

An Introduction to Bankruptcy Cases

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Bankruptcy

- Constitutional in origin
 - Article 1, section 8, clause 4
 - “Uniform laws on bankruptcy”
- Title 11, United States Code, the “Bankruptcy Code.”
- Bankruptcy cases reported in West Bankruptcy Reporter and on-line

History of Bankruptcy

- 1800 Act
- 1841
- 1867
- 1898 (the “Act”) with 1938 Chandler Act Amendments
- 1978 (the “Code”)
- 2005 Amendments to Code

Why Bankruptcy as Opposed to State Law?

- Assignment for the Benefit of Creditors (“ABC”)
 - Ground for involuntary bankruptcy relief
 - No compelled discharge of debt
- Receiverships under state and federal law
 - Ground for involuntary bankruptcy relief
 - Inefficiencies

Why File a Bankruptcy Petition?

- Individual
 - Excessive liabilities
 - Unforeseen circumstances or event
 - Pending dramatic creditor action
- Business
 - Distortion of right side of balance sheet
 - Mismanagement of assets
 - Time

Bankruptcy Law's Purposes

- Efficient collection of debts
- Distribution of debtor's property in accordance with uniform and national priorities (*not equal treatment*)
- Capturing going concern value
- Establish of debtor's right to discharge or to reorganize (reallocation or rehabilitation)

Structure of Bankruptcy Code

- Chapter 1: Definitions, rules of construction, and general provisions
- Chapter 3: Case administration
- Chapter 5: Creditors, the debtor, and the estate

Forms of Bankruptcy relief

- Chapter 7 Liquidation
- Chapter 13 Adjustments of Debts of an Individual with Regular Income
- Chapter 11 Reorganizations
- Chapter 12 Adjustments of Debts of a Family Farmer with Regular Income
- Chapter 9 Adjustments of Debts of a Municipality
- Chapter 15 International

Key Players

- Debtor and DIP
- Creditor
 - Holder of unsecured claim
 - Priority
 - General
 - Holder of secured claim
 - Oversecured
 - Undersecured
- Official Committees
- US Trustee

Key Players (cont'd)

- Chapter 7 Trustee
- Chapter 11 Trustee
- Bankruptcy Court

Chapter 7

- Trustee is ALWAYS appointed
- Identification, collection, liquidation and distribution of property of the debtor
- Debtor seeks discharge
 - Reserved for individuals
 - Partnerships and corporations may not receive a chapter 7 discharge
- Claims are paid in accordance with priority scheme of the Code
- Case closed after estate fully administered

Chapter 11

- DIP – debtor remains in control
- Best interest of creditors requirement
- Classes of creditors
- Plan is operative document
- Absolute priority rule
- Consent or cram down
- Liquidation/rehabilitation
- Confirmation

Chapter 13

- Debtor is an individual with regular income
 - Can be a business case, that is, a sole proprietorship
- Debtor proposes plan that seeks to pay out creditors over 3-5 years
- Chapter 13 trustee operates as disbursing agent

Jurisdiction

- What is a bankruptcy judge?
- Where does jurisdiction reside?

Statutory Roadmap

- 28 USC §1334
 - *Pacor*: any conceivable effects test – does the action have any conceivable effect on the administration of the bankruptcy estate?
- 28 USC §157

Title 11 Case

- CASE
 - Civil proceeding
 - 1. Adversary proceeding
 - 2. Contested matter

Jurisdiction

- Cases under title 11
- Proceedings *arising under* title 11
- Proceedings *arising in* a case under title 11
- Proceedings *related to* a case under title 11

Jurisdictional Structure

- Bankruptcy jurisdiction rests with the district court
- District court may assign cases through reference to the bankruptcy court
- Bankruptcy court may hear all matters (unless specifically limited by statute) but can render final judgment in core matters only

Bankruptcy: Eligibility,
Commencement, Dismissal,
Conversion

Commencement of a Case

- Voluntary – §301
 - Filing = Commencement = Order for Relief
- Involuntary -- §303
 - Filing = Commencement \neq Order for Relief

Debtor Eligibility

- First determine the status of the potential debtor
- Second determine residence requirements
- Third determine if categorical exclusions apply
- Fourth determine what chapters for relief may apply

Chapters for Relief

- Debtor must have certain minimum contacts with the United States
- Chapter 7 – all PERSONS except railroads
- Chapter 13 – an “individual with regular income”
- Chapter 11 – all those eligible for relief under chapter 7 except stockbrokers and commodity brokers and including railroads
- Any individual debtor must have taken an approved counseling session within 180 days before commencement of the case

Voluntary Case

- Authority
- Papers
- Eligibility
- Official Forms 1, 2, and 3

Involuntary Case

- Right type of debtor
- Right type of chapter
- Right number of creditors
- Right reasons for relief

Section 303 Analysis

- 303(a) –
 - How involuntary case commenced
 - 7 or 11 only
 - Must be a person eligible for relief under that particular chapter
 - Only against person, except farmer, family farmer, and nonprofits

Analysis (cont'd)

- 303(b) – Requisite number of petitioning creditors
 - <12 creditors, then 1 creditor can commence case
 - > or= 12 creditors, then 3 creditors holding in excess of stated dollar amount must commence case
- 303(c) – creditors can join in petition

Analysis (cont'd)

- 303(d) – Only Debtor may answer
- 303(e) – Court may require bond
- 303(f) – Debtor may continue business through the Gap Period
- 303(g) – Interim trustee may be appointed to preserve the estate or prevent loss

Analysis (cont'd)

- 303(h) – grounds for relief
 - Generally not paying debts as such debts become due unless subject to a bona fide dispute
 - Within 120 days of the filing, custodian appointed or took possession of debtor's property

Analysis (cont'd)

- 303(i) – sanctions for wrongful filing
- 303(j) – dismissal
- 303(k) – foreign banks (limited to chapter 7 where the bank is under a foreign proceeding)

Debtor's Duties

- §521
 - File list of creditors
 - Schedule of assets and liabilities
 - Schedule of current income and expenditures
 - Statement of the debtor's financial affairs
 - Cooperate with court officers
 - Appear at examinations and hearings
 - Turn over books and records
 - File all postpetition tax returns
 - Comply with all court orders

Dismissal: Statutory Grounds

- Premature end of the case
- Chapter 7 dismissal – cause [707(a), 305(a)]
 - Means testing: Applies to an individual who seeks relief under chapter 7. 707(b).
- Chapter 13 dismissal
 - 1307(b) – Debtor as of right
 - 1307(c) – Creditor for cause
- Chapter 11 dismissal – cause [1112(b)]
- All chapters – section 521(j) failure to file postpetition returns

Dismissal: Implied Grounds

- Duty of good faith filing
 - Prevent abuse of process
 - Protect integrity of judicial process
 - Efficiency
- Code support
 - 1112(b)(1), (b)(2), and (b)(5), 1129(a)(3)

Duty of Good Faith: Factors

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

Practice Pointer

- *Ways in which creditor can use bad faith allegations:*
 - *Dismissal*
 - *Conversion*
 - *Relief from stay*
 - *Objection to plan*

Conversion

- Initial choice of chapter is not conclusive even if eligible
- Court may convert the case on motion or on its own
- Each chapter has its own conversion section
- §348 deals with consequences of conversion

