

## CHAPTER 30

# Bankruptcy Law

Historically, debtors had few rights. Today, in contrast, debtors have numerous rights. Some of these rights were discussed in Chapters 28 and 29. In this chapter, we look at another significant right of debtors: the right to petition for bankruptcy relief under federal law. Article I, Section 8, of the U.S. Constitution gave Congress the power to establish "uniform Laws on the subject of Bankruptcies throughout the United States." Bankruptcy law

in the United States has two goals—to protect a debtor by giving him or her a fresh start, free from creditors' claims, and to ensure equitable treatment to creditors who are competing for a debtor's assets. Federal bankruptcy legislation was first enacted in 1898 and has undergone several modifications since that time, most recently in 2005 as a result of the Bankruptcy Reform Act.<sup>1</sup> The 2005 act significantly overhauled certain provisions of the Bankruptcy Code

for the first time in twenty-five years.

1. The full title of the act is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (April 20, 2005). The bulk of the act became effective 180 days after being signed by the president on April 20, 2005. Thus, the new provisions took effect in October 2005. (Bankruptcy petitions that were filed before the act became effective continued to be administered and governed by the 1978 Reform Act, as amended.)



### Bankruptcy Proceedings

Bankruptcy proceedings are held in federal bankruptcy courts, which are under the authority of the U.S. district courts, and rulings from bankruptcy courts can be appealed to the district courts. Although bankruptcy law is federal law, state laws on secured transactions, liens, judgments, and exemptions also play a role in federal bankruptcy proceedings.

#### The Role of the Bankruptcy Courts

Essentially, a bankruptcy court fulfills the role of an administrative court for the federal district court concerning matters in bankruptcy. The bankruptcy court holds proceedings dealing with the procedures required to administer the estate of the debtor in bankruptcy (the *estate* consists of the debtor's assets, as will

be discussed shortly). A bankruptcy court can conduct a jury trial if the appropriate district court has authorized it and the parties to the bankruptcy consent.

#### Types of Bankruptcy Relief

Title 11 of the *United States Code* encompasses the Bankruptcy Code, which has eight chapters. Chapters 1, 3, and 5 of the Code contain general definitional provisions, as well as provisions governing case administration, creditors, the debtor, and the estate. These three chapters normally apply to all kinds of bankruptcies. The next five chapters of the Code set forth the different types of relief that debtors may seek. Chapter 7 provides for **liquidation** proceedings (the selling of all nonexempt assets and the distribution of the proceeds to the debtor's creditors). Chapter 9 governs the adjustment of a municipality's debts. Chapter 11 governs reorganizations. Chapters 12 and 13 provide for the adjustment of debts by parties with regular



incomes (family farmers and family fishermen under Chapter 12 and individuals under Chapter 13).<sup>2</sup> A debtor (except for a municipality) does not have to be insolvent<sup>3</sup> to file for bankruptcy relief under any chapter of the Bankruptcy Code. Anyone obligated to a creditor can declare bankruptcy.

In this chapter, we deal first with liquidation proceedings under Chapter 7 of the Code. We then examine the procedures required for Chapter 11 reorganizations and Chapter 12 and 13 plans. (The latter three chapters of the Code are known as "rehabilitation" chapters.)

### Special Treatment of Consumer-Debtors

To ensure that consumer-debtors are fully informed of the various types of relief available, the Code requires that the clerk of the bankruptcy court provide certain information to all consumer-debtors before they file for bankruptcy. (Recall from Chapter 29 that a consumer-debtor is a debtor whose debts result primarily from the purchase of goods for personal, family, or household use.) First, the clerk must give consumer-debtors written notice of the general purpose, benefits, and costs of each chapter of the Bankruptcy Code under which they might proceed. Second, under the 2005 act, the clerk must provide consumer-debtors with informational materials on the types of services available from credit counseling agencies.



## Liquidation Proceedings

Liquidation under Chapter 7 of the Bankruptcy Code is generally the most familiar type of bankruptcy proceeding and is often referred to as an *ordinary*, or *straight*, *bankruptcy*. Put simply, a debtor in a liquidation bankruptcy turns all assets over to a **trustee**. The trustee sells the nonexempt assets and distributes the

proceeds to creditors. With certain exceptions, the remaining debts are then **discharged** (extinguished), and the debtor is relieved of the obligation to pay the debts.

Any "person"—defined as including individuals, partnerships, and corporations<sup>4</sup>—may be a debtor in a liquidation proceeding. Railroads, insurance companies, banks, savings and loan associations, investment companies licensed by the Small Business Administration, and credit unions cannot be debtors in a liquidation bankruptcy, however. Other chapters of the Bankruptcy Code or other federal or state statutes apply to them. A husband and wife may file jointly for bankruptcy under a single petition.

A straight bankruptcy may be commenced by the filing of either a voluntary or an involuntary **petition in bankruptcy**—the document that is filed with a bankruptcy court to initiate bankruptcy proceedings. If a debtor files the petition, it is a voluntary bankruptcy. If one or more creditors file a petition to force the debtor into bankruptcy, it is called an involuntary bankruptcy. We discuss both voluntary and involuntary bankruptcy proceedings under Chapter 7 in the following subsections.

### Voluntary Bankruptcy

To bring a voluntary petition in bankruptcy, the debtor files official forms designated for that purpose in the bankruptcy court. The Bankruptcy Reform Act of 2005 specifies that before debtors can file a petition, they must receive credit counseling from an approved nonprofit agency within the 180-day period preceding the date of filing. The act provides detailed criteria for the **U.S. trustee** (a government official who performs appointment and other administrative tasks that a bankruptcy judge would otherwise have to perform) to use to approve nonprofit budget and counseling agencies and requires that a list of approved agencies be made publicly available.<sup>5</sup> A debtor filing a Chapter 7 petition must include a certificate proving that he or she received individual or group briefing from an approved counseling agency within the last 180 days (roughly six months).

2. There are no Chapters 2, 4, 6, 8, or 10 in Title 11. Such "gaps" are not uncommon in the *United States Code*. This is because chapter numbers (or other subdivisional unit numbers) are sometimes reserved for future use when a statute is enacted. (A gap may also appear if a law has been repealed.)

3. The inability to pay debts as they become due is known as *equitable* insolvency. A *balance sheet* insolvency, which exists when a debtor's liabilities exceed assets, is not the test. Thus, it is possible for debtors to petition for bankruptcy voluntarily or to be forced into involuntary bankruptcy even though their assets far exceed their liabilities. This may occur when a debtor's cash flow problems become severe.

4. The definition of *corporation* includes unincorporated companies and associations. It also covers labor unions.

5. The Bankruptcy Reform Act of 2005 also required the director of the Executive Office for the U.S. Trustees to develop a curriculum for financial-management training and create materials that can be used to educate individual debtors on how to better manage their finances.



The Code requires a consumer-debtor who has opted for liquidation bankruptcy proceedings to confirm the accuracy of the petition's contents. The debtor must also state in the petition, at the time of filing, that he or she understands the relief available under other chapters of the Code and has chosen to proceed under Chapter 7. If an attorney is representing the consumer-debtor, the attorney must file an affidavit stating that she or he has informed the debtor of the relief available under each chapter of the Bankruptcy Code. In addition, the 2005 act requires the attorney to reasonably attempt to verify the accuracy of the consumer-debtor's petition and schedules (described below). Failure to do so is considered perjury.

**Chapter 7 Schedules** The voluntary petition must contain the following schedules:

1. A list of both secured and unsecured creditors, their addresses, and the amount of debt owed to each.
2. A statement of the financial affairs of the debtor.
3. A list of all property owned by the debtor, including property that the debtor claims is exempt.
4. A list of current income and expenses.
5. A certificate of credit counseling (as discussed previously).
6. Proof of payments received from employers within sixty days prior to the filing of the petition.
7. A statement of the amount of monthly income, itemized to show how the amount is calculated.
8. A copy of the debtor's federal income tax return for the most recent year ending immediately before the filing of the petition.

As previously noted, the official forms must be completed accurately, sworn to under oath, and signed by the debtor. To conceal assets or knowingly supply false information on these schedules is a crime under the bankruptcy laws.

With the exception of tax returns, failure to file the required schedules within forty-five days after the filing of the petition (unless an extension of up to forty-five days is granted) will result in an automatic dismissal of the petition. The debtor has up to seven days before the date of the first creditors' meeting to provide a copy of the most recent tax returns to the trustee.

#### **Additional Information May Be Required**

At the request of the court, the trustee, or any party in interest, the debtor must file tax returns at the end of each tax year while the case is pending and provide copies to the court. This requirement also applies to

Chapter 11 and 13 bankruptcies (discussed later in this chapter). Also, if requested by the trustee, the debtor must provide a photo document establishing his or her identity (such as a driver's license or passport) or other such personal identifying information.

**Substantial Abuse** Prior to 2005, a bankruptcy court could dismiss a Chapter 7 petition for relief (discharge of debts) if the use of Chapter 7 would constitute a "substantial abuse" of that chapter. The Bankruptcy Reform Act of 2005 established a new system of "means testing" (the debtor's income) to determine whether a debtor's petition is presumed to be a "substantial abuse" of Chapter 7.

**When Abuse Will Be Presumed.** If the debtor's family income is greater than the median family income in the state in which the petition is filed, the trustee or any party in interest (such as a creditor) can bring a motion to dismiss the Chapter 7 petition. State median incomes vary from state to state and are calculated and reported by the U.S. Bureau of the Census.

The debtor's current monthly income is calculated using the last six months' average income, less certain "allowed expenses" reflecting the basic needs of the debtor. The monthly amount is then multiplied by twelve. If the resulting income exceeds the state median income by \$6,000 or more,<sup>6</sup> abuse is presumed, and the trustee or any creditor can file a motion to dismiss the petition. A debtor can rebut (refute) the presumption of abuse "by demonstrating special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative." (An example might be anticipated medical costs not covered by health insurance.) These additional expenses or adjustments must be itemized and their accuracy attested to under oath by the debtor.

**When Abuse Will Not Be Presumed.** If the debtor's income is below the state median (or if the debtor has successfully rebutted the means-test presumption), abuse will not be presumed. In these situations, the court may still find substantial abuse, but the creditors will not have standing (see Chapter 2) to file a motion to dismiss. Basically, this leaves intact the prior law on substantial abuse, allowing the court to consider such

6. This amount (\$6,000) is the equivalent of \$100 per month for five years, indicating that the debtor could pay at least \$100 per month under a Chapter 13 five-year repayment plan.

factors as the debtor's bad faith or circumstances indicating substantial abuse.

Can a debtor seeking relief under Chapter 7 exclude voluntary contributions to a retirement plan as a reasonably necessary expense in calculating her income?

The Code does not disallow the contributions, but whether their exclusion constitutes substantial abuse requires a review of the debtor's circumstances, as in the following case.



### EXTENDED CASE 30.1 **Hebbring v. U.S. Trustee**

United States Court of Appeals, Ninth Circuit, 2006. 463 F.3d 902.

**WARDLAW, Circuit Judge.**

\* \* \* \*

Lisa Hebbring filed a Chapter 7 bankruptcy petition in the United States Bankruptcy Court for the District of Nevada on June 5, 2003, seeking relief from \$11,124 in consumer credit card debt. Her petition and accompanying schedules show that Hebbring owns a single-family home in Reno, Nevada valued at \$160,000, on which she owes \$154,103; a 2001 Volkswagen Beetle valued at \$14,000, on which she owes \$18,839; and miscellaneous personal property valued at \$1,775. Hebbring earns approximately \$49,000 per year as a customer service representative for SBC Nevada. Her petition reports monthly net income of \$2,813 and monthly expenditures of \$2,897, for a monthly deficit of \$84. In calculating her income, Hebbring excluded a \$232 monthly pre-tax deduction for a 401(k) plan and an \$81 monthly after-tax deduction for a retirement savings bond.

abuse, see 11 U.S.C. [Section] 707(b), arguing that she should not be allowed to deduct voluntary retirement contributions from her income and that her recent paystubs showed that her gross income was higher than she had claimed. As a result, the Trustee contended, Hebbring's monthly net income was actually \$3,512, leaving her \$615 per month in disposable income, sufficient to repay 100% of her unsecured debt over three years.

\* \* \* \*

The bankruptcy court granted the Trustee's motion to dismiss \* \* \* [and ultimately Hebbring appealed the dismissal to the U.S. Court of Appeals for the Ninth Circuit].

\* \* \* \*

\* \* \* In determining whether a petition constitutes a substantial abuse of Chapter 7, we examine the totality of the circumstances, focusing principally on whether the debtor will have sufficient future disposable income to fund a Chapter 13 plan that would pay a substantial portion of his unsecured debt. To calculate a debtor's disposable income, we begin with current monthly income and subtract amounts reasonably necessary to be expended \* \* \* for the maintenance or support of the debtor or a dependent of the debtor.

\* \* \* [Some] courts \* \* \* have adopted a case-by-case approach, under which contributions to a retirement plan may be found reasonably necessary depending on the debtor's circumstances.

We believe this \* \* \* approach better comports [is consistent] with Congress's intent, as expressed in the language, purpose, and structure of the Bankruptcy Code. By not defining the phrase "reasonably necessary" or providing any examples of expenses that categorically are or are not reasonably necessary, the Code suggests courts should examine each debtor's specific circumstances to determine whether a claimed expense is reasonably necessary for that debtor's maintenance or support. We find no evidence that Congress intended courts to employ a *per se* rule against retirement contributions, which may be crucial for debtors' support upon retirement, particularly for older debtors who have little or no savings. Where Congress intended courts to use a *per se* rule rather than a case-by-case approach in classifying financial interests or obligations under the Bankruptcy Code, it has explicitly communicated its intent. *Congress's decision not to categorically exclude any specific expense, including retirement contributions, from being considered reasonably necessary is probative [an indication] of its intent.* [Emphasis added.]



## CASE 30.1 CONTINUED

Requiring a fact-specific analysis to determine whether an expense is reasonably necessary is sound policy because it comports with the Code's approach to identifying substantial abuse of the Chapter 7 relief provisions. \* \* \* Congress chose [not] to define "substantial abuse" \* \* \*. Congress thus left a flexible standard enabling courts to address each petition on its own merit. That Congress granted courts the discretion to identify substantial abuse necessarily suggests it intended courts to have the discretion to answer the subsidiary question of whether particular expenses are reasonably necessary.

In light of these considerations, and in the absence of any indication that Congress sought to prohibit debtors from voluntarily contributing to retirement plans *per se*, we conclude that bankruptcy courts have discretion to determine whether retirement contributions are a reasonably necessary expense for a particular debtor based on the facts of each individual case. In making this fact-intensive determination, courts should consider a number of factors, including but not limited to: the debtor's age, income, overall budget, expected date of retirement, existing retirement savings, and amount of contributions; the likelihood that stopping contributions will jeopardize the debtor's fresh start by forcing the debtor to make up lost contributions after emerging from bankruptcy; and the needs of the debtor's dependents. *Courts must allow debtors to seek bankruptcy protection while voluntarily saving for retirement if such savings appear reasonably necessary for the maintenance or support of the debtor or the debtor's dependents.* [Emphasis added.]

\* \* \* \*

Here, the bankruptcy court \* \* \* found \* \* \* that Hebbring's retirement contributions are not a reasonably necessary expense based on her age and specific financial circumstances. \* \* \* When she filed her bankruptcy petition, Hebbring was only thirty-three years old and was contributing approximately 8% of her gross income toward her retirement. Although Hebbring had accumulated only \$6,289 in retirement savings, she was earning \$49,000 per year and making mortgage payments on a house. In light of these circumstances, the bankruptcy court's conclusion that Hebbring's retirement contributions are not a reasonably necessary expense is not clearly erroneous.

\* \* \* \*

For the foregoing reasons, the district court's order affirming the bankruptcy court's order dismissing this case is AFFIRMED.



## QUESTIONS

1. Is it fair for the court to treat retirement contributions differently depending on a person's age?
2. Is it likely to have made a difference to the result in this case that the debtor's retirement contributions were automatically and electronically deducted from her pay? Explain.

**Additional Grounds for Dismissal** As noted, a debtor's voluntary petition for Chapter 7 relief may be dismissed for substantial abuse or for failing to provide the necessary documents (such as schedules and tax returns) within the specified time. In addition, a motion to dismiss a Chapter 7 filing might be granted in two other situations under the Bankruptcy Reform Act of 2005. First, if the debtor has been convicted of a violent crime or a drug-trafficking offense, the victim can file a motion to dismiss the voluntary petition.<sup>7</sup>

7. Note that the court may not dismiss a case on this ground if the debtor's bankruptcy is necessary to satisfy a claim for a domestic-support obligation.

Second, if the debtor fails to pay postpetition domestic-support obligations (which include child and spousal support), the court may dismiss the debtor's Chapter 7 petition.

**Order for Relief** If the voluntary petition for bankruptcy is found to be proper, the filing of the petition will itself constitute an **order for relief**. (An order for relief is a court's grant of assistance to a petitioner.) Once a consumer-debtor's voluntary petition has been filed, the clerk of the court or other appointee must give the trustee and creditors notice of the order for relief by mail not more than twenty days after entry of the order.

## Involuntary Bankruptcy

An involuntary bankruptcy occurs when the debtor's creditors force the debtor into bankruptcy proceedings. An involuntary case cannot be commenced against a farmer<sup>8</sup> or a charitable institution. For an involuntary action to be filed against other debtors, the following requirements must be met: If the debtor has twelve or more creditors, three or more of these creditors having unsecured claims totaling at least \$13,475 must join in the petition. If a debtor has fewer than twelve creditors, one or more creditors having a claim of \$13,475 may file.

If the debtor challenges the involuntary petition, a hearing will be held, and the bankruptcy court will enter an order for relief if it finds either of the following:

1. The debtor is generally not paying debts as they become due.
2. A general receiver, assignee, or custodian took possession of, or was appointed to take charge of, substantially all of the debtor's property within 120 days before the filing of the petition.

If the court grants an order for relief, the debtor will be required to supply the same information in the bankruptcy schedules as in a voluntary bankruptcy.

An involuntary petition should not be used as an everyday debt-collection device, and the Code provides penalties for the filing of frivolous petitions against debtors. Judgment may be granted against the petitioning creditors for the costs and attorneys' fees incurred by the debtor in defending against an involuntary petition that is dismissed by the court. If the petition is filed in bad faith, damages can be awarded for injury to the debtor's reputation. Punitive damages may also be awarded.

## Automatic Stay

The moment a petition, either voluntary or involuntary, is filed, an **automatic stay**, or suspension, of virtually all actions by creditors against the debtor or the debtor's property normally goes into effect. In other words, once a petition has been filed, creditors cannot contact the debtor by phone or mail or start any legal proceedings to recover debts or to repossess property.

8. The definition of *farmer* includes persons who receive more than 50 percent of their gross income from farming operations, such as tilling the soil, dairy farming, ranching, or the production or raising of crops, poultry, or livestock. Corporations and partnerships may qualify under certain conditions.

A secured creditor or other party in interest, however, may petition the bankruptcy court for relief from the automatic stay. The Code provides that if a creditor knowingly violates the automatic stay (a willful violation), any injured party, including the debtor, is entitled to recover actual damages, costs, and attorneys' fees, and may be awarded punitive damages as well.

Underlying the Code's automatic-stay provision for a secured creditor is a concept known as *adequate protection*. The **adequate protection doctrine**, among other things, protects secured creditors from losing their security as a result of the automatic stay. The bankruptcy court can provide adequate protection by requiring the debtor or trustee to make periodic cash payments or a one-time cash payment (or to provide additional collateral or replacement liens) to the extent that the stay may actually cause the value of the property to decrease.

**Exceptions to the Automatic Stay** The 2005 Bankruptcy Reform Act provided several exceptions to the automatic stay. A new exception was created for domestic-support obligations, which include any debt owed to or recoverable by a spouse, former spouse, or child of the debtor; a child's parent or guardian; or a governmental unit. In addition, proceedings against the debtor related to divorce, child custody or visitation, domestic violence, and support enforcement are not stayed. Also excepted are investigations by a securities regulatory agency, the creation or perfection of statutory liens for property taxes or special assessments on real property, eviction actions on judgments obtained prior to filing the petition, and withholding from the debtor's wages for repayment of a retirement account loan.

**Limitations on the Automatic Stay** Under the new Code, if a creditor or other party in interest requests relief from the stay, the stay will automatically terminate sixty days after the request, unless the court grants an extension<sup>9</sup> or the parties agree otherwise. Also, the automatic stay on secured debts (see Chapter 29) will terminate thirty days after the petition is filed if the debtor had filed a bankruptcy petition that was dismissed within the prior year. Any party in interest can request the court to extend the stay by showing that the filing is in good faith.

9. The court might grant an extension, for example, on a motion by the trustee that the property is of value to the estate.



If two or more bankruptcy petitions were dismissed during the prior year, the Code presumes bad faith, and the automatic stay does not go into effect until the court determines that the filing was made in good faith. In addition, if the petition is subsequently dismissed because the debtor failed to file the required documents within thirty days of filing, for example, the stay is terminated. Finally, the automatic stay on secured property terminates forty-five days after the creditors' meeting (to be discussed shortly) unless the debtor redeems or reaffirms certain debts (*reaffirmation* is discussed later in this chapter). In other words, the debtor cannot keep the secured property (such as a financed automobile), even if she or he continues to make payments on it, without reinstating the rights of the secured party to collect on the debt.

### Property of the Estate

On the commencement of a liquidation proceeding under Chapter 7, an *estate in property* is created. The estate consists of all the debtor's legal and equitable interests in property currently held, wherever located, together with community property (property jointly owned by a husband and wife in certain states—see Chapter 48), property transferred in a transaction voidable by the trustee, proceeds and profits from the property of the estate, and certain after-acquired property. Interests in certain property—such as gifts, inheritances, property settlements (from divorce), and life insurance death proceeds—to which the debtor becomes entitled *within 180 days after filing* may also become part of the estate. Under the 2005 act, withholdings for employee benefit plan contributions are excluded from the estate. Generally, though, the filing of a bankruptcy petition fixes a dividing line: property acquired prior to the filing of the petition becomes property of the estate, and property acquired after the filing of the petition, except as just noted, remains the debtor's.

### Creditors' Meeting and Claims

Within a reasonable time after the order for relief has been granted (not less than twenty days or more than forty days), the trustee must call a meeting of the creditors listed in the schedules filed by the debtor. The bankruptcy judge does not attend this meeting, but the debtor is required to attend and to submit to examination under oath by the creditors and the trustee. At the meeting, the trustee ensures that the debtor is aware of the potential consequences of bankruptcy and of his

or her ability to file for bankruptcy under a different chapter of the Bankruptcy Code.

To be entitled to receive a portion of the debtor's estate, each creditor normally files a *proof of claim* with the bankruptcy court clerk within ninety days of the creditors' meeting.<sup>10</sup> The proof of claim lists the creditor's name and address, as well as the amount that the creditor asserts is owed to the creditor by the debtor. A proof of claim is necessary if there is any dispute concerning the claim. Generally, any legal obligation of the debtor is a claim (except claims for breach of employment contracts or real estate leases for terms longer than one year).

### Exemptions

The trustee takes control over the debtor's property, but an individual debtor is entitled to exempt certain property from the bankruptcy. The Bankruptcy Code exempts the following property:<sup>11</sup>

1. Up to \$20,200 in equity in the debtor's residence and burial plot (the homestead exemption).
2. Interest in a motor vehicle up to \$3,225.
3. Interest, up to \$525 for a particular item, in household goods and furnishings, wearing apparel, appliances, books, animals, crops, and musical instruments (the aggregate total of all items is limited, however, to \$10,775).<sup>12</sup>
4. Interest in jewelry up to \$1,350.
5. Interest in any other property up to \$1,075, plus any unused part of the \$20,200 homestead exemption up to \$10,125.
6. Interest in any tools of the debtor's trade up to \$2,025.
7. Any unmatured life insurance contract owned by the debtor.
8. Certain interests in accrued dividends and interest under life insurance contracts owned by the debtor, not to exceed \$10,775.

10. This ninety-day rule applies in Chapter 12 and Chapter 13 bankruptcies as well.

11. The dollar amounts stated in the Bankruptcy Code are adjusted automatically every three years on April 1 based on changes in the Consumer Price Index. The adjusted amounts are rounded to the nearest \$25. The amounts stated in this chapter are in accordance with those computed on April 1, 2007.

12. The 2005 Bankruptcy Reform Act clarified that "household goods and furnishings" includes, for example, one computer, one radio, one television, and one videocassette recorder. Other items, such as works of art, electronic entertainment equipment with a fair market value of more than \$500, and antiques and jewelry (except wedding rings) valued at more than \$500, are not included.



9. Professionally prescribed health aids.
10. The right to receive Social Security and certain welfare benefits, alimony and support, certain retirement funds and pensions, and education savings accounts held for specific periods of time.
11. The right to receive certain personal-injury and other awards up to \$20,200.

Individual states have the power to pass legislation precluding debtors from using the federal exemptions within the state; a majority of the states have done this (see Chapter 28). In those states, debtors may use only state, not federal, exemptions. In the rest of the states, an individual debtor (or a husband and wife filing jointly) may choose either the exemptions provided under state law or the federal exemptions.

### The Homestead Exemption

The 2005 Bankruptcy Reform Act significantly changed the law for those debtors seeking to use state homestead exemption statutes (which were discussed in Chapter 28). Under prior law, the homestead exemptions of six states, including Florida and Texas, allowed debtors petitioning for bankruptcy to shield *unlimited* amounts of equity in their homes from creditors. The 2005 act places limits on the amount that can be claimed as exempt in bankruptcy. Also, under the act, a debtor must have lived in a state for two years prior to filing the petition to be able to use the state homestead exemption (the prior law required only six months).

In general, if the debtor acquired the homestead within three and a half years preceding the date of filing, the maximum equity exempted is \$136,875, even if state law would permit a higher amount. (This does not apply to equity that has been rolled over during the specified period from the sale of a previous homestead in the same state.) Moreover, the debtor may not claim the homestead exemption if he or she has committed any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding five years. Similarly, a debtor who has been convicted of a felony may not be able to claim the exemption.

### The Trustee

Promptly after the order for relief in the liquidation proceeding has been entered, a trustee is appointed. The basic duty of the trustee is to collect the debtor's available estate and reduce it to cash for distribution, preserving the interests of both the debtor and unsecured creditors. This requires that the trustee be

accountable for administering the debtor's estate. To enable the trustee to accomplish this duty, the Code gives the trustee certain powers, stated in both general and specific terms. These powers must be exercised within two years of the order for relief.

Under the 2005 act, the trustee has additional duties with regard to means testing debtors and protecting domestic-support creditors. The trustee is required to promptly review all materials filed by the debtor to determine if there is substantial abuse. Within ten days after the first meeting of the creditors, the trustee must file a statement indicating whether the case is presumed to be an abuse under the means test. The trustee must provide all creditors with a copy of this statement. When there is a presumption of abuse, the trustee must either file a motion to dismiss the petition (or convert it to a Chapter 13 case) or file a statement setting forth the reasons why a motion would not be appropriate. If the debtor owes a domestic-support obligation (such as child support), the trustee is required to provide written notice of the bankruptcy to the claim holder (a former spouse, for example).

**The Trustee's Powers** The trustee occupies a position *equivalent* in rights to that of certain other parties. For example, the trustee has the same rights as a creditor who could have obtained a judicial lien or levy execution on the debtor's property. This means that a trustee has priority over an unperfected secured party (see Chapter 29) as to the debtor's property.<sup>13</sup> This right of a trustee, which is equivalent to that of a lien creditor, is known as the *strong-arm power*. A trustee also has power equivalent to that of a *bona fide purchaser* of real property from the debtor.

**The Right to Possession of the Debtor's Property** The trustee has the power to require persons holding the debtor's property at the time the petition is filed to deliver the property to the trustee. (Usually, though, the trustee takes constructive, rather than actual, possession of the debtor's property. For example, to obtain control of a debtor's business inventory, a trustee might change the locks on the doors to the business and hire a security guard.)

**Avoidance Powers** The trustee also has specific powers of *avoidance*—that is, the trustee can set aside

13. Nevertheless, in most states a creditor with an unperfected purchase-money security interest may prevail against a trustee if the creditor perfects (files) within twenty days of the debtor's receipt of the collateral. This is normally true even if the debtor files a bankruptcy petition before the creditor perfects.



a sale or other transfer of the debtor's property, taking it back as a part of the debtor's estate. These powers include any voidable rights available to the debtor, preferences, certain statutory liens, and fraudulent transfers by the debtor. Each of these powers is discussed in more detail below. Note that under the 2005 act, the trustee no longer has the power to avoid any transfer that was a bona fide payment of a domestic-support debt.

The debtor shares most of the trustee's avoidance powers. Thus, if the trustee does not take action to enforce one of the rights mentioned above, the debtor in a liquidation bankruptcy can still enforce that right.<sup>14</sup>

**Voidable Rights** A trustee steps into the shoes of the debtor. Thus, any reason that a debtor can use to obtain the return of her or his property can be used by the trustee as well. These grounds include fraud, duress, incapacity, and mutual mistake.

For example, Ben sells his boat to Tara. Tara gives Ben a check, knowing that she has insufficient funds in her bank account to cover the check. Tara has committed fraud. Ben has the right to avoid that transfer and recover the boat from Tara. Once an order for relief under Chapter 7 of the Code has been entered for Ben, the trustee can exercise the same right to recover the boat from Tara, and the boat becomes a part of the debtor's estate.

**Preferences** A debtor is not permitted to transfer property or to make a payment that favors—or gives a **preference** to—one creditor over others. The trustee is allowed to recover payments made both voluntarily and involuntarily to one creditor in preference over another. If a **preferred creditor** (one who has received a preferential transfer from the debtor) has sold the property to an innocent third party, the trustee cannot recover the property from the innocent party. The preferred creditor, however, generally can be held accountable for the value of the property.

To have made a preferential payment that can be recovered, an *insolvent* debtor generally must have transferred property, for a *preexisting* debt, within *ninety days* prior to the filing of the bankruptcy petition. The transfer must have given the creditor more

than the creditor would have received as a result of the bankruptcy proceedings. The trustee need not prove insolvency, as the Code presumes that the debtor is insolvent during this ninety-day period.

**Preferences to Insiders.** Sometimes, the creditor receiving the preference is an **insider**—an individual, a partner, a partnership, a corporation, or an officer or a director of a corporation (or a relative of one of these) who has a close relationship with the debtor. In this situation, the avoidance power of the trustee is extended to transfers made within *one year* before filing; however, the *presumption* of insolvency is confined to the ninety-day period. Therefore, the trustee must prove that the debtor was insolvent at the time of a transfer that occurred prior to the ninety-day period.

**Transfers That Do Not Constitute Preferences.** Not all transfers are preferences. To be a preference, the transfer must be made for something other than current consideration. Most courts generally assume that payment for services rendered within fifteen days prior to the payment is not a preference. If a creditor receives payment in the ordinary course of business from an individual or business debtor, such as payment of last month's telephone bill, the trustee in bankruptcy cannot recover the payment. To be recoverable, a preference must be a transfer for an antecedent (preexisting) debt, such as a year-old printing bill. In addition, the Code permits a consumer-debtor to transfer any property to a creditor up to a total value of \$5,475, without the transfer's constituting a preference (this amount was increased from \$600 to \$5,000 by the 2005 act). Payment of domestic-support debts does not constitute a preference.

**Liens on Debtor's Property** The trustee has the power to avoid certain statutory liens against the debtor's property, such as a landlord's lien for unpaid rent. The trustee can avoid statutory liens that first became effective against the debtor when the bankruptcy petition was filed or when the debtor became insolvent. The trustee can also avoid any lien against a good faith purchaser that was not perfected or enforceable on the date of the bankruptcy filing.

**Fraudulent Transfers** The trustee may avoid fraudulent transfers or obligations if they were made within two years of the filing of the petition or if they were made with actual intent to hinder, delay, or

14. Under a Chapter 11 bankruptcy (to be discussed later), for which no trustee other than the debtor generally exists, the debtor has the same avoidance powers as a trustee under Chapter 7. Under Chapters 12 and 13 (also to be discussed later), a trustee must be appointed.

defraud a creditor. Transfers made for less than a reasonably equivalent consideration are also vulnerable if by making them, the debtor became insolvent or intended to incur debts that he or she could not pay. Similarly, a transfer that left a debtor engaged in business with an unreasonably small amount of capital may be considered fraudulent. When a fraudulent transfer is made outside the Code's two-year limit, creditors may seek alternative relief under state laws. Some state laws often allow creditors to recover for transfers made up to three years prior to the filing of a petition.

### Distribution of Property

The Code provides specific rules for the distribution of the debtor's property to secured and unsecured creditors. (We will examine these distributions shortly.) Anything remaining after the priority classes of creditors have been satisfied is turned over to the debtor. Exhibit 30-1 illustrates graphically the collection and distribution of property in most voluntary bankruptcies.

In a bankruptcy case in which the debtor has no assets (called "no-asset cases"), creditors are notified of the debtor's petition for bankruptcy but are instructed not to file a claim. In no-asset cases, the unsecured creditors will receive no payment, and most, if not all, of these debts will be discharged.

**Distribution to Secured Creditors** The rights of perfected secured creditors were discussed in Chapter 29. The Code provides that a consumer-debtor must file with the clerk a statement of intention with

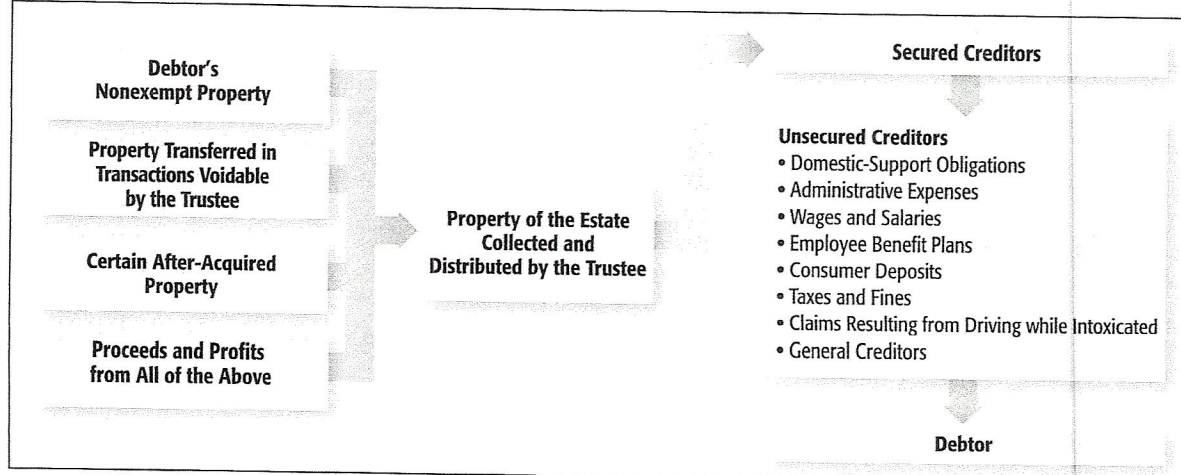
respect to the secured collateral. The statement must be filed within thirty days of filing a liquidation petition or before the date of the first meeting of the creditors (whichever is first). The statement must indicate whether the debtor will redeem the collateral (make a single payment equal to the current value of the property), reaffirm the debt (continue making payments on the debt), or surrender the property to the secured party.<sup>15</sup> The trustee is obligated to enforce the debtor's statement within forty-five days after the meeting of the creditors. As noted previously, failure of the debtor to redeem or reaffirm within forty-five days terminates the automatic stay.

If the collateral is surrendered to the perfected secured party, the secured creditor can either accept the property in full satisfaction of the debt or foreclose on the collateral and use the proceeds to pay off the debt. Thus, the perfected secured party has priority over unsecured parties as to the proceeds from the disposition of the collateral. When the proceeds from sale of the collateral exceed the amount of the perfected secured party's claim, the secured party also has priority to an amount that will cover the reasonable fees and costs incurred. Any excess over this amount is returned to the trustee and used to satisfy the claims of unsecured creditors. If the collateral is insufficient to cover the secured debt owed, the secured creditor becomes an unsecured creditor for the difference.

15. Also, if applicable, the debtor must specify whether the collateral will be claimed as exempt property.

### EXHIBIT 30-1 • Collection and Distribution of Property in Most Voluntary Bankruptcies

This exhibit illustrates the property that might be collected in a debtor's voluntary bankruptcy and how it might be distributed to creditors. Involuntary bankruptcies and some voluntary bankruptcies could include additional types of property and other creditors.





**Distribution to Unsecured Creditors**

Bankruptcy law establishes an order of priority for classes of debts owed to *unsecured* creditors, and they are paid in the order of their priority. Each class must be fully paid before the next class is entitled to any of the remaining proceeds. If there are insufficient proceeds to pay fully all the creditors in a class, the proceeds are distributed *proportionately* to the creditors in that class, and classes lower in priority receive nothing.

The new bankruptcy law elevated domestic-support (mainly child-support) obligations to the highest priority of unsecured claims—so these are the first debts to be paid. After that, administrative expenses related to the bankruptcy (such as court costs, trustee fees, and attorneys' fees) are paid; next come any expenses that a debtor in an involuntary bankruptcy incurs in the ordinary course of business. Unpaid wages, salaries, and commissions earned within ninety days prior to the petition are paid next, followed by certain claims for contributions to employee benefit plans, claims by some farmers and fishermen, consumer deposits, and certain taxes. Claims of general creditors rank last in the order of priority, which is why these unsecured creditors often receive little, if anything, in a Chapter 7 bankruptcy.

**Discharge**

From the debtor's point of view, the primary purpose of liquidation is to obtain a fresh start through a discharge of debts.<sup>16</sup> As mentioned earlier, once the debtor's assets have been distributed to creditors as permitted by the Code, the debtor's remaining debts are then discharged, meaning that the debtor is not obligated to pay them. Any judgments on the debts are voided, and creditors are enjoined (prevented) from bringing any actions to collect them. A discharge does not affect the liability of a co-debtor.

Certain debts, however, are not dischargeable in bankruptcy. Also, certain debtors may not qualify to have all debts discharged in bankruptcy. These situations are discussed next.

16. Discharges are granted under Chapter 7 only to individuals, not to corporations or partnerships. The latter may use Chapter 11, or they may terminate their existence under state law.

**Exceptions to Discharge** Discharge of a debt may be denied because of the nature of the claim or the conduct of the debtor. A court will not discharge claims that are based on a debtor's willful or malicious conduct or fraud,<sup>17</sup> or claims related to property or funds that the debtor obtained by false pretenses, embezzlement, or larceny. Any monetary judgment against the debtor for driving while intoxicated cannot be discharged in bankruptcy. When a debtor fails to list a creditor on the bankruptcy schedules (and thus the creditor is not notified of the bankruptcy), that creditor's claims are not dischargeable.

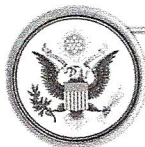
Claims that are not dischargeable in a liquidation bankruptcy include amounts due to the government for taxes, fines, or penalties.<sup>18</sup> Additionally, amounts borrowed by the debtor to pay these taxes will not be discharged. Domestic-support obligations and property settlements arising from a divorce or separation cannot be discharged. Certain student loans and educational debts are not dischargeable (unless payment of the loans imposes an undue hardship on the debtor and the debtor's dependents),<sup>19</sup> nor are amounts due on a retirement account loan. Consumer debts for purchasing luxury items worth more than \$550 and cash advances totaling more than \$825 generally are not dischargeable.

In the following case, the court considered whether to order the discharge of a debtor's student loan obligations. What does a debtor have to prove to show "undue hardship"?

17. Even if a debtor who is sued for fraud settles the lawsuit, the United States Supreme Court has held that the amount due under the settlement agreement may not be discharged in bankruptcy because of the underlying fraud. See *Archer v. Warner*, 538 U.S. 314, 123 S.Ct. 1462, 155 L.Ed.2d 454 (2003).

18. Taxes accruing within three years prior to bankruptcy are nondischargeable, including federal and state income taxes, employment taxes, taxes on gross receipts, property taxes, excise taxes, customs duties, and any other taxes for which the government claims the debtor is liable in some capacity. See 11 U.S.C. Sections 507(a)(8), 523(a)(1).

19. For a case discussing whether a student loan should be discharged because of undue hardship, see *In re Savage*, 311 Bankr. 835 (1st Cir. 2004).

**CASE 30.2 In re Mosley**

United States Court of Appeals, Eleventh Circuit, 2007. 494 F.3d 1320.

• **Background and Facts** Keldric Mosley incurred student loans while attending Georgia's Alcorn State University between 1989 and 1994. At Alcorn, Mosley joined the U.S. Army Reserve Officers'

CASE CONTINUES

**CASE 30.2 CONTINUED** Training Corps. During training in 1993, Mosley fell from a tank and injured his hip and back. Medical problems from his injuries led him to resign his commission. He left Alcorn to live with his mother in Atlanta from 1994 to 1999. He worked briefly for several employers, but depressed and physically limited by his injury, he was unable to keep any of the jobs. He tried to return to school but could not obtain financial aid because of the debt he had incurred at Alcorn. In 1999, a federal bankruptcy court granted him a discharge under Chapter 7, but it did not include the student loans. In 2000, after a week at the Georgia Regional Hospital, a state-supported mental-health facility, Mosley was prescribed medication through the U.S. Department of Veterans' Affairs for depression, back pain, and other problems. By 2004, his monthly income consisted primarily of \$210 in disability benefits from the Veterans' Administration. Homeless and in debt for \$45,000 to Educational Credit Management Corporation, Mosley asked the bankruptcy court to reopen his case. The court granted him a discharge of his student loans on the basis of undue hardship. Educational Credit appealed to the U.S. Court of Appeals for the Eleventh Circuit.



**IN THE LANGUAGE OF THE COURT**  
**JOHN R. GIBSON, Circuit Judge.**

\* \* \* \*

\* \* \* To establish undue hardship [the courts require:] \* \* \*

(1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living \* \* \* 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.

Educational Credit does not contest that Mosley has satisfied the first requirement, an inability to maintain a minimal standard of living, as he lives below the poverty line and has for several years. It contends that the bankruptcy court improperly relaxed Mosley's evidentiary burden [duty to produce enough evidence to prove an assertion] on the second and third requirements \* \* \*. The bankruptcy court concluded that Mosley established undue hardship with his credible testimony that he has tried to obtain work but, for ten years, his "substantial physical and emotional ailments" have prevented him from holding a steady job. \* \* \* Educational Credit argues that corroborating medical evidence independent from the debtor's testimony is required \* \* \* where medical disabilities are the "additional circumstances" \* \* \*.

\* \* \* \*

We \* \* \* decline to adopt a rule requiring Mosley to submit independent medical evidence to corroborate his testimony that his depression and back problems were additional circumstances likely to render him unable to repay his student loans. We see no inconsistency between \* \* \* holding that the debtor's detailed testimony was sufficient evidence of undue hardship and the \* \* \* cases cited by Educational Credit where debtors' less detailed testimony was held to be insufficient. \* \* \*

Educational Credit also argues that Mosley's medical prognosis [prediction about how a situation will develop in the future] is a subject requiring specialized medical knowledge \* \* \* and that Mosley was not competent to give his opinion on this matter. Mosley, however, did not purport to give an opinion on his medical prognosis, but rather testified from personal knowledge about how his struggles with depression, back pain, and the side effects of his medication have made it difficult for him to obtain work. \* \* \*

We now turn to Educational Credit's argument that the record does not support a conclusion of undue hardship because Mosley's testimony did not establish \* \* \* that he likely will be unable to repay his student loans in the future and that he has made good faith efforts to repay the loans. \* \* \*

\* \* \* In showing that "additional circumstances" make it unlikely that he will be able to repay his loans for a significant period of time, Mosley testified that his depression and chronic back pain have frustrated his efforts to work, and thus his ability to repay his loans, as well as to provide himself with shelter, food, and transportation, for several years. \* \* \* Mosley's testimony \* \* \* is \* \* \* unrefuted and is corroborated by his Social Security earnings statements. He testified that his back problems preclude him from heavy lifting, which rules out most of the jobs available [through the Georgia Department of Labor where] he seeks work. Exacerbating [aggra-



## CASE 30.2 CONTINUED

vating] the problem, his medications make it difficult for him to function. He did not finish college and has been unable to complete the training necessary to learn a trade. Mosley relies on public assistance programs for health care and food, and \* \* \* there is no reason to believe that Mosley's condition will improve in the future. \* \* \*

The bankruptcy court also correctly concluded that Mosley's testimony established the \* \* \* requirement that he has made good faith efforts to repay his student loans. \* \* \* *Good faith is measured by the debtor's efforts to obtain employment, maximize income, and minimize expenses; his default should result, not from his choices, but from factors beyond his reasonable control.* Mosley has attempted to find work, as demonstrated by the series of jobs he held while living with his mother from 1994 to 1999 and his participation in the [state] labor pool since 2000. Because of his medical conditions, Mosley has been largely unsuccessful, and thus has not had the means even to attempt to make payments. \* \* \* [H]is income has been below the poverty line for years. He lives without a home and car and cannot further minimize his expenses. [Emphasis added.]

• **Decision and Remedy** *The U.S. Court of Appeals for the Eleventh Circuit affirmed the lower court's discharge of the debtor's student loans. The debtor's medical problems, lack of skills, and "dire living conditions" made it unlikely that he would be able to hold a job and repay the loans. Furthermore, the debtor "has made good faith efforts to repay his student loans and would suffer undue hardship if they were excepted from discharge."*

• **The Ethical Dimension** *Should a debtor be required to attempt to negotiate a repayment plan with a creditor to demonstrate good faith? Why or why not?*

• **The Global Dimension** *If this debtor were to relocate to a country with a lower cost of living than the United States, should his change in circumstances be a ground for revoking the discharge? Explain your answer.*

**Objections to Discharge** In addition to the exceptions to discharge previously discussed, a bankruptcy court may also deny the discharge of the *debtor* (as opposed to the *debt*). In the latter situation, the assets of the debtor are still distributed to the creditors, but the debtor remains liable for the unpaid portion of all claims. Grounds for the denial of discharge of the debtor include the following:

1. The debtor's concealment or destruction of property with the intent to hinder, delay, or defraud a creditor.
2. The debtor's fraudulent concealment or destruction of financial records.
3. The granting of a discharge to the debtor within eight years of the filing of the petition. (This period was increased from six to eight years by the 2005 act.)
4. The debtor's failure to complete the required consumer education course (unless such a course is unavailable).
5. Proceedings in which the debtor could be found guilty of a felony (basically, a court may not discharge any debt until the completion of felony proceedings against the debtor).

**Revocation of Discharge** On petition by the trustee or a creditor, the bankruptcy court can, within one year, revoke the discharge decree. The discharge decree will be revoked if it is discovered that the debtor acted fraudulently or dishonestly during the bankruptcy proceedings. The revocation renders the discharge void, allowing creditors not satisfied by the distribution of the debtor's estate to proceed with their claims against the debtor.

### Reaffirmation of Debt

An agreement to pay a debt dischargeable in bankruptcy is called a **reaffirmation agreement**. A debtor may wish to pay a debt—for example, a debt owed to a family member, physician, bank, or some other creditor—even though the debt could be discharged in bankruptcy. Also, as noted previously, under the 2005 act a debtor cannot retain secured property while continuing to pay without entering into a reaffirmation agreement.

**Reaffirmation Procedures** To be enforceable, reaffirmation agreements must be made before

the debtor is granted a discharge. The agreement must be signed and filed with the court (along with certain required disclosures, described next). Court approval is required unless the debtor is represented by an attorney during the negotiation of the reaffirmation and submits the proper documents and certifications. Even when the debtor is represented by an attorney, court approval may be required if it appears that the reaffirmation will result in undue hardship on the debtor.<sup>20</sup> When court approval is required, a separate hearing will take place. The court will approve the reaffirmation only if it finds that the agreement will not result in undue hardship to the debtor and that the reaffirmation is consistent with the debtor's best interests.

**New Reaffirmation Disclosures** To discourage creditors from engaging in abusive reaffirmation practices, the 2005 act added new requirements for reaffirmation. The Code now provides specific language for several pages of disclosures that must be given to debtors entering reaffirmation agreements. Among other things, these disclosures explain that the debtor is not required to reaffirm any debt, but that liens on secured property, such as mortgages and cars, will remain in effect even if the debt is not reaffirmed.

The reaffirmation agreement must disclose the amount of the debt reaffirmed, the rate of interest, the date payments begin, and the right to rescind. The disclosures also caution the debtor: "Only agree to reaffirm a debt if it is in your best interest. Be sure you can afford the payments you agree to make." The original disclosure documents must be signed by the debtor, certified by the debtor's attorney, and filed with the court at the same time as the reaffirmation agreement. A reaffirmation agreement that is not accompanied by the original signed disclosures will not be effective.



## Reorganizations

The type of bankruptcy proceeding most commonly used by corporate debtors is the Chapter 11 *reorganization*. In a reorganization, the creditors and

the debtor formulate a plan under which the debtor pays a portion of the debts and is discharged of the remainder. The debtor is allowed to continue in business. Although this type of bankruptcy is generally a corporate reorganization, any debtors (including individuals but excluding stockbrokers and commodities brokers) who are eligible for Chapter 7 relief are eligible for relief under Chapter 11.<sup>21</sup> In 1994, Congress established a "fast-track" Chapter 11 procedure for small-business debtors whose liabilities do not exceed \$2.19 million and who do not own or manage real estate. This allows bankruptcy proceedings without the appointment of committees and can save time and costs.

The same principles that govern the filing of a liquidation (Chapter 7) petition apply to reorganization (Chapter 11) proceedings. The case may be brought either voluntarily or involuntarily. The same guidelines govern the entry of the order for relief. The automatic-stay and adequate protection provisions are applicable in reorganizations as well. The 2005 Bankruptcy Reform Act's exceptions to the automatic stay also apply to Chapter 11 proceedings, as do the new provisions regarding substantial abuse and additional grounds for dismissal (or conversion) of bankruptcy petitions. Additionally, the 2005 act contained specific rules and limitations for *individual* debtors who file a Chapter 11 petition. For example, an individual debtor's postpetition acquisitions and earnings become the property of the bankruptcy estate.

### Must Be in the Best Interests of the Creditors

Under Section 305(a) of the Bankruptcy Code, a court, after notice and a hearing, may dismiss or suspend all proceedings in a case at any time if dismissal or suspension would better serve the interests of the creditors. Section 1112 also allows a court, after notice and a hearing, to dismiss a case under reorganization "for cause." Cause includes the absence of a reasonable likelihood of rehabilitation, the inability to effect a plan, and an unreasonable delay by the debtor that is prejudicial to (may harm the interests of) creditors.<sup>22</sup>

20. Under the provisions of the 2005 act, if the debtor's monthly income minus the debtor's monthly expenses as shown on her or his completed and signed statement is less than the scheduled payments on the reaffirmed debt, undue hardship will be presumed. The debtor can rebut the presumption by providing a statement that explains and identifies additional sources of funds from which the debtor will make the agreed-on payments.

21. In addition, railroads are eligible for Chapter 11 relief.

22. See 11 U.S.C. Section 1112(b). Debtors are not prohibited from filing successive petitions, however. A debtor whose petition is dismissed, for example, can file a new Chapter 11 petition (which may be granted unless it is filed in bad faith).



## Workouts

In some instances, creditors may prefer private, negotiated adjustments of creditor-debtor relations, also known as **workouts**, to bankruptcy proceedings. Often, these out-of-court workouts are much more flexible and thus more conducive to a speedy settlement. Speed is critical because delay is one of the most costly elements in any bankruptcy proceeding. Another advantage of workouts is that they avoid the various administrative costs of bankruptcy proceedings.

## Debtor in Possession

On entry of the order for relief, the debtor generally continues to operate the business as a **debtor in possession (DIP)**. The court, however, may appoint a trustee (often referred to as a *receiver*) to operate the debtor's business if gross mismanagement of the business is shown or if appointing a trustee is in the best interests of the estate.

The DIP's role is similar to that of a trustee in a liquidation.<sup>23</sup> The DIP is entitled to avoid preferential payments made to creditors and fraudulent transfers of assets. The DIP has the power to decide whether to cancel or assume prepetition executory contracts (those that are not yet performed) or unexpired leases. The DIP can also exercise a trustee's strong-arm powers.

## Creditors' Committees

As soon as practicable after the entry of the order for relief, a creditors' committee of unsecured creditors is appointed. If the debtor has filed a reorganization plan accepted by the creditors, however, the trustee may decide not to call a meeting of the creditors. The committee may consult with the trustee or the DIP concerning the administration of the case or the formulation of the plan. Additional creditors' committees may be appointed to represent special interest creditors. Under the 2005 act, a court may order the trustee to change the membership of a committee or to increase the number of committee members to include a small-business concern if the court deems it necessary to ensure adequate representation of the creditors.

Orders affecting the estate generally will be entered only with the consent of the committee or after a hearing in which the judge is informed of the position of the committee. As mentioned earlier, businesses with debts of less than \$2.19 million that do not own or

manage real estate can avoid creditors' committees. In these cases, orders can be entered without a committee's consent.

## The Reorganization Plan

A reorganization plan to rehabilitate the debtor is a plan to conserve and administer the debtor's assets in the hope of an eventual return to successful operation and solvency.

**Filing the Plan** Only the debtor may file a plan within the first 120 days after the date of the order for relief. Under the 2005 act, the 120-day period may be extended but not beyond eighteen months from the date of the order for relief. If the debtor does not meet the 120-day deadline or obtain an extension, and if the debtor fails to procure the required creditor consent (discussed below) within 180 days, any party may propose a plan up to twenty months from the date of the order for relief. (In other words, the 180-day period cannot be extended beyond twenty months past the date of the order for relief.) For a small-business debtor, the time for the debtor's filing is 180 days.

The plan must be fair and equitable and must do the following:

1. Designate classes of claims and interests.
2. Specify the treatment to be afforded the classes. (The plan must provide the same treatment for all claims in a particular class.)
3. Provide an adequate means for execution. (The 2005 act requires individual debtors to utilize postpetition assets as necessary to execute the plan.)
4. Provide for payment of tax claims over a five-year period.

## Acceptance and Confirmation of the Plan

Once the plan has been developed, it is submitted to each class of creditors for acceptance. Each class must accept the plan unless the class is not adversely affected by it. A class has accepted the plan when a majority of the creditors, representing two-thirds of the amount of the total claim, vote to approve it. Confirmation is conditioned on the debtor certifying that all postpetition domestic-support obligations have been paid in full. For small-business debtors, if the plan meets the listed requirements, the court must confirm the plan within forty-five days (unless this period is extended).

Even when all classes of creditors accept the plan, the court may refuse to confirm it if it is not "in the best

23. 11 U.S.C. Section 544(a).

interests of the creditors.”<sup>24</sup> A former spouse or child of the debtor can block the plan if it does not provide for payment of her or his claims in cash. Under the 2005 act, if an unsecured creditor objects to the plan, specific rules apply to the value of property to be distributed under the plan. The plan can also be modified on the request of the debtor, a trustee, or a holder of the unsecured claim. Tax claims must be paid over a five-year period.

Even if only one class of creditors has accepted the plan, the court may still confirm the plan under the Code’s so-called **cram-down provision**. In other words, the court may confirm the plan over the objections of a class of creditors. Before the court can exercise this right of cram-down confirmation, it must be demonstrated that the plan is fair and equitable, and does not discriminate unfairly against any creditors.

**Discharge** The plan is binding on confirmation; however, the Bankruptcy Reform Act of 2005 provides that confirmation of a plan does not discharge an individual debtor. Individual debtors must complete the plan prior to discharge, unless the court orders otherwise. For all other debtors, the court may order discharge at any time after the plan is confirmed. The debtor is given a reorganization discharge from all claims not protected under the plan. This discharge does not apply to any claims that would be denied discharge under liquidation.



## Bankruptcy Relief under Chapter 13 and Chapter 12

In addition to bankruptcy relief through liquidation and reorganization, the Code also provides for individuals’ repayment plans (Chapter 13) and family-farmer and family-fishermen debt adjustments (Chapter 12).

24. The plan need not provide for full repayment to unsecured creditors. Instead, creditors receive a percentage of each dollar owed to them by the debtor.

## Individuals’ Repayment Plan

Chapter 13 of the Bankruptcy Code provides for “Adjustment of Debts of an Individual with Regular Income.” Individuals (not partnerships or corporations) with regular income who owe fixed (liquidated) unsecured debts of less than \$336,900 or fixed secured debts of less than \$1,010,650 may take advantage of bankruptcy repayment plans. Among those eligible are salaried employees; sole proprietors; and individuals who live on welfare, Social Security, fixed pensions, or investment income. Many small-business debtors have a choice of filing under either Chapter 11 or Chapter 13. Repayment plans offer several advantages, however. One advantage is that they are less expensive and less complicated than reorganization proceedings or, for that matter, even liquidation proceedings.

**Filing the Petition** A Chapter 13 repayment plan case can be initiated only by the filing of a voluntary petition by the debtor or by the conversion of a Chapter 7 petition (because of a finding of substantial abuse under the means test, for example). Certain liquidation and reorganization cases may be converted to repayment plan cases with the consent of the debtor.<sup>25</sup> A trustee, who will make payments under the plan, must be appointed. On the filing of a repayment plan petition, the automatic stay previously discussed takes effect. Although the stay applies to all or part of the debtor’s consumer debt, it does not apply to any business debt incurred by the debtor. The automatic stay also does not apply to domestic-support obligations.

The Bankruptcy Code imposes the requirement of good faith on a debtor at both the time of the filing of the petition and the time of the filing of the plan. The Code does not define good faith—it is determined in each case through a consideration of “the totality of the circumstances.” Bad faith can be cause for the dismissal of a Chapter 13 petition, as the following case illustrates.

25. A Chapter 13 repayment plan may be converted to a Chapter 7 liquidation either at the request of the debtor or, under certain circumstances, “for cause” by a creditor. A Chapter 13 case may be converted to a Chapter 11 case after a hearing.



## CASE 30.3 In re Buis

United States Bankruptcy Court, Northern District of Florida, Pensacola Division, 2006. 337 Bankr. 243.

• **Background and Facts** In 2000, Roger and Pauline Buis bought an air show business, including a helicopter, a trailer, and props, from Robert and Annette Hosking. The price was \$275,000, which the Buises agreed to pay in installments. The Buises formed Otto Airshows and decorated the helicopter



**CASE 30.3 CONTINUED** as "Otto the Clown." They performed in air shows and took passengers on flights for a fee. In 2003, the Buisés began accusing a competitor, Army Aviation Heritage Foundation and Museum, Inc. (AAHF), of safety lapses. AAHF filed a suit in a federal district court against the Buisés and their company, alleging defamation. The court issued a summary judgment in AAHF's favor. While the amount of the damages was being determined, the Buisés stopped doing business as Otto Airshows. They formed a new firm, Prop and Rotor Aviation, Inc., to which they leased the Otto equipment. Within a month, they filed a bankruptcy petition under Chapter 13. The plan and the schedules did not mention AAHF, the Prop and Rotor lease, a settlement that the Buisés received in an unrelated suit, and other items. AAHF filed a motion to dismiss the case, asserting, among other things, that the Buisés filed their petition in bad faith.



**IN THE LANGUAGE OF THE COURT**  
**LEWIS M. KILLIAN, JR., Bankruptcy Judge.**

\* \* \* \*

\* \* \* In considering the totality of circumstances surrounding the debtors' filing of their petition, it is clear to me that *this case was filed in bad faith and therefore should be dismissed.* [Emphasis added.]

First, *the debtors did not accurately state their assets and liabilities on their initial bankruptcy petition.* The debtors failed to list AAHF as a creditor, which is especially hard for the court to comprehend when the debtor admitted that it was AAHF's judgment that pushed them into bankruptcy. The debtors listed income on their schedules from "[r]ent from personal property lease," but did not list any such lease on [the schedules] and did not report any income from leases in their statement of financial affairs or list any agreement with Prop and Rotor anywhere in their schedules \* \* \*. The debtors also did not disclose the \$55,000.00 personal injury settlement they received prepetition. In addition to all of these omissions, the debtors also "forgot" about a Kubota lawn tractor worth \$10,000 and their generator, worth \$400. The debtors did not amend their schedules to reflect any of this until the day of the hearing on this motion. [Emphasis added.]

Next, the timing of the debtors' petition leads to the conclusion of bad faith, in two ways. First, the debtors filed their Chapter 13 petition after they were found liable in the District Court Action and after an unsuccessful mediation with AAHF, but before a final judgment could be entered. \* \* \* It appears to me that *the timing of the bankruptcy filing was an ultimately futile attempt to keep the debtors eligible to file for relief under Chapter 13, because the debts owed to AAHF would be dischargeable in a \* \* \* so-called Chapter 13 "super discharge."* The other reason the timing of the petition is suspect involves the grant of [certain] interests in [some of the Buisés' assets to some of their creditors]. While the granting of these \* \* \* interests may not have been fraudulent transfers as a matter of law, they certainly would have been preferences subject to avoidance \* \* \* had they been made within 90 days of the filing of the petition. All of these transfers appear to have been made between 90 and 120 days pre-petition. Thus, the debtors granted these \* \* \* interests, \* \* \* waited 90 days so they would "stick," then filed their petition. The debtor admitted that he began planning to avoid AAHF's judgment through a Chapter 13 bankruptcy shortly after the adverse ruling on summary judgment in the District Court. The timing of the bankruptcy petition further demonstrates both the debtors' attempt to continue in their pre-petition pattern of egregious [flagrant] behavior towards AAHF and their bad faith in filing their petition. [Emphasis added.]

• **Decision and Remedy** *The court dismissed the Buisés' petition. The debtors had not included all of their assets and liabilities on their initial petition and had timed its filing to avoid payment on the judgment to AAHF. They had also attempted to transfer interests in some of their assets in preference to certain creditors. The court determined that "the debtors filed their petition in bad faith and it is in the creditors' and estate's best interests that this case be dismissed."*

• **What If the Facts Were Different?** *If AAHF had lost its defamation suit against the Buisés, would the result in this case have been the same? Why or why not?*

• **The Global Dimension** *Could the Buisés have shipped their assets to Canada or Mexico to prevent them from being included in the bankruptcy estate? Explain.*

**The Repayment Plan** Only the debtor may file the repayment plan. This plan may provide either for payment of all obligations in full or for payment of a lesser amount.<sup>26</sup> The plan must provide for the following:

1. The turning over to the trustee of such future earnings or income of the debtor as is necessary for execution of the plan.
2. Full payment through deferred cash payments of all claims entitled to priority, such as taxes.<sup>27</sup>
3. Identical treatment of all claims within a particular class. (The Code permits the debtor to list co-debtors, such as guarantors or sureties, as a separate class.)

**Time Allowed for Repayment.** Prior to the 2005 act, the time for repayment under a plan was usually three years unless the court approved an extension for up to five years. Under the new act, the length of the payment plan (three or five years) is determined by the debtor's family income. If the debtor's family income is greater than the state median family income under the means test (previously discussed), the proposed plan must be for five years.<sup>28</sup> The term may not exceed five years, however.

The Code requires the debtor to make "timely" payments from her or his disposable income, and the trustee must ensure that the debtor commences these payments. The debtor must begin making payments under the proposed plan within thirty days after the plan has been *filed*. Failure of the debtor to make timely payments or to commence payments within the thirty-day period will allow the court to convert the case to a liquidation bankruptcy or to dismiss the petition.

**Confirmation of the Plan.** After the plan is filed, the court holds a confirmation hearing, at which interested parties (such as creditors) may object to the

plan. Under the 2005 act, the hearing must be held at least twenty days, but no more than forty-five days, after the meeting of the creditors. Confirmation of the plan is dependent on the debtor's certification that postpetition domestic-support obligations have been paid in full and that all prepetition tax returns have been filed. The court will confirm a plan with respect to each claim of a secured creditor under any of the following circumstances:

1. If the secured creditors have accepted the plan.
2. If the plan provides that secured creditors retain their liens until there is payment in full or until the debtor receives a discharge.
3. If the debtor surrenders the property securing the claims to the creditors.

In addition, for confirmation, the plan must provide that a creditor with a purchase-money security interest (PMSI—see Chapter 29) retains its lien until payment of the entire debt for a motor vehicle purchased within 910 days before filing the petition. For PMSIs on other personal property, the payment plan must cover debts incurred within a one-year period preceding the filing.

**Objection to the Plan.** Unsecured creditors do not have the power to confirm a repayment plan, but they can object to it. The court can approve a plan over the objection of the trustee or any unsecured creditor only in either of the following situations:

1. When the value of the property (replacement value as of the date of filing) to be distributed under the plan is at least equal to the amount of the claims.
2. When all of the debtor's projected disposable income to be received during the plan period will be applied to making payments. Disposable income is all income received less amounts needed to pay domestic-support obligations and/or amounts needed to meet ordinary expenses to continue the operation of a business. The 2005 act also excluded from disposable income charitable contributions up to 15 percent of the debtor's gross income and the reasonable and necessary costs for health insurance for the debtor and his or her dependents.

**Modification of the Plan.** Prior to completion of payments, the plan may be modified at the request of the debtor, the trustee, or an unsecured creditor. If any interested party objects to the modification, the court must hold a hearing to determine whether the modified plan will be approved.

26. Under the 2005 act, a plan under Chapter 13 or Chapter 12 (to be discussed shortly) may propose to pay less than 100 percent of prepetition domestic-support obligations that were assigned, but only if disposable income is dedicated to a five-year plan. Disposable income is also redefined to exclude the amounts reasonably necessary to pay current domestic-support obligations.

27. As with a Chapter 11 reorganization plan, full repayment of all claims is not always required.

28. See 11 U.S.C. Section 1322(d) for details on when the court will find that the Chapter 13 plan should extend to a five-year period.



**Discharge** After the debtor has completed all payments, the court grants a discharge of all debts provided for by the repayment plan. Except for allowed claims not provided for by the plan, certain long-term debts provided for by the plan, certain tax claims, payments on retirement accounts, and claims for domestic-support obligations, all other debts are dischargeable. Under prior law, a discharge of debts under a Chapter 13 repayment plan was sometimes referred to as a “superdischarge” because it allowed the discharge of fraudulently incurred debt and claims resulting from malicious or willful injury.

The 2005 Bankruptcy Reform Act, however, deleted most of the “superdischarge” provisions, especially for debts based on fraud. Today, debts for trust fund taxes, taxes for which returns were never filed or filed late (within two years of filing), domestic-support payments, student loans, and injury or property damage from driving under the influence of alcohol or drugs are nondischargeable. The new law also excludes fraudulent tax obligations, criminal fines and restitution, fraud by a person acting in a fiduciary capacity, and restitution for willfully and maliciously causing personal injury or death.

Even if the debtor does not complete the plan, a hardship discharge may be granted if failure to complete the plan was due to circumstances beyond the debtor’s control and if the value of the property distributed under the plan was greater than what would have been paid in a liquidation. A discharge can be revoked within one year if it was obtained by fraud.

### Family Farmers and Fishermen

In 1986, to help relieve economic pressure on small farmers, Congress created Chapter 12 of the Bankruptcy Code. In 2005, Congress extended this protection to family fishermen,<sup>29</sup> modified its provisions somewhat, and made it a permanent chapter in the Bankruptcy Code (previously, the statutes authorizing Chapter 12 had to be periodically renewed by Congress).

**Definitions** For purposes of Chapter 12, a *family farmer* is one whose gross income is at least 50 percent farm dependent and whose debts are at least 50 percent farm related. The total debt for a family farmer must not exceed \$3,544,525. (Prior law required a farmer’s debts to be 80 percent farm related and not to

exceed \$1.5 million.) A partnership or closely held corporation (see Chapter 38) at least 50 percent owned by the farm family can also qualify as a family farmer.

A *family fisherman* is defined by the 2005 act as one whose gross income is at least 50 percent dependent on commercial fishing operations<sup>30</sup> and whose debts are at least 80 percent related to commercial fishing. The total debt for a family fisherman must not exceed \$1,642,500. As with family farmers, a partnership or closely held corporation can also qualify.

**Filing the Petition** The procedure for filing a family-farmer or family-fishermen bankruptcy plan is very similar to the procedure for filing a repayment plan under Chapter 13. The debtor must file a plan not later than ninety days after the order for relief. The filing of the petition acts as an automatic stay against creditors’ and co-obligors’ actions against the estate.

A farmer or fisherman who has already filed a reorganization or repayment plan may convert it to a Chapter 12 plan. The debtor may also convert a Chapter 12 plan to a liquidation plan.

### Content and Confirmation of the Plan

The content of a plan under Chapter 12 is basically the same as that of a Chapter 13 repayment plan. The plan can be modified by the debtor but, except for cause, must be confirmed or denied within forty-five days of filing.

Court confirmation of the plan is the same as for a repayment plan. In summary, the plan must provide for payment of secured debts at the value of the collateral. If the secured debt exceeds the value of the collateral, the remaining debt is unsecured. For unsecured debtors, the plan must be confirmed if either (1) the value of the property to be distributed under the plan equals the amount of the claim, or (2) the plan provides that all of the debtor’s disposable income to be received in a three-year period (or longer, by court approval) will be applied to making payments. Disposable income is all income received less amounts needed to support the farmer or fisherman and his or her family and to continue the farming or commercial fishing operation. Completion of payments under the plan discharges all debts provided for by the plan. See *Concept Summary 30.1* for a comparison of bankruptcy procedures under Chapters 7, 11, 12, and 13.

29. Although the Code uses the terms *fishermen* and *fisherman*, Chapter 12 provisions apply equally to men and women.

30. Commercial fishing operations include catching, harvesting, or aquaculture raising fish, shrimp, lobsters, urchins, seaweed, shellfish, or other aquatic species or products.



### CONCEPT SUMMARY 30.1

#### Forms of Bankruptcy Relief Compared

Issue	Chapter 7	Chapter 11	Chapters 12 and 13
PURPOSE	Liquidation.	Reorganization.	Adjustment.
WHO CAN PETITION	Debtor (voluntary) or creditors (involuntary).	Debtor (voluntary) or creditors (involuntary).	Debtor (voluntary) only.
WHO CAN BE A DEBTOR	Any "person" (including partnerships, corporations, and municipalities) <i>except</i> railroads, insurance companies, banks, savings and loan institutions, investment companies licensed by the Small Business Administration, and credit unions. Farmers and charitable institutions also cannot be involuntarily petitioned. If the court finds the petition to be a substantial abuse of the use of Chapter 7, the debtor may be required to convert to a Chapter 13 repayment plan.	Any debtor eligible for Chapter 7 relief; railroads are also eligible. Individuals have specific rules and limitations.	<i>Chapter 12</i> —Any family farmer (one whose gross income is at least 50 percent farm dependent and whose debts are at least 50 percent farm related) or family fisherman (one whose gross income is at least 50 percent dependent on commercial fishing operations and whose debts are at least 80 percent related to commercial fishing) or any partnership or closely held corporation at least 50 percent owned by a family farmer or fisherman, when total debt does not exceed a specified amount (\$3,544,525 for farmers and \$1,642,500 for fishermen). <i>Chapter 13</i> —Any individual (not partnerships or corporations) with regular income who owes fixed unsecured debts of less than \$336,900 or fixed secured debts of less than \$1,010,650.
PROCEDURE LEADING TO DISCHARGE	Nonexempt property is sold with proceeds to be distributed (in order) to priority groups. Dischargeable debts are terminated.	Plan is submitted; if it is approved and followed, debts are discharged.	Plan is submitted and must be approved if the value of the property to be distributed equals the amount of the claims or if the debtor turns over disposable income for a three-year or five-year period; if the plan is followed, debts are discharged.
ADVANTAGES	On liquidation and distribution, most debts are discharged, and the debtor has an opportunity for a fresh start.	Debtor continues in business. Creditors can either accept the plan, or it can be "crammed down" on them. The plan allows for the reorganization and liquidation of debts over the plan period.	Debtor continues in business or possession of assets. If the plan is approved, most debts are discharged after the plan period.





## REVIEWING Bankruptcy Law

Three months ago, Janet Hart's husband of twenty years died of cancer. Although he had medical insurance, he left Janet with outstanding medical bills of more than \$50,000. Janet has worked at the local library for the past ten years, earning \$1,500 per month. Since her husband's death, Janet also receives \$1,500 in Social Security benefits and \$1,100 in life insurance proceeds every month, for a total monthly income of \$4,100. After she pays the mortgage payment of \$1,500 and the amounts due on other debts, Janet has barely enough left over to buy groceries for her family (she has two teenage daughters at home). She decides to file for Chapter 7 bankruptcy, hoping for a fresh start. Using the information presented in the chapter, answer the following questions.

1. Under the Bankruptcy Code after the 2005 act, what must Janet do before filing a petition for relief under Chapter 7?
2. How much time does Janet have after filing the bankruptcy petition to submit the required schedules? What happens if Janet does not meet the deadline?
3. Assume that Janet files a petition under Chapter 7. Further assume that the median family income in the state in which Janet lives is \$49,300. What steps would a court take to determine whether Janet's petition is presumed to be "substantial abuse" using the means test?
4. Suppose that the court determines that no *presumption* of substantial abuse applies in Janet's case. Nevertheless, the court finds that Janet does have the ability to pay at least a portion of the medical bills out of her disposable income. What would the court likely order in that situation?



## TERMS AND CONCEPTS

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## QUESTIONS AND CASE PROBLEMS

30-1. Burke has been a rancher all her life, raising cattle and crops. Her ranch is valued at \$500,000, almost all of which is exempt under state law. Burke has eight creditors and a total indebtedness of \$70,000. Two of her largest creditors are Oman (\$30,000 owed) and Sneed (\$25,000 owed). The other six creditors have claims of less than \$5,000 each. A drought has ruined all of Burke's crops and forced her to sell many of her cattle at a loss. She cannot pay off her creditors.

- (a) Under the Bankruptcy Code, can Burke, with a \$500,000 ranch, voluntarily petition herself into bankruptcy? Explain.
- (b) Could either Oman or Sneed force Burke into involuntary bankruptcy? Explain.



## 30-2. QUESTION WITH SAMPLE ANSWER

Peaslee is not known for his business sense. He started a greenhouse and nursery business two

years ago, and because of his lack of experience, he soon was in debt to a number of creditors. On February 1, Peaslee borrowed \$5,000 from his father to pay some of these creditors. On May 1, Peaslee paid back the \$5,000, depleting his entire working capital. One creditor, the Cool Springs Nursery Supply Corp., extended credit to Peaslee on numerous purchases. Cool Springs pressured Peaslee for payment, and on July 1, Peaslee paid Cool Springs half the amount owed. On September 1, Peaslee voluntarily petitioned himself into bankruptcy. The trustee in bankruptcy claims that both Peaslee's father and Cool Springs must turn over to the debtor's estate the amounts Peaslee paid to them. Discuss fully the trustee's claims.

- For a sample answer to Question 30-2, go to Appendix I at the end of this text.

**30-3.** Montoro petitioned himself into voluntary bankruptcy. There were three major claims against his estate. One was made by Carlton, a friend who held Montoro's negotiable promissory note for \$2,500; one was made by Elmer, an employee who was owed three months' back wages of \$4,500; and one was made by the United Bank of the Rockies on an unsecured loan of \$5,000. In addition, Dietrich, an accountant retained by the trustee, was owed \$500, and property taxes of \$1,000 were owed to Rock County. Montoro's nonexempt property was liquidated, with proceeds of \$5,000. Discuss fully what amount each party will receive, and why.

**30-4. Automatic Stay.** On January 22, 2001, Marlene Moffett bought a used 1998 Honda Accord from Hendrick Honda in Woodbridge, Virginia. Moffett agreed to pay \$20,024.25, with interest, in sixty monthly installments, and Hendrick retained a security interest in the car. (As discussed in Chapter 29, Hendrick thus had the right to repossess the car in the event of default, subject to Moffett's right of redemption.) Hendrick assigned its rights under the sales agreement to Tidewater Finance Co., which perfected its security interest. The car was Moffett's only means of traveling the forty miles from her home to her workplace. In March and April 2002, Moffett missed two monthly payments. On April 25, Tidewater repossessed the car. On the same day, Moffett filed a Chapter 13 plan in a federal bankruptcy court. Moffett asked that the car be returned to her, in part under the Bankruptcy Code's automatic-stay provision. Tidewater asked the court to terminate the automatic stay so that it could sell the car. How can the interests of both the debtor and the creditor be fully protected in this case? What should the court rule? Explain. [*In re Moffett*, 356 F3d 518 (4th Cir. 2004)]

**30-5. Discharge in Bankruptcy.** Between 1980 and 1987, Craig Hanson borrowed funds from Great Lakes Higher Education Corp. to finance his education at the

University of Wisconsin. Hanson defaulted on the debt in 1989, and Great Lakes obtained a judgment against him for \$31,583.77. Three years later, Hanson filed a bankruptcy petition under Chapter 13. Great Lakes timely filed a proof of claim in the amount of \$35,531.08. Hanson's repayment plan proposed to pay \$135 monthly to Great Lakes over sixty months, which in total was only 19 percent of the claim, but said nothing about discharging the remaining balance. The plan was confirmed without objection. After Hanson completed the payments under the plan, without any additional proof or argument being offered, the court granted a discharge of his student loans. In 2003, Educational Credit Management Corp. (ECMC), which had taken over Great Lakes' interest in the loans, filed a motion for relief from the discharge. What is the requirement for the discharge of a student loan obligation in bankruptcy? Did Hanson meet this requirement? Should the court grant ECMC's motion? Discuss. [*In re Hanson*, 397 F3d 482 (7th Cir. 2005)]

**30-6. Exceptions to Discharge.** Between 1988 and 1992, Lorna Nys took out thirteen student loans, totaling about \$30,000, to finance an associate of arts degree in drafting from the College of the Redwoods and a bachelor of arts degree from Humboldt State University (HSU) in California. In 1996, Nys began working at HSU as a drafting technician. As a "Drafter II," the highest-paying drafting position at HSU, Nys's gross income in 2002 was \$40,244. She was fifty-one years old. Her net monthly income was \$2,299.33, and she had \$2,295.05 in monthly expenses, including saving \$140 for her retirement, which she planned for age sixty-five. When Educational Credit Management Corp. (ECMC) began to collect payments on Nys's student loans, she filed a Chapter 7 petition in a federal bankruptcy court, seeking a discharge of the loans. ECMC argued that Nys did not show any "additional circumstances" that would impede her ability to repay. What is the standard for the discharge of student loans under Chapter 7? Does Nys meet that standard? Why or why not? [*In re Nys*, 446 F3d 938 (9th Cir. 2006)]



### 30-7. CASE PROBLEM WITH SAMPLE ANSWER

James Stout, a professor of economics and business at Cornell College in Iowa City, Iowa, filed a petition in bankruptcy under Chapter 7, seeking to discharge about \$95,000 in credit-card debts. At the time, Stout had been divorced for ten years and had custody of his children: Z. S., who attended college, and G. S., who was twelve years old. Stout's ex-wife did not contribute child support. According to Stout, G. S. was an "elite" ice-skater who practiced twenty hours a week and had placed between first and third at more than forty competitive events. He had decided to home



school G. S., whose achievements were average for her grade level despite her frequent absences from public school. His petition showed monthly income of \$4,227 and expenses of \$4,806. The expenses included annual home school costs of \$8,400 and annual skating expenses of \$6,000. They did not include Z. S.'s college costs, such as airfare for his upcoming studies in Europe, and other items. The trustee allowed monthly expenses of \$3,227—with nothing for skating—and asked the court to dismiss the petition. Can the court grant this request? Should it? If so, what might it encourage Stout to do? Explain. [*In re Stout*, 336 Bankr. 138 (N.D. Iowa 2006)]

- To view a sample answer for Problem 30-7, go to this book's Web site at [academic.cengage.com/blaw/clarkson](http://academic.cengage.com/blaw/clarkson), select "Chapter 30," and click on "Case Problem with Sample Answer."

**30-8. Discharge in Bankruptcy.** Rhonda Schroeder married Gennady Shvartshteyn (Gene) in 1997. Gene worked at Royal Courier and Air Domestic Connect in Illinois, where Melissa Winyard also worked in 1999 and 2000. During this time, Gene and Winyard had an affair. A year after leaving Royal, Winyard filed a petition in a federal bankruptcy court under Chapter 7 and was granted a discharge of her debts. Sometime later, in a letter to Schroeder who had learned of the affair, Winyard wrote, "I never intentionally wanted any of this to happen. I never wanted to disrupt your marriage." Schroeder obtained a divorce and, in 2005, filed a suit in an Illinois state court against Winyard, alleging "alienation of affection." Schroeder claimed that there had been "mutual love and affection" in her marriage until Winyard engaged in conduct intended to alienate her husband's affection. Schroeder charged that Winyard "caused him to have sexual intercourse with her," resulting in "the destruction of the marital relationship." Winyard filed a motion for summary judgment on the ground that any liability on her part had been discharged in her bankruptcy. Is there an exception to discharge for "willful and malicious conduct"? If so, does Schroeder's claim qualify? Discuss. [*Schroeder v. Winyard*, 375 Ill.App.3d 358, 873 N.E.2d 35, 313 Ill.Dec. 740 (2 Dist. 2007)]



### 30-9. A QUESTION OF ETHICS

In October 1994, Charles Edwards formed ETS Payphones, Inc., to sell and lease pay phones as investment opportunities—an investor would buy a phone from ETS, which would lease it back. ETS promised returns of 14 to 15 percent but consistently lost money. To meet its obligations to existing investors, ETS had to continually attract new investors. Eventually, ETS defrauded

thousands of investors of more than \$300 million. Edwards transferred the funds from ETS to himself. In 2000, ETS filed a petition in a federal bankruptcy court to declare bankruptcy. Darryl Laddin was appointed trustee. On the debtor's behalf, Laddin filed a suit against Reliance Trust Co. and others, alleging, among other things, that the defendants helped defraud investors by "ignoring the facts" and "funneling" the investors' funds to ETS, causing it to "incur millions of dollars in additional debt." Laddin sought treble (triple) damages. [Official Committee of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006)]

- The defendants argued, in part, that the doctrine of *in pari delicto*, which provides that a wrongdoer may not profit from his or her wrongful acts, barred Laddin's claim. Who should be considered ethically responsible for the investors' losses? Explain.
- Laddin contended that his actions, as trustee on behalf of the debtor, should not be subject to the doctrine of *in pari delicto* because that doctrine depends on the "personal malfeasance of the individual seeking to recover." The defendants filed a motion to dismiss Laddin's complaint. Do you think that the court should rule in favor of Laddin or the defendants? Why?



### 30-10. VIDEO QUESTION

Go to this text's Web site at [academic.cengage.com/blaw/clarkson](http://academic.cengage.com/blaw/clarkson) and select "Chapter 30." Click on "Video Questions" and view the video titled *The River*. Then answer the following questions.

- In the video, a crowd (including Mel Gibson) is gathered at a farm auction in which a neighbor's (Jim Antonio's) farming goods are being sold. The people in the crowd, who are upset because they believe that the bank is selling out the farmer, begin chanting "no sale, no sale." In an effort to calm the situation, the farmer tells the crowd that "they've already foreclosed" on his farm. What does he mean?
- Assume that the auction is a result of Chapter 7 bankruptcy proceedings. Was the farmer's petition for bankruptcy voluntary or involuntary? Explain.
- Suppose that the farmer purchased the homestead three years prior to filing a petition for bankruptcy and that the current market value of the farm is \$215,000. What is the maximum amount of equity the farmer could claim as exempt under the 2005 Bankruptcy Reform Act?
- Compare the results of a Chapter 12 bankruptcy as opposed to a Chapter 7 bankruptcy for the farmer in the video.



## LAW ON THE WEB

For updated links to resources available on the Web, as well as a variety of other materials, visit this text's Web site at

[academic.cengage.com/blaw/clarkson](http://academic.cengage.com/blaw/clarkson)

The U.S. Bankruptcy Code is online at

[www.law.cornell.edu/80/uscode/11](http://www.law.cornell.edu/80/uscode/11)

For information and news on bankruptcy law and cases, go to the site maintained by Bankruptcy Media at

[www.bankruptcymedia.com](http://www.bankruptcymedia.com)

Another good resource for bankruptcy information is the American Bankruptcy Institute (ABI) at

[www.abiworld.org](http://www.abiworld.org)

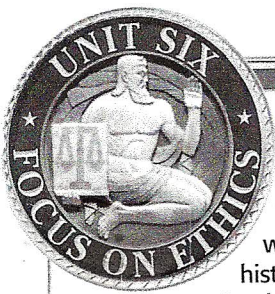
### Legal Research Exercises on the Web

Go to [academic.cengage.com/blaw/clarkson](http://academic.cengage.com/blaw/clarkson), the Web site that accompanies this text. Select "Chapter 30" and click on "Internet Exercises." There you will find the following Internet research exercises that you can perform to learn more about the topics covered in this chapter.

Internet Exercise 30-1: Legal Perspective  
Bankruptcy

Internet Exercise 30-2: Management Perspective  
Bankruptcy Alternatives





## Creditors' Rights and Bankruptcy

We have certainly come a long way from the period in our history when debtors' prisons existed. Today, debtors are in a much more favorable position—they can file for protection under bankruptcy law. Indeed, after the Bankruptcy Reform Act of 1978 was passed, some claimed that we had gone too far toward protecting debtors and had made it too easy for them to avoid paying what they legally owed. Critics of the 2005 Bankruptcy Reform Act are concerned that the pendulum has swung too far in the opposite direction—favoring creditors' interests and making it too difficult for debtors to obtain a fresh start. Clearly, it is hard to protect the rights of both debtors and creditors at the same time, and laws governing debtor-creditor relationships have traditionally been perceived, by one group or another, as being unfair.

It is obviously not possible for the law to protect both debtors and creditors at all times under all circumstances. Attempts to balance the rights of both groups necessarily raise questions of fairness and justice. In this *Focus on Ethics* feature, we look at several aspects of debtor-creditor relationships that frequently involve issues of fairness, and we examine the ethical ramifications of the 2005 Bankruptcy Reform Act for debtors and creditors.

### "Self-Help" Repossession

Section 9–503 of the Uniform Commercial Code (UCC) states that “[u]nless otherwise agreed, a secured party has on default the right to take possession of the collateral. In taking possession, a secured party may proceed without judicial process if this can be done without breach of the peace.” The underlying rationale for this “self-help” provision of Article 9 is that it simplifies the process of repossession for creditors and reduces the burden on the courts. Because the UCC does not define “breach of the peace,” however, it is not always easy to predict what behavior will constitute such a breach.

One problem is that the debtor may not realize what is happening when agents of the creditor show up to repossess the collateral. Often, to avoid confrontation with the debtor and any potential violence or breach of the peace, a secured creditor will arrange to have the collateral repossessed during the night or in the early-morning hours, when the repossession effort is least likely to be observed. But a debtor who awakens in the night and sees his or her car being towed away may not realize that it is being repossessed.

At the same time, repossession can be risky for the creditor; if the repossession results in a breach of the peace, the creditor may be liable for substantial damages. Inevitably, repossession attempts will occasionally result in confrontations with the debtor. Indeed, some contend that the self-help provision encourages violence by providing an incentive for debtors to incite creditors to breach the peace, which may entitle the debtors to damages.

### Ethics and Bankruptcy

As we have seen, the first goal of bankruptcy law is to provide relief and protection to debtors. Society has generally concluded that everyone should be given the chance to start over. But how far should society go in allowing debtors to avoid obligations that they voluntarily incurred? This question has been debated for some time, and it is certainly at the forefront of the issues raised by the 2005 Bankruptcy Reform Act.

Consider the concept of bankruptcy from the point of view of the creditor. The creditor has extended a transfer of purchasing power from herself or himself to the debtor. That transfer of purchasing power represents a transfer of an asset for an asset. The debtor obtains the asset of funds, goods, or services, and the creditor obtains the asset of a *secured* or *unsecured* legal obligation to repay. Once the debtor is in bankruptcy, voluntarily or involuntarily, the asset that the creditor owns most often has a diminished value. Indeed, in many circumstances, that asset has no value. Yet the easier it becomes for debtors to discharge their debts under bankruptcy laws, the greater will be the incentive for debtors to use such laws to avoid paying amounts that are legally owed.

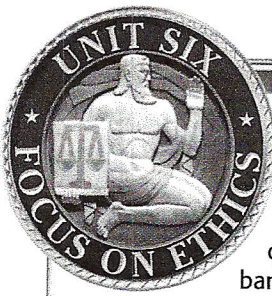
Clearly, bankruptcy law is a balancing act between providing a second chance for debtors and ensuring that creditors are given reasonable protection. Understandably, ethical issues arise in the process.

### Bankruptcy and Economics

Among other things, the increasing number of bankruptcies since the early 1990s meant that creditors incurred higher risks in making loans—because bankruptcy shifts the cost of the debt from the debtor to the creditor. To compensate for these higher risks, creditors take one or more of the following actions: increase the interest rates charged to everyone, require additional security (collateral), or be more selective in granting credit.

(Continued)





Thus, with more lenient bankruptcy laws, debtors who find themselves in bankruptcy will be better off, but those debtors who will never be in bankruptcy will be worse off. Ethical concerns regarding this trade-off must be matched with the economic concerns of other groups of individuals affected by the law.

**Consequences of Bankruptcy** Under the 2005 Bankruptcy Reform Act, filing for personal bankruptcy (particularly under Chapter 7) has become more difficult. Although the stigma attached to bankruptcy today is less than it once was, bankruptcy is never easy for debtors. Many debtors feel a sense of shame and failure when they petition for bankruptcy. After all, bankruptcy is a matter of public record, and there is no way to avoid a certain amount of publicity. In one case, for example, a couple who filed for Chapter 7 bankruptcy wanted to use their attorney's mailing address in another town on their bankruptcy schedules in an effort to prevent an elderly parent and one of their employers from learning about the bankruptcy. The court, however, held that debtors are not entitled to be protected from publicity surrounding the filing of their cases.<sup>1</sup>

A court in another case held that the public interest in information involving a particular bankruptcy debtor (Gitto Global Corporation) was important enough to justify disclosing a previously sealed report from a bankruptcy examiner. In essence, the court gave the media access to the bankruptcy examiner's report on the misconduct of more than 120 individuals at the debtor company.<sup>2</sup>

Bankruptcy also has other consequences for debtors, including blemished credit ratings for up to ten years and higher interest charges for new debts, such as those incurred through the purchase of cars or homes. Some private employers may even refuse to hire a job applicant who has filed for bankruptcy. The courts provide little relief for applicants who are denied a job for this reason.<sup>3</sup>

Thus, bankruptcy can have adverse effects for both debtors and creditors. Because of the consequences of bankruptcy, debtors do not always get the fresh start promised by bankruptcy law. At the same time, creditors rarely are able to recover all that is owed them once a debtor petitions for bankruptcy.

1. *In the Matter of Laws*, 223 Bankr. 714 (D.Neb. 1998).

2. *In re Gitto Global Corp.*, 2005 WL 10273348 (D.Mass. 2005).

3. See, for example, *In re Potter*, 354 Bankr. 301 (D.Ala. 2006); and *In re Stinson*, 285 Bankr. 239 (W.D.Va. 2002).

**Is It Fair to Increase the Costs for Debtors Seeking Bankruptcy Relief?** The 2005 Bankruptcy Reform Act increased the costs of filing for bankruptcy. Not only did the filing fee for Chapter 7 bankruptcies increase from \$155 to \$200, but attorneys' fees also increased in many instances. Attorneys' fees, rather than filing fees, typically constitute the major expense for bankruptcy filings. Many attorneys have raised the fees they charge to handle bankruptcy cases in the wake of the 2005 act because they are assuming greater risk. Under the 2005 law, the debtor's attorney must certify the accuracy of all factual allegations in the bankruptcy petition and schedules under the penalty of perjury. In other words, attorneys may be subject to sanctions (fines) if there are any factual inaccuracies.

Because attorneys are held accountable for factual inaccuracies, the debtor's attorney may decide to independently investigate the truth of the facts stated in the petition and schedules. This may entail hiring private investigators, appraisers, and auditors for assistance in accounting for all of the debtor's income and assets. If the debtor enters a reaffirmation agreement, it will not be enforceable unless the attorney certifies that the debtor is capable of making the payments due under the agreement. Thus, another round of investigations may be needed before the attorney will sign the certification. Obviously, the debtor ends up paying these costs. Is this fair considering that a main goal of bankruptcy is to give debtors a fresh start?

## DISCUSSION QUESTIONS

1. Do you think that the law favors debtors at the expense of creditors or vice versa? Is there any way to achieve a better balance between the interests of creditors and those of debtors?
2. So long as a breach of the peace does not result, a lender may repossess goods on the debtor's default under the self-help provision of Article 9. Do you think that debtors have a right to be told in advance about a planned repossession? Some observers argue that the self-help remedy under Article 9 should be abolished. Do you agree? Why or why not?
3. Is it unethical to avoid paying one's debts by going into bankruptcy? Does a person have a moral responsibility to pay his or her debts?
4. Are borrowers better off as a result of the 2005 Bankruptcy Reform Act? Why or why not? Do credit-card companies have a duty to reduce the interest rates they charge to all consumers if their costs fall? Should they?