. One of the most common tax liabilities not discharged in bankruptcy is for unpaid withholding and social security taxes.

Items 3 and 4, which were added by the 1984 amendments, now prevent the debtor from going on a spending spree or “loading up” at creditors’ expense just before filing a bankruptcy petition. The phrase “luxury goods and services” is defined as not including goods or services acquired for the support or maintenance of the debtor or his or her dependents.

The denial of a discharge of debts that are not properly scheduled on the bankruptcy petition means that the claim of any creditor who is not listed or who does not learn of the proceedings in time to file a claim continues to be valid. The debtor, under such circumstances, remains liable to pay the creditor unless the debtor can prove that the creditor did have knowledge of the proceeding in time to file a claim. Proof of actual knowledge is required; and although such knowledge often exists, care should be taken to list all creditors so all claims are subject to being discharged.

Typically, for a debt to be denied discharge because of fraud, the creditor must have placed reasonable reliance on a false written statement. One issue involving the use of fraud to deny a discharge of the underlying debt has concerned the creditor’s burden of proof in establishing that the fraud exists.

Tort liability claims based on negligence are discharged. Tort liability claims arising from willful and malicious acts are not discharged. A judgment arising out of an assault and battery is not discharged. Item 11 was added by the 1984 amendments. The logic behind making this tort liability nondischargeable indicates support in the battle to discourage drunk driving. A 1990 amendment made it clear that this policy of nondischargeability extends to injuries arising out of the operation of a motor vehicle under the influence of alcohol, drugs, or other substances.

The provision generally denying discharge to student loans was added in the 1978 revision. It seeks to give creditors and the government five years to collect student loans. There is an exception if the debtor is able to convince the court that undue hardship will result on him or her and dependents if the student loan debt is not discharged. If the debtor fails to prove the undue hardship caused by the student loan, a general discharge will not relieve the debtor of the obligation to pay that student loan. Student loans are not discharged automatically. A person seeking a discharge of them must prove undue hardship in the bankruptcy court. Application of this provision is illustrated in the following case.



## CASE

### ***In the matter of Jonathon R. Gerhardt, Debtor: United States Department of Education, Appellee v. Jonathon R. Gerhardt, Appellant***

#### **UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT**

*348 F.3d 89 (2003)*

#### **EDITH H. JONES, CIRCUIT JUDGE**

*Over a period of years, Jonathon Gerhardt obtained over \$77,000 in government-insured student loans to finance his education at the University of Southern California, the Eastman School of Music, the University of Rochester, and the New England Conservatory of Music. Gerhardt is a professional cellist. He subsequently defaulted on each loan owed to the United States Government.*

*In 1999, Gerhardt filed for Chapter 7 bankruptcy and, thereafter, filed an adversary proceeding seeking discharge of his student loans. The bankruptcy court discharged Gerhardt's student loans as causing undue hardship. On appeal, the district court reversed, holding that it would not be an undue hardship for Gerhardt to repay his student loans. Finding no error, we affirm the district court's judgment.*

This circuit has not explicitly articulated the appropriate test with which to evaluate the undue hardship determination. The Second Circuit in *Brunner* crafted the most widely-adopted test. To justify discharging the debtor's student loans, the *Brunner* test requires a three-part showing: (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans; (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and (3) that the debtor has made good faith efforts to repay the loans. Because the Second Circuit presented a workable approach to evaluating the "undue hardship" determination, this court expressly adopts the *Brunner* test.

Under the first prong of the *Brunner* test, the bankruptcy court determined that Gerhardt could not maintain a minimal standard of living if forced to repay his student loans. Evidence was produced at trial that Gerhardt earned \$1,680.47 per month as the principal cellist for the Louisiana Philharmonic Orchestra ("LPO"), including a small amount of supplemental income earned as a cello teacher for Tulane University. His monthly expenses, which included a health club membership and Internet access, averaged \$1,829.39. The bankruptcy court's factual findings are not clearly erroneous. Consequently, we agree with the bankruptcy court's conclusion of law that flows from these factual

findings. Given that Gerhardt's monthly expenses exceed his monthly income, he has no ability at the present time to maintain a minimal standard of living if forced to repay his loans.

The second prong of the *Brunner* test asks if "additional circumstances exist indicating that this state of affairs is likely to persist [for a significant period of time]." "Additional circumstances" encompass "circumstances that impacted on the debtor's future earning potential but which [were] either not present when the debtor] applied for the loans or [have] since been exacerbated." This second aspect of the test is meant to be "a demanding requirement." Thus, proving that the debtor is "currently in financial straits" is not enough. Instead, the debtor must specifically prove "a total incapacity ... in the future to pay [his] debts for reasons not within [his] control." Some examples of "additional circumstances" include "psychiatric problems, lack of usable job skills, and severely limited education."

Under the second prong of the test, the district court correctly concluded that Gerhardt has not established persistent undue hardship entitling him to discharge his student loans. Gerhardt holds a masters degree in music from the New England Conservatory of Music. He is about 43 years old, healthy, well-educated, and has no dependents; yet he has repaid only \$755 of his over \$77,000 debt. During the LPO's off-seasons, Gerhardt has collected unemployment, but he has somehow managed to attend the Colorado Music Festival. Although trial testimony tended to show that Gerhardt would likely not obtain a position at a higher-paying orchestra, he could obtain additional steady employment in a number of different arenas. For instance, he could attempt to teach full-time, obtain night-school teaching jobs, or even work as a music store clerk. Thus, no reasons out of Gerhardt's control exist that perpetuate his inability to repay his student loans.

Our analysis of the second *Brunner* prong inevitably overlaps, to some degree, with the third prong, which asks if the debtor has made a good faith effort to repay the loan. However, because we resolve this case under the second prong, it is unnecessary to explore the third prong in depth.

In addition, nothing in the Bankruptcy Code suggests that a debtor may choose to work only in the field in which he was trained, obtain a low-paying job, and then claim that it would be an undue hardship to repay his student loans. Under the facts presented by Gerhardt, it is difficult to imagine a professional orchestra musician who would not qualify for an undue hardship discharge. Accordingly, Gerhardt "has failed to demonstrate the type of exceptional circumstances that are necessary in order to meet [his] burden under the second prong" of *Brunner*. Finding no error, the judgment of the district court is AFFIRMED.

■ *Affirmed.*

#### CASE CONCEPTS REVIEW

1. Did it surprise you that the debtor had repaid only \$755 of his over \$77,000 debt? Do you believe this fact might have influenced the decision of the judges on appeal? Why?
2. What are the provisions of the test used to determine undue hardship?

As a result of item 13, criminals will not be able to use the bankruptcy laws to avoid fines that have been levied. The Supreme Court has extended this nondischargeable debt to include restitution obligations imposed on debtors in state criminal proceedings. Great deference is given to state criminal proceedings, and amounts owed to accomplish the penal goals of a state, such as the deterrence of crime, are not dischargeable.

## 8. Grounds for Denying Discharge

A discharge in bankruptcy is a privilege, not a right. Therefore, in addition to providing that certain debts are not discharged, the 1978 Bankruptcy Act specifies the following grounds for denying an individual debtor a discharge:

1. Fraudulent transfers
2. Inadequate records
3. Commission of a bankruptcy crime
4. Failure to explain a loss of assets or deficiency of assets
5. Refusing to testify in the proceedings or to obey a court order
6. Any of the above within one year in connection with another bankruptcy case of an insider
7. Another discharge within eight years (under the 1978 Bankruptcy Act, the time between discharges was six years, but the BAPCPA extended this duration)
8. Approval by the court of a waiver of discharge
9. Failure to complete the required consumer credit education course, as mandated under the BAPCPA. The first three grounds for denying discharge are predicated on wrongful conduct by the debtor in connection with the case. Fraudulent transfers involve such acts as removing, destroying, or concealing property with the intent to hinder, delay, or defraud creditors or the trustee. The conduct must occur within one year preceding the case, or it may occur after the case is commenced.