Chapter 7 Conversion

- §706
 - Chapter 7 debtor may convert to Chapter 11 or 13 if the case had not been previously converted from 11 or 13 to 7
 - Court may convert from 7 to 11 at any time
 - No forced conversion to Chapter 13
- §305

Chapter 11 Conversion

- §1112
 - Debtor may convert from 11 to 7 unless certain limits are met. 1112(a).
 - Court may convert case from 11 to 7 for cause at any time. 1112(b).
 - Court can't convert without consent from 11 to 7 if the debtor is:
 - Farmer
 - Nonprofit
 - 2005 Amendments expand grounds that constitute cause for dismissal or conversion

Practice Pointer

- *Debtor may answer involuntary chapter 7 petition by simply converting case to a case under chapter 11 and proceed as DIP!*

Return Filing Requirements

Return Filings

- Importance in bankruptcy
 - Dischargeability
 - Dismissal
 - Plan confirmation
- §§521(j), 1307, 1308, 1325

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 - File list of creditors
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 - Schedule of current income and expenditures
 - Statement of the debtor's financial affairs
 - Cooperate with court officers
 - Appear at examinations and hearings
 - Turn over books and records
 - File all tax returns
 - Comply with all court orders

Income tax returns prepared by tax authorities

- Section 523(a) excepts from discharge tax associated with a return that was not filed
- Section 6020(a) returns will qualify for discharge (cooperation & signing)
- Section 6020(b) returns will not qualify for discharge.
- Applies to federal, state and local returns.
- Return, written stipulation to a judgment or a final order by a nonbankruptcy tribunal.

Dismissal for Failure to Timely File Tax Returns

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

Chapter 13 Return Filings

- Section 1308
- Prepetition returns

Requirement to file tax returns to confirm chapter 13 plans—§1325(a)

- Returns now required for plan confirmation – New Sec. 1308
- File prepetition tax returns for past 4 years.
- Time limit – Sec. 341 hearing date or up to 120 days if extended.
- Failure to comply – dismissal or conversion – Sec. 1307
- Includes Sec. 6020(a) and (b) returns.
- Governmental unit gets 60 days after returns filed to object to plan.

Bankruptcy: Estate and Stay

Filing of Petition and Commencement of Case

- Triggers two events –
 - *Commencement of the case creates an estate*
 - Filing of petition operates as a stay, protecting the estate, the debtor, and the debtor's property

Purpose of Estate

- Fundamental aspect of bankruptcy
- The stash
- Value to be distributed to holders of claims and interests

Methodology

- Identify all the debtor's legal or equitable interests in property wherever located and by whomever held as of the petition date.
 - Federal question but consult state law
 - Note that §541 reaches interests and not property – 541(a)(1) and (d)
- Apply rules under §541(a)
- Apply chapter-specific rules
- Apply property exclusions under §541(b)
- Apply anti-forfeiture, recapture, and exclusion provisions under §541(c)

§541: Property of the Estate

- (a)(1) – general standard
- (a)(2) – includes community property
- (a)(3) and (a)(4) – any property recovered by trustee for benefit of the estate
- (a)(5) – property from certain transfers within 180 days after the filing
- (a)(6) – proceeds, products, rents, and profits from POE, except earnings from services performed by individual debtor in a chapter 7 case after commencement; however, in individual chapter 11 case, postpetition earnings are estate property
- (a)(7) – any interest in property that estate acquires

Chapter-Specific Rules

- Expansion of the estate
 - Chapter 11: Section 1115
 - Chapter 13: Section 1306

Section 541(b) Exclusions

- Exclusions to the basic estate definition
- Nine exclusions

Section 541(c)

- Anti-forfeiture clause unenforceable
- Restrictions in trust under applicable nonbankruptcy law is enforceable in bankruptcy
 - Spendthrift provisions are enforceable
 - ERISA?

Patterson v. Shumate

- An anti-alienation provision in an ERISA-qualified pension plan constitutes a restriction on transfer enforceable under applicable nonbankruptcy law for purposes of section 541(c)(2) exclusion of property of bankruptcy estate.
- Not immune from federal tax lien
- IRA's?

Purpose of POE

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Interplay Between §541 and §362

- §362(a)(2)
- §362(a)(3)
- §362(a)(4)
- §362(b)(2)
- Lesson –
 - Broader the definition of “estate” the greater the protection under the stay

Filing of Petition and Commencement of Case

- Triggers two events –
 - Commencement of the case creates an estate
 - *Filing of petition operates as a stay, protecting the estate, the debtor, and the debtor's property*

Methodology

- *When does the stay become effective?*
- *What is the scope of the stay?*
- *What are the limits of the stay?*
- *When does the stay end?*
- *How can a party in interest obtain relief from the stay?*

Triggering Event

- Filing of petition in bankruptcy
 - Voluntary
 - Involuntary

Scope

- Protects the following:
 - Debtor
 - Debtor's property
 - Property of the estate
- From what?
 - Any act worth taking from a creditor's perspective

Purpose

- Preserve the estate
- Marshal property of the estate
- Sell assets
- Distribute proceeds of asset sales
- Propose and confirm plan of reorganization

Acts in Violation of the Stay

- Stay is self-enforcing
- Knowledge irrelevant
- Void/Voidable distinction in circuits
- Sanctions for willful violations: §362(h)
 - Split on whether corporation may seek sanctions for harms caused it

Limits of the Stay

- First order: Scope itself
- Second order: §362(b)

Exceptions to the Stay

- §362(b) sets out 28 exceptions
- Narrowly drawn and strictly construed
- *Example:*
 - Criminal actions -- §362(b)(1)
 - Governmental action -- §362(b)(4)

Basic Bankruptcy: Claims and Priorities

Methodology

- What property is available to satisfy unsecured claims?
 - POE
- Which unsecured claims are eligible to participate in the distribution?
 - Allowed claims
- How is the property to be distributed?
 - Depends

Role of Claim

- Only holders of claims may receive a distribution in the bankruptcy case
- Claims are subject to the stay
- Claims are discharged
- Claims vote on the plan in chapter 11

Bankruptcy Quirks

- Focus on claim and not creditor
 - Oversecured
 - Undersecured
- No distinction between consensual and nonconsensual creditors

Allowance

- Key to participation in the distribution process
- Bankruptcy concept and not tantamount to enforceable against the debtor
- Filing of POC makes out the prima facie case for allowance
- The POC deemed allowed unless timely objection

Elements of POC

- Sets out the nature and grounds of claim and the circumstances surrounding it
- Identifies the amount and extent of claim
- Identifies the status of claim

POC Filing Requirements

- Must file POC in chapter 7 case by the bar date (unless no asset case)
- Need not file POC in chapter 11 case unless claim is not scheduled or is listed as disputed, contingent or unliquidated
- Must file POC in a chapter 13 case by the bar date

POC Bar Date

- Private Creditor
 - 90 days from first scheduled 341 meeting in 7 and 13
 - Court-set deadline in 11
- Government Creditor
 - 180 days from order for relief (§502(b)(9))
- Informal POC
- “Excusable neglect”

Claims Allowance Process

- POC filed
- Party in interest files objection
- “After notice and hearing”
- “As of the date of the filing of the petition”
- Consolidate claims objections
- Live testimony
- Contested matter

Grounds for Disallowance

- 502(b)(1) – unenforceable against debtor
- 502(b)(2) – unmatured interest
 - 506(b) secured claims may receive postpetition interest to the extent of value of collateral
- 502(b)(5) – support and alimony
- 502(b)(6) – lessor claims cap
- 502(b)(9) – miss bar date

Lessor Cap on Damages

- CAP = A. Greater of – (1) one year's rent
- Or
- B. lesser of -- (a) 15% of remaining term
- Or
- 3 year's rent
- PLUS
- Unpaid accrued rents.

Just What is a Claim?

- §101(5) – right to payment, reduced to judgment or not, liquidated, unliquidated, fixed or contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, unsecured PLUS right to equitable remedy if breach of right gives rise to a right to payment

When Does a Claim Arise?

- Three tests:
 - State law test – Holder must have an action under state law
 - Prepetition relationship test – some prepetition privity, contact, impact or hidden harm affecting the holder (notice themes)
 - Conduct test – claim arises at the time of debtor's wrongful conduct

Compliance with the Law

- No “free pass” on the law given in bankruptcy
- Must comply with applicable federal and state law
- 28 USC §959(b)

Payment of Claims in Chapter 7

- Sections 704(1) and 726
- Estate assets pay off allowed claims
- Secured creditor receives collateral or value of collateral: §725
- Unsecured creditors: §726
 - Priority
 - General unsecured

Payment of Claims in Chapter 11

- Best interests of creditors
- Plan terms ultimately control distribution and treatment
- Confirmation replaces the nonbankruptcy relationships

Estimation of Claims

- §502(c)
- Purpose –
 - Voting
 - Feasibility
 - Allowability
- Bankruptcy court makes determination
- Reconsideration permitted under §502(j)

Estimation Methods

- Face value
- Zero value
- Market theory
- Forced settlement
- Discounted value
- Summary trial

Payment of Claims in Chapter 7: Revisited

- Sections 704(1), 725, 726, 507, and 503
- Estate assets pay off allowed claims
- Secured creditor receives collateral or value of collateral: §725
- Unsecured creditors: §726
 - Priority
 - General unsecured

Priorities: An Introduction

- Priority claims are disruptions in the basic theme regarding the treatment of unsecured claims in bankruptcy
- Every increase in priority claims results in a corresponding decrease in payout to unsecured creditors

Priorities: §726

- PRIORITY claims under §§507(a) and 503(b) in the order of priority
- TIMELY filed ALLOWED unsecured claims
- TARDILY filed ALLOWED unsecured claims
- Fines, penalties, and punitive damages
- Payment of interest on above claims
- Surplus to debtor

Best Interest of Creditors Test

- §726 is foundation to understanding of other chapter under the Bankruptcy Code
- Best interest of creditors test
 - §§1129(a)(7) and 1325(a)(4)
 - Holder of impaired claim may veto plan
 - Litmus test

Priorities Revisited: 507(a)

- 1. Domestic support obligations owed as of the petition date subject to trustee fees incurred to recover same
- 2. Administrative expenses (§503(b))
 - 7's beat 11's
 - Super-priorities for postpetition lenders
 - Taxes of all types incurred by the estate
 - Paid in ordinary course
 - No request for payment necessary

Priorities (cont'd)

- 3. Gap creditors -- §502(f)
- 4. Eligible wage claims
 - Cap of \$10,000 for each claimant
 - Earned within 180 days of petition filing
 - Wage, salaries, commissions, and vacation pay, sick leave, severance pay

Priorities (cont'd)

- 5. Contributions to employee benefits plans
 - Within 180 days of filing
 - To the extent of
 - Number of covered employees x \$10,000 LESS
 - The aggregate amount paid to employees in level 4 and by the estate to other benefit plans
- 6. Grain farmers and fishermen up to \$4,925
- 7. Consumer lay-a-ways up to \$2,225

Priorities (cont'd)

- 8. Certain tax liabilities (federal, state, and local)
 - (A) tax on income or gross receipts for a taxable year ending on or before the date of the filing of the petition:
 - Three-year return due rule: measure petition date and when return was due including extensions (not when actually filed) (hanging paragraph and tolling plus 90 days)
 - 240-day assessment rule (consider tolling by offer in compromise but not installment agreement)
 - Still-assessable rule (but not taxes associated with non-filers, fraudulent returns or willful attempt to evade or defeat a tax)
 - (B) Property tax incurred before case but payable within 1 year of filing
 - (C) Trust fund taxes forever
 - (D) Employer's share of employment taxes incurred within 3 years
 - (E) Excise taxes where transaction is within 3 years
 - (F) Custom duties
 - (G) Certain penalties for actual pecuniary loss associated with claims above

Priorities (cont'd)

- 9. Certain commitments by debtors to FDIC to maintain capital
- 10. Wrongful death or personal injury claims as a result of DUI, etc.
- *A tax claim arising from an erroneous refund or credit has the same priority as a claim for a tax to which the refund or credit relates*

§ 705. Priority Tax Claims--§ 507(A): A Closer Look

- (8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for--
- (A) a tax on or measured by income or gross receipts *for a taxable year ending on or before the date of the filing of the petition--*
- (i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
- (ii) assessed within 240 days before the date of the filing of the petition, exclusive of--
- (I) any time during which an offer in compromise with respect to that tax was pending *or in effect during that 240-day period, plus 30 days; and*
- (II) *any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days.*

2005 Amendments

- Background: Section 507(a)(8) priority tax rules are designed to give taxing authority 3 years to collect taxes before such taxes become nonpriority and dischargeable or 240 days after assessment in long-running tax shelter cases, for example.
- Recurring issue was whether events that stopped statute of limitations also tolled time periods under section 507(a)(8).
- *Young v. US*, 535 US 43 (2002).
- Chief Counsel Notice 2002-023 (no add-on)
- Chief Counsel Advice 200404049 position

Tolling

- Hanging paragraph after 507(a)(8)(G)
- Tolls time periods in this subsection if:
 - A taxing authority is *prohibited* under applicable nonbankruptcy law from collecting a tax as a result of a request of a debtor for a hearing and an appeal of any collection action taken or proposed against the debtor;
 - The automatic stay is in effect;
 - Collection is precluded by 1 or more confirmed plans

Tolling Add-Ons

- If the priority time period is suspended, then there is also an add-on of 90 days

Late-Filed Priority Tax Claims

- Section 726(a)(1): Late filed priority claim filed may participate in distribution if filed earlier of:
 - The date that is 10 days after the mailing to creditors of the summary of trustee's final report or
 - The date on which the trustee commences final distribution

Executory Contracts and Unexpired Leases

Section 365

Authorizes the trustee or DIP to reject, assume, or assign executory contracts and unexpired leases

- Why special treatment?
 - Both a potential asset and liability

Executory Contract: Definition

- No well-defined bankruptcy definition
- Countryman Test – An executory contract is one under which the obligations of the debtor and the other party are both so far unperformed that the failure of either to perform would constitute a material breach excusing the performance of the other.
- Functional Test – Is the estate benefited from characterization as an executory contract? *In re Booth*.
- Legislative History – Some performance on both sides.

Unexpired Leases

- Not much problem in identification
- Real property leases
- Personal property leases
- Real property law and UCC 2A as sources

Forfeiture Clause

- Generally not enforceable in a bankruptcy case if tied to bankruptcy filing, insolvency, etc.
 - §363(l), 365(e), 541(c)
- If exercised before filing, then may be enforceable
 - Check to see if debtor still has interest
 - Potential avoidance power action

Forfeiture Clause (cont'd)

- Forfeiture clauses in specified kinds of contracts may be effective to prevent *assumption* of a contract by the trustee and may actually permit termination by the nondebtor party after filing of petition
 - §§365(c), (e)(2)
 - Examples – Contracts to make a loan, financial accommodations, issue security

Forfeiture Clause (cont'd)

- Forfeiture clauses may also be enforceable in bankruptcy if the contract is for *personal services*.
 - Only the case where nonbankruptcy law, independent of the clause, would excuse a party from accepting or rendering performance.
 - Key is that nonbankruptcy law prohibits assignment

Contract Must Be Property of the Estate

- If fully terminated before bankruptcy, no contract or lease may be assumed, etc. There is nothing there!
- Noncurable notice of termination given before the case, then neither the stay or §365 will prevent termination when the notice period has run. The stay does not prevent running of time!
 - §§105, 108

Section 365 Time Limits

- Chapter 7 – within 60 days after the order for relief
- Any nonresidential lease situation – within 120 days after the order for relief with a 90 day extension for cause. No other extensions without lessor consent.
- §§365(d)(1), (4)

Section 365 Time Limits (cont'd)

- Chapters 9, 11, 12, 13 – any time before confirmation (unless nonresidential real property lease)
- Party in interest may move to set an earlier date to accept or reject.
- Ride through in Chapter 11 and 13

Limbo Period

- Period between filing of petition and the time of assumption or rejection
 - Debtor not in default – other party must continue to perform
 - Debtor in default – need not perform unless contract cured and assumed
 - Failure to perform would then constitute a breach
 - Nonresidential real property – must perform in timely manner.
§365(d)(3)
- Postpetition use – Estate must pay but conflict between contract price, FMV, or use value to the estate. Special rule for nonresidential real estate

Trustee's Powers Under §365

- Rejection
- Assumption
- Assignment
- “Ride-through”

Rejection

- Rejection constitutes a breach
- §§365(g), 502(g) treat the breach as a prepetition claim
 - If assumed and then breached, then administrative expense under §365(g)(2)
- Rejection excuses trustee from future performance
 - Overrides remedy of specific performance under applicable nonbankruptcy law

Rejection: Procedures

- Subject to court approval
- Apply business judgment rule
- Focus is on whether the rejection benefits the estate?
- Not a balancing calculus

Limits to Damages Claims

- Allowability of lessor of real estate claim limited under §502(b)(6)
- If such lease is assumed and then breached, additional cap imposed to limit extent of administrative expense
- Allowability of employee under a terminated employment contract limited under §506(b)(7)

Assumption

- Assumption binds the estate and the nondebtor party
 - Most contracts and leases may be assumed except the personal services and other financial accommodation varieties under §365(c)
- Effect is to make the contract an administrative expense of the estate as if estate had originally entered into the contract
 - Post-assumption breach gives rise to an administrative expense under §365(g)(2) but limited and capped by 2005 Amendments

Assumption: Procedures

- Requires court approval
 - No default (or financial condition default) – court *must approve* the contract. §§365(a), (b)(2)
 - Default – court must *approve contract* and trustee must *cure all defaults* (except the financial condition types) or provide adequate assurance of a prompt cure (including adequate compensation for nonpecuniary losses like fees), §§365(b)(1)(A), (b)(2), (b)(1)(B), and provide *adequate assurance of future performance* under §365(b)(1)(C).
- Business judgment rule
- Focus is on benefit to the estate

Assignment

- Trustee has power to assign , notwithstanding a prohibition on assignability in the contract or under applicable nonbankruptcy law. §365(f)(1).
- Court can avoid anti-assignment provisions under §365(f)(3).
 - Types of failed attempts –
 - Rent increase upon assignment, cross-default, use restriction, etc.

Assignment cont'd

- Trustee must first assume before it may assign under §365(f)(2)(A)
- Recall assumption limits re specific contracts found in §365(c)
- After assignment, the estate is no longer liable under §365(k). Overrides applicable nonbankruptcy law.

Assignment Procedure

- Recall that all assumption procedures must be met as well
- However, adequate assurance of future performance must come from the assignee, whether or not there has been a default under the contract under §365(f)(2)(B).

Debtor as Landlord

- Several provisions protect nondebtor party –
 - Under §365(h), rejection by debtor landlord cannot result in eviction of tenant from lease of real property
 - If debtor landlord rejects, tenant may stay and setoff against future rent any damages caused by rejection
- Purchaser of timeshare interest given the same protections

Debtor as Licensor of Intellectual Property

- Section 365(n) protects nondebtor licensee of intellectual property
- IP is defined in §§101(52) and (53) to include copyrights, patents and applications therefor, trade secrets and mask works, but not *tradenames, trademarks, or related rights*.

Limited Protection

- If trustee rejects licensing agreement, then:
 1. Treat license as terminated and assert a damage claim or
 2. May retain the rights under the license and continue to make royalty payments, waiving any right of setoff or any administrative expense resulting from the performance under the license
- During limbo period, debtor must perform if requested by licensee

Methodology Summary

1. What are the *consequences* of rejection, assumption, or assignment?
2. What are the *procedures* for rejection, etc.?
3. What are the *limitations* on rejection, etc.?
4. What are the *time limits* on rejection, etc.?
5. What are the *definitions* of an executory contract and unexpired lease?

Satisfaction of Secured Claims in Chapter 7 Cases

Secured Claims: General Rule

- Liens ride through bankruptcy
- Secured creditor entitled to collateral or value of collateral

Dewsnup

- CV = \$39,000
- Debt = \$120,000
- Secured claim = \$39,000
- Unsecured claim = \$81,000
- STRIP DOWN

Rash and Valuations of Property

- ❑ Valuations under §506(a) in a chapter 13 cram down plan
- ❑ Three methods
 1. Foreclosure value
 2. Replacement value
 3. Middle-ground value

Equitable Subordination, Claims Classification, and Secured Claims

Subordination: §510

- Purpose
- Effect
- Standard

§510 Standard

- §510(a) – contractual subordination
- §510(b) – statutory subordination
- §510(c) – equitable subordination

§510 Standard

- Inequitable conduct
- Result in harm
 - Subordinate only to extent of harm
- Consistent with Code

Classification of Claims

- Key in Chapter 11 and 13
- Distributions made to classes of claims
- Votes are cast within classes
- Key provisions
 - §§1122, 1123(a), 1322(b)(1)

Chapter 11

- Chapter 11 Plan must designate classes of claims
- §1122 provides the rules for classification
- Only like claims may be classified in same class

Overriding Principle

- Is the proposed classification fair? To whom?
 - Reasonable basis
 - Reasonably necessary
 - Good faith
 - Treatment

Classification and Cram Down

- Read §§1129(a)(8) and (a)(10)
- Enter 1129(b) cram down
- Threshold to cram down is (a)(10)
 - One impaired non-insider class must vote in favor of the plan
- Gerrymandering

Secured Claims

- §506(a) and bifurcation policy in bankruptcy
- Secured creditor entitled to its collateral or value thereof
- §524(a)(2) creditor's in rem right survives the discharge
- Valuation of the thing
- Valuation hearings

Collateral Focus

- What can Trustee do with collateral?
 1. Surrender under 725
 2. Use under 363(b) and (c)
 3. Sell or lease under 363(f)
 4. Abandon under 554

Agree to stay relief under 362(d)

Collateral Focus (cont'd)

- What can SP do with the collateral?
 1. Request surrender
 2. Move for abandonment under 554(b)
 3. Request adequate protection under 361
 4. Move to dismiss for bad faith filing
 5. Move to convert under 1112(b)
 6. Move to appoint chapter 11 trustee under 1104
 7. Propose its own plan of reorganization
 8. Obtain relief from the stay

Relief From Stay

- (d)(1) – for cause, including lack of adequate protection
- (d)(2) – debtor has no equity in the property and the property is not necessary for an effective reorganization
- (d)(3) – debtor fails to file feasible plan within 90 days of the filing or has failed to begin monthly payments to creditors holding interest in the property
- (e) – short procedural fuse

Adequate Protection: §361

- Periodic cash payments
- Additional or substitute lien
- Indubitable equivalent
- **MUST ASK FOR IT!**
- *Alyucan* and the equity cushion
- *Timbers* and lost opportunity cost

Postpetition Interest

- §502(b)(2)
- §506(b)

Whiting Pools

- Prepetition seizure of assets by creditor
- Turnover action by debtor under 542
- Role of stay and adequate protection
- Undoing creditor debt collection efforts.

Hartford Underwriters

- Administrative expense holder seeks to surcharge collateral under section 506(c) in an administratively insolvent case
- Supreme Court holds that only the trustee has standing to bring a surcharge action
- Conflict here was over who gets proceeds from surcharge – the estate or the individual holder of claim or expense seeking surcharge

Chapter 11: Introduction

Purpose of Chapter 11

- Capture going concern value of enterprise
- Prevent debtor from going into liquidation
 - Return to creditors
 - Return to equity
 - Loss of jobs
 - Loss of tax base
 - Misuse of economic resources

Debtor Control of Chapter 11

- Debtor remains in possession of the estate under 1108 and defined under 1101(1)
- Debtor has powers of a chapter 11 trustee under 1107
- Debtor is only party in interest that may propose a plan of reorganization for the first 120 days from the order for relief
- Debtor then has 60 days to convince the court to confirm the plan without competing plans in play
- Period of exclusivity cannot be extended beyond 18 months from order for relief

Powers of the Chapter 11 Debtor

- Debtor may reject executory contracts and leases, including CBA's
- Debtor may use secured party's collateral
- Debtor may borrow money
- Debtor is protected by the stay
 - §105 injunction to protect insiders
- Debtor may modify the debt and equity portion of its capital structure

Powers cont'd

- Debtor may bind dissenting members of a class
- Debtor may cram down a plan over the objection of most classes
- Debtor may enjoy certain tax benefits through reorganization

US Trustee

- DOJ official
- Convenes and presides over first meeting of creditors
- May call a meeting of equity security holders
- Supervises the case
- Appoints the creditors committee
 - May appoint other official committees (bond, equity, etc.)
- 2005 Amendments authorize court to order change in committee composition

Committees

- Unsecured creditors committee is intended to play a key role in chapter 11
- US Trustee generally appoints the committee from the 7 largest unsecured creditors
 - UST may use discretion to balance the committee
 - Court may order US Trustee to do so
- Prepetition informal committee may stay in place if selected fairly and representative
- Court may order additional committees
- Committees may retain professionals with court approval

Committee Counterbalance

- Party in interest
- Appear and be heard on any issue
- Retention of professionals
- With court permission, may bring avoidance powers actions
- Section 1109(b) and 1103 powers
 - Plan negotiation

Classification of Claims

- Key in Chapter 11 and 13
- Distributions made to classes of claims
- Votes are cast within classes
- Key provisions
 - §§1122, 1123(a), 1322(b)(1)

Chapter 11

- Chapter 11 Plan must designate classes of claims
- §1122 provides the rules for classification
- Only like claims may be classified in same class

Voting in Chapter 11

- Impaired creditors vote
- A class of creditors accepts when over $\frac{1}{2}$ in number and at least $\frac{2}{3}$ in amount of those voting vote in favor of the claims

Keeping the Ship Afloat

- Operating the business
- Achieving stability
- Protecting the estate

Operating the Business

- DIP operates the business without court approval under 1108
- Operation v. liquidation
- Court may order termination of operations under 1112
- Turnaround or recapitalize

Business Failures

- Identify causes
 - External
 - Economic changes
 - Competitive changes
 - Government constraints
 - Social change
 - Technological change
 - Management and internal
 - Fraud
- Distinguish between causes and symptoms

Management and Internal Causes

- Primary cause
- Poor management
- Unbalanced top management team
- Dysfunctional BOD

Turnaround

- Solving operating problems
- Analyze operational issues
- Design strategy
- Implement strategy
- Develop business plan
- Need key information in timely fashion

Turnaround Techniques

- Just in Time
- Activity Based Costing
- Four Wall Analysis

Restructuring

- Developing a financial structure as a basis for the turnaround
- Financial management
 - Debt restructuring
 - Working capital improvements
 - Cost reduction analysis
 - Low cost producer

Achieving Stability

- Key period from operational perspective – from filing to plan confirmation
- Stem operational losses
- Operations take place under the umbrella of the Bankruptcy Code

Protecting the Estate

- The stay
- Section 365
- Abandonment under 554
- Surrender
- Collateral swaps

Firm Valuation

- Enterprise Value (EV) = Long term debt (so-called funding debt) + Market value of the equity
 - Methods to value EV
 - Comparables
 - Income
 - DCF
 - EBITDA multiple
- Reorganization Value (RV) = Current Liabilities + EV

Goodwill

- Going concern goodwill
 - That amount of EV in excess of total identifiable asset value
- Methods of valuation
 - Comparables
 - DCF
 - Multiple of earnings

Appointment of Trustee or Examiner

- 2005 Amendments expand grounds for relief
- Section 1104 permits appointment of trustee for cause or if in best interests of creditors
- UST appoints the trustee after consultation with the creditors and other parties in interest
- Court may replace trustee with DIP under 1105
- Appointment of trustee terminates period of exclusivity
- Examiner may be appointed in certain circumstances to investigate the debtor or current management and to report findings
 - Appointment may be mandatory in some circumstances
 - Appointment may not displace DIP

Operating the Business

- Window of vulnerability
 - Petition date to confirmation date
- Postpetition transactions
 - Ordinary course
 - Outside ordinary course

Ordinary course transactions

- No court approval necessary
- Horizontal and vertical test
- Sell, etc., collateral assuming adequate protection

Outside Ordinary Course

- Court approval necessary
- Unauthorized postpetition transfer

Special Case for Cash Collateral

- Cash – Treat like any other property
- Cash collateral – Can not use unless all those with interest in CC consent or court order
 - Adequate protection
 - Check setoff right and lien in proceeds situations

Funding Options

- Sale of assets
- Avoidance actions
- Equity for debt swaps
- Equity infusions
- Future operations
- Accumulated cash
- Postpetition financing

Postpetition Financing

- Section 364
 - DIP authorized to obtain postpetition financing
 - (a) – administrative expense priority to obligations incurred in OCB
 - (b) – same to those obligations authorized by court
 - (c)(1) – super-super priority upon court order
 - (c)(2) – court grants lien on unencumbered property
 - (c)(3) – court grants junior lien on property
 - (d) – court grants priming lien on property
- Cross-collateralization

Chapter 11 Plan Confirmation

Overview

- Chapter 11 crafted to accommodate both consensual and nonconsensual plans
- Designed to force negotiation and ultimate agreement among parties in interest through system of checks and balances

Consensual Plans

- Section 1129(a) provides for consensual plans
- Binds dissenting members of a consenting class
 - Class accepts if over $\frac{1}{2}$ in number and $\frac{2}{3}$ in amount of claims vote in favor
- Juniors may receive value under the plan even if seniors not fully paid if seniors receive at least what entitled to in a liquidation

Non-Consensual Plans

- If one impaired class rejects the plan, confirmation must meet cram down requirements under section 1129(b)
- No reorganizational value may be given to juniors under the plan unless senior non-accepting class has been fully compensated

Core Concept in Confirmation

- A plan cannot be confirmed unless each class of claims or interests:
 1. Has accepted the plan by requisite vote;
 2. Is not impaired by the plan; or
 3. The plan “does not discriminate unfairly” and complies with the “fair and equitable rule.”

Voting on Plan

- All classes must accept or have been deemed to accept the plan
- Absent unanimous acceptance, then one noninsider impaired class must accept the plan

Best Interest of Creditors Test

- Financial protection for dissenting members of an accepting class
- All impaired creditors may invoke best interests requirement even if class voted to accept the plan
 - Not in play when all class members vote for the plan – waiver by class
 - Not in play with unimpaired classes
 - Deemed to have accepted plan

Cram Down – Section 1129(b)

- Confirmation over the objection of an impaired class or classes where plan –
 - Plan does not discriminate unfairly and
 - Plan is fair and equitable

Fair and Equitable: Absolute Priority Rule

- Seniors entitled to full payment before juniors may participate
 - Payment may be in cash, property, or equity
 - Most common payment form is new securities in the reorganized debtor
- Analysis requires an assessment of enterprise value usually through DCF method
- Seniors give up value to juniors to forge a plan and juniors may reasonable demands for fear of Absolute Priority Rule

Fair and Equitable Trends

- Seniors are entitled to full but not over compensation
- Subtle distinction between secured and unsecured
 - Secured -- Must preserve PV of collateral
 - Unsecured – Must provide PV of claim or no one junior participates

New Value Exception to Absolute Priority Rule

- Elements
 - Contribution to reorganized debtor by old equity
 - Money or money's worth
 - No sweat equity
 - Necessary
 - Substantial equivalent in value to the interest retained by old equity

Other Requirements: Boilerplate

- Plan must comply with title 11
- Proponent must comply with title 11
- Plan must be proposed in good faith
- Requirements met for disclosure and payment re plan and identify of insiders
- Regulatory approval if necessary
- Pay all fees

Feasibility

- Gauge the business plan and the distribution plan
- Proponent must show a reasonable likelihood of success

Feasibility Focus

- Focus on future cash flow and net earnings to meet its restructured interest and dividend needs as well as amortize the principal
- Proposed new capital structure, including the relationship of debt to equity in the reorganized debtor is sound

Priority Claims

- Admin. expense and gap paid in full in cash as of effective date – no class vote
- Priority tax claims paid over 5 years from order for relief
 - Prepetition interest – yes
 - Postpetition interest – no
 - Postconfirmation interest – yes
- Other priorities – paid in full in cash unless class accepts extension with PV of claim

§ 705. Priority Tax Claims--§ 507(A): A Closer Look

- (8) Eighth, allowed unsecured claims of governmental units, only to the extent that such claims are for--
- (A) a tax on or measured by income or gross receipts *for a taxable year ending on or before the date of the filing of the petition--*
 - (i) for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition;
 - (ii) assessed within 240 days before the date of the filing of the petition, exclusive of--
 - (I) any time during which an offer in compromise with respect to that tax was pending *or in effect during that 240-day period, plus 30 days; and*
 - (II) *any time during which a stay of proceedings against collections was in effect in a prior case under this title during that 240-day period, plus 90 days.*

§ 704. Rate of interest on tax claims— §511

- **§ 511. Rate of interest on tax claims**
- (a) If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law.
- (b) In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed.

§ 704. Rate of interest on tax claims-§ 511

- Nonbankruptcy tax rate is a terrible provision—only example were creditor may receive more than the value of its claim
- Federal rate will be close to market and makes sense
- State rate may be much higher than market at a rate greater than 20 percent

§ 710 Periodic payments of taxes in chapter 11 cases—§ 1129(a)(9)

- (C) with respect to a claim of a kind specified in section 507(a)(8) of this title, the holder of such claim will receive on account of such claim regular installment payments in cash--
- (i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim;
- (ii) over a period ending not later than 5 years after the date of the order for relief under section 301, 302, or 303; and
- (iii) in a manner not less favorable than the most favored nonpriority unsecured claim provided for by the plan (other than cash payments made to a class of creditors under section 1122(b) [convenience class]); and

Plan Treatment of Tax Claims

- Section 1129(a)(9)(C) has been amended to provide that Section 507(A)(8) tax claims must receive
 - *Regular installment* payments in cash (old law was *deferred* cash payments)
 - Over a 5 year period measured from the start of the case (old law was 6 years from assessment)
 - And must be in a manner no less favorable than the “most favored” nonpriority unsecured claim other than the administrative convenience class

§ 710 Periodic payments of taxes in chapter 11 cases—§ 1129(a)(9)

- (D) with respect to a secured claim which would otherwise meet the description of an unsecured claim of a governmental unit under section 507(a)(8), but for the secured status of that claim, the holder of that claim will receive on account of the claim, cash payments in the same manner and over the same period, as prescribed in subparagraph (C).

§ 717. Standards for Tax Disclosures— §1125(a)

- (1) “adequate information” means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor’s books and records, including a discussion of the potential Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such hypothetical investor of the relevant class to make an informed judgment about the plan,

§ 717. Standards for Tax Disclosures—§1125(a)

- but adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information;

§ 708. No Discharge of Fraudulent Taxes in Chapter 11—§ 1141(d)

- Section 1141 defines the effect of confirmation of a Chapter 11 plan and specifically discharges certain debts that arose before confirmation.
- The amendment excepts tax liabilities from a Chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty.
- The new provision also excepts from discharge any debt incurred under false pretenses or by making a false statement in writing.

Fraud Exception to Corporation's Discharge in Chapter 11

- Corporations cannot discharge a debt based on fraud owed to a governmental unit arising out of false pretenses, false representations or actual fraud, whether or not based on use of a financial statement in writing.
 - The language of this provision makes it unclear whether these nondischargeable debts to governmental units must arise from the debtor's own fraudulent dealings with the government, or if this extends to claims or fines the government could impose on account of the debtor's defrauding of investors or creditors.
 - Debt owed to an individual on a qui tam claim is also not dischargeable.

Chapter 11 and Individuals

- Timing of discharge
 - If debtor is an individual and
 - Debtor filed a chapter 11 case, then
 - Section 1141(d)(5) delays the discharge until full performance under the chapter 11 plan absent a chapter 11 hardship discharge

Discharge

Importance

- To an individual debtor the single most important feature of modern bankruptcy law is the discharge. See 11 U.S.C. 727.
- Along with exemptions and the carve out of future income from property of the estate under section 541(a)(6) for chapter 7 cases, the discharge fuels the fresh start of the debtor, a policy of singular importance in individual bankruptcies.
- Individual debtors can also obtain a discharge under chapters 11 and 13 of the Code. See 1141(d) and 1328(a) and (b).

Introduction

- The discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in certain prohibited conduct, usually some type of gross misconduct, fraud or bankruptcy crime. See 11 U.S.C. 727(a).
- The objecting party has the burden of establishing a ground for the denial of a discharge.

Prior Denial of Discharge

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

Effect of Discharge

- A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt. See 11 U.S.C. 524(a).
- The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts, to collect, recover, or offset any discharged debt.

Effect cont'd

- In effect, the discharge is a total prohibition on debt collection efforts.
- Furthermore, under 524 of the Code, any attempt to reaffirm a particular debt is void unless the particular provisions of the Code delineating the requirements of reaffirmation are specifically followed. See generally 11 U.S.C. 524(c).

Non-discrimination Provision: Government

- To ensure the effectiveness of the discharge, Code 525 prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment *solely* because the person involved was discharged under the Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt.

Non-discrimination Provision: Private Employer

- Additionally, under 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the Code, or an individual associated with a debtor under the Code, *solely* because the debtor is or has been a debtor under the Code, was insolvent before the commencement of case under the Code, or has not paid a debt that is dischargeable under the Code.

Scope of Discharge

- Chapter 7: all debts that arose before the order for relief
- Chapter 11: all debts that arose before confirmation of the plan
- Chapter 13: all debts provided for in the plan or disallowed under section 502

Chapter 7 Discharge

- Under 727(a), the bankruptcy court must grant the individual debtor a discharge of all debts that arose before the order for relief unless one of 12 conditions is met.
- Only an individual is eligible for a discharge under chapter 7 pursuant to 727(a); a partnership or corporation may not receive a discharge under chapter 7.
- Additionally, 727(a) applies only in liquidation cases under chapter 7.

Chapter 11 Discharge

- Under 1141(d) of the Bankruptcy Code, the confirmation of the plan of reorganization discharges the debtor from any debt that arose before the confirmation of the plan.
- Unlike 727(a), a partnership or corporation (as well as an individual) may receive a 1141(d) discharge.

Chapter 11 Discharge: Revisited

- The 1141(d) discharge is broader than the 727(a) discharge in that the latter discharges any debts that arose before the order for relief (time petition was filed in a voluntary case), while the former discharges any debts that arose before the confirmation of the plan.

Limits to Chapter 11 Discharge

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

Chapter 13 Discharge

Chapter 13 Debtor Eligible for Discharge

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

§ 707. No Discharge of Fraudulent Taxes in Chapter 13—§ 1328(a)(2)

- Chapter 13 “super-discharge” now conforms to chapter 7 discharge for individual debtors for purposes of so-called fraud taxes
- Tax claims under section 523(a)(1) are now excepted from the chapter 13 discharge
- Such claims include priority tax claims, claims associated with fraudulent returns, unfiled returns, and willful attempts to evade or defeat a tax

§ 720. Dismissal for Failure to Timely File Tax Returns

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

Remaining Chapter 13 Benefits

Benefits of Chapter 13

- Cure mortgage arrearages and prevent foreclosure
- Discharges priority taxes paid by credit card provided original intent was to pay the card
- Discharges certain hold harmless divorce obligations under section 523(a)(15)
- Discharges all types of tax penalties

Benefits cont'd

- Priority/Nondischargeable tax obligations other than trust fund taxes can be paid without postpetition interest being incurred
- Effectively caps the payment to secured creditors on their secured claim at the plan confirmation value and allows the debtor to benefit from post-confirmation appreciation
- Debtor retains tax attributes

Hardship Discharge

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

Discharge Hearing

- Section 524(e) of the Code requires an individual debtor to appear before the court to receive the discharge.
- The discharge hearing gives the court an opportunity to explain the nature of the discharge and to warn the debtor against reaffirming discharged obligations.
- The discharge hearing is intended to be a formal affair that is intended to impress upon the individual debtor the significance of the bankruptcy case.
- At the discharge hearing, the court will also hear the debtor's attempt to reaffirm any debts.

Reaffirmations

- A reaffirmation agreement is an agreement between the debtor and one of the creditors wherein the debtor agrees to pay an otherwise dischargeable debt.
- As a general rule, reaffirmation agreements are void unless certain procedures are met.

Reaffirmation Procedures

- However, the Code recognizes certain reaffirmation agreements if certain Code requirements are met.
- First, the reaffirmation agreement must be entered into before the granting of the discharge.
- Second, the debtor must have 60 days after approval of the agreement to rescind it.
- Third, if the individual debtor is seeking to reaffirm a consumer debt that is not secured by the debtor's real property, the court must find that the agreement will not impose an undue hardship on the debtor.

Court Reluctance

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

Redemption

- Reaffirmations should be contrasted with **redemptions**.
- A redemption occurs pursuant to 722 of the Code, and gives the debtor a right to buy back collateral from the secured creditor.
- The strike price is set by the court through a court-imposed valuation.
- The right applies only to consumer goods securing a consumer debt.

Redemption cont'd

- Moreover, the property in question must either be exempt or abandoned by the trustee.
- Finally, courts hold that the debtor must pay the entire strike price at the time the right is exercised – no installment deals on this one.
- Of course, if not the type of property in that right category, a debtor could always buy it from the trustee through cash that is not property of the estate.

Objections to Discharge

- Not all debtors are entitled to a discharge under 727(a) of the Code. The right to discharge is a right reserved for the honest but unfortunate debtor.
- Over-extending oneself, unforeseen contingencies, the inability to pay debt, or lack of business acumen are not reasons to deny a debtor's discharge. But fraud, criminal activity, and misconduct are.
- If a creditor or the trustee is successful in attacking the debtor's discharge under 727(a), then all claims survive the bankruptcy case and may be enforced and ultimately satisfied.

Grounds for Denial

- Grounds for denial of a discharge include:
 - The debtor is not an individual.
 - A transfer or concealment of property within one year of bankruptcy by the debtor with the intent to hinder, delay, or defraud its creditors. Purge the taint?
 - The debtor's failure to keep adequate financial records.
 - Debtor misconduct during the bankruptcy case, including perjury, false statements, false oaths, or failure to obey a court order.
 - A debtor's inability to satisfactorily explain any losses or deficiencies of assets.
 - Insider action and subsequent personal bankruptcy

Grounds for Denial cont'd

- A chapter 7 discharge within eight years of the commencement of the pending case. Measure from filing date to filing date.
- A chapter 13 discharge granted within

Chapter 7 Debtor Eligible for Discharge: Timing

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

Revocation of Discharge

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

Waiver of Discharge

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

Exceptions of Debt from Discharge

- Policy
- Bad conduct

Types

- Priority taxes, non- and late filers, fraudulent returns, and willful attempts to evade or defeat a tax
- Fraudulent incurred obligations
- Debts not timely filed
- Fiduciary, fraud, larceny, embezzlement
- Family obligations
- Willful and malicious injury
- Government stuff
- Educational loans
- Drunk driving judgments

Types (cont'd)

- Debts in prior bankruptcy
- More government stuff
- Even more government stuff
- Criminal restitution
- Etc., etc., etc.

Approach to Taxes Claims

1. Priority and Nondischargeable
 - Read sections 507(a)(8) with 523(a)(1)(A)
 - Better scenario than #2
2. Nonpriority and Nondischargeable
 - Read section 523(a)(1)(B) and (C)
 - Least favorable to taxpayer
3. Nonpriority and dischargeable
 - Most favorable to taxpayer

Concepts

- Priority claims
 - Sections 507(a) and 726
 - Absolute priority rule
- Nondischargeable
 - Claim survives bankruptcy discharge
 - Applicable nonbankruptcy collection rights continue

Priority/Nondischargeable Taxes

- Taxes entitled to priority under §§ 507(a)(2) and (a)(8).
 - Three-year rule
 - 240-day assessment rule
 - Still-assessable rule
 - Recent property taxes
 - Trust fund taxes
 - Employer's share of payroll tax within 3 years of petition date
 - Excise taxes within 3 years of petition date
 - Certain custom duties

Nonpriority/Nondischargeable Taxes

- Taxes connected with fraudulent returns
 - Innocent spouse defense
- Taxes connected with late returns or a failure to file
 - Meaning of return and SFRs – see section 523(a)(19)
- Taxes connected with a willful attempt to evade or defeat a tax
 - Criminal v. civil standard
- Governmental fines and penalties to the extent that they are not compensation for actual pecuniary loss.
 - Nonetheless, this category of non-dischargeable debt does not include tax penalties relating to dischargeable taxes or to any transaction or event that occurred more than 3 years before the filing of the bankruptcy petition.

Fraud Exception to Corporation's Discharge in Chapter 11

- Corporations cannot discharge a debt based on fraud owed to a governmental unit arising out of false pretenses, false representations or actual fraud, whether or not based on use of a financial statement in writing.
 - The language of this provision makes it unclear whether these nondischargeable debts to governmental units must arise from the debtor's own fraudulent dealings with the government, or if this extends to claims or fines the government could impose on account of the debtor's defrauding of investors or creditors.
 - Debt owed to an individual on a qui tam claim is also not dischargeable.

Chapter 11 and Individuals

- Timing of discharge
 - If debtor is an individual and
 - Debtor filed a chapter 11 case, then
 - Section 1141(d)(5) delays the discharge until full performance under the chapter 11 plan absent a chapter 11 hardship discharge

Chapter 13 Debtor Eligible for Discharge

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

No Discharge of Fraudulent Taxes in Chapter 13—§ 1328(a)(2)

- Chapter 13 “super-discharge” now conforms to chapter 7 discharge for individual debtors for purposes of so-called fraud taxes
- Tax claims under section 523(a)(1)(B) and (C) are now excepted from the chapter 13 discharge
- Such claims include claims associated with fraudulent returns, unfiled returns, willful attempts to evade or defeat a tax, or trust fund taxes
- Additionally, priority tax claims must be provided for in the plan and be paid in full

§ 707. No Discharge of Fraudulent Taxes in Chapter 13—§ 1328(a)(2)

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§ 708. No Discharge of Fraudulent Taxes in Chapter 11—§ 1141(d)

- Section 1141 defines the effect of confirmation of a Chapter 11 plan and specifically discharges certain debts that arose before confirmation.
- The amendment excepts tax liabilities from a Chapter 11 discharge if the debtor corporation made a fraudulent return or willfully attempted in any manner to evade or defeat that tax or duty.
- The new provision also excepts from discharge any debt incurred under false pretenses or by making a false statement in writing.

Fraudulent Transfers and Preferences

Fraudulent Transfers and Obligations

Section 548

- Actual fraud
- Constructive fraud

Actual Fraud Elements

- Trustee
- Transfer
- Property of the Debtor
- Two-year reach back (even farther with asset-planning strategies in play)
- Actual intent to hinder, delay or defraud

Constructive Fraud Elements

- Trustee
- Transfer
- Property of the Debtor
- Two-year reach back (even farther in some circumstance)
- Lack of reasonably equivalent value
- Financial distress
 - Insolvent or rendered insolvent
 - Unreasonably small capital
 - Inability to pay debts as they become due

Intercompany Transfers and Obligations

- Distinguish between transfers and obligations
- Reasonably equivalent value –
 - Indirect benefits
 - Identify of interests
- Financial distress
 - How do you treat contingent liabilities?

State Fraud and §544(b)

- Trustee
- Actual creditor with an allowed unsecured claim
- State law allows creditor to avoid
- Remedy: *Moore v. Bay*

Section 548 Defenses

- Good faith value to the debtor
- Section 550

Remedies

- Section 550
- Section 551

Preferences and Defenses

Preferences: Elements

- Trustee
- Transfer
- Of property of the debtor
- To or for benefit of creditor
- For a or on account of antecedent debt
- Made while the debtor was insolvent
- Made within 90 days (or up to 1 year if insider)
- Preferential effect

Purpose

- Prevent opt-out
- Prevent secret liens
- Protect distributional scheme in bankruptcy

Preference Defenses

- Section 547(c)
- Plead and Proof
- Burden of proof on transferee

First Defense

- Contemporaneous exchanges for new value
 - Intended to be contemporaneous exchange for new value
 - New value – money or money's worth in goods or services, or release of property
 - In fact substantially contemporaneous
- Examples
 - 10 days -- §§547(e)(2)(A) and 547(b)(2)
 - 30 days
 - With intent
 - Without intent
 - 60 days
 - With intent

Second Defense

- Ordinary course of business (*Tolona Pizza*)
 - Debt incurred in the ordinary course of business of the debtor and the transferee AND
 - Transfer was made in the ordinary course of the debtor and transferee OR [AND]
 - Transfer made in accordance with ordinary business terms
- Used chiefly by trade creditors
- *Wolas*
 - Banks may use in appropriate circumstances

Factors to Be Considered

- Character of payment
- Method of payment
 - Check
 - Wire transfer
 - Return of goods
- Automated or manual check processing
- Amount of check
- Check invoice dates – compare to payment date

Factors cont'd

- Term changes
- Timing of payments
- Proof of delivery issues
- Lost invoices
- Misplaced invoices
- Return or nonconforming goods
- Custom goods
- Credit and discount issues

Factors cont'd

- Exposure
 - Increase in purchases or later payments
- New preference period account
- One invoice or payment situation
- Stump period
- Deviate from internal procedure
- Horizontal comