PROTECTING THE CREDITOR'S RIGHTS DURING BANKRUPTCY

Originally Presented January 18, 2011

OVERVIEW OF CREDITOR'S RIGHTS UNDER EACH CHAPTER;

SPECIAL RIGHTS IN PARTICULAR PROPERTY;

AND

MISCELLANEOUS CREDITOR RIGHTS

by Matthew M. Boley[1]

[1] This article is provided for informational purposes only. It is not intended as, and does not constitute, legal advice. Further, access to or receipt of this article by any recipient shall not be construed to create an attorney-client relationship. Finally, the author disclaims any and all representations or warranties, express or implied. Among other things, recipients of this article hereby are warned and notified that the information provided herein may be incorrect and/or incomplete. As such, it is not reasonable for any person to rely upon this article or the information provided herein. Rather, all persons who obtain or review this article are encouraged to retain a licensed attorney to provide him, her or it with individualized and current legal advice.

III. Overview of Creditor's Rights under Each Chapter

A. Voluntary Bankruptcies – Threshold Requirements

The 2005 bankruptcy amendments have imposed a number of new threshold requirements upon individual debtors. Failure to satisfy these prerequisites will result in automatic dismissal.

Absent exigent circumstances, an individual may not be a debtor in bankruptcy unless, within 180 days of the filing, the debtor received "an individual or group briefing" from "an approved nonprofit budget and credit counseling agency." 11 U.S.C. § 109(h). Failure to obtain and file a certificate of credit counseling renders the debtor ineligible to be a debtor under title 11 of the United States Code. See also 11 U.S.C. §§ 521(b)(1).

The bankruptcy case will be automatically dismissed unless, within 45 days of the petition date (subject to a 45-day extension in instances where the court finds "justification), the debtor files: (i) copies of all payment advices received by the debtor within 60 days prior to the petition date; (ii) a statement of the amount of monthly net income itemized to show how the amount is calculated; and (iii) a statement disclosing any reasonably anticipated increase in income or expenditures during the twelve months following the petition date. See 11 U.S.C. §§ 521(i) and 521(a)(1).

Unless the debtor demonstrates "circumstances beyond the control of the debtor," the case will be dismissed if the debtor fails to provide (i) to the trustee, no later than 7 days before the date first set for the meeting of creditors, a copy of his federal tax return, or transcript, for the most recent tax year ending immediately before the petition date and for which a return was filed; or (ii) a copy of such return or transcript, at the "same time" provided to the trustee, to "any creditor that timely requests such copy." See 11 U.S.C. § 521(e)(2).

B. Chapter 7 – Liquidation

Cases under chapter 7 of the Bankruptcy Code are liquidation cases. Upon the filing of a chapter 7 bankruptcy petition, a bankruptcy estate is created. All of the debtor's non-exempt property as of the petition date will be property of the estate, available for liquidation and distribution to creditors. The chapter 7 bankruptcy estate will be controlled and administered by an independent individual who is appointed to serve as trustee of the estate. "Two ideals underlie chapter 7. From the creditor's viewpoint, chapter 7 establishes the concept of equitable distribution among creditors of a debtor's resources which, in most cases, are insufficient to permit full payment to all. From the individual debtor's vantage point, chapter 7 permits the honest debtor to obtain a new financial life through the discharge of unpaid debts." In re Winters, 40 P.3d 1231, 1234 (Wyo. 2002).

"Persons" (including individuals, partnerships, corporations and business trusts) are eligible to file a chapter 7 case. Trusts other than business trusts, however, are not eligible. See In re Sung Soo Rim Irrevocable Intervivos Trust, 177 B.R. 673, 675 (Bankr. C.D. Cal. 1995) ("By limiting eligibility to 'persons,' rather than 'entities,' Congress intentionally excluded trusts as a category from filing bankruptcies.") Further, chapter 7 relief is specifically not available to certain types of organizations, including: railroads, insurance companies, banks, savings and loan associations and credit unions. "Eligibility for relief under the Bankruptcy Code is a jurisdictional matter which may be raised at any time either by a motion to dismiss or by a motion to vacate …." In re Citizens Bank & Trust Co. of Park Ridge, 8 B.R. 812, 8115 (Bankr. D. Ill. 1981).

While corporations and certain other types of legal entities are eligible to seek chapter 7 relief, only an "individual" may receive a discharge. See 11 U.S.C. § 727(a)(1). In other words, if a corporation seeks protection under chapter 7 of the bankruptcy code, it will receive the protection of the automatic stay for the duration of the case, and its assets will be administered and liquidated for distribution to its creditors. Upon conclusion of the case, however, the corporation will remain liable for all of its pre-petition debts.

In all chapter 7 cases, a trustee is appointed, among other things (a) to collect and reduce property of the estate to cash, (b) to investigate the debtor's financial affairs, (c) to examine and object to claims, and (d) if advisable, to oppose the debtor's discharge. See 11 U.S.C. § 707. If assets are available for distribution, the trustee will reduce them to cash and, after paying the estate's administrative expenses, will distribute the cash to those unsecured creditors of the debtor holding allowed claims.

1. The "Means Test"

The recent bankruptcy amendments added a new requirement for eligibility under chapter 7. If the debtor is an individual whose debts are "primarily consumer debt," then he or she must pass the so-called "means test" imposed under section 707(b) of the Bankruptcy Code.

The means test has three steps. The first part of the test, the median income test, determines whether the debtor even should be taking the test. The debtor's average income for the last six months is compared with the applicable median income of the state. See 11 U.S.C. § 707(b)(7). If the debtor's income is less than the median then the rest of the means test is inapplicable.

The second part of the test, the monthly disposable income test, compares the debtor's projected disposable income against his or her expenses. The expenses are calculated as a combination of (i) certain assumed expenses specified by the IRS plus the debtor's actual expenses in certain limited areas, (ii) the debtor average monthly payments on account of secured debts, plus (iii) the debtor's expenses for payment of all priority claims (including child support and alimony). The "disposable income" over sixty months must be less than the lesser of (i) $10,000 or (ii) the greater of 25% of the debtor's nonpriority unsecured claims, or $6,000.00. If the disposable income exceeds this amount, then the debtor is not eligible for relief under chapter 7.

The third part of the test is the debtor's opportunity to rebut the presumption of abuse. The presumption, however, may be rebutted only "by demonstrating special circumstances."

2. Dismissal under 11 U.S.C. § 707(a)

Section 707(a) of the Bankruptcy Code provides that a chapter 7 case can be dismissed, after notice and a hearing, "for cause." The non-exhaustive grounds for dismissal delineated in the statute are:

> (1) unreasonable delay by the debtor that is prejudicial to creditors;

> (2) nonpayment of any fees and charges required under chapter 123 of title 28; and
>
> (3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521, but only on a motion by the United States trustee.

11 U.S.C. § 707(a).

Dismissal under subsection (1), for unreasonable delay, is intended to prevent the debtor from filing a petition to take advantage of the automatic stay and/or other bankruptcy protections and subsequently failing to appear or file necessary papers (*i.e.*, the list of creditors, the schedules of assets and liabilities and the statement of financial affairs), or otherwise failing to take any necessary steps for the proper administration of the estate. See, e.g., In re Rust, 1 B.R. 656 (Bankr. M.D. Tenn. 1979) (dismissing case for debtor's failure to appear at section 341 meeting of creditors); In re Bresler, 119 B.R. 400 (Bankr. E.D.N.Y. 1990) (dismissing case for debtor's failure to appear at creditors' meeting and failure to file schedules).

Delay under subsection (1) does not encompass any delay in the bankruptcy filing itself, but refers only to delays by the debtor after the bankruptcy petition is filed. See In re Lang, 5 B.R. 371 (Bankr. S.D.N.Y. 1980).

In addition to the grounds for dismissal enumerated in section 707(a), any other "cause" for dismissal may be offered. As an example, the Utah Bankruptcy Court has held that a debtor's lack of good faith in filing his chapter 7 bankruptcy case constituted cause for dismissal. See, e.g., In re Sink, Ch. 13 Case No. 02-40042 JAB, slip op. at 8 (Bankr. D. Utah Feb. 28, 2003) (Boulden, J.) (dismissing chapter 7 case of debtor Clay Peterson where "the total failure, twice, to file required papers or appear at the meeting of creditors [wa]s … strong[] evidence of bad faith"), opinion available on the internet at www.utb.uscourts.gov/LocalOpinions/opinions/434opin.pdf. See also Davis v. Mather (In re Davis), 239 B.R. 573, 578 (B.A.P. 10th Cir. 1999) (holding that "lack of good faith in commencing a case" may constitute "cause" for dismissal or conversion in a chapter 13 case).

3. Dismissal under 11 U.S.C. § 707(b) for "abuse"

Section 707(b) of the Bankruptcy Code provides that a chapter 7 case "filed by an individual debtor … whose debts are primarily consumer debts" can be dismissed, after notice and a hearing, if the bankruptcy court determines that "the granting of relief would be an abuse of the provision of [chapter 7 of the Bankruptcy Code]." 11 U.S.C. § 707(b).

Prior to the 2005 amendments, only the bankruptcy court itself (on its own motion) or the United State trustee could seek dismissal under section 707(b). Under current law, however, dismissal for "abuse" is a remedy available to the debtor's general creditors.

A motion to dismiss under section 707(b) requires two findings (i) that the debts of the debtor are "primarily consumer debts," and (ii) that granting the debtor a discharge under chapter 7 would be an "abuse." Regarding the first element, the Court of Appeals for the Tenth Circuit has provided the following guidance: "The Bankruptcy Code defines 'consumer debt' as 'debt incurred by an individual primarily for a personal, family, or household purpose.' 'Consumer debt' is further distinguished from 'non-consumer' debt as a debt incurred without a 'profit motive.' " Stewart, 175 F.3d at 806 (holding that loans used to support the debtor's family and support payments to the debtor's spouse and children were "consumer debts"). The Stewart court further "define[d] 'primarily' in the context of § 707(b) as meaning consumer debt exceeding fifty percent of the total debt." Id. at 808.

Regarding the second element—abuse—the Tenth Circuit has adopted a "totality of the circumstances" standard, which must be applied on a case-by-case basis. See id. at 809. "[T]he debtor's ability to repay his debts out of future earnings is a primary factor in determining if substantial abuse occurred." Id. at 808. "[O]ther relevant or contributing factors, [however,] such as unique hardships, must also be examined before dismissing a Chapter 7 petition. Conversely, where an inability to pay exists,… other factors may nevertheless establish substantial abuse." Id. at 809.

In its Stewart decision, the court of appeals identified the following additional factors that may be relevant to a "substantial abuse" determination: (i) sudden illness, calamity, disability, or unemployment; (ii) cash advances and consumer purchases greatly in excess of the debtor's ability to repay; (iii) excessive or unreasonable expenses; (iv) whether the debtor accurately stated his financial condition in his schedules, including his statements of income and expenses; (v) the debtor's good or bad faith; (vi) whether the debtor enjoys a stable source of future income; (vii) whether the debtor is eligible for adjustment of debt under chapter 13; (viii) whether state law remedies exist to ease the debtor's financial difficulties, as an alternative to chapter 7 relief; (ix) the degree of relief obtainable through private negotiations; and (x) whether the debtor's expenses can be significantly reduced without depriving the debtor's family of adequate food, clothing, shelter and other necessities. See id. at 809. Regarding the second additional factor noted above, the Stewart court noted: "Bankruptcy relief is not intended to remedy the consequences of extravagant spending." Stewart, 175 F.3d at 806.

In Stewart, the court of appeals affirmed dismissal of a chapter 7 case for substantial abuse, even though the debtor was not eligible for relief under chapter 13. See id. at 810. The Stewart court relied heavily on the following factors in arriving at its decision (a) the debtor's ability to repay his debt from future earnings, (b) the fact that the debtor had lived an extravagant lifestyle, spending substantially more than his income could support; and (c) the debtor's apparent bad faith in filing the bankruptcy case. See id. at 809-10. Remarking that the debtor's circumstances bring to mind "the old adage, 'having your cake, and eating it too,' " the Stewart court concluded that debtor's attempt to obtain relief under chapter 7 constituted a "substantial abuse" of the bankruptcy laws. Id. at 810.

The 2005 amendments to the Bankruptcy Code also imposed a rebuttable presumption of abuse where the debtor does not satisfy the "means test." In cases where the debtor's satisfy the "median income" portion of the means test, however, (i) there is no presumption of abuse, and (ii) only the court or the United States Trustee may file a motion for dismissal.

C. Chapter 13 – Individual Reorganization

In a chapter 13 case, the debtor must propose and obtain confirmation of a plan for the repayment (or partial repayment) of its debts. Thereafter, the debtor must complete its plan (making all plan payments) in order to receive a discharge. In contrast to chapter 7 cases, the debtor is allowed to retain control and possession of its assets. In lieu of surrendering its non-exempt assets, the chapter 13 debtor is required to apply all of his or her projected "disposable income," for a period of at least three and no more than five years, for the repayment of secured and unsecured debt.

Only an "individual" with "regular income" (defined in § 101(30) as "individual whose income is sufficiently stable and regular" to allow for chapter 13 plan payments) is eligible to file a chapter 13 case. See 11 U.S.C. § 109(e). Further, the individual's secured and unsecured debts cannot exceed certain statutorily prescribed limits. In this regard, an individual is not eligible to file a chapter 13 case if (i) his or her noncontingent, liquidated unsecured debts equal or exceed $336,900.00, or (ii) he or she has noncontingent, liquidated secured debt of not less than $1,010,650.00. See 11 U.S.C. § 109(e). "While the word 'liquidated' is not defined, courts have generally held that a debt is 'liquidated' if its amount is readily and precisely determinable, as where the claim is determinable by reference to an agreement or by a simple computation. The mere fact that the amount of or liability on a claim is disputed does not necessarily render the claim unliquidated. Further, a debtor who fails to object to a proof of claim may not assert that the claim is unliquidated." In re Toronto, 165 B.R. 746, 752 (Bankr. D. Conn. 1994) (citations omitted).

The chapter 13 debtor must file his or her list of creditors (*i.e.*, creditor mailing matrix), schedules of assets and liabilities, statement of financial affairs and plan within fifteen (15) days after the bankruptcy petition is filed, or within such extended period as the bankruptcy court may allow. As part of its schedules of assets and liabilities, which are signed under penalty of perjury, the debtor must state his or her projected monthly income and provide a budget of his or her regular monthly expenses. The debtor's chapter 13 plan will not be confirmed unless all of the debtor's disposable income is devoted to repayment of his or her unsecured debt for at least a three year period. Indeed, one of the requirements for confirmation of a chapter 13 plan is that,

> as of the effective date of the plan—
>
> (A) the value of the property to be distributed under the plan on account of [all allowed unsecured claims] is not less than the amount of such claim; or
>
> (B) the plan provides that all of the debtor's projected disposable income to be received in the three-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

11 U.S.C. § 1325(b)(1).

As defined in the Bankruptcy Code:

> "disposable income" means current monthly income received by the debtor (other than child support payments, foster care payment, or disability payments for a dependent child … to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended—
>
> (A) (i) for the maintenance or support of the debtor or a dependent of the debtor, or for a domestic support obligation, that first becomes payable after the date the petition is filed; and
>
> (ii) for [certain charitable contributions]; and
>
> (B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

11 U.S.C. § 1325(b)(2). "Amounts reasonably necessary to be expended" are calculated in accordance with the standards that govern the means test, as described under subparagraphs (A) and (B) of section 707(b)(2). See 11 U.S.C. § 1325(b)(3)

Another requirement for confirmation of a chapter 13 plan is that "the value, as of the effective date of the plan, of property to distributed under the plan on account of each allowed unsecured claim [must be] not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such claim." 11 U.S.C. § 1325(a)(4). This is sometimes referred to as the "best interest of creditors test." In other words, while a chapter 13 debtor is entitled to retain all of its assets and does not surrender them for payment of its creditors, as in a chapter 7 case, the chapter 13 plan must provide for payment to the debtor's unsecured creditors in an amount not less than the creditors would receive if all the assets were liquidated and distributed under a chapter 7 case.

Yet another condition to confirmation of a chapter 13 plan is that the plan must be "proposed in good faith and not by any means forbidden by law." 11 U.S.C. § 1325(b)(3). To meet this requirement, the Debtor must show that he is "putting forth [his] best efforts to repay creditors." In re Smith, 130 B.R. 102, 105 (Bankr. D. Utah 1991) (Allen J.). This generally requires a meaningful distribution to unsecured creditors. See, e.g., In re Iacovoni, 2 B.R. 256 (Bankr. D. Utah 1980) (holding that plan that provided no payment to unsecured creditors was not filed in good faith). "The party who seeks a discharge under Chapter 13 bears the burden of proving good faith. Best efforts under 11 U.S.C. § 1325(b), without more, are not enough. A determination of good faith must be made on a case by case basis, looking at the totality of the circumstances." Davis v. Mather (In re Davis), 239 B.R. 573, 577 (B.A.P. 10th Cir. 1999) (citations omitted).

The Court of Appeals for the Tenth Circuit has identified a non-exhaustive list of factors indicative of a debtor's good or bad faith in proposing a plan:

> (1) the amount of the proposed payments and the amount of the debtor's surplus;
>
> (2) the debtor's employment history, ability to earn and likelihood of future increases in income;
>
> (3) the probable or expected duration of the plan;
>
> (4) the accuracy of the plan's statement of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court;
>
> (5) the extent of preferential treatment between classes of creditors;
>
> (6) the extent to which secured claims are modified;
>
> (7) the type of debt sought to be discharged and whether any such debt is non-dischargeable in Chapter 7;

> (8) the existence of special circumstances such as inordinate medical expenses;
>
> (9) the frequency with which the debtor has sought relief under the Bankruptcy Reform Act;
>
> (10) the motivation and sincerity of the debtor in seeking Chapter 13 relief; and
>
> (11) the burden which the plan's administration would place upon the trustee.

Flygare v. Boulden, 709 F.2d 1344, 1347-48 (10th Cir. 1983) (citations omitted). These factors are among the "totality of circumstances" that should be considered "in determining whether a chapter 13 petition has been filed in bad faith under 1307(c)." Gier v. Farmers State Bank (In re Gier), 986 F.2d 1326, 1329 (10th Cir. 1993); see also Pioneer Bank v. Rasmussen (In re Rasmussen), 888 F.2d 703, 706 (10th Cir. 1989) ("using the 'totality of the circumstances' approach required by *Flygare*" to "conclude that [the debtor's] Chapter 13 filing was not made in good faith"). As stated above, the factors identified in Flygare are non-exhaustive. Other courts have identified the following additional considerations as relevant to a determination of bad faith:

> 1. The length of time between prior cases and the present one;
>
> 2. Whether successive cases were filed to obtain favorable treatment afforded by the automatic stay;
>
> 3. The effort made to comply with prior case plan;
>
> 4. The fact that Congress intended the debtor to achieve its goals in a single case; and
>
> 5. Any other facts the courts find relevant relating to the debtor's purpose in making the successive filings.

In re Merrill, 192 B.R. 245, 249 (Bankr. D. Colo. 1995) (quoting In re Oglesby, 158 B.R. 602, 607 (E.D.Pa. 1993)). The Merrill court further noted: "Past filings and dismissals are circumstantial evidence of a debtor's motivation and ability to perform obligations under the Code. A debtor's performance in prior Chapter 13 cases is probative of a debtor's ability and motivation to repay creditors." Id.

If the debtor has secured creditors, then pursuant to section 1325(a)(5) of the Bankruptcy Code, the chapter 13 plan cannot be confirmed unless, as to each secured creditor, (i) the secured creditor accepts the plan (which it will be deemed to do if it does not object), (ii) the debtor surrenders the collateral to the secured creditor or (iii) the plan provides that the secured creditor will retain its lien and will be distributed property under the plan not less than allowed amount of claim its secured claim (A) in equal monthly installments and (B) in an amount sufficient to provide the creditor with adequate protection.

Nevertheless, a chapter 13 plan *may* "modify the rights of holders of secured claims …." 11 U.S.C. § 1322(b)(2); see also Kittell v. First Union Nat'l Bank (In re Kittell), 285 B.R. 344 (B.A.P. 10th Cir. 2002). The debtor may cure existing defaults under its plan, and may decelerate the debt to the extent it was accelerated pre-petition. See In re Colvin, 57 B.R. 299 (Bankr. D. Utah 1986). Through its plan, the debtor also may "strip down" an undersecured creditor's lien, except an undersecured claim secured solely by the debtor's principal residence. See 11 U.S.C. § 1322(b)(2); Nobelman v. American Savs. Bank, 508 U.S. 324 (1993). In effect, the debtor is able to bifurcate the secured creditor's claim into two parts: (i) a secured claim in the amount of the value of the collateral, which must be paid in full under the plan, together with a market rate of interest; and (ii) an unsecured claim for the amount by which the creditor's pre-petition claim exceeds the value of the collateral, which will be paid *pro rata* with other unsecured claims.

The debtor also may use the plan to "strip off" the liens of junior lienholders to the extent there is no equity in the "collateral" to support such creditor's lien. Such claim will not be treated as a secured claim under the plan, but will be treated and paid as a wholly unsecured claim. See Pierce v. Beneficial Mortg. Co. (In re Pierce), Adv. Pro. No. 01-2367, Bankr. Lexis 11473, at *1 (Bankr. D. Utah May 8, 2002) (holding that creditor holding a lien interest in the debtor's principal residence was properly treated as an unsecured creditor, and did not hold a secured claim, because there was insufficient equity in property to allow payment to such creditor); Zimmer v. PSB Lending Corp. (In re Zimmer), 313 F.3d 1220 (9th Cir. 2002).

D. Chapter 11 – Reorganization and/or Orderly Liquidation

The underlying purpose of chapter 11 is to preserve the debtor's going concern value. If the goal is reorganization, the debtor will seek to maintain an ongoing business enterprise through and, hopefully, following the bankruptcy case. If the goal is orderly liquidation, then the debtor will seek to liquidate its assets in an orderly manner, perhaps selling all or substantially all of its assets as going concern. Persons eligible to file for chapter 11 bankruptcy protection include all "persons" eligible to file a chapter 7 case, plus railroads, uninsured state member banks and federal clearing house banks.

After filing the bankruptcy case, a chapter 11 debtor generally will continue to operate and transact its normal business as a "debtor-in-possession." See 11 U.S.C. §§ 1107 and 1108. Following the filing of the chapter 11 petition, the debtor has a 120-day "exclusive period" to file a plan. See 11 U.S.C. § 1121(b). This 120-day period may be, for cause, reduced or increased by order of the bankruptcy court, after notice and a hearing. See 11 U.S.C. § 1121(d). Unless a chapter 11 trustee has been appointed in the case, no creditor or other party-in-interest may file a plan until the exclusive period has run. See 11 U.S.C. § 1121(c)(2). Further, if the debtor files a plan within the exclusive period, then the debtor will be allowed an additional sixty days to confirm the plan, during which creditors and parties-in-interest will continue to be prohibited from filing a competing plan. See 11 U.S.C. § 1121(c)(3).

A chapter 11 plan will provide for the repayment, restructuring and/or modification of the debtor's obligations. A confirmed chapter 11 plan is treated as a contract between the debtor and its creditors. Under principles of both *res judicata* and contract law, once confirmed, the plan is binding on all creditors and parties-in-interest, whether or not they voted for the plan and irrespective of whether their rights are impaired under the plan.

So long as certain criteria are satisfied, the court may confirm a chapter 11 plan if the plan has been accepted by at least one impaired class of creditors and provided that the plan is fair and equitable to each non-accepting impaired class. A chapter 11 plan must provide an "adequate means" for the plan's implementation. Permissible "means" include, without limitation:

> (A) retention by the debtor of all or any part of the property of the estate;
>
> (B) transfer of all or any part of the property of the estate to one or more entities, whether organized before or after the confirmation of such plan;
>
> (C) merger or consolidation of the debtor with one or more persons;
>
> (D) sale of all or any part of the property of the estate subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate;
>
> (E) satisfaction or modification of any lien;
>
> (F) cancellation or modification of any indenture or similar instrument;
>
> (G) curing or waiving any default;
>
> (H) extension of a maturity date or a change in an interest rate or other term of outstanding securities;
>
> (I) amendment of the debtor's charter; or
>
> (J) issuance of securities of the debtor, or of any entity referred to in subparagraph (B) or (C) …, for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose ….

11 U.S.C. § 1123(a)(5). Accordingly, as discussed above in the materials regarding chapter 13 cases, the plan may "strip down" or "strip off" the liens of secured creditors. The plan also may modify repayment terms, including the interest rate to be paid to secured creditors, the frequency and amount of payments and/or the period over which repayment will occur.

As with chapter 13 plans, a chapter 11 plan cannot be confirmed unless it is "proposed in good faith and not by any means forbidden by law." 11 U.S.C. § 1129(a)(3). On this subject, one of Utah's three bankruptcy judges has written: "When a creditor raises the issue of bad-faith filing, a debtor must generally establish to the court's satisfaction that there exists the realistic possibility of an effective reorganization." William Thomas Thurman & Brett P. Johnson, Bankruptcy and the Bad Faith Filing, Vol. 10 No. 10 Utah Bar Journal 12, 14 (Dec. 1997) (quoting Carolin Corp. v. Miller, 886 F.2d 693, 698 (4th Cir. 1989)). Where "a debtor has no real intent to reorganize, nor a legitimate prospect of reorganization, [the] petition [should] be considered an attempt to frustrate creditor rights and therefore 'an abuse of process—the unlawful exercise of a right or remedy.' " Thurman, supra at 14 (quoting In re Mill Place Ltd. P'ship, 94 B.R. 139, 142 (Bankr. D. Minn. 1988)).

Another prerequisite to confirmation of a chapter 11 plan is that, unless they otherwise agree, the debtor must pay the holders of allowed administrative expense claims in full on the effective date of the plan. See 11 U.S.C. § 1129(a)(9). Further, the plan cannot be confirmed if "[c]onfirmation of the plan is … likely to be followed by the liquidation, or the need for further financial reorganization of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." See 11 U.S.C. § 1129(a)(11).

If a class of secured claims does not accept the plan, then to confirm the plan over such dissenting class' objection the plan must: (i) allow the holders of secured claims to retain their liens to the extent of the allowed amount of their secured claims and provide for payment to such creditors of "deferred cash payments totaling at least the allowed amount of such claim," 11 U.S.C. § 1129(b)(2)(A)(i); (ii) provide for the sale of the secured creditors' collateral, with the liens to attach to the proceeds of the sale, see 11 U.S.C. § 1129(b)(2)(A)(i); or (iii) provide the secured creditor with the "indubitable equivalent of" its secured claim, 11 U.S.C. § 1129(b)(2)(A)(iii).

In contrast, if a class of unsecured creditors does not accept the plan, the plan need only ensure that "the holder of any claim or interest that is junior to the claims of such class will not receive or retain under the plan on account of such junior claim or interest any property," unless such dissenting unsecured class first is paid in full. 11 U.S.C. § 1129(b)(2)(B).

A debtor may seek to sell some or all of its assets prior to confirming or even proposing a plan. See In re Allison, 39 B.R. 300, 301-02 (D.N.M. 1984) ("The clear weight of authority authorizes the sale of all or substantially all of the debtor's assets pursuant to Section 363(b) in a chapter 11 proceeding, even absent a disclosure statement, plan, and vote of the creditors.") Pursuant to section 363 of the Bankruptcy Code, the debtor may be authorized to sell its property free and clear of any liens, claims or interests of its creditors. If the sale is outside the ordinary course of the debtor's business, however, the debtor will be able to complete the sale only if it shows that a sound business purpose exists for doing so. See, e.g., In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983); In re Martin, 91 F.3d 395 (3d Cir. 1996); In re Titusville Country Club, 128 B.R. 396 (W.D. Pa. 1991); In re Ancor Exploration Co., 30 B.R. 802, 808 (N.D.Okl. 1983) (bankruptcy court has wide-latitude in approving sale of substantially all of the estate assets under section 363(b)).

Courts have applied four factors in determining whether a sound business justification exists to approve a pre-plan sale under section 363 of the Bankruptcy Code: (i) whether a sound business reason exists for the proposed transaction; (ii) whether fair and reasonable consideration is provided; (iii) whether the transaction has been proposed and negotiated in good faith; and (iv) whether adequate and reasonable notice is provided. See Lionel Corp., 722 F.2d at 1071 (identifying the "sound business purpose" test); In re Abbotts Dairies of Penn., Inc., 788 F.2d 143, 145-47 (3d Cir. 1986) (implicitly adopting the articulated business justification test of Lionel, and adding the "good faith" requirement); In re Delaware & Hudson Ry. Co., 124 B.R. 169, 176 (D. Del. 1991) (adopting Lionel). On this subject, a well respected bankruptcy treatise explains:

> There has been disagreement historically on the issue of whether and under what circumstances a chapter 11 debtor may sell substantial assets under section 363. It is now generally accepted that section 363 allows such sales in chapter 11, provided, however, that the sale proponent demonstrates a good, sound business justification for conducting the sale prior to confirmation (other than appeasement of the loudest creditor), that there has been adequate and reasonable notice of the sale, that the sale has been proposed in good faith, and that the purchase price is fair and reasonable. These factors are

> considered to assure that the interests of all parties in interest are protected and that the sale is not for an illegitimate purpose.

3 Collier on Bankruptcy (15th Rev. 2002), ¶363.02[4], at 363-19 to –20.

Further, as alluded to above, under section 363(f) of the Bankruptcy Code, the debtor or a trustee may sell property free and clear of any lien, claim or interest in such property if:

> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f). Because Bankruptcy Code section 363(f) is drafted in the disjunctive, satisfaction of any one of its five requirements will suffice to approve the sale of assets free and clear of liens, claims, encumbrances, and other interests. See 11 U.S.C. § 363(f); Michigan Employment Security Comm'n v. Wolverine Radio Co. (In re Wolverine Radio Co.), 930 F.2d 1132, 1147 n.24 (6th Cir. 1991) (section 363(f) written in disjunctive; court may approve sale "free and clear" provided at least one of the subsections is met); Citicorp Homeowners Servs., Inc. v. Elliot (In re Elliot), 94 B.R. 343 (E.D. Pa. 1988) (same).

E. Dismissal and Conversion

Bankruptcy cases under any chapter may be dismissed or converted to a case under another chapter of the Bankruptcy Code if cause exists for dismissal or conversion. Further, under appropriate circumstances, a dismissal may be "with prejudice" so as to prevent any bankruptcy re-filing for a period of 180 days.

Under section 1112 of the Bankruptcy Code, a creditor or other party in interest may move for conversion or dismissal of a chapter 11 bankruptcy case "for cause." 11

U.S.C. § 1112(b). Grounds that may support conversion or dismissal of a chapter 11 case include, but are not limited to:

> (A) a substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation;
>
> (B) gross mismanagement of the estate;
>
> (C) failure to maintain appropriate insurance that poses a risk to the estate or to the public;
>
> (D) unauthorized use of cash collateral substantially harmful to 1 or more creditors;
>
> (E) failure to comply with an order of the court;
>
> (F) unexcused failure to satisfy timely any filing or reporting requirement established by [title 11] or by any rule applicable to a case under [chapter 11];
>
> (G) failure to attend the meeting of creditors … without good cause shown by the debtor;
>
> (H) failure timely to provide information or attend meetings reasonably requested by the United States trustee (or the bankruptcy administrator, if any);
>
> (I) failure timely to pay taxes owed after the order for relief or to file tax returns due after the date of the order for relief;
>
> (J) failure to file a disclosure statement, or to file or confirm a plan within the time fixed by [title 11] or by order of the court;
>
> (K) failure to pay any fees or charges required under chapter 123 of title 28;
>
> (L) revocation of an order of confirmation under section 1144;
>
> (M) inability to effectuate substantial consummation of a confirmed plan;
>
> (N) material default by the debtor with respect to a confirmed plan;
>
> (O) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan; and

> (P) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

11 U.S.C. § 1112(b). If "cause" for conversion or dismissal is established, after notice and a hearing, then "absent unusual circumstances specifically identified by the court that establish that the requested conversion or dismissal is not in the best interests of creditors and the estate, the court shall convert [the chapter 11 case] to a case under chapter 7 or dismiss [the chapter 11 case], whichever is in the best interests of creditors and the estate." Id. The determination of whether conversion or dismissal is more appropriate will be within the sole discretion of the bankruptcy court.

Similarly, a creditor or other party in interest has standing to move the bankruptcy court to dismiss or convert a chapter 13 case "for cause." 11 U.S.C. § 1307(c). A nonexclusive list of grounds that may support conversion or dismissal of a chapter 13 case include:

> (1) unreasonable delay by the debtor that is prejudicial to creditors;
>
> (2) nonpayment of any fees and charges required under chapter 123 of title 28;
>
> (3) failure to file a plan timely …;
>
> (4) failure to commence making timely [plan] payments …;
>
> (5) denial of confirmation of a plan … and denial of a request made for additional time for filing another plan or a modification of a plan;
>
> (6) material default by the debtor with respect to a term of a confirmed plan;
>
> (7) revocation of the order of confirmation …, and denial of confirmation of a modified plan …; [or]
>
> (8) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan other than the completion of payments under the plan ….

11 U.S.C. § 1307(c). In addition to these grounds enumerated in the statute, the Bankruptcy Appellate Panel for the Tenth Circuit has explained that "lack of good faith

in commencing a case" may constitute "cause" for dismissal or conversion. Davis v. Mather (In re Davis), 239 B.R. 573, 578 (B.A.P. 10th Cir. 1999). As with conversion or dismissal in the chapter 11 context, once "cause" under section 1307(c) has been established, the bankruptcy court has the discretion to either convert or dismiss the case, based upon "whichever is in the best interests of creditors and the estate." 11 U.S.C. § 1307(c).

Normally, dismissal of a bankruptcy case is without prejudice to a debtor's right to immediately re-file under title 11, and also without prejudice to the debtor's right to discharge its debts in that subsequent bankruptcy. See 11 U.S.C. § 349(a). Under section 349(a) of the Bankruptcy Code, however, a bankruptcy court's order of dismissal may be *with prejudice* in that the court may, " 'for cause,' … permanently disqualify a class of debts from discharge." Frieouf v. United States (In re Frieouf), 938 F.2d 1099, 1103 (10th Cir. 1991).

Further, pursuant to section 109(g)(1) of the Bankruptcy Code, a bankruptcy court may dismiss a case *with prejudice* so as to bar a debtor from re-filing a bankruptcy case for a period of 180 days, if the debtor (i) has willfully failed to abide by orders of the bankruptcy court, (ii) has willfully failed to appear before the court in proper prosecution of the case, or (iii) has requested and obtained voluntary dismissal of the case following the filing of a request for relief from the automatic stay pursuant to section 362(d) of the Bankruptcy Code. See 11 U.S.C. § 109(g).

The purpose of section 109(g) is to "prevent debtors from using repetitive filings as a method of frustrating a creditor's efforts to recover what is owed them." 2 Collier on Bankruptcy § 109.08, 109-48 (15th ed. rev. 1999); see also In re Richardson, 217 B.R. 479, 488 n.15 (Bankr. M.D. La. 1998) (discussing legislative history of section 109(g)); In re Kaul, 76 B.R. 79, 80-81 (Bankr. E.D. Pa. 1987). "The broad and powerful protections afforded a debtor under bankruptcy law are counterbalanced by a debtor's duties to facilitate a liquidation under Chapter 7 or accomplish a reorganization and repayment through a plan under Chapters 9, 11, 12 and 13. The purpose of Chapter 13 is to afford an honest debtor confronted with financial distress with a breather period while providing creditors with an equitable and predictable repayment." In re Merrill, 192 B.R. 245, 250-51 (Bankr. D. Colo. 1995). "When a debtor seeks and enjoys the protection of the Bankruptcy Code without intending to perform his or her obligations to disclose, to facilitate a liquidation or to accomplish a repayment program, the debtor abuses both the system and the creditors." Id.

Judge Boulden, one of the three bankruptcy judges sitting in the district of Utah, has issued two written opinions discussing the meaning and application of section 109(g), *to wit*, In re Sink, Ch. 13 Case No. 02-40042 JAB (Bankr. D. Utah Feb. 28, 2003), available on the internet at www.utb.uscourts.gov/LocalOpinions/opinions/434opin.pdf., and In re Tilson, Ch. 13 Case No. 03-22735 JAB (Bankr. D. Utah June 6, 2003), available online at http://www.utb.uscourts.gov/LocalOpinions/opinions/434opin.pdf. In both cases, Judge Boulden explained the heavy burden of proof and persuasion that must be carried by a creditor seeking 109(g) dismissal:

> Dismissal with prejudice is a severe sanction that should be infrequently invoked by the courts. The burden is on the movant to show that the sanction is appropriate. Once the movant has set forth a sufficient *prima facie case*, the burden shifts to the debtor to show that § 109(g)(1) does not apply. Ultimately, the burden of persuasion lies with the movant to demonstrate, by a preponderance of the evidence, either that the debtor willfully failed to abide by orders of the court, or that the debtor willfully failed to appear before the court in proper prosecution of the case.

Tilson, slip op. at 5-6 (italics in original). The Sink and Tilson decisions are further helpful in that (i) they discuss and catalogue circumstances that constitute a failure "to appear before the court in proper prosecution of the case," 11 U.S.C. § 109(g)(1), and (ii) explain the meaning of "willful" in the context of section 109(g)(1).

In Tilson and Sink, the bankruptcy court held that the following acts and omissions will constitute a failure to appear before the court in proper prosecution of the case: (i) the debtor's failure to make filings required by the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure and/or the bankruptcy court's Local Rules, including (a) the list of creditors (i.e., mailing matrix) required under section 521(1), Federal Rule of Bankruptcy Procedure 1007(a) and Local Rules 1007-1, 2002-1(d) and 5005-1(c), (b) the statement of financial affairs and schedules required under section 521(1), Federal Rule of Bankruptcy Procedure 1007(a) and Local Rule 5005-1(c), and (c) a plan of reorganization as required under section 1321 and Local Rule 5005-1(b), see Tilson, slip op. at 8; (ii) the debtor's failure to attend the meeting of creditors as required by section 343 and Local Rule 2003-1(a), see id.; (iii) the debtor's failure to tender its first plan payment at the meeting of creditors, as required by Local Rule 2083-1(b), see id.; (iv) the debtor's "fail[ure] to make plan payments subsequent to the first meeting of creditors," Sink, slip op. at 17; and (v) the debtor's failure to defend against a motion to dismiss, see id.

Of course, merely proving that the debtor has failed to abide by orders of the bankruptcy court or has failed to appear in prosecution of its case will not alone justify dismissal with prejudice. A moving creditor also must show "that such failure was willful." Tilson, slip op. at 7. "Conduct is willful within the meaning of § 109(g) when the debtor had notice of the responsibility to act, and the debtor intentionally engaged in conduct that resulted in a failure to fulfill that responsibility." Id. at 6-7. "This necessarily rules out accidental failures, or failures resulting from circumstances beyond the debtor's control." Sink, slip op. at 16.

In the Sink and Tilson decisions, the court suggests that an inference that the debtor had notice of his responsibility and that his failure was intentional may be drawn from the fact that (i) the debtor is represented by counsel, and/or (ii) a history of repeated bankruptcy filings. See Tilson, slip op. at 10 ("The Debtor was represented by counsel throughout this case. That fact, coupled with his prior filing, permits an inference that the Debtor was aware of his statutory duties as well as the potential consequences of not fulfilling those duties."); Sink, slip op. at 17 ("Both debtors, because of the repeated filings, can be deemed to have a certain level of familiarity with bankruptcy proceedings and knowledge of the consequences of their failure to fulfill their responsibilities under the Bankruptcy Code."); Sink, slip op. at 18 ("Because his prior case was dismissed for identical conduct, the Court concludes that [the debtor] knew of his responsibility to act, and intentionally engaged in conduct that resulted in a failure to fulfill that responsibility.”). In short, a moving creditor’s chances of prevailing on a motion to dismiss with prejudice will be much greater if the debtor is guilty of serial filings. On the flip side, it will be very difficult for a creditor to obtain dismissal with prejudice of a debtor’s first bankruptcy filing, especially of the debtor is able to come up with some reasonable non-willful explanation of its failures.

F. Discharge of Debt and Grounds for Nondischargeability

1. Discharge under Chapter 11

Only individuals are eligible for a “discharge” under either chapter 7 or 11. See 11 U.S.C. §§ 727(a) and 1141(d)(1)(A). Under chapter 11, an individual’s debts will be discharged upon confirmation of the plan of reorganization unless (i) the plan is a liquidating plan, (ii) the debtor does not engage in business after confirmation, and (iii) the debtor would not be eligible for a discharge under § 727(a), although certain debts may be excepted from discharge. See 11 U.S.C. § 1141(d)(2) and (3).

A corporation or other entity is not eligible to receive a discharge. See 11 U.S.C. § 727(a)(1). Although a non-individual entity will not receive a discharge, confirmation of a chapter 11 plan does bind all creditors, equity security holders and general partners “whether or not such creditor, equity security holder, or general partner has accepted the plan.” 11 U.S.C. § 1141(a). Accordingly, although a chapter 11 corporate debtor may not receive a discharge, the plan may still act as an injunction and a *de facto* discharge, requiring the parties to perform according to the plan provisions. See United States Trustee v. CF & I Fabricators (In re CF & I Fabricators), 150 F.3d 1233, 1239 (10th Cir. 1998) (“[I]t is also clear a confirmed plan is much more than a contract. For example, once confirmed, a plan is enforceable as a court order against parties who did not even agree to its terms.”).

2. Discharge under Chapter 7

A discharge under chapter 7 is comprehensive in scope and, except for specific debts set forth in § 523(a), “ ‘a discharge in bankruptcy discharges the debtor *from all debts that arose before bankruptcy*.’ ” FCC v. NextWave Pers. Communications, Inc., 537 U.S. 293, 303 (2003) (citation omitted) (emphasis in original); see also 11 U.S.C. § 727(b).

Section 523 of the Bankruptcy Code, however, describes certain debts that are excepted from discharge. These will be discussed more fully below.

In addition to challenging the dischargeability of a particular debt pursuant to section 523(a), a trustee, creditor or the United States Trustee may challenge the debtor's entire discharge under section 727(c). A trustee or creditor objecting to the debtor's discharge must file its complaint within 60 days after the first meeting of creditors. See Fed. R. Bankr. P. 4004(a). The court, for cause and after a hearing on notice, may extend the time for filing complaints objecting to discharge if a motion seeking an extension is filed prior to the expiration of the 60 days. See Fed. R. Bankr. Pro. 4004(b).

To prevail on a complaint objecting to discharge, the creditor must show by a preponderance of evidence that one of the following grounds provided in section 727(a) exists: (1) the debtor is not an individual; (2) the debtor, with intent to hinder or defraud the estate has transferred, removed, destroyed, mutilated, or concealed property of the debtor within one year of the petition date or after the petition date; (3) the debtor has concealed or destroyed books and records from which the debtor's "financial condition or business transactions might be ascertained;" (4) the debtor knowingly or fraudulently in connection with the bankruptcy case (i) made a false oath or account, (ii) used a false claim, (iii) gave, offered or received money for acting or forbearing to act, or (iv) withheld books and records from an officer of the estate; (5) the debtor fails to explain satisfactorily any loss or deficiency of assets; (6) the debtor (i) refused to obey an order of the court, (ii) on the ground of privilege, refused to answer material questions after the debtor has been granted immunity with respect to those matters, or (iii) refused to respond to material questions or to testify; (7) the debtor committed any of the acts enumerated in (2) through (6) within one year before the date of the petition; (8) the debtor has been granted a discharge under chapters 11 in a case commenced within eight years before the petition date; (9) the debtor received a discharge under chapters 12 or 13 in a case commenced within six years of the petition, unless 100 percent of allowed claims were paid or 70 percent of claims were paid and the plan was proposed in good faith and was the debtor's best effort; (10) the court approves a waiver of discharge; (11) the debtor fails to complete an instruction course concerning personal financial management; or (12) where the court determines that that the debtor has been convicted of certain felonies or owed debts arising in connection with the violation of federal securities laws. See 11 U.S.C. § 727(a)(1) through (a)(12). Only the above-referenced grounds (11) and (12) were added by the Bankruptcy Amendments.

Although a creditor may bring a section 523 complaint objecting to the dischargeability of its particular debt as well as the debtor's overall discharge under section 727(a), once a complaint under section 727(a) has been filed, the creditor may be unable to voluntarily dismiss the section 727(a) claims. In Bank One v. Kallstrom (In re Kallstrom), 298 B.R. 753 (B.A.P. 10th Cir. 2003), Bank One filed a complaint against the debtors under section 727(a) and later sought to have a settlement agreement approved whereby the debtors agreed to repay the Bank One debt in exchange for Bank One's dismissal of the complaint. The bankruptcy court refused to approve the settlement agreement noting that it appeared that the "Bank's receipt of consideration in exchange for dismissal of the § 727(a) proceeding created the appearance that the Debtors were buying their discharge." Id. at 756. The Bankruptcy Appellate Panel affirmed, noting that the "discharge 'is not a proper subject for negotiation and the exchange of a *quid pro quo*' between a debtor and creditors." Id. at 759. The Kallstrom court held that Bankruptcy Rule 7041 specifically discourages this sort of *quid pro quo* and that the settlement was nothing more than what it appeared. The court, however, distinguished between section 523(a) and section 727(a) actions, concluding that the former may be dismissed by stipulation between the parties subject to court approval. See id. at 760 n.32.

In addition, section 1228(a) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 provided: "The court shall not grant a discharge in the case of an individual seeking bankruptcy under chapter 7 of title 11, United States Code, unless requested tax documents have been provided to the court." Section 521(e)(2) of the

Bankruptcy Code requires a debtor to provide to the trustee a copy of his, her or its federal income tax return for the most recent tax year ending prior to commencement of the case. Further, section 521(f) of the Bankruptcy Code requires individual debtors to file with the court (1) post-petition federal income tax returns, (2) pre-petition tax returns filed post-petition, (3) any amendments to said returns, and (4) in chapter 13 cases, an annual statement of the income and expenditures of the debtor during the prior tax year. Further, section 521(j) provides that, if a debtor fails to file post-petition tax returns, the case shall be dismissed or converted.

Finally, section 727(d) provides that a debtor's discharge may be revoked under certain circumstances. The discharge may be revoked if it was obtained through fraud that the complaining party did not know about prior to the discharge. See 11 U.S.C. § 727(d)(1). The discharge may be revoked if the debtor acquired property of the estate and knowingly and fraudulently failed to report such acquisition to the trustee, and/or to deliver or surrender the property to the trustee. See 11 U.S.C. § 727(d)(2). The discharge may be revoked if the debtor (i) refused to obey an order of the court, (ii) on the ground of privilege, refused to answer material questions after the debtor has been granted immunity with respect to those matters, or (iii) refused to respond to material questions or to testify. See 11 U.S.C. § 727(d)(3). A fourth ground to revoke a discharge, added by the Bankruptcy Amendments, is the debtor's failure to explain satisfactorily (i) a material misstatement in an audit conducted by the United States trustee and/or (i) failure to make available all necessary accounts and documents requested for such an audit. A complaint to seek revocation of discharge must be filed within one year of the discharge, or in the case of the debtor's acquisition of property of the estate or failure to obey a court's order, within one year after the discharge or when the case is closed, whichever is later. Furthermore, the complaint must do more than allege a particular debt nondischargeable due to fraud, but must allege that the entire discharge would not have been granted but for the fraud. See Lawrence Nat'l Bank v. Edmonds (In re Edmonds), 924 F.2d 176, 180 (10th Cir. 1991).

3. *Discharge under Chapter 13*

Under chapter 13, upon completion by the debtor of all payments under the chapter 13 plan, the debtor is granted a discharge of all debts except: (i) certain long term debts provided for in the plan, see 11 U.S.C. § 1322(b)(5); (ii) certain taxes, see 11 U.S.C. § 507(a)(8); (iii) taxes for which the return or return equivalent either (a) was not filed, or (b) was filed late and within two years prior to the petition date, see 11 U.S.C. § 523(a)(1)(B); (iv) taxes for which the debtor filed a fraudulent return or willfully attempted in any manner to evade or defeat the tax, see 11 U.S.C. § 523(a)(1)(C); (v) certain debt arising from the debtor's fraud, see 11 U.S.C. § 523(a)(2); (vi) debts neither listed on the debtor's creditor matrix nor scheduled in time for the creditor to file a proof of claim and/or seek nondischargeability, see 11 U.S.C. § 523(a)(3); (vii) debts arising in connection with fraud or defalcation while acting in a fiduciary capacity, see 11 U.S.C. § 523(a)(4); (viii) domestic support obligations, see 11 U.S.C. § 523(a)(5); (ix) student loans, see 11 U.S.C. § 523(a)(8); (x) personal injury obligations due to the debtor's operation of a vehicle, vessel or aircraft while intoxicated see 11 U.S.C. § 523(a)(9); (xi) criminal fines and criminal restitution; and (xii) restitution, or damages, awarded in a civil action against the debtor as a result of willful or malicious injury that caused personal injury or death to another individual. See 11 U.S.C. § 1328(a).

This discharge is commonly referred to as the "super" discharge because even some debts that are nondischargeable under chapter 7 may be discharged under chapter 13. See In re Gonzales, 297 B.R. 143, 152 (Bankr. D.N.M. 2003) ("Congress enacted the 'super discharge' provisions of chapter 13 in part based on its finding that most creditors who obtain a nondischargeable judgment in connection with a chapter 7 case ultimately collected little or nothing from that judgment, and thus even those creditors would be better off with the receipt of some small sum of money from a chapter 13 which discharged the rest of the debt, rather than nothing at all.").

Furthermore, a debtor who has filed a chapter 7 petition has the absolute right to convert the case to one under chapter 13 if the case has not previously been converted under chapters 11, 12 or 13. See 11 U.S.C. § 706(a). This right is absolute, as long as the debtor has not previously converted the case and meets the chapter 13 eligibility requirements of section 109(e). See Miller v. United States Trustee (In re Miller), 303 B.R. 471, 476 (B.A.P. 10th Cir. 2003). On November 6, 2006, however, the United States Supreme Court heard oral argument on this issue in the case of Marrama v. Citizens Bank of Massachusetts. The lower courts held that the debtor and petitioner, Marrama, who allegedly misrepresented his assets, did not have an absolute right to convert because his request to convert was and is part of an "abusive scheme," and because denial of the debtor's request to convert was necessary to protect the integrity of the bankruptcy system. Unless the Justices dismiss the appeal as moot, we should learn sometime before spring whether the right to convert to chapter 13 is indeed absolute.

A court may grant a discharge if the debtor does not complete payments under the plan only if the failure to make the plan payments is due to circumstances for which the debtor is not accountable, the value of property distributed under the plan is not less than what would have been paid under chapter 7, and modification of the plan is not practicable. See 11 U.S.C. § 1328(b). Such a discharge, however, does not discharge certain long term debts provided for in the plan and does not discharge any debts of the kind listed in section 523(a). Finally, a chapter 13 discharge is revocable within one year of the discharge if the discharge was obtained through fraud and the requesting party was not aware of the fraud until after the discharge was granted. See 11 U.S.C § 1328(e).

4. Non-Dischargeable Debts under Section 523

Section 523(a) of the Bankruptcy Code identifies certain debts that are excepted from discharge under chapters 7, 11, and 12 of the Bankruptcy Code, or in the case of a hardship discharge under chapter 13, pursuant to 11 U.S.C. § 1328(b). In some cases, the Bankruptcy Amendments expanded or modified some of these discharge exceptions.

Section 523(a)(1) excepts from discharge certain taxes, including: (i) taxes arising from ordinary post-petition business operations of the debtor, see 11 U.S.C. §§ 523(a)(1)(A), 507(a)(3) and 502(f), (ii) pre-petition taxes for which the return was due within three years prior to the petition date, see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(A)(i), (iii) pre-petition taxes "assessed" within 240 days prior to the petition date (such 240 day period to be extended by any period during which an offer in compromise or stay of proceedings against collections was in effect regarding the assessed tax), see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(A)(ii), (iv) pre-petition taxes not assessed before, but assessable after the petition date, see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(A)(iii), (v) property taxes incurred pre-petition and last payable without penalty within one year of the petition date, see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(B), (vi) any "tax required to be collected or withheld and for which the debtor is liable in whatever capacity," *e.g.*, trust fund taxes, 11 U.S.C. § 507(a)(8)(C), (vii) employment taxes on wages of the kind described in section 523(a)(4), see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(D), (viii) certain excise taxes, see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(E), (ix) certain customs duties, see 11 U.S.C. §§ 523(a)(1)(A) and 507(a)(8)(F), (x) a penalty due on any of the taxes described in section 507(a)(8) and "in compensation for actual pecuniary loss," 11 U.S.C. § 507(a)(8)(G), (xi) taxes for which the return or return equivalent either (a) was not filed "or given", or (b) was filed "or given" late and within two years prior to the petition date, see 11 U.S.C. § 523(a)(1)(B), and (iv) taxes for which the debtor filed a fraudulent return or willfully attempted in any manner to evade or defeat the tax, see 11 U.S.C. § 523(a)(1)(C).

Section 523(a)(2) excepts from discharge any debt "for money, property, services, or an extension, renewal or refinancing of credit, to the extent obtained by" (A) fraud, false representations and/or false pretenses other than statements respecting the debtor's financial condition, (B) use of a statement in writing that is (i) materially false, (ii) respecting the debtor's financial condition, (iii) upon which the creditor reasonably relied, and (iv) that the "debtor caused or made to be published with the intent to deceive," or (C) consumer debts for luxury goods and services aggregating more than $1,225 made within 60 days of the petition.

Section 523(a)(3) excepts from discharge certain debts not listed on the schedules in time for a creditor to file a proof of claim and/or to pursue a finding or judgment or nondischargeability.

Section 523(a)(4) excepts from discharge debts arising from "fraud or defalcation while acting in a fiduciary capacity," embezzlement, or larceny.

Section 523(a)(5) excepts from discharge "domestic support obligations." Under the prior law, section 523(a)(5) excepted from discharge obligations for alimony, maintenance and support owed to a child, spouse or former spouse. This exception to discharge is now somewhat expanded. Under the revised code, "domestic support obligation" is defined in 11 U.S.C. § 101(14A). As so defined, the term encompasses a debt (i) owed to a spouse, former spouse, child, legal guardian or governmental unit, (ii) in the nature of alimony, maintenance or support "without regard to whether such debt is expressly so designated," (iii) established by court order, separation agreement, divorce decree, property settlement agreement, or by the determination of a governmental unit made in accordance with applicable nonbankruptcy law, and (iv) whether established before or after the bankruptcy. If the debt is assigned to a non-governmental entity, however, then it must be assigned by the spouse, child or guardian "voluntarily" and "for the purpose of collecting the debt."

Section 523(a)(6) excepts from discharge "willful and malicious injury by the debtor to another entity or to the property of another entity." Section 523(a)(7) excepts from discharge certain government fines, penalties and forfeitures that are not compensation for actual pecuniary loss. Under certain circumstances, this would include criminal restitution imposed by state or municipal courts.

Section 523(a)(8) excepts from discharge student loan obligations, unless such debt imposes an undue hardship on the debtor and the debtor's dependents. Section 523(a)(9) excepts from discharge debts arising from a death or personal injury caused by the debtor while operating a vehicle, vessel or aircraft while intoxicated. Section 523(a)(10) excepts from discharge debts previously denied discharge or waived discharge in a previous bankruptcy case.

Section 523(a)(11) excepts from discharge debts incurred in final judgment or settlement decree arising from the debtor's fraud or defalcation while acting in a fiduciary capacity with respect to a federally insured bank or credit union. Section

523(a)(12) excepts from discharge malicious or reckless failure to maintain capital of a federally insured bank.

Section 523(a)(13) excepts from discharge any debt arising under any federal criminal restitution order. Section 523(a)(14) excepts from discharge debts incurred to pay nondischargeable taxes.

Section 523(a)(15) excepts from discharge debts incurred by the debtor in connection with a divorce or separation agreement that do not constitute a "domestic support obligation." These would include, among other things, directives that the debtor pay certain marital debts.

Section 523(a)(16) excepts from discharge condominium association fees that become payable post-petition and while the debtor occupied the condominium or rented the condominium and received rent from the tenant. Section 523(a)(17) excepts from discharge bankruptcy court filing fees. Section 523(a)(18) excepts from discharge debts on account of a persons borrowing from a pension, profit-sharing, stock bonus, individual retirement account or other similar type plan. Finally, Section 523(a)(19) excepts from discharge certain debts that arise from a violation of securities laws.

Although all of the above listed debts are considered "nondischargeable," those described in subsections (a)(2), (a)(4) or (a)(6) will be discharged unless the creditor files a complaint against the debtor pursuant to Rule 4007. See 11 U.S.C. § 523(c)(1) and Fed. R. Bankr. P. 4007(c). A complaint to determine the dischargeability of these particular debts must be filed no later than 60 days after the first meeting of creditors unless the court may, for cause, extends the time upon a motion filed prior to the expiration of the 60 days. See Fed. R. Bankr. P. 4007(c). If the 60 days expires and no motion to extend the deadline has been filed, these debts are discharged unless the creditor can show that the debts were not listed and the debtor did not receive notice of the case in time to file a complaint. See 11 U.S.C. § 523(a)(3)(B); see also Chanute Prod. Credit Assoc. v. Schicke (In re Schicke), 290 B.R. 792, 798 n.11 (B.A.P. 10th Cir. 2003). Furthermore, although section 523(a)(3) specifies that certain debts will not be discharged if they were not listed on the debtor's schedules in time to permit the timely filing of a proof of claim, section 523(a)(3) does not apply in a chapter 7 no asset case and, unless a debt is found to be nondischargeable under section 523(a)(2), (4), (6) or (15), these debts are discharged as a matter of law pursuant to section 727(b). See Watson v. Parker (In re Parker), 313 F.3d 1267, 1268-69 (10th Cir. 2002).

IV. Special Rights In Particular Property

A. Reclamation Rights

Bankruptcy law imposes special rights and restrictions on the rights of sellers of goods to assert reclamation claims. Section 546(c) governs the rights of reclamation claimants to demand reclamation as a remedy in the bankruptcy case.

The section applies to “a seller of goods that has sold goods to the debtor, in the ordinary course of such seller’s business” to the extent the debtor “received such goods while insolvent, within 45 days before” the bankruptcy case was filed.

The section does not trump section 541 (property of the estate) or section 362 (the automatic stay). It does give the rights of a reclamation claimant priority of the claims that a trustee may assert under section 544, 545, 547 and 549 of the Bankruptcy Code.

The statute imposes a requirement upon the seller to “demand[] in writing reclamation of such goods” not later than (a) 45 days after receipt by the debtor, or (b) if the 45 days expires after the bankruptcy case was filed, within 20 days after commencement of the bankruptcy case.

Section 503(b)(9) also gives a seller of goods “received by the debtor within 20 days” before the bankruptcy case was filed a priority claim, with rights to priority in payment and distribution.

B. Setoffs

The automatic stay generally prevents post-petition setoffs. There is a court recognized exception to this in the context of recoupment.

Section 553 of the Bankruptcy Code creates a cause of action against creditors who exercised setoff within 90 days of the bankruptcy petition and thereby improved their position.

C. <u>Landlords and Equipment Lessors -- Rejection vs. Assumption (and Assignment) of Leases</u>

The Bankruptcy Court empowers a debtor in bankruptcy (a) to cure defaults under pre-bankruptcy contracts and leases, and (b) to assign those contracts to third parties. The Code also empowers debtors to "reject" unexpired leases.

Under Bankruptcy Code section 365(a), a debtor, "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." 11 U.S.C. § 365(a). Bankruptcy Code section 365(b)(1), in turn, codifies the requirements for assuming an unexpired lease or executory contract of a debtor. This subsection provides:

> (b)(1) If there has been a default in an executory contract or unexpired lease of the debtor, the trustee may not assume such contract or lease unless, at the time of assumption of such contract or lease, the trustee—
>
> (A) cures, or provides adequate assurance that the trustee will promptly cure, such default;
>
> (B) compensates, or provides adequate assurance that the trustee will promptly compensate, a party other than the debtor to such contract or lease, for any actual pecuniary loss to such party resulting from such default; and
>
> (C) provides adequate assurance of future performance under such contract or lease.

11 U.S.C. § 365(b)(1).

The meaning of "adequate assurance of future performance" depends on the facts and circumstances of each case, but should be given "practical, pragmatic construction." <u>EBG Midtown South Corp. v. McLaren/Hart Env. Engineering Corp. (In re Sanshoe Worldwide Corp.)</u>, 139 B.R. 585, 593 (S.D.N.Y. 1992); <u>see</u> <u>In re Prime Motor Inns Inc.</u>, 166 B.R. 993, 997 (Bankr. S.D. Fla. 1994) ("[a]lthough no single solution will satisfy every case, the required assurance will fall considerably short of an absolute guarantee of performance"); <u>Carlisle Homes, Inc. v. Azzari (In re Carlisle Homes, Inc.)</u>, 103 B.R. 524, 538 (Bankr. D.N.J. 1988).

Among other things, adequate assurance may be provided by demonstrating the assignee's financial health and experience in managing the type of enterprise or property assigned. See, e.g., In re Bygaph, Inc., 56 B.R. 596, 605-06 (Bankr. S.D.N.Y. 1986) (adequate assurance of future performance is present when prospective assignee of lease from debtor has financial resources and has expressed willingness to devote sufficient funding to business in order to give it strong likelihood of succeeding).

Assignment of contracts and leases is permitted under section 365(f)(2) of the Bankruptcy Code, which provides, in pertinent part:

> The trustee may assign an executory contract or unexpired lease of the debtor only if—
>
> (A) the trustee assumes such contract or lease in accordance with the provisions of this section; and
>
> (B) adequate assurance of future performance by the assignee of such contract or lease is provided, whether or not there has been a default in such contract or lease.

11 U.S.C. § 365(f)(2).

In short, the rights of landlords and tenants regarding the termination, cure and/or assignment of a lease are governed by section 365 of the Bankruptcy Code. Generally, a bankrupt tenant has the option either (i) to reject and abandon the lease, or (ii) to cure any existing defaults and assume the lease. The tenant also may be permitted to assign the lease to a third party, provided that any defaults are cured and provided further that the third party is able to provide adequate assurance of future performance.

Unless and until the lease has been rejected, a tenant's obligation to pay post-petition rent ordinarily will be treated as an administrative expense, which will receive priority in the order of payment in the bankruptcy case. See 11 U.S.C. §§ 503(b)(1)(A) and 507(a)(2).

Finally, the claim of a landlord of a bankrupt tenant is statutorily circumscribed. The landlord's claim for damages resulting from termination of the lease (including a rejection of the lease pursuant to section 365) is limited to (i) unpaid rent due on the earlier of the date of the filing of the petition or the date on which the lessor repossessed or the lessee surrendered the premises, plus (ii) the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of the lease after such date. See 11 U.S.C. § 502(b)(6).

D. Reaffirmation and Redemption

1. Statement of Intention

Under section 521(a)(2)(A) of the Bankruptcy Code, if an individual debtor has consumer debts secured by property of the estate, then by the earlier of thirty days after the petition date or before the date of the meeting of creditors, the debtor must file a statement of intent with respect to such property. More specifically, the debtor must "specify[] that such property is claimed as exempt," and must state whether he or she "intends to redeem such property, or that the debtor intends to reaffirm debts secured by such property." 11 U.S.C. §§ 521(a)(2)(A); see also 11 U.S.C. §§ 522 (exemptions), 722 (redemption), and 524(c) and (d) (reaffirmation); Colman v. Wendover Funding, Inc., No. 95-8051, 1996 U.S. App. LEXIS 14251, at *11-12 (10th Cir. June 12, 1996). Within thirty days after the date first set for the meeting of creditors, "the debtor shall perform his intention with respect to such property." 11 U.S.C. § 521(a)(2)(B).

Prior to the 1995 amendments, these provisions had no teeth. Arguably, a debtor's failure to comply with the requirements of former section 521(2) may have provided "cause" for dismissal under section 707(a) or "cause" for granting relief from the automatic stay under section 362(d)(1). Unfortunately, however, a "debtors' failure to comply fully with [former] § 521(2) d[id] not give a secured creditor an automatic right to repossess collateral." Lowry Fed. Credit Union v. West, 882 F.2d 1543, 1546 (10th Cir. 1989).

Indeed, although some courts applying the old law held that a debtor must choose between surrender, reaffirmation, or redemption of collateral, see, e.g., In re Edwards, 901 F.2d 1383, 1387 (7th Cir. 1990) (debtor must reaffirm or redeem to keep property), the Court of Appeals for the Tenth Circuit has held that a debtor may continue making payments and retain collateral without redemption or reaffirmation if the debtor has remained current on the obligation. See Lowry Fed. Credit Union, 882 F.2d at 1547 (10th Cir. 1989) ("[A]lthough we regard as mandatory the provisions of Code § 521(b), we do not believe those provisions make redemption or reaffirmation the exclusive means by which a bankruptcy court can allow a debtor to retain secured property. When the state of the evidence indicates neither the debtor nor the creditor would be prejudiced, a bankruptcy court may allow retention conditioned upon performance of the duties of the security agreement as a condition of retention.”).

2. Congress Eliminated the “Ride Through” as to a Purchase Money Security Interest in Personal Property

By the 1995 amendments, Congress has statutorily overruled the “ride through” allowed by the Tenth Circuit in Lowry Fed. Credit Union v. West, 882 F.2d 1543 (10th Cir. 1989), but only in chapter 7 cases and only with respect to a purchase money security interest in personal property.

Section 521(a)(6) of the Bankruptcy Code now provides:

> in a case under chapter 7 of this title in which the debtor is an individual, [the debtor shall] not retain possession of personal property as to which a creditor has an allowed claim for the purchase price secured in whole or in part by an interest in such personal property unless the debtor, not later than 45 days after the first meeting of creditors under section 341(a), either—
>
> > (A) enters into an agreement with the creditor pursuant to section 524(c) with respect to the claim secured by such property; or
> >
> > (B) redeems such property from the security interest pursuant to section 722.
>
> If the debtor fails to so act within the 45-day period …, the stay under section 362(a) is terminated with respect to the personal property of the estate or of the debtor which is affected, such property shall no longer be property of the estate, and the creditor may take whatever action as to such property as is permitted by applicable nonbankruptcy law, unless the court determines on the motion of the trustee filed before the expiration of such 45-day period, and after notice and a hearing, that such property is of consequential value or benefit to the estate, orders appropriate adequate protection of the creditor’s interest, and orders the debtor to deliver any collateral in the debtor’s possession to the trustee.

11 U.S.C. § 521(a)(6).

3. Reaffirmation

Subsections (c), (d) and (k) of section 524 of the Bankruptcy Code govern reaffirmation agreements. Provided that certain requirements are satisfied, the debtor can enter into a binding agreement to "reaffirm" particular debts. If effective, the "reaffirmed" debt, as modified by the agreement, will survive the discharge.

To be effective, however, a reaffirmation agreement must satisfy the following requirements. First, it must be in writing. Second, the agreement must be made and entered into *before* the debtor receives his or her discharge. See 11 U.S.C. § 524(c)(1). Third, the debtor must "receive[] the disclosures described in subsection (k) at or before the time at which the debtor signed the agreement." 11 U.S.C. § 524(c)(2). These mandatory disclosures are very numerous and lengthy—spanning approximately five pages of text. Fourth, the agreement must be filed with the Court. See 11 U.S.C. § 524(c)(3). Finally, the agreement must be either: (i) accompanied by a declaration or affidavit of an attorney representing the debtor stating (a) that the attorney represented the debtor during the negotiation of the agreement, (b) that the agreement represents a fully informed and voluntary agreement of the debtor, (c) that the agreement does not impose undue hardship on the debtor or the debtor's dependents, and (d) that the attorney has fully advised the debtor of the legal effect and consequences of entering the agreement and of a default under the agreement, see 11 U.S.C. § 524(c)(3); (ii) approved by the bankruptcy court as (a) not imposing an undue hardship on the debtor or the debtor's dependents, and (b) in the best interest of the debtor, see 11 U.S.C. § 524(c)(6)(A); or (iii) an agreement for reaffirmation of a consumer debt secured by real property, see 11 U.S.C. § 524(c)(6)(B).

Even if the reaffirmation agreement satisfies all of the requirements stated above, so as to be effective, however, the debtor may rescind the reaffirmation agreement "at any time prior to discharge or within sixty days after such agreement is filed with the court, whichever occurs later, by giving notice of rescission to the holder of such claim." 11 U.S.C. § 524(c)(4).

4. Redemption

Pursuant to section 722 of the Bankruptcy Code, if an individual debtor has sufficient funds available, he or she may "redeem tangible personal property intended primarily for personal, family or household use from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 [of the Bankruptcy Code] or has been abandoned under section 554 …, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien in full at the time of redemption." 11 U.S.C. § 722.

Further, pursuant to Bankruptcy Rule 6008, "upo[n] motion by the debtor, trustee, or debtor in possession and after hearing on notice as the court may direct, the [bankruptcy] court may authorize the redemption of property from a lien or from a sale to enforce a lien in accordance with applicable law." Fed. R. Bankr. Pro. 6008. In this respect, the debtor may exercise redemption rights available under state law.

Consequently, if the debtor has funds available, the debtor can choose to pay the amount of the secured claim and keep the property, as an alternative to reaffirmation. A practical problem for redemption, however, is the fact that the debtor rarely has sufficient funds available to redeem the property and, as a result, is forced to seek a reaffirmation of the debt.

Finally, the 1995 amendments have clarified that the value of a secured claim and, therefore, the price of redeeming collateral, will always be based on the "replacement value" of the property, without deducting costs of sale or marketing. Further, if the property was acquired for personal, family or household purposes, then the replacement value will be the retail price for property of similar age and condition. <u>See</u> 11 U.S.C. § 506(a)(2).

V. Miscellaneous Creditor's Rights

A. <u>Involuntary Bankruptcy</u>

Creditors can force a debtor into bankruptcy by filing a petition under either chapter 7 (liquidation) or chapter 11 (reorganization) of the Bankruptcy Code. In order to have standing to file an involuntary petition, a creditor first must prove that it is the "holder of a claim" that is not contingent or subject to bona fide dispute as to liability or amount. See 11 U.S.C. § 303(b)(1).

Unless the debtor has less than twelve such creditors, the involuntary petition must be jointly filed by three or more creditors whose unsecured claims exceed $13,475.00, in the aggregate. See 11 U.S.C. § 303(b)(1). If the debtor has less than twelve creditors, then the involuntary petition may be filed by one creditor who holds a noncontingent, undisputed claim of at least $13,475.00. See 11 U.S.C. § 303(b)(2). A single creditor seeking to initiate an involuntary bankruptcy "has the burden of proving that [the debtor] had less than twelve qualifying creditors as of the filing date." In re Smith, 243 B.R. 169, 183 (Bankr. N.D.Ga. 1999). An involuntary bankruptcy petition also may be filed by any general partner of a partnership. See 11 U.S.C. § 303(b)(3).

Once the involuntary bankruptcy petition is filed, an answer must be filed within twenty days after service of the involuntary petition and the summons. See Fed. R. Bankr. Pro. 1011(b). The answer may be filed (i) by the debtor, (ii) by a party in interest to a petition commencing a case ancillary to foreign proceedings, or, (iii) if the debtor is a partnership, by a general partner of the debtor that did not join in the petition. See Fed. R. Bankr. Pro. 1011(a).

If the petition is not timely controverted, then the bankruptcy court will enter an order for relief against the debtor. If the petition is timely controverted, then the petitioning creditor must prove either (i) that "the debtor is generally not paying [its] debts as [they] become due," or (ii) that a custodian, other than a custodian appointed to take possession of less than substantially all of the property of the debtor, was appointed within 120 days prior to the filing of the petition. 11 U.S.C. § 303(h).

B. Use, Sale or Lease of Real Property

Where a sound business reason exists and the sale would be in the interests of creditors, the Bankruptcy Court may approve a use, sale or lease of some or substantially all of the debtor's assets prior to confirmation of a plan. See 11 U.S.C. § 363(b)(1).

In re Medical Software Solutions, Inc., 268 B.R. 431 (2002) is a good example of a successful sale under section 363 of the Bankruptcy Code. Less than 30 days after the case was filed, the debtor filed a motion to sell substantially all of its assets to an "insider." The debtor had engaged in substantial efforts to locate a buyer of the debtor as a "going concern" both pre- and post-petition.

Upon a "first day" motion by the debtor, which was joined by the US Trustee, the court had appointed an "examiner" to investigate the possibility of a sale of substantially all of the debtor's assets to an insider. After a full evidentiary hearing and after considering the examiner's report, the Court concluded that a "sound business purpose" existed for the sale, that the price was fair and reasonable, that notice was reasonable, and that the buyer was acting in good faith. Applying these facts to the law, more fully described below, the sale was approved two months and one day after the bankruptcy case first was filed.

A sale of a debtor's assets should be authorized pursuant to Bankruptcy Code section 363 if a sound business purpose exists for doing so. See, e.g., In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983); In re Martin, 91 F.3d 395 (3d Cir. 1996); In re Titusville Country Club, 128 B.R. 396 (W.D. Pa. 1991); In re Industrial Valley Refrigeration and Air Conditioning Supplies, Inc., 77 B.R. 15 (E.D. Pa. 1987); In re Ancor Exploration Co., 30 B.R. 802, 808 (N.D.Okl. 1983) (bankruptcy court has wide-latitude in approving sale of substantially all of the estate assets under section 363(b)); In re Allison, 39 B.R. 300, 301-02 (D.N.M. 1984) ("The clear weight of authority authorizes the sale of all or substantially all of the debtor's assets pursuant to Section 363(b) in a chapter 11 proceeding, even absent a disclosure statement, plan, and vote of the creditors.").

"In order to approve a sale of substantially all the Debtor's assets outside the ordinary course of business, the following elements must be met. The Debtor must show (1) that a sound business reason exists for the sale; (2) there has been adequate and reasonable notice to interested parties, including full disclosure of the sale terms and the Debtor's relationship with the buyer; (3) that the sale price is fair and reasonable; and (4) that the proposed buyer is proceeding in good faith." Medical Software Solutions, Inc., 268 B.R. at 439-40. See also Lionel Corp., 722 F.2d at 1071 (identifying the "sound business purpose" test); In re Abbotts Dairies of Penn., Inc., 788 F.2d 143, 145-47 (3d

Cir. 1986) (implicitly adopting the articulated business justification test of Lionel, and adding the "good faith" requirement); In re Delaware & Hudson Ry. Co., 124 B.R. 169, 176 (D. Del. 1991) (adopting Lionel).

As Collier notes:

> There has been disagreement historically on the issue of whether and under what circumstances a chapter 11 debtor may sell substantial assets under section 363. It is now generally accepted that section 363 allows such sales in chapter 11, provided, however, that the sale proponent demonstrates a good, sound business justification for conducting the sale prior to confirmation (other than appeasement of the loudest creditor), that there has been adequate and reasonable notice of the sale, that the sale has been proposed in good faith, and that the purchase price is fair and reasonable. These factors are considered to assure that the interests of all parties in interest are protected and that the sale is not for an illegitimate purpose.

3 Collier on Bankruptcy (15th Rev. 2002), ¶363.02[4].

Under Bankruptcy Code section 363(f), a debtor-in-possession may sell property free and clear of any lien, claim or interest in such property if:

> (1) applicable nonbankruptcy law permits sale of such property free and clear of such interest;
>
> (2) such entity consents;
>
> (3) such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property;
>
> (4) such interest is in bona fide dispute; or
>
> (5) such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest.

11 U.S.C. § 363(f).

Because Bankruptcy Code section 363(f) is drafted in the disjunctive, satisfaction of any one of its five requirements will suffice to approve the sale of the Assets free and clear of liens, claims, encumbrances, and other interests (collectively, the "**Interests**"). See 11 U.S.C. § 363(f); Michigan Employment Security Comm'n v. Wolverine Radio Co. (In re

Wolverine Radio Co.), 930 F.2d 1132, 1147 n.24 (6th Cir. 1991) (section 363(f) written in disjunctive; court may approve sale "free and clear" provided at least one of the subsections is met); Citicorp Homeowners Servs., Inc. v. Elliot (In re Elliot), 94 B.R. 343 (E.D. Pa. 1988) (same).

Likewise, a plan of reorganization or plan of liquidation in a chapter 11 case may provide for the sale of some or all of the debtor's assets. See 11 U.S.C. §§ 1123(a)(5)(D) and 1123(b)(4). As with sales under section 363 of the Bankruptcy Code, sales pursuant to a confirmed plan may be "free and clear." 11 U.S.C. § 1129(b)(2)(A)(ii).

Under a confirmed plan, the debtor also may have the option of substituting collateral or other consideration which provides the "indubitable equivalent" to the secured creditor. 11 U.S.C. § 1129(b)(2)(A)(iii). In this manner, the Debtor may be able to sell assets subject to lien and use the money without paying the proceeds to the secured creditor.

C. Other Bankruptcy Considerations

1. The Meeting of Creditors

Within a reasonable time after the bankruptcy case is filed, the United States trustee will convene a meeting of creditors. See 11 U.S.C. § 341(a). Notice of the meeting will be provided to all creditors listed on the debtor's mailing matrix at least twenty days in advance of the meeting. See Fed. R. Bankr. Pro. 2002(a)(1). A representative of the United States Trustee or, if a trustee has been appointed in the case, the appointed trustee will preside at the meeting.

Pursuant to section 343 of the Bankruptcy Code, the debtor is required to "appear and submit to examination under oath at the meeting of creditors under section 341(a) …." 11 U.S.C. § 343. By statute, creditors have the right to examiner the debtor at this meeting. See id. This is the creditor's opportunity to elicit testimony from the debtor or its representative on any relevant subject matter, including the debtor's assets and liabilities and any pre-petition transfers of the debtor's property. It also is often used by secured creditors as an opportunity to obtain a statement of the debtor's intentions regarding the creditor's collateral and/or to discuss reaffirmation.

2. Post-Petition Examinations of the Debtor – Rule 2004

Federal Rule of Bankruptcy Procedure 2004 gives all creditors and parties-in-interest the opportunity to compel the debtor (and/or other relevant parties) to produce documents and/or to appear for deposition. Permissible subjects including any assets or claims of the debtor and any other matters that may affect the administration of the bankruptcy case.

3. Post-Petition Credit

Section 364 of the Bankruptcy Code governs the debtor's ability to obtain secured and unsecured credit post-petition. Generally, the debtor is authorized to obtain unsecured credit and to incur unsecured debt in the ordinary course of its business. <u>See</u> 11 U.S.C. § 364(a). If, however, the post-petition creditor desires to obtain administrative priority or collateral for the post-petition debt, the financing terms must be approved by order of the bankruptcy court, after notice and a hearing. <u>See</u> 11 U.S.C. § 364(b), (c) and (d).

4. Use of Cash Collateral

As defined in the Bankruptcy Code, " 'cash collateral' mean cash, negotiable instruments, documents of tile, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of room and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of [title 11], whether existing before or after the commencement of a [bankruptcy] case …." 11 U.S.C. § 363(a).

After a bankruptcy case has been filed, the debtor may not "use, sell, or lease cash collateral" unless (i) the person having a lien or other interest in the cash collateral "consents" or (ii) the court authorizes the debtor's use of the cash collateral, after notice and a hearing. Generally, in order to obtain court authorization, the debtor must prove that the creditor's lien or interest in the cash collateral is adequately protected.

5. Adequate Protection

Although the "automatic stay" prohibits a secured creditor from taking any action to seize, collect or liquidate its collateral, the Bankruptcy Code requires that the secured creditor's substantive property rights must be protected. Indeed, "lack of adequate protection" is specifically identified as a ground for relief from the automatic stay. 11 U.S.C. § 362(d)(1).

Accordingly, the chapter 7 trustee (and/or the debtor) is required to maintain casualty insurance on the creditor's collateral. Further, the trustee and debtor are required to perform ordinary maintenance on the collateral, and should not be allowed to take actions that will injure, destroy or otherwise diminish the value of the collateral. Further, if the value of the collateral is depreciating, and there is little or no equity cushion to protect the secured creditor's claim, then the trustee and/or debtor may be required "to make a cash payment or periodic cash payments" to the creditor, or may be required to provide the creditor with additional or replacement liens. 11 U.S.C. § 361.

6. Scope and Amount of Secured Claim – Claim Bifurcation

A claim is treated as "a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property." 11 U.S.C. § 506(a). The creditor's interest in property of the estate may arise by a valid security interest, mortgage, statutory lien, or judicial lien.

If the creditor is "oversecured," *i.e.*, if the value of its collateral exceeds the amount of its claim on the petition date, then the creditor may be entitled to have allowed, as part of its secured claim, post-petition "interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement under which the claim arose." 11 U.S.C. § 506(b).

If, on the other hand, the value of the collateral is less than the amount of the claim, *i.e.*, if the creditor is "undersecured," the creditor is treated as holding both (i) a secured claim up to the value of the collateral, and (ii) "an unsecured claim to the extent that the value of such creditor's interest … is less than the amount of such allowed claim." Id. The debtor may cure existing defaults under its plan, and may decelerate the debt to the extent it was accelerated pre-petition. See In re Colvin, 57 B.R. 299 (Bankr. D. Utah 1986). Through its plan, the debtor also may "strip down" an undersecured creditor's lien. In effect, the debtor is able to bifurcate the secured creditor's claim into two parts: (i) a secured claim in the amount of the value of the collateral, which must be paid in full under the plan, together with a market rate of interest; and (ii) an unsecured claim for the amount by which the creditor's pre-petition claim exceeds the value of the collateral, which will be paid *pro rata* with other unsecured claims. This treatment, however, is limited in two different contexts in a chapter 13 case, as described below. See 11 U.S.C. §§ 1322(b)(2) and 1325(a).

The debtor also may use the plan to "strip off" the liens of junior lienholders to the extent there is no equity in the "collateral" to support such creditor's lien. Such claim will not be treated as a secured claim under the plan, but will be treated and paid as a wholly unsecured claim.

Finally, if the collateral is sold or otherwise liquidated by the chapter 7 trustee, the secured creditor is entitled to receive the proceeds of the collateral, up to the amount of the secured creditor's claim. Further, the creditor has the right to credit bid the amount of its claim for the purchase of the collateral, pursuant to section 363(k) of the Bankruptcy Code.

7. Protection of Mortgagees in Chapter 13

Chapter 13 generally permits a debtor to "modify the rights of holders of secured claims." 11 U.S.C. § 1322(b)(2). This includes the right to bifurcate and/or "strip down" a secured claim. A chapter 13 debtor may not, however, modify the rights of the holder of "a claim secured only by a security interest in real property that is the debtor's principal residence." In short, a chapter 13 debtor cannot "strip down" the secured claim of a mortgage secured by their principal residence. Nobelman v. American Savs. Bank, 508 U.S. 324 (1993).

This protection will not apply, however, where the mortgagee's claim is, in truth, wholly unsecured. In order to qualify for the protections of section 1322(b), the claims must be secured, at least in part, by the principal residence. See Pierce v. Beneficial

Mortg. Co. (In re Pierce), Adv. Pro. No. 01-2367, Bankr. Lexis 11473, at *1 (Bankr. D. Utah May 8, 2002) (holding that creditor holding a lien interest in the debtor's principal residence was properly treated as an unsecured creditor, and did not hold a secured claim, because there was insufficient equity in property to allow any payment to such creditor); Zimmer v. PSB Lending Corp. (In re Zimmer), 313 F.3d 1220 (9th Cir. 2002) (same).

8. Appointment of a Trustee

A trustee automatically is appointed in chapter 7 and chapter 13 cases. In chapter 11 cases, however, the debtor will remain in control of its business and assets unless grounds for appointment of a trustee are established. See 11 U.S.C. § 1107 ("a debtor in possession shall have all the rights,… powers, and shall perform all the functions and duties … of a trustee serving in a case under [chapter 11]").

A creditor may obtain the appointment of a trustee in a chapter 11 case if it shows either (i) that "cause" exists for the appointment, or (ii) that appointment of a trustee will be in the best interests of creditors. Section 1104(a) of the Bankruptcy Code, which governs appointment of a trustee in a chapter 11 case, states, in relevant part:

> At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest ... and after notice and hearing, the court shall order the appointment of a trustee—
>
> (1) for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause ... ;
>
> (2) if such appointment is in the best interests of creditors ... and other interests of the estate … ; or
>
> (3) if grounds exist to convert or dismiss the case under section 1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate.

11 U.S.C. § 1104(a).

Further, the United States Trustee is required to seek appointment of a trustee in cases where "there are reasonable grounds to suspect that current members of the governing body of the debtor … participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." 11 U.S.C. § 1104(e).

Generally, the appointment of a trustee is an extraordinary remedy and there is a strong presumption that the debtor is to continue in control and possession of its business unless a party-in-interest can prove that the appointment of a trustee is warranted. See Sims v. Sims (In re Sims), BAP No. NM-97-022, 1997 Bankr. LEXIS 2112, at *10 (B.A.P. 10th Cir. 1997); In re TS Industries, Inc., 125 B.R. 638, 643 (Bankr. D. Utah 1991). Thus, the party moving for the appointment of a trustee has the burden of proof. See id. Nonetheless, once a bankruptcy court determines that "cause" exists for the appointment of a trustee under section 1104(a)(1), or that the appointment of a trustee would be in the best interest of creditors under section 1104(a)(2), "it has no discretion but must appoint a trustee." Sims, 1997 Bankr. LEXIS 2112, at *10 (quoting In re Oklahoma Refining Co., 838 F.2d 1133, 1136 (10th Cir. 1988)).

A debtor-in-possession stands in the shoes of a trustee and, thus, is a fiduciary for creditors and the estate. Among other things, a debtor-in-possession "must act … to 'protect and to conserve property in his possession for the benefit of creditors,' and to 'refrain from acting in a manner which could damage the estate, or hinder a successful reorganization of the business.' " In re Ionosphere Clubs, Inc., 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) (quoting In re Sharon Steel Corp., 86 B.R. 455, 457 (Bankr. W.D.Pa. 1988)). Likewise, the debtor's "fiduciary obligations proscribe self-dealing and negligent behavior" and "forbid directors and other business operators from using their position of trust and control over the rights of other parties to further their own private interests, either by usurping opportunities, holding undisclosed conflicts, or otherwise exploiting their position." In re Microwave Prods. of America, 102 B.R. 666, 672 (Bankr. W.D. Tenn. 1989). Thus, if a debtor's ability to fairly and adequately perform these duties is called into question by prepetition or postpetition conduct, or by the existence of conflicts of interest, a chapter 11 trustee "must" be appointed. See Oklahoma Refining Co., 838 F.2d at 1136.

The list in section 1104(a)(1) of the Bankruptcy Code is a non-exclusive list of circumstances which may provide "cause" for the appointment of a trustee in a chapter 11 case, including "fraud, dishonesty, incompetence [and] gross mismanagement." 11 U.S.C. § 1104(a). In addition to these specifically enumerated causes, federal courts have found that "cause" also exists (1) where there are conflicts of interest on the part of management that interfere with management's ability to fulfill their fiduciary duties to the debtor, (2) where the debtor has evidenced a disregard for legal or judicial authority, (3) where there is self-dealing by management, (4) where the debtor has or is squandering estate assets, (5) where there is inadequate record-keeping and reporting, (6) where there are questionable dealings between a debtor and affiliated entities, and (7) where there are prepetition avoidable preferences or fraudulent transfers. See, e.g., Oklahoma Refining, 838 P.2d at 1136 (citing both "a history of transactions with companies affiliated with the debtor company" and "failure to keep adequate records and make prompt and complete reports" as proper cause for appointing a trustee); In re Rivermeadows Assocs., 185 B.R. 615, 617-18 (Bankr. D. Wyo. 1995) (discussing both the debtor's disregard of judicial authority and the debtor's questionable and undocumented transactions with, transfers to, and financial dealings with entities under common control as "cause" for appointing trustee); In re Nautilus of New Mexico, Inc., 83 B.R. 784, 789-90 (Bankr. D. N.M. 1988) (finding "cause" for the appointment of a trustee in the conflicts of interest held by debtor's management and by his violations of the Bankruptcy Code); In re McCorhill Publ'g, Inc., 73 B.R. 1013, 1017 (Bankr. S.D.N.Y. 1987) (holding that "where there are questionable inter-company financial transfers and the principals of the debtor occupy conflicting positions in the transferee companies, a trustee should be appointed in the best interests of creditors and all parties in interest in order to investigate the financial affairs of the debtor" and that "[u]nauthorized post-petition transfers of estate assets will constitute grounds for the appointment of a trustee"); In re Cajun Elec. Power Coop., 74 F.3d 599, 600 (5th Cir. 1996) ("find[ing] the conflicts of interest within the members of the Board of [the debtor], to be such that the court below was correct in the appointment of a trustee"); In re Intercat, Inc., 247 B.R. 911, 921 (Bankr. D. Ga. 2000) (noting factors to consider in deciding whether to appoint a trustee). In re L.S. Good & Co., 8 B.R. 312, 315 (Bankr. N.D.W.Va. 1980) (holding that conflicts of interest held by the debtor's current management warranted appointment of a trustee).

If a creditor successfully proves that "cause" for the appointment of a trustee exists, then the bankruptcy court must appoint a trustee. See Oklahoma Refining, 838 F.2d at 1136 (holding that if the court so finds, "it has no discretion but must appoint a trustee."). The court need not find "cause" for appointment of a trustee, however, whether based on the wrongs enumerated in section 1104(a)(1) or otherwise. "It is sufficient that the appointment be in the interest of creditors." Id.

D. Recovery of Property for the Benefit of Creditors

A trustee in bankruptcy (or debtor-in-possession) has a panoply of statutory claims and remedies to recover property for the benefit of creditors. Section 544 of the Bankruptcy Code permits the trustee to avoid any transfer, claim or lien that is avoidable under applicable non-bankruptcy law by (a) a bona fide purchase or real estate, or (b) a hypothetical lien creditor. Section 547 of the Bankruptcy Code permits the trustee to avoid "preferential transfers." Section 548 of the Bankruptcy Code permits the trustee to avoid "fraudulent transfers." Section 549 of the Bankruptcy Code permits the trustee to avoid unauthorized post-petition transfers. Section 553 of the Bankruptcy Code permits the trustee to avoid and recover on account of certain pre-bankruptcy setoffs.

1. Preference Actions

One of the basic purposes of bankruptcy is to place all of the debtor's assets within the jurisdiction of a single forum in order to facilitate the fair, expeditious and efficient distribution of the debtor's property to creditors. Another fundamental bankruptcy policy is that all creditors of equal legal status should be treated the same, *i.e.*, that one should not be preferred over another.

Section 547 of the Bankruptcy Code creates a cause of action in favor of a bankruptcy trustee or debtor-in-possession to recover certain payments made to creditors prior to the bankruptcy filing. The purpose of this section is to prevent the debtor from preferring certain of its creditors above others, and to bring any "preferential" transfers back into the bankruptcy estate for the benefit of all creditors.

a. The Prima Facie Case

The essential elements of a preference action under section 547 are:

(i) a "transfer of an interest of the debtor in property;"

(ii) "to or for the benefit of a creditor;"

(iii) "for or on account of an antecedent debt;"

(iv) "made while the debtor was insolvent;"

(v) made either (a) "on or within 90 days" prior to the bankruptcy petition date, or (b) to an "insider" within one year prior to the bankruptcy petition; and

(vi) the transfer must allow the creditor to receive more than it would receive (a) in a chapter 7 case, (b) if the transfer had not been made, and (c) the creditor received a normal distribution on account of its claim.

11 U.S.C. § 547(b). The trustee or debtor-in-possession has the burden of proving each of these elements. See 11 U.S.C. § 547(g).

i. Transfer of Property of the Debtor

The first requirement to a successful claim under section 547 is that some property must have been transferred and that the property must have belonged to the debtor. Accordingly, section 547 would not support a claim for the transfer of property to which the debtor held only legal title and not an equitable interest.

"Transfer" is defined very broadly in the Bankruptcy Code as: "Every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest, and foreclosure of the debtor's equity of redemption." 11 U.S.C. § 101(54). The attachment of a judgment lien, execution or garnishment to collect a judgment, and/or the granting of a voluntary security interest all are transfers potentially subject to avoidance under section 547.

ii. Creditor

A creditor is any person or entity that holds a "claim" against the debtor. See 11 U.S.C. § 101(10). In turn, the term "claim" is very broadly defined under the Bankruptcy Code to include any "right to payment" and any "right to an equitable remedy." See U.S.C. § 101(5).

iii. Antecedent Debt

An antecedent debt is one that existed prior to the transfer. In contrast, an advance payment or a contemporaneous exchange would not be avoidable under section 547 because there is no antecedent debt.

iv. Insolvency

The trustee is entitled to a rebuttable presumption that the debtor was insolvent on and during the ninety days immediately preceding the bankruptcy filing. See 11 U.S.C. § 547(f). To the extent insolvency is in dispute, a determination of insolvency under the Bankruptcy Code is a "balance sheet test." In this regard, the Bankruptcy Code defines "insolvent" as follows: "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation," excluding from consideration any property transferred concealed, or removed with intent to hinder, delay or defraud creditors and further excluding any property that is "exempt." See 11 U.S.C. § 101(32)(A).

v. When did the Transfer Occur?

Not surprisingly, there has been substantial litigation over the date on which a transfer occurs. For example, a check may have been prepared, mailed, and cashed by the creditor prior to the 90 day preference period, but may have "cleared" or been paid by the payor bank within the 90 day period. Resolving this question, the United States Supreme Court held that a transfer does not occur "until the bank honor[s] the check." Barnhill v. Johnson, 503 U.S. 393, 399 (1992) ("For the purposes of payment by ordinary check, therefore, a 'transfer' as defined by § 101(54) occurs on the date of honor, and not before."). In contrast, in the case of payment by certified check, the transfer occurs when the debtor delivers or otherwise surrenders possession of the check.

b. Affirmative Defenses

Because it is relatively easy to establish a prima facie case under section 547, most preference litigation focuses on the statutory defenses available to a transferee. These affirmative defenses are provided under subsection (c) of section 547. There are several such defenses:

i. Contemporaneous Exchange

Pursuant to statute, a trustee or debtor-in-possession may not avoid a transfer "to the extent such transfer was … (A) intended by the debtor and the creditor … to be a contemporaneous exchange for new value; and (B) in fact a substantially contemporaneous exchange." 11 U.S.C. § 547(c)(1). One example of such a transfer is a sale of goods pursuant to which the debtor pays by cash or check at the time of sale, or upon delivery. A second example is a security interest granted to secure a new loan.

ii. Ordinary Course of Business

The trustee or debtor-in-possession cannot avoid a transfer "in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee "and" (A) made in the ordinary course of business or financial affairs of the debtor and transferee or (B) made according to ordinary business terms." 11 U.S.C. § 547(c)(2).

The major factor relating to "ordinary course of business" is the timing of the payment. If the timing of payments is generally unchanged over time and if they are roughly within contract terms, then the defense may be available. To successfully raise the defense, the timing of payments must be ordinary both (i) in light of the history and course of dealing between debtor and transferee or (ii) industry standards and norms.

The nature of payment also may be relevant. For example, if the debtor historically has remitted payment by regular check and the transfer in question was remitted by cashier's check, then the defense probably is not available.

iii. Security Interest for New Value

Subsection (c)(3) of section 547 creates a defense in favor of a creditor who is granted a security interest in property acquired with the proceeds of the new loan. See 11 U.S.C. § 547(c)(3).

iv. New Value

The trustee or debtor-in-possession cannot avoid a transfer "to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor." 11 U.S.C. § 547(c)(4). To qualify for this defense, the creditor must prove that (i) it provided new value to the debtor, (ii) after the date of the transfer, and (iii) for which it was not paid or granted security. "New value" is defined in the Bankruptcy Code as "money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee in a transaction that is neither void nor voidable by the debtor or the trustee under any applicable law, including proceeds of such property, but does not include an obligation substituted for an existing obligation." 11 U.S.C. § 547(a)(2).

v. Lien in Inventory and Receivables

Under certain circumstances, the creation or perfection of a lien upon inventory or accounts is not avoidable under section 547. See 11 U.S.C. § 547(c)(5).

vi. Statutory Lien

The fixing of a statutory lien not avoidable under section 545 is not avoidable as a preference under section 547. See 11 U.S.C. § 547(c)(6).

vii. Alimony and Support

The bona fide payment of a debt to a spouse, former spouse or child of the debtor for alimony, maintenance or support is not avoidable as a preference unless the debt was assigned to a nongovernmental entity. See 11 U.S.C. § 547(c)(7) (describing defense); 11 U.S.C. § 101(14A) (defining "domestic support obligation").

viii. Certain payments in "consumer" cases less than $600

In a case where an individual debtor's debts are primarily consumer debts, the trustee or debtor-in-possession cannot avoid transfers if the aggregate value of the property transferred to the particular creditor is less than $600. See 11 U.S.C. § 547(c)(8).

ix. Certain payments in "non-consumer" cases less than $600

In a case where the debtor's debts are *not* primarily consumer debts, the trustee or debtor-in-possession cannot avoid transfers if the aggregate value of the property transferred to the particular creditor is less than $5,475.00. See 11 U.S.C. § 547(c)(9).

x. Earmarking Defense

The so-called "Earmarking" defense arises under section 541(c) of the Bankruptcy Code, on the theory that the property transferred did not become property of the estate. In essence, the argument is that the debtor borrowed money from creditor A to pay off its indebtedness to creditor B, that such funds were earmarked for creditor B and that, therefore, the debtor never had an interest in the funds.

" 'Earmarking' is a judicially-created doctrine said to apply when a new creditor pays a debtor's existing debt to an old creditor. This doctrine originally arose under the Bankruptcy Act in codebtor cases—the new creditor, who was obligated on an existing debt as a guarantor or surety, provided the debtor with funds to pay the old creditor. In such cases, courts reasoned that the codebtor's payment to the old creditor did not constitute a transfer of the debtor's property, and there was no diminution of the debtor's estate inasmuch as the amount available for unsecured creditors remained the same as before the transfer regardless of the debtor's control of the transferred funds. Courts also noted that earmarking was equitable because if the transfer were avoided, the codebtor would be subject to double liability. The earmarking doctrine was eventually extended 'to situations where the new creditor is not a guarantor but merely loans funds to the debtor for the purpose of enabling the debtor to pay the old creditor.' " Manchester v.

First Bank & Trust Co. (In re Moses), 256 B.R. 641, 654-46 (B.A.P. 10th Cir. 2000) (citations omitted).

The Tenth Circuit Bankruptcy Appellate Panel, however, has criticized (and arguably rejected) the defense, reasoning: "Generally, a new creditor's unconditioned promise to loan a debtor money to pay the debtor's antecedent debt is property in which the debtor holds an interest, as are the proceeds of the loan once it is made. Whether the debtor directs that the asset be paid to it or to a particular creditor to whom it owes a debt does not alter the fact that the debtor is transferring property in which it holds an interest within the meaning of § 547(b)." Id. at 549.

xi. Conduit Defense

The conduit defense is the flip side of the earmarking defense. Some courts use the term "conduit" to refer to an innocent third party who may receive funds or property from a debtor, but who merely holds it briefly for another and derives no benefit from the transfer. In those cases, the party who only acts as a "conduit" is not held liable under section 550 as a transferee.

c. Statute of Limitations

An action under section 547 is barred if not commenced by the later of (i) two years after "entry of the order for relief" or, (ii) if a trustee is appointed or elected within said two year period, one year after appointment or election of the first trustee. 11 U.S.C. § 546(a). An action under 547 also is barred if not commenced before the underlying bankruptcy case is closed or dismissed.

d. Liability of Transferees

While section 547 gives the trustee the power to avoid a transfer, the trustee's remedies against transferees are provided under and governed by section 550. A claim under section 550 usually is joined with the section 547 avoidance claim, but need not be. Indeed, section 550 is subject to a separate limitations period. An action or proceeding under section 550 need not be brought within the limitations period provided under section 546, but must be commenced by the earlier of (i) one year after the avoidance of the transfer on account of which recovery under section 550 is sought, or (ii) the time the case is closed or dismissed. 11 U.S.C. § 550(f).

If a transfer has been avoided under section 547, section 550 allows the trustee to "recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from … (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transferee." 11 U.S.C. § 550(a). The trustee may not obtain judgment, however, against an immediate or mediate transferee who "takes for value,… in good faith, and without knowledge of the voidability of the transfer avoided." 11 U.S.C. § 550(b). Further, if the avoided transfer is a transfer to an insider more than 90 days but less than one year prior to the petition date, the trustee may not obtain judgment against any transferee that is not an insider. <u>See</u> 11 U.S.C. § 550(c).

Finally, section 550 gives a good faith transferee a limited lien right to the extent of any costs undertaken to improve the property transferred as well as any increase in the value of the property resulting from such improvement. <u>See</u> 11 U.S.C. § 550(e).

2. Fraudulent Transfer Actions

A trustee or debtor-in-possession may avoid certain "fraudulent" transfers under sections 544 and 548 of the Bankruptcy Code.

a. Claims under Section 548

Under section 548, the trustee may avoid any transfer of property that is actually fraudulent or constructively fraudulent provided that the transfer occurred within two (2) years of the bankruptcy filing.

i. Actual Fraud

To avoid a transfer on account of actual fraud, the trustee must show that the debtor made a transfer or incurred an obligation "with actual intent to hinder, delay, or defraud" its creditors. 11 U.S.C. § 548(a)(1)(A). "Intent to hinder, delay, or defraud creditors is rarely admitted by a debtor. Therefore, a court may consider circumstantial evidence establishing badges of fraud. Relevant factors include whether the transfer was to an insider; whether the debtor retained possession or control of the property after the transfer; concealment of the transfer; pending or threatened litigation against the debtor at the time of transfer; a transfer of substantially all of the debtor's assets; absconding by the debtor; removal or concealment of assets; reasonably equivalent value in exchange for the transfer; the debtor's insolvency at the time of the transfer; the proximity in time of the transfer to the incurrence of a substantial debt; and a transfer of substantial business assets to a lienor followed by a subsequent transfer of such assets to an insider of the debtor. Transfers to family members are subjected to particularly close scrutiny. The relationship of the parties in conjunction with other circumstances often provides compelling evidence of fraud." Zubrod v. Kelsey (In re Kelsey), 270 B.R. 776, 782 (B.A.P. 10th Cir. 2001) (citations omitted).

Unlike preference actions and claims for constructive fraud, the trustee suing on account of actual fraud need not prove insolvency.

ii. Constructive Fraud

Even in the absence of actual fraud, a transfer is avoidable under section 548 if: (i) the debtor "received less than reasonably equivalent value in exchange for such transfer or obligation;" and (ii) the debtor was (a) insolvent or rendered insolvent by the transfer, (b) "engaged in a business or a transaction, or was about [to so engage], for which any property remaining with the debtor was unreasonably small capital" or (c) "intended to incur, or believed that [it] would incur, debts that would be beyond [its] ability to pay as such debts matured." 11 U.S.C. § 548(a)(1)(B).

For purposes of section 548 " 'value' means property, or satisfaction or securing of a present or antecedent debt of the debtor, but does not include an unperformed promise to furnish support to the debtor or to a relative of the debtor." 11 U.S.C. § 548(d)(2)(A). Accordingly, transfers that satisfy or secure a loan or other debt are not avoidable so long as the "value" received by the debtor is "reasonably equivalent" to the value of the property transferred. See Sender v. Buchanan (In re Hedged-Investments Assocs.), 84 F.3d 1286, 1289 (10th Cir. 1996) ("[A] debtor receives 'value' for a transfer if the transfer satisfies a 'claim' the transferee-creditor has against the debtor.").

The Bankruptcy Code does not define the term "reasonably equivalent." Courts and commentators have suggested that "reasonable equivalence will depend on the facts of each case. In some cases, no less than 100 percent of fair market value may be a reasonable price. In all cases, facts such as 'the bargaining position of the parties .... and the marketability of the property transferred' will be relevant." In re Richardson, 23 B.R. 434, 448 (Bankr. D. Utah 1982) (citations omitted). One court explained: "A review of the case law reveals four precepts in construing [reasonably equivalent value]. First, the fair market value of the property in question cannot usually be used as the sole determinant, especially in foreclosure actions. Second, although not wholly determinative, the market value of the property at issue is an important query and will often serve as a starting point for deciding whether [reasonably equivalent value] was received by the debtor. Third, the property at issue must be disposed of in a manner consistent with the law of the forum state. Finally, a bankruptcy court should consider all of the facts of each case, one of which may be the market value of the property. McCanna v. Burke, 197 B.R. 333, 339 (Bankr. D.N.M. 1996).

iii. Good Faith Defense

Unlike section 547, Congress did not provide any complete affirmative defenses to a fraudulent transfer action under section 548. Accordingly, a transferee's best defense usually is to challenge the trustee's prima facie case. Such defenses usually focus on insolvency, intent and the amount of value given.

Section 548 does provide, however, a limited affirmative defense in that "a transferee or obligee … that takes for value and in good faith has a lien on or may retain any interest transferred or may enforce any obligation incurred … to the extent that such transferee or obligee gave value to the debtor in exchange for such transfer or obligation." 11 U.S.C. § 548(c). Thus, where some value is given, even if it is not reasonably equivalent value, a good faith transferee will be entitled to retain a lien or interest in the property transferred so as to recover the value given in good faith to the debtor.

b. Claims under Section 544

Section 544(b) of the Bankruptcy Code gives a trustee or debtor-in-possession the right to avoid any transfer of property "that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 [of the Bankruptcy Code] …." 11 U.S.C. § 544(b)(1). "Before asserting applicable state law, however, the trustee 'must first show that there is an *actual creditor* holding an allowable unsecured claim … who under [state] law, could avoid the transfers in question.'… '[I]f there are not creditors within the terms of section 544(b) against whom the transfer is voidable under the applicable law, the trustee is powerless to act so far as section 544(b) is concerned.'" Sender v. Simon (In re Hedged-Investments Assocs., Inc.), 84 F.3d 1299, 1304 (10th Cir. 1996) (emphasis added) (citations omitted); see also Merrill v. Abbott (In re Independent Clearing House Co.), 77 B.R. 843, 863 n.30 (D. Utah 1987) (en banc) ("As a prerequisite to recovering under section 544(b), the trustee must show that at least one of the present creditors of the estate, holding an allowable claim, was an actual unsecured creditor or the successor in interest of an actual unsecured creditor against whom the transfer was fraudulent and voidable under the controlling state or federal law.")

The trustee, however, will be subject to all of the same defenses and limitations that could be raised against the creditor in whose shoes he stands, see 5 Collier on Bankruptcy ¶ 544.09[3] (15th ed. rev. 2001), *except that* the Trustee's recovery will not be limited to the amount necessary to satisfy the single creditor's claim. Instead, the entire transfer is avoidable to the extent necessary to benefit the estate. See 5 Collier on Bankruptcy ¶ 544.09[5]; Moore v. Bay, 284 U.S. 4 (1931).

Under section 544(a) of the Bankruptcy Code, a trustee has the power to avoid any transfer of property of the debtor that would be voidable by a creditor who extended credit to the debtor at the time of the commencement of the debtor's bankruptcy case, and that obtains, at such time and with respect to such credit, either (i) a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, or (ii) an execution against the debtor that is returned unsatisfied, whether or not such a creditor exists. See 11 U.S.C. § 544(a). While section 544(a) has not traditionally been viewed as a basis for standing to assert state law fraudulent transfer claims, a plain reading of the statute suggests that section 544(a) gives the Trustee standing to assert state fraudulent transfer claims to the extent a creditor with a claim of the type described in § 544(a)(1) or (2), arising on the petition date, would have such standing under applicable state law. An unpublished decision of the Court of Appeals for the Tenth Circuit supports this view. See Lewis v. Delap (In re Delap), No. 96-1327, 1997 U.S. App. LEXIS 21204, at *8 (10th Cir. Aug. 12, 1997) (holding that "the trustee had standing to assert [state law fraudulent transfer] claims under § 544(a)").

Utah and many other states have adopted the Uniform Fraudulent Transfer Act (the "**UFTA**"). See Utah Code Ann. § 25-6-1 *et seq*. Accordingly, a trustee or debtor in possession may use section 544 to assert claims under the UFTA or under other applicable fraudulent transfer or fraudulent conveyance law.

The UFTA is very similar to section 548 in that it provides for the avoidance of transfers on the grounds of either actual or constructive fraud. There are, however, several distinctions of note. First, at least under the Utah act, the statute of limitations is four years. See Utah Code Ann. § 25-6-10. Accordingly, this gives the trustee a much longer look-back period than he has under section 548. Second, the UFTA presumes that a debtor who is not paying its debts as they become due is insolvent. See Utah Code Ann. § 25-6-3(2). Third, the UFTA provides a non-exhaustive list of certain badges of fraud to be considered in determining the debtor's "actual intent." See Utah Code Ann. § 25-6-5(2). Fourth a transfer otherwise voidable on account of actual fraud "is not voidable … against a person who took in good faith and for a reasonably equivalent value." Utah Code Ann. § 25-6-9(1). Finally, the UFTA allows for "adjustment as the equities may require." Utah Code Ann. § 25-6-9(3).

c. Statute of Limitations

Claims under sections 548 and 544 are subject to the same time limitations as preference actions. An action under sections 548 or 544 is barred if not commenced by the later of (i) two years after "entry of the order for relief" or, (ii) if a trustee is appointed or elected within said two year period, one year after appointment or election of the first trustee. 11 U.S.C. § 546(a). An action under section 548 or 544 also is barred if not commenced before the underlying bankruptcy case is closed or dismissed.

Actions under 544, however, must pass an additional statute of limitations hurdle in that, the statute of limitations governing the state law claim cannot have run prior to the filing of the bankruptcy petition. See 11 U.S.C. § 108(a).

d. Liability of Transferees

Section 550 governs the liability of transferees of transfers avoided under sections 548 and 544. For a more complete discussion of section 550 and the liability of transferees, see the discourse above.