A debtor is also denied a discharge if he or she has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any books and records relating to his or her financial condition. A debtor is required to keep records from which his or her financial condition may be ascertained, unless the failure is justified.

Bankruptcy crimes are generally related to the proceedings. They include a false oath, the use or presentation of a false claim, or bribery in connection with the proceedings and with the withholding of records.

The six-year rule, which allows a discharge only if another discharge has not been ordered within six years, extends to Chapter 11 and Chapter 13 proceedings, as well as to those under Chapter 7. Confirmation of a plan under Chapter 11 or 13 does not have the effect of denying a discharge within six years if all the unsecured claims were paid in full, or if 70 percent of them were paid and the debtor has used his or her best efforts to pay the debts.

Either a creditor or the trustee may object to the discharge. The court may order the trustee to examine the facts to see if grounds for the denial of the discharge exist. Courts are also granted the authority to revoke a discharge within one year if it was obtained by fraud on the court.

## PROCEDURAL STEPS

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### 9. Introduction

Chapter 3 of the 1978 Bankruptcy Reform Act is concerned with procedural aspects and administration of all types of bankruptcy cases, regardless of the chapter under which the case is filed. The provisions of Chapter 3 give guidance in how to and who can file a case, in how the automatic stay prohibits any action against the debtor, and in how creditors are informed of the debtor's status. These provisions are discussed in the next five sections. The most technical portion of Chapter 3 is entitled "administrative powers." These provisions grant the bankruptcy court and the trustee a wide range of powers to accomplish the purposes of the bankruptcy law. Sections 15 through 19 present a more detailed examination of these powers and duties.

### 10. Voluntary Commencement

A debtor may voluntarily instigate a bankruptcy case under any appropriate chapter by filing a *petition* with the bankruptcy court. In recognition of the fact that husbands and wives often owe the same debts, a joint case may be filed. A *joint case* is a voluntary one concerning a husband and wife, and it requires only one petition. Both spouses must sign the petition since one spouse cannot take the other into bankruptcy without the other's consent. Insolvency is not a condition precedent to any form of voluntary bankruptcy action.

As of June 2009, all petitioners must pay a filing fee, in installments if they prefer, of \$299 for Chapter 7, \$1,039 for Chapter 11, and \$274 for Chapter 13. Only one filing fee is required in a joint case. A petition filed by a partnership as a firm is not a petition on behalf of the partners as individuals. If they intend to obtain individual discharges, separate petitions are required.

The petition contains lists of secured and unsecured creditors, all property owned by the debtor, property claimed by the debtor to be exempt, and a statement of affairs of the debtor. This statement includes current income and expenses, so the judge can dismiss a case if he or she believes that a substantial abuse of the bankruptcy code has occurred. This is an important consideration when a debtor's liabilities do not exceed assets and the filing is based on some fact other than that the debtor cannot pay debts as they come due. The statement of affairs of a debtor engaged in business is much more detailed than the one filed by a debtor not in business.

In general, the filing of a voluntary petition constitutes an order of relief indicating that the debtor is entitled to the bankruptcy court's protection. Further, the filing of the petition (either voluntary or involuntary) triggers an *automatic stay* that has the effect of suspending almost all actions by creditors against the debtor or the debtor's assets. This powerful doctrine is discussed below in Section 13.

### 11. Involuntary Commencement

Involuntary cases are commenced by one or more creditors filing a petition. If there are twelve or more creditors, the petition must be signed by at least three creditors whose unsecured claims are not contingent and aggregate at least \$13,475. If there are fewer than twelve creditors, only one need sign the petition, but the \$13,475 amount must still be met. Employees, insiders, and transferees of voidable transfers are not counted in determining the number of creditors. "Insiders" are persons such as relatives, partners of the debtor, and directors and officers of the corporation involved. The subject of voidable transfers is discussed later in this chapter.

Creditors may commence involuntary proceedings to harass the debtor. To protect the debtor, the court may require the petitioning creditors to file a bond to indemnify the debtor. This bond will cover the amounts for which the petitioning creditors may have liability to the debtor. The liability may include court costs, attorney's fees, and damages caused by taking the debtor's property.

Until the court enters an order for relief in an involuntary case, the debtor may continue to operate his or her business and to use, acquire, and dispose of property. However, the court may order an interim trustee appointed to take possession of the property and to operate the business. If the case is a liquidation proceeding, the appointment of the interim trustee is mandatory unless the debtor posts a bond guaranteeing the value of the property in his or her estate.

Since some debtors against whom involuntary proceedings are commenced are, in fact, not bankrupt, the debtor has a right to file an answer to the petition of the creditors and to deny the allegations of the petition. If the debtor does not file an answer, the court orders relief against the debtor. If an answer is filed, the court conducts a trial on the issues raised by the petition and the answer. A court will order relief in an involuntary proceeding against the debtor only if it finds that the debtor is generally not paying debts as they become due. Insolvency in the balance sheet sense (liabilities exceeding assets) is not required. Relief may also be ordered if, within 120 days before the filing of the petition, a custodian, receiver, or agent has taken possession of property of the debtor for the purpose of enforcing a lien against the debtor.

Creditors also are prohibited from forcing any debtor into a Chapter 13 proceeding. The reason for this rule is that a Chapter 13 debtor is required to pay off his or her debts pursuant to an approved plan. To force an individual debtor to work to pay debts is equivalent to involuntary servitude, which violates the Thirteenth Amendment of the Constitution. Moreover, federal bankruptcy law provides penalties against creditors who file frivolous petitions and allow a debtor to receive damages, including punitive damages, against such creditors.

## 12. Conversion of Cases

Because a case may be filed voluntarily or involuntarily under the various chapters, the issue arises as to whether the debtor or the creditors can convert a filing to another type of proceeding. If the original filing is under Chapter 7, the debtor can request a conversion to a Chapter 11 or 13 proceeding. Creditors can have a Chapter 7 case converted to Chapter 11, but not to Chapter 13. If the case was filed voluntarily as a Chapter 11 reorganization proceeding, the debtor may request that the case be converted to a Chapter 7 or 13 proceeding. However, if the Chapter 11 proceeding was begun involuntarily, the creditors must consent to a conversion to Chapter 7. Creditors may seek to convert a Chapter 11 proceeding to Chapter 7 as long as the debtor is neither a farmer nor a nonprofit corporation. Creditors cannot convert a case from Chapter 11 to Chapter 13 without the debtor's consent.

In general, a debtor may convert a Chapter 13 proceeding to Chapter 7 or 11, whichever is more appropriate. Creditors also may ask the court to convert a case filed under Chapter 13 to Chapter 7 or 11 unless the debtor is a farmer. If the debtor is a farmer, any conversion must be agreed to by that farmer before that conversion will occur.

The following United States Supreme Court case discusses a variety of issues concerning the conversion of cases. Principally involved is the question of whether an individual debtor may convert a Chapter 7 case into a Chapter 11 case.



## CASE

### *Toibb v. Radloff*

#### SUPREME COURT OF THE UNITED STATES

501 U.S. 157 (1991)

#### BLACKMUN, J.

In this case we must decide whether an individual debtor not engaged in business is eligible to reorganize under Chapter 11 of the Bankruptcy Code.

From March 1983 until April 1985, petitioner Sheldon Baruch Toibb, a former staff attorney with the Federal Energy Regulatory Commission, was employed as a consultant by Independence Electric Corporation (IEC), a company he and two others organized to produce and market electric power. Petitioner owns 24 percent of the company's shares. After IEC terminated his employment, petitioner was unable to find work as a consultant in the energy field; he has been largely supported by his family and friends since that time.

On November 18, 1986, petitioner filed a voluntary petition for relief under Chapter 7 of the Code in the United States Bankruptcy Court. The Schedule of Assets and Liabilities accompanying petitioner's filing disclosed unsecured debts of \$170,605. Petitioner listed as nonexempt assets his IEC shares and a possible claim against his former business associates. He stated that the market value of each of these assets was unknown.

On August 6, 1987, the Chapter 7 Trustee notified the creditors that the Board of Directors of IEC had offered to purchase petitioner's IEC shares for \$25,000. When petitioner became aware that this stock had such value, he decided to avoid its liquidation by moving to convert his Chapter 7 case to one under the reorganization provisions of Chapter 11.

The Bankruptcy Court granted petitioner's conversion motion, and on February 1, 1988, petitioner filed a plan of reorganization. Under the plan, petitioner proposed to pay his unsecured creditors \$25,000 less administrative expenses and priority tax claims, a proposal that would result in a payment of approximately 11 cents on the dollar. He further proposed to pay the unsecured creditors, for a period of six years, 50 percent of any dividends from IEC or of any proceeds from the sale of the IEC stock, up to full payment of the debts.

On March 8, 1988, the Bankruptcy Court on its own motion ordered petitioner to show cause why his petition should not be dismissed because petitioner was not engaged in business and, therefore, did not qualify as a Chapter 11 debtor. Petitioner argued that Chapter 11 should be available to an individual debtor not engaged in an ongoing business. On August 1, the Bankruptcy Court ruled that petitioner failed to qualify for relief under Chapter 11.

The District Court upheld the Bankruptcy Court's dismissal of petitioner's Chapter 11 case. The Court of Appeals affirmed. We granted certiorari.

In our view, the plain language of the Bankruptcy Code disposes of the question before us. Section 109 defines who may be a debtor under the various chapters of the Code. Section 109(d) provides: "Only a person that may be a debtor under Chapter 7 of this title, except a stockbroker or a commodity broker, and a railroad may be a debtor under Chapter 11 of this title." The Code defines "person" as used in Title 11 to "include [an] individual." Under the express terms of the Code, therefore, petitioner is "a person who may be a debtor under Chapter 7" and satisfies the statutory requirements for a Chapter 11 debtor.

The Code contains no ongoing business requirement for reorganization under Chapter 11, and we are loath to infer the exclusion of certain classes of debtors from the protections of Chapter 11 because Congress took care in § 109 to specify who qualifies—and who does not qualify—as a debtor under the various chapters of the Code. Congress knew how to restrict recourse to the avenues of bankruptcy relief; it did not place Chapter 11 reorganization beyond the reach of a nonbusiness individual debtor.

We are not persuaded by the contention that Chapter 11 is unavailable to a debtor without an ongoing business because many of the Chapter's provisions do not apply to a nonbusiness debtor. There is no doubt that Congress intended that a business debtor be among those who might use Chapter 11. Code provisions certainly are designed to aid in the rehabilitation of a business. It does not follow, however, that a debtor whose affairs do not warrant recourse to these provisions is ineligible for Chapter 11 relief. Instead, these provisions reflect an understandable expectation that Chapter 11 would be used primarily by debtors with ongoing businesses; they do not constitute an additional prerequisite for Chapter 11 eligibility beyond those established in § 109(d).

Although the foregoing analysis is dispositive of the question presented, we deal briefly with policy considerations inferring a congressional intent to preclude a nonbusiness debtor from reorganizing under Chapter 11. Petitioner suggests, and we agree, that Chapter 11 embodies the general Code policy of maximizing the value of the bankruptcy estate. Under certain circumstances a consumer debtor's estate will be worth more if reorganized under Chapter 11 than if liquidated under Chapter 7. Allowing such a debtor to proceed under Chapter 11 serves the congressional purpose of deriving as much value as possible from the debtor's estate.

Section 1129 (a) (7) provides that a reorganization plan may not be confirmed unless all the debtor's creditors accept the plan or will receive not less than they would receive under a Chapter 7 liquidation. Because creditors cannot be expected to approve a plan in which they would receive less than they would from an immediate liquidation of the debtor's assets, it follows that a Chapter 11 reorganization plan usually will be confirmed only when creditors will receive at least as much as if the debtor were to file under Chapter 7. Absent some showing of harm to the creditors of a nonbusiness debtor allowed to reorganize under Chapter 11, we see nothing in the allocation of "burdens" and "benefits" of Chapter 11 that warrants an inference that Congress intended to exclude a consumer debtor from its coverage.

The plain language of the Bankruptcy Code permits individual debtors not engaged in business to file for relief under Chapter 11. Although the structure and legislative history of Chapter 11 indicate that this Chapter was intended primarily for the use of business debtors, the Code contains no “ongoing business” requirement for Chapter 11 reorganization, and we find no basis for imposing one. Accordingly, the judgment of the Court of Appeals is reversed.

■ *Reversed.*

#### CASE CONCEPTS REVIEW

1. What type of bankruptcy proceeding was utilized initially by the debtor?
2. What motivated the debtor to convert the initial case to a Chapter 11 proceeding?
3. The lower courts all agreed on the proper outcome of this case. What was that judgment?
4. Why does the Supreme Court reverse these judgments? Discuss at least three reasons for this conclusion.

## 13. Automatic Stay

### Stay

The order of relief that prevents all creditors from taking any action to collect debts owed by the protected debtor

Bankruptcy cases operate to **stay** other judicial or administrative proceedings against the debtor. These stays of proceedings may operate to the detriment of a creditor or third party. For example, a stay would prevent a utility company from shutting off service. Despite this potential harm to creditors, the stay automatically becomes applicable immediately upon the bankruptcy petition being filed.

The stay provision often works to the disadvantage of secured creditors, especially in reorganization cases under Chapter 11. If the value of the property securing the debt does not cover the full debt, the creditor will lose because he or she cannot sell the property during the period of the stay. Creditors whose collateral is worth less than the loan amount are not entitled to compensation for the period of the stay in the bankruptcy court.

When the trustee continues to operate the debtor’s business, it is frequently necessary to use, sell, or lease property of the debtor. To prevent irreparable harm to creditors and other third parties as a result of stays, a trustee may be required to provide “adequate protection” to third parties. In some cases, adequate protection requires that the trustee make periodic cash payments to creditors. In others, the trustee may be required to provide a lien to the creditor. When the sale, lease, or rental of the debtor’s property may decrease the value of an entity’s interest in property held by the trustee, a creditor may be entitled to a lien on the proceeds of any sale, lease, or rental. The court is empowered to determine if the trustee has furnished adequate protection; and when the issue is raised, the burden of proof is on the trustee.

The automatic stay is designed to protect both debtor and creditor. The stay provides the debtor time and freedom from financial pressures to attempt repayment or to develop a plan of reorganization. The stay protects creditors since it forces them to comply with the orderly administration of the debtor’s estate. In other words, the stay prevents some creditors from grabbing all the debtor’s assets while other creditors receive nothing. It also allows for orderly trials of claims such as those for personal injury or wrongful death. Such claims are tried in the federal district courts and not in the bankruptcy courts.

Despite these advantages of staying all proceedings against the debtor who files a bankruptcy petition, there are exceptions to the application of the automatic stay. These exceptions apply to proceedings that are not directly related to the debtor’s financial situation. Proceedings that are not automatically stayed when a bankruptcy petition is made include (1) criminal actions against the debtor; (2) the collection of alimony, maintenance, or support from property that is not part of the estate; and (3) the commencement or continuation of an action by a governmental unit to enforce that governmental unit’s police power. Although these actions are not stayed automatically by the filing of a bankruptcy petition, the trustee may seek to enjoin these actions if they harm the debtor’s estate.

The significance of the automatic stay can be appreciated as the court in the following case determines the proper recourse for debtors who filed, but had not completed, the statutory credit counseling.



## CASE

### ***Diana Adams, Acting United States Trustee— against—Diana M. Finlay, et al.***

#### **UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK**

*2006 U.S. Dist. LEXIS 81591 (2006)*

*Debtor Lena Elmendorf filed a voluntary Chapter 7 Petition on November 29, 2005, with the aid of a retained attorney. It was her first bankruptcy filing. Ms. Elmendorf did not file with her Bankruptcy Petition a Credit-Counseling Certificate. On February 1, 2006, the United States Trustee filed a Motion to Dismiss. A hearing on the Motion was held May 16, 2006, at which time the Bankruptcy Court reserved decision.*

*Ms. Diana Finlay filed a Chapter 13 case on April 3, 2006, acting pro se. Ms. Finlay also did not file a Credit Counseling Certificate but did seek an extension of time to file such a certificate. The Court denied the request for an extension because Ms. Finlay had failed to state that she attempted to obtain the counseling within five days of her filing. This was Ms. Finlay's third bankruptcy filing in the past year. On May 9, 2006, the Bankruptcy Judge issued an Order at the request of Ameriquest Mortgage Company to the effect that due to the prior two filings, no automatic stay came into effect upon the filing of this Petition.*

*Mrs. Shayna A. Zarnel, also acting pro se, filed a Chapter 13 case on March 13, 2006. This was her first filing. However, her husband, Alfred R. Zarnel, had filed five bankruptcy petitions in this District since January, 2004. Mrs. Zarnel did not file a Credit Counseling Certificate. She did seek from the Bankruptcy Court an extension of time to do so, but the request was denied because she had failed to set forth exigent circumstances in support of the extension, as required by BAPCPA. On April 3, 2006, she did file a Credit Counseling Certificate, which stated that on March 21, 2006, she received credit counseling. The Trustee moved to dismiss Mrs. Zarnel's Petition for literal Non-Compliance with respect to credit counseling.*

*In all three cases now on appeal by the United States Trustee, the Bankruptcy Court by a decision in writing on July 18, 2006, "struck the petitions" of the would-be debtors, concluding that striking the petition was the proper remedy for a debtor's failure to obtain counseling prior to filing the petition because: 1) no case was "commenced" by such filing, and 2) Congress didn't intend for debtor's protections under the BAPCPA to be limited in respect to a future bankruptcy filing "where the debtor's failure to comply with § 109(h) was obviously done out of ignorance of the gate-keeping requirement." The Court noted that the vast majority of debtors who fail to obtain credit counseling before filing a petition are pro*

*se petitioners, but acknowledged that, in some cases, such failure combined with other circumstances revealing a larger scheme of delay or hindrance could merit some other sort of relief with prejudice*

The consolidated structure of BAPCPA is such that no rational pro se litigant or attorney would intentionally fail to satisfy § 109(h). Although modern courts generally act to relieve pro se litigants (and also careless lawyers) from inadvertent defaults or procedural failures, Congress has, by its terms, so constructed § 109(b) that it is impossible to relieve non-compliance even in the most compelling situation where no credit counseling has been obtained or certified to have been timely sought and not obtained within five days of a request for same. This is so even where credit counseling would be an empty charade, for example, where sudden illness, loss of employment, divorce, incarceration of the breadwinner or any number of causes not related to fiscal irresponsibility, compel a person to seek refuge in the bankruptcy court.

The draconian consequences of a dismissal could include a resultant limited applicability of the fundamental protection of the automatic stay under § 362(c), in subsequent filings, merely for an initial failure to comply properly with the credit counseling requirement. This Court is loathe to believe that those drafting this "reform" legislation, in this nation whose westward expansion was largely facilitated by those fleeing debtor's prison, intended such a consequence.

The United States Trustee argues that when an individual is ineligible for debt relief for failure to seek credit counseling before filing, dismissal of the case pursuant to 11 U.S.C. § 707(a), and not striking the petition, is the only proper response of the Court.

The Bankruptcy Court concluded that when read together, Sections 109(h), 301, and 362(a) establish that no automatic stay can exist for debtors who fail to obtain the required credit counseling or qualify for a "waiver" or extension of time to do so.

This Court agrees.

The filing of a petition is not synonymous with the commencement of a case, and only petitions filed by those eligible to be debtors can commence a case; and if no case is commenced, there is no case to dismiss. Thus, striking is the appropriate way to conclude the matter.

The appeals are dismissed for want of standing to appeal. Alternatively, the Orders appealed from are affirmed in all respects because they are within the power of the Bankruptcy Court.

■ *Affirmed.*

#### CASE CONCEPTS REVIEW

1. Are there exceptions to the credit-counseling requirement? Explain.
2. Why might the debtors be pleased with the decision of the court?

## 14. Meeting of Creditors

In a voluntary case, the debtor has filed the required schedules with the petition. In an involuntary case, if the court orders relief, the debtor will be required to complete the same schedules as the debtor in a voluntary proceeding. From this point, the proceedings are identical. All parties are given notice of the order for relief. If the debtor owns real property, notice is usually filed in the public records of the county where the land is situated. The notice to creditors will include the date by which all claims are to be filed and the date of a meeting of the creditors with the debtor. This meeting of creditors must be within a reasonable time after the order for relief. The debtor appears at the meeting with the creditors, and the creditors are allowed to question the debtor under oath. The court may also order a meeting of any equity security holders of the debtor.

At the meeting of creditors, the debtor may be examined by the creditors to ascertain if property has been omitted from the list of assets, if property has been conveyed in defraud of creditors, and other matters that may affect the right of the debtor to have his or her obligations discharged.

In liquidation cases, the first meeting of creditors includes the important step of electing a *permanent trustee*. This trustee will replace the interim trustee appointed by the court at the time the order for relief was entered. The unsecured creditors who are not insiders elect this permanent trustee. To have a valid election, creditors representing at least 20 percent of the amount of unsecured claims held against the debtor must vote. The election is then determined by a majority of the unsecured creditors voting.

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## TRUSTEE AND CASE ADMINISTRATION

### 15. Trustee and the Estate

The trustee may be an individual or a corporation that has the capacity to perform the duties of a trustee. In a case under Chapter 7 or 13 of the Act, an individual trustee must reside or have an office and the corporate trustee must have an office in the judicial district in which the case is pending or in an adjacent district. Prior to becoming a trustee in a particular case, the trustee must file with the court a bond in favor of the United States. This bond may be used as a source of collection if the trustee should fail to faithfully perform his or her duties.

The trustee is the representative of the *estate* and has the capacity to sue and to be sued. Trustees are authorized to employ professional persons such as attorneys, accountants, appraisers, and auctioneers and to deposit or invest the money of the estate during the proceedings. In making deposits or investments, the trustee must seek the maximum reasonable net return, taking into account the safety of the deposit or investment.

The statute has detailed provisions on the responsibilities of the trustee under the tax laws. As a general rule, the trustee has responsibility for filing tax returns for the estate. After the order for relief, income received by the estate is taxable to it and not to an individual debtor. The estate of a partnership or a corporation debtor is not a separate entity for tax purposes. While the technical requirements of the tax laws are beyond the scope of this text, it should be remembered that the bankruptcy laws contain detailed rules complementary to the Internal Revenue Code in bankruptcy cases; the trustee must follow both.

### 16. General Duties and Powers

The statutory duties of the trustees in liquidation proceedings are to (1) collect and reduce to money the property of the estate; (2) account for all property received; (3) investigate the financial

affairs of the debtor; (4) examine proofs of claims and object to the allowance of any claim that is improper; (5) oppose the discharge of the debtor, if advisable; (6) furnish information required by a party in interest; (7) file appropriate reports with the court and the taxing authorities, if a business is operated; and (8) make a final report and account and file it with the court.

A trustee that is authorized to operate the business of the debtor is authorized to obtain unsecured credit and to incur debts in the ordinary course of business. These debts are paid as administrative expenses.

A trustee in bankruptcy has several rights and powers with respect to the property of the debtor. First, the trustee has a judicial lien on the property, just as if the trustee were a creditor. Second, the trustee has the rights and powers of a judgment creditor who obtained a judgment against the debtor on the date of the adjudication of bankruptcy and who had an execution issued that was returned unsatisfied.

Third, the trustee has the rights of a bona fide purchaser of the real property of the debtor as of the date of the petition. Finally, the trustee has the rights of an actual unsecured creditor to avoid any transfer of the debtor's property and to avoid any obligation incurred by the debtor that is voidable under any federal or state law. As a result of these rights, the trustee is able to set aside transfers of property and to eliminate the interests of other parties where creditors or the debtor could do so.

The trustee also has the power to avoid certain liens of others on the property of the debtor. Liens that first become effective on the bankruptcy or insolvency of the debtor are voidable. As a general rule, liens that are not perfected or enforceable against a bona fide purchaser of the property are also voidable. Assume that a seller or creditor has an unperfected lien on goods in the hands of the debtor on the date the petition is filed. The lien is perfected later. That lien is voidable if it could not be asserted against a good-faith purchaser of the goods. Liens for rent and for distress for rent are also voidable.

The law imposes certain limitations on all these rights and powers of the trustee. A purchase-money security interest under Article 9 of the Code may be perfected after the petition is filed if it is perfected within ten days of delivery of the property. Such a security interest cannot be avoided by the trustee if properly perfected.

The rights and powers of the trustee are subject to those of a seller of goods in the ordinary course of business that has the right to reclaim goods if the debtor was insolvent when the debtor received them. The seller must demand the goods back within ten days, and the right to reclaim is subject to any superior rights of secured creditors. Courts may deny reclamation and protect the seller by giving his or her claim priority as an administrative expense.

## 17. Executory Contracts and Unexpired Leases

Debtors are frequently parties to contracts that have not been performed. Also, there are often lessees of real property, and the leases usually cover long periods of time. As a general rule, the trustee is authorized, subject to court approval, to assume or to reject an executory contract or unexpired lease. If the contract or lease is rejected, the other party has a claim subject to some statutory limitations. A rejection by the trustee creates a pre-petition claim for the rejected contract or lease debt subject to these limitations.

If the contract or lease is assumed, the trustee will perform the contract or assign it to someone else, and the estate will presumably receive the benefits. If the trustee assumes a contract or lease, he or she must cure any default by the debtor and provide adequate assurance of future performance. In shopping-center leases, adequate assurance includes protection against declines in percentage rents and preservation of the tenant mix, among other things.

A trustee may not assume an executory contract that requires the other party to make a loan, deliver equipment, or issue a security to the debtor. A party to a contract based on the financial strength of the debtor is not required to extend new credit to a debtor in bankruptcy.

Contracts and leases often have clauses prohibiting assignment. The law also prohibits the assignment of certain contract rights, such as those that are personal in nature. The trustee in bankruptcy is allowed to assume contracts, notwithstanding a clause prohibiting the assumption or assignment of the contract or lease. The trustee is not allowed to assume a contract if applicable nonbankruptcy law excuses the other party from performance to someone other than the debtor, unless the other party consents to the assumption.

The statute invalidates contract clauses that automatically terminate contracts or leases upon filing of a petition in bankruptcy or upon the assignment of the lease or contract. The law also invalidates contract clauses that give a party other than the debtor the right to terminate the contract upon assumption by the trustee or assignment by the debtor. Such clauses hamper rehabilitation efforts and are against public policy. They are not needed because the court can require the trustee to provide adequate protection and can ensure that the other party receives the benefit of its bargain.

If the trustee assigns a contract to a third party and the third party later breaches the contract, the trustee has no liability. This is a change of the common law in which an assignor is not relieved of liability by an assignment. An assignment by a trustee in bankruptcy is, in effect, a novation if the assignment is valid.

## 18. Voidable Preferences

One of the goals of bankruptcy proceedings is to provide an equitable distribution of a debtor's property among creditors. To achieve this goal, the trustee in bankruptcy is allowed to recover transfers that constitute a **preference** of one creditor over another. As one judge said, "A creditor who dips his hand in a pot which he knows will not go round must return what he receives, so that all may share." To constitute a recoverable preference, the transfer must (1) have been made by an insolvent debtor; (2) have been made to a creditor for, or on account of, an antecedent debt owed by the debtor before the transfer; (3) have been made within ninety days of the filing of the bankruptcy petition; and (4) enable the creditor to receive a greater percentage of the claim than he or she would receive under a distribution from the bankruptcy estate in a liquidation proceeding.

Insofar as the time period is concerned, there is an exception when the transfer is to an insider. In this case, the trustee may avoid the transfer if it occurred within one year of the date of filing the petition, provided the insider had reasonable cause to believe the debtor was insolvent at the time of the transfer.

A debtor is presumed to be insolvent during the ninety-day period prior to the filing of the petition. Any person contending that the debtor was solvent has the burden of coming forward with evidence to prove solvency. Once credible evidence is introduced, the party with the benefit of the presumption of insolvency has the burden of persuasion on the issue.

Recoverable preferences include not only payments of money but also the transfer of property as payment of, or as security for, a prior indebtedness. Since the law is limited to debts, payments by the debtor of tax liabilities are exempt from the preference provision and are not recoverable. A mortgage or pledge may be set aside as readily as direct payments. A pledge or mortgage can be avoided if received within the immediate ninety-day period prior to the filing of the petition in bankruptcy, provided it was obtained as security for a previous debt. The effective date of a transfer or a mortgage of real property may be questioned if the date the legal documents are signed is different from the date these documents are recorded. A logical solution to this potential problem seems to be to rely on the date the document is recorded in the public records.

### Preference

If an insolvent debtor pays some creditors a greater percentage of the debts than other creditors in the same class, and if the payments are made within ninety days prior to filing a bankruptcy petition; illegal and voidable payments to one creditor over another

Payment of a fully secured claim does not constitute a preference and, therefore, may not be recovered. Transfers of property for a contemporaneous consideration may not be set aside, because there is a corresponding asset for the new liability. A mortgage given to secure a contemporaneous loan is valid even when the mortgagee took the security with knowledge of the debtor's insolvency. An insolvent debtor has a right to attempt to extricate himself or herself, as far as possible, from financial difficulty. If the new security is personal property, it must be perfected within ten days after the security interest attaches. The law also creates an exception for transfers in the ordinary course of business or in the ordinary financial affairs of persons not in business. The payment of such debts is not recoverable by the trustee. This exception covers ordinary debt payments such as utility bills. The law on preferences is directed at unusual transfers and payments, not those occurring promptly in the ordinary course of the debtor's affairs.

## 19. Fraudulent Transfers

A transfer of property by a debtor may be fraudulent under federal or state law. The trustee may proceed under either to set aside a fraudulent conveyance. Under federal law, a *fraudulent conveyance* is a transfer within two years of the filing of the petition, with the intent to hinder, delay, or defraud creditors. Under state law, the period may be longer and is usually within the range of two to five years.

Fraudulent intent may be inferred from the fact that the consideration is unfair, inadequate, or nonexistent. Solvency or insolvency at the time of the transfer is significant, but it is not controlling. Fraudulent intent exists when the transfer makes it impossible for the creditors to be paid in full or for the creditors to use legal remedies that would otherwise be available.

The intent to hinder, delay, or defraud creditors may also be implied. Such is the case when the debtor is insolvent and makes a transfer for less than a full and adequate value. Fraudulent intent is present if the debtor was insolvent on the date of the transfer or if the debtor becomes insolvent as a result of the transfer.

If the debtor is engaged in business or is about to become so, the fraudulent intent will be implied when the transfer leaves the businessperson with an unreasonably small amount of capital. The businessperson may be solvent; nevertheless, he or she has made a fraudulent transfer if the net result of the transfer leaves him or her with an unreasonably small amount of capital, provided the transfer was without fair consideration. Whether or not the remaining capital is unreasonably small is a question of fact.

The trustee may also avoid a transfer made in contemplation of incurring obligations beyond the debtor's ability to repay as they mature. Assume that a woman is about to enter business and that she plans to incur debts in the business. Because of her concern that she may be unable to meet these potential obligations, she transfers all her property to her husband, without consideration. Such a transfer may be set aside as fraudulent. The requisite intent is supplied by the factual situation at the time of the transfer and the state of mind of the transferor. The actual financial condition of the debtor in such a case is not controlling, but it does shed some light on the intent factor and state of mind of the debtor.

The trustee of a partnership debtor may avoid transfers of partnership property to partners if the debtor was or thereby became insolvent. This rule was made to prevent a partnership's preferring partners who are also creditors over other partners. Such transfers may be avoided if they occurred within one year of the date of filing the petition.

If a transferee is liable to the trustee only because the transfer was to defraud creditors, the law limits the transferee's liability. To the extent that the transferee does give value in good faith, the transferee has a lien on the property. For the purpose of defining value in the fraudulent transfer situation, the term includes property or the satisfaction or securing of a present or existing debt. It does not include an unperformed promise to support the debtor or a relative of a debtor.

## CREDITORS

### 20. Creditors and Claims

Creditors are required to file proof of their claims if they are to share in the debtor's estate. Filed claims are allowed unless a party in interest objects. If an objection is filed, the court conducts a hearing to determine the validity of the claim. A claim may be disallowed if it is (1) unenforceable because of usury, unconscionability, or failure of consideration, (2) for unmaturing interest, (3) an insider's or attorney's claim and exceeds the reasonable value of the services rendered, (4) for unmatured alimony or child support, (5) for rent, and (6) for breach of an employment contract. These latter two claims may be disallowed to the extent that they exceed the statutory limitations for such claims.

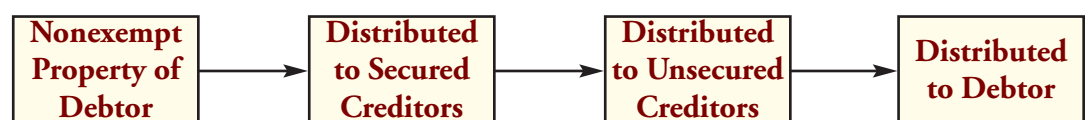
Illegality can be raised because any defense available to the debtor is available to the trustee. Post-petition interest is not collectible because interest stops accruing at the date of filing the petition. Bankruptcy operates as an acceleration of the principal due. From the date of filing, the amount of the claim is the total principal plus interest to that date.

Unreasonable attorney's fees and claims of insiders are disallowed because they encourage concealing assets or returning them to the debtor. Since alimony claims are not dischargeable in bankruptcy, there is no reason to allow a claim for post-petition alimony and child support.

Claims are sometimes contingent or otherwise unliquidated and uncertain. Personal injury and wrongful death claims against a debtor that cannot be settled are tried in federal district courts and not in bankruptcy courts. The law authorizes the bankruptcy court to estimate and to fix the amount of such claims, if necessary, to avoid undue delay in closing the estate or approving of a plan of reorganization. The same is true of equitable remedies such as specific performance. Courts will convert such remedies to dollar amounts and proceed to close the estate or approve the plan.

If a secured claim is undersecured—that is, if the debt exceeds the value of the collateral—the claim is divided into two parts. The claim is secured to the extent of the value of the collateral. It is an unsecured claim for the balance.

FIGURE 39-1 ■ General Distribution Process



## 21. Right of Setoff

Any creditor who also owes the debtor money may have a right of *setoff*. In essence, this creditor is allowed to cancel out these obligations. For example, suppose that a bank lends a debtor \$2,000 and that this debtor has \$1,500 on deposit at the bank. If the debtor fails to make payment on the \$2,000 loan, the bank can use the deposit to reduce the amount of the debtor's loan.

If a debtor files a bankruptcy petition and the creditor exercises the right of setoff, the issue of a preference arises. In our example, the bank becomes a preferred creditor to the extent of the \$1,500 setoff; but the bank, generally, is legally entitled to this preference if the amount of the deposit has not increased during the ninety days preceding the filing of the petition in bankruptcy. However, this preference would be nullified if the deposit was made or increased just before the bankruptcy petition was filed for the purpose of preferring the bank over other creditors. In that case, the deposit becomes a part of the debtor's estate, and the setoff is disallowed.

Since the filing of the petition in bankruptcy operates as a stay of all proceedings, the right of setoff operates at the time of final distribution of the estate. Since the law allows the trustee, with court approval, to use the funds of the debtor, parties who wish to exercise the right of setoff should seek "adequate protection."

The right to setoff will usually be exercised by a creditor against a deposit that has been made within ninety days of the filing of a petition in bankruptcy. Quite frequently, there are several such deposits, and there may also have been several payments on the debt during the ninety-day period. As a result of these variables, the application of setoff principles is sometimes difficult.

The law seeks to prohibit a creditor from improving his or her position during the ninety-day period. It does so by allowing the trustee to recover that portion of the setoff that would be considered a preference. This amount recoverable by the trustee is the insufficiency between the amount owed and the amount on deposit on the first day of the ninety-day period preceding the filing of a bankruptcy petition that a deficiency occurred—to the extent that this insufficiency is greater than the insufficiency existing on the day the petition is filed. If the deposit on the first day of the preceding ninety-day period exceeds the creditor's claim, look for the first insufficiency during the ninety-day period and calculate the setoff based on the first insufficiency.

Assume that a bankruptcy petition was filed on September 2. Throughout the ninety days prior to this filing, the debtor owes \$2,000 to the creditor. On June 4, the debtor has \$1,500 on deposit with the creditor. On July 15, the amount on deposit is reduced to \$700. On September 1, the debtor's balance is increased to \$1,800. At the time of the filing, the creditor seeks to use the entire \$1,800 on deposit to set off its claim against the debtor. The trustee would be able to recover \$300 of this attempted setoff since there was a greater insufficiency of that amount on the first day of the ninety-day period prior to the petition's being filed. In other words, the creditor's setoff would be limited to \$1,500.

## 22. Priorities

The bankruptcy law establishes certain priorities in the payment of claims. After *secured* creditors have had the opportunity to benefit from a security interest in collateral, the general order of priority for *unsecured debts* is as follows (from first priority to last):

1. Domestic-support obligations
2. Administrative expenses associated with administering the bankruptcy estate
3. Involuntary GAP creditors
4. Wages, salaries, and commissions

5. Contributions to employee benefit plans
6. Suppliers of grain to a grain storage facility or of fish to a fish produce storage or processing facility
7. Consumer deposits
8. Governmental units for certain taxes
9. Certain claims for death or personal injury
10. Claims of general creditors

Alimony and child support are the most prominent examples of domestic-support obligations. Administrative expenses include all costs of administering the debtor's estate, including taxes incurred by the estate. Typical costs include attorney's fees, appraiser's fees, and wages paid to persons employed to help preserve the estate.

The term *involuntary GAP creditor* describes a person who extends credit to the estate after the filing of an involuntary petition under Chapter 11 and before a trustee is appointed or before the order for relief is entered. Such claims include taxes incurred as the result of the conduct of business in this period.

The fourth class of priority is limited to amounts earned by an individual within 180 days of the filing of the petition or the cessation of the debtor's business, whichever occurred first. The priority is limited to \$10,950 for each individual, but it includes vacation, severance, and sick leave pay as well as regular earnings. The employee's share of employment taxes is included in this fourth category, provided the wages and the employee's share of taxes have been paid in full. The category does not include fees paid to independent contractors.

The fifth priority recognizes that fringe benefits are an important part of many employment contracts. The priority is limited to claims for contributions to employee benefit plans, arising from services rendered within 180 days before commencement of the case or cessation of the debtor's business, whichever occurs first. The priority is limited to \$10,950 multiplied by the number of employees less the amount paid under priority 4. The net effect is to limit the total priority for wages and employee benefits to \$10,950 per employee.

The sixth priority is designed to protect the farmer who raises grain and the fisherman if their grain or fish are held by the owner of a production or storage facility. If the farmers or fishermen have not been paid for the grain or fish transferred, they have a priority claim to the extent of \$5,400 per creditor.

The seventh priority is an additional method of consumer protection. It protects consumers who have deposited money in connection with the purchase, lease, or rental of property or the purchase of services for personal, family, or household use that were not delivered or provided. The priority is limited to \$2,245 per consumer.

The eighth priority is for certain taxes. Priority is given to income taxes for a taxable year that ended on or before the date of filing the petition. The last due date of the return must have occurred not more than three years before the filing. Employment taxes and transfer taxes such as gift, estate, sale, and excise taxes are also given seventh-class priority. Again the transaction or event that gave rise to the tax must precede the petition date, and the return must have been due

The image shows a portion of a pay stub. At the top right, it says 'Social Security Number: XXX-XX-XXXX' and 'Federal:'. Below that, there are columns for 'rate', 'hours', 'this period', and 'year to date'. The 'Earnings' section lists 'Regular', 'Holiday', and 'Retroactive Pay'. The 'Deductions' section is divided into 'Statutory' (Federal Income Tax, Social Security Tax, Medicare Tax, IL State Income Tax) and 'Other' (Dental, Medical, Savings 1, Vision, 401K). At the bottom, 'Net Pay' is indicated. A note at the very bottom says '\* Excluded from federal tax...'.

Wages are one of the priorities considered in discharging debt in a bankruptcy filing.

within three years. The bankruptcy laws have several very technical aspects relating to taxation, and they must be reviewed carefully for tax returns filed by the trustee and claims for taxes.

The ninth priority is for claims of death or serious injury resulting from an automobile accident caused by the unlawful use of alcohol or drugs.

In liquidation cases, the property available is first distributed among the priority claimants in the order just discussed. Then, the property is distributed to *general unsecured creditors* who file their claims on time. Next, payment is made to unsecured creditors who tardily file their claims. Thereafter distribution is made to holders of penalty, forfeiture, or punitive damage claims. Punitive penalties, including tax penalties, are subordinated to the first three classes of claims, as a matter of policy. Regular creditors should be paid before windfalls to persons and entities collecting penalties. Finally, post-petition interest on pre-petition claims is paid if any property is available to do so. After the interest is paid, any surplus goes to the debtor. Claims within a particular class are paid pro rata if the trustee is unable to pay them in full.

## CHAPTER SUMMARY

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1. Of major importance today is the *Bankruptcy Reform Act of 1978* as it has been amended in 1984, 1986, 1988, 1990, and substantially with the BAPCPA in 2005.
2. The basic purpose of the bankruptcy law is to give a debtor in financial difficulty an opportunity to overcome this problem.
3. Terms to remember include *debtor, claim, order of relief, discharge, and trustee*.

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### TYPES OF PROCEEDINGS

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**In General** 1. The bankruptcy law has two basic approaches to resolving a debtor's financial problems: one is liquidation, and the other is reorganization.

**Liquidation Proceedings** 1. This proceeding is governed by Chapter 7 of the statute.  
 2. In general, a debtor surrenders all assets from which creditors are paid as much as possible.  
 3. Individual debtors generally have all unpaid debts discharged or forgiven. Technically, a business organization's debts are not discharged.

**Reorganization Proceedings** 1. This proceeding is governed by Chapter 11 of the statute.  
 2. In essence, the debtor attempts to restructure the financial situation so creditors can be substantially paid over time.  
 3. The key to a successful reorganization is the court's approval of a reasonable confirmation plan.

**Adjustment of Individuals' Debts** 1. This proceeding is governed by Chapter 13 of the statute.  
 2. The debtor must be an individual who has regular income and who has unsecured debts not exceeding \$307,675, and the secured debts cannot exceed \$922,975.  
 3. Again, a plan of repayment must be approved. The unsecured creditors must receive at least as much as they would under a Chapter 7 liquidation proceeding.

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### GENERAL PRINCIPLES

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**Property of the Estate** 1. All the property interests of a debtor are used to create an estate.

2. The trustee, in essence, has whatever interests a debtor had at the time a bankruptcy petition was filed.

- Exemptions**
1. To enhance the debtor's fresh start, the debtor may exempt certain property from the estate.
  2. These exemptions are governed by either federal or state law, whichever the state law provides.

- Debts that Are Not Discharged**
1. Certain debts are not discharged; therefore, they survive the bankruptcy case and remain payable to the creditor.

- Grounds for Denying Discharge**
1. There also are grounds for denying a discharge.
  2. Basically, in its balancing process, the drafters of the law decided that debts created in certain situations should not be forgiven.

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### PROCEDURAL STEPS

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- Voluntary Commencement**
1. Any proceeding may be started by a debtor filing a petition in bankruptcy.
  2. The voluntary filing acts as an order of relief unless the bankruptcy judge decides that a consumer debtor is not entitled to Chapter 7 protection.

- Involuntary Commencement**
1. In general, cases may also be started by creditors with at least \$12,300 in claims filing a petition. This creditor-commenced action is known as an *involuntary case*.
  2. In an involuntary case, the bankruptcy judge must decide whether an order of relief is appropriate.
  3. An involuntary case cannot be filed under Chapter 13 of the statute regardless of who the debtor is. An involuntary case under Chapters 7 and 11 cannot be filed when the debtor is a farmer or a nonprofit corporation.

- Automatic Stay**
1. The filing of a bankruptcy petition protects the debtor against any action taken by creditors.
  2. This stay is automatic even before the creditors learn of the petition's being filed.
  3. The stay remains in effect until the bankruptcy judge permits actions by creditors.

- Meeting of Creditors**
1. After the order of relief is entered, a meeting of the creditors will be scheduled. At this meeting, creditors can question the debtor and examine documents.
  2. Also at this meeting, unsecured creditors will elect a permanent trustee.

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### TRUSTEE AND CASE ADMINISTRATION

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- Trustee and the Estate**
1. The trustee must satisfy statutory prerequisites before he, she, or it is qualified.
  2. The trustee has the responsibility for preserving the estate for the benefit of all creditors.
  3. The trustee must fulfill the administrative duties with regard to taxes and similar matters.
  4. In general, the trustee is a fiduciary of the estate.

- General Duties and Powers**
1. The trustee may employ professionals in representing the estate. The trustee also may sue and be sued in a representative capacity.
  2. The trustee has several statutory duties designed to ensure the proper workings of the bankruptcy law.

3. The trustee may operate the business of the debtor and may incur expenses associated with such an operation.
4. The trustee may assume the position of a lienholder or a good-faith purchaser if such positions enhance the estate.
5. The trustee also may avoid certain liens on the debtor's property.

### **Executory Contracts and Unexpired Leases**

1. The trustee has the general power to perform or avoid executory contracts and unexpired leases, regardless of what the agreement may state about the debtor's right to assign.
2. The trustee's power to avoid or modify a collective bargaining contract has been limited, but not removed, by the 1984 amendments.
3. The 1988 amendment added a mechanism whereby the obligation to pay insurance benefits to retired employees might be modified.

### **Voidable Preferences**

1. To keep all creditors on an equal basis, the trustee can avoid any transfer or payment to a creditor if such was made within ninety days of the petition being filed, if such was made to satisfy all or part of antecedent debts, if such was made while the debtor was insolvent, and if such was indeed a preference.
2. The debtor is presumed to be insolvent during the ninety days prior to the petition's being filed.
3. If the preferred creditor is an insider, the time period of concern is one year, not ninety days, before the petition was filed.

### **Fraudulent Transfers**

1. A transfer of property may be fraudulent under either federal or state law.
2. In general, any transfer within a statutory time period prior to the filing of a bankruptcy petition is fraudulent if the debtor intended to hinder, delay, or defraud creditors.
3. The trustee has the power to declare these transfers invalid to protect the estate for the creditors' benefit.

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## CREDITORS

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### **Creditors and Claims**

1. Creditors must be able to prove their claims to be paid from the debtor's estate.
2. There are numerous reasons why a claim may be disallowed altogether or otherwise limited.

### **Right of Setoff**

1. Because the debtor may have a claim against the creditor, that creditor can set off the amount owed to the debtor against the claims the creditor makes on the debtor's estate.
2. This setoff must not give an unreasonable preference to the creditor. The trustee will examine all events during the ninety days prior to the filing of the bankruptcy to determine the proper amount of the setoff.

### **Priorities**

1. The creditors' claims are subject to payment according to the priority established by the bankruptcy law.
2. Seven categories of priority claims must be paid before the first general unsecured creditor's claim is paid.

## REVIEW QUESTIONS AND PROBLEMS

1. Match each term in Column A with the appropriate statement in Column B.

A	B
(1) Liquidation	(a) A creditor's right to payment
(2) Reorganization	(b) Entered by bankruptcy judge whenever debtor is entitled to the court's protection
(3) Claim	(c) The creditor's right to reduce the amount of its claim by the amount it owes the debtor
(4) Discharge	(d) The type of proceeding pursued under Chapter 7
(5) Order of relief	(e) A transfer that gives a creditor an unfair advantage over other creditors
(6) Meeting of creditors	(f) The legal forgiveness of a debt
(7) Voidable preference	(g) The type of proceeding pursued under Chapter 11
(8) Right of setoff	(h) The event when, among other things, a permanent trustee is elected
(9) Debtor	(i) Person who handles the assets and obligations during bankruptcy
(10) Trustee	(j) Person or entity who files for bankruptcy or has a petition filed against them

2. The bankruptcy court approved a repayment plan proposed by debtors, Eddie and Angela Freeman, pursuant to Chapter 13. Under the plan, the Freemans agreed to pay their secured creditors in full, but their unsecured creditors were to receive nothing. Public Finance is an unsecured creditor and appeals the affirmation of the plan, arguing that a plan that proposes no payment to unsecured creditors fails to meet the good-faith requirement of the bankruptcy law. Does "good faith" exist only when the debtor proposes payment to unsecured creditors? Explain.
3. Pauline lives in a state that exempts \$800 for an automobile owned by a debtor in a bankruptcy proceeding. Pauline's car was worth more than \$800, so she sought to recover \$800 of the sales price when the court sold the car to satisfy her debts. Her creditors contend that she is not entitled to any exemption for a car worth more than \$800. Who is correct? Explain.
4. A state court awarded a wife \$100,000 in alimony. The ex-husband did not pay it and later filed a petition under Chapter 7 of the bankruptcy law. He proved that his ex-wife did not need the money, as she was now gainfully employed and was in fact quite wealthy. Is this debt dischargeable? Explain.

5. Taylor borrowed money pursuant to the Guaranteed Student Loan Program. Three years later he filed a petition in voluntary bankruptcy and included his student loans on his list of debts. Taylor was given a general discharge in bankruptcy. Is he still liable for his student loans? Why or why not?
6. Robinson pleaded guilty to larceny in the second degree. The charge was based on her wrongful receipt of \$9,932.95 in welfare benefits from the state of Connecticut. As a part of her sentence, Robinson was required to make restitution at the rate of \$100 per month during her probationary period. Robinson filed a Chapter 7 bankruptcy petition. She sought to have her obligation to make restitution discharged. Although they received notice of the Chapter 7 petition, the staff members of the Connecticut Department of Income Maintenance and of the Probation Office did not respond. Robinson's obligation to make restitution was discharged. Later the Probation Office objected when the restitution payments ceased. Robinson filed this action to have the discharge affirmed. Were the restitution payments, as required as a condition of Robinson's probation, dischargeable in a Chapter 7 bankruptcy proceeding? Why?
7. The Chocolate Cookie Company entered into a twenty-year lease at an annual rental of \$4,000 a year. This lease contained a clause that the lease was not assignable without the lessor's consent. Eighteen months after the lease was signed, the Chocolate Cookie Company commenced voluntary liquidation proceedings. The trustee sought to enforce the lease, despite the non-assignability clause. May the trustee enforce the lease as written? Why?
8. With the facts as in problem 7, how much could the lessor claim in the bankruptcy proceeding if the trustee terminated the lease six months after the petition was filed (after two years of the lease term had passed)? Explain.
9. Despite financial difficulties, Barney bought two suits for \$500. When he received a bill for the suits, two weeks later, he was insolvent; however, he fully paid this bill in cash. One month later he filed a petition in bankruptcy. The appointed trustee sued to recover the \$500 paid, contending that the payment was a preferential transfer. Was the trustee correct? Why?
10. After filing for Chapter 11 reorganization, an employer continued to pay wages to its employees and to withhold the required amounts of FICA and income taxes from their paychecks. However, it did not pay the withheld amount to the IRS. Subsequently, the bankruptcy court appointed a trustee to supervise the liquidation of the estate. The government filed a claim for the taxes due from the reorganization period. Which priority claim does the government have? Explain.

### Internet Sources

The United States government provides general information bankruptcy at:

<http://www.uscourts.gov/bankruptcycourts/bankruptcybasics.html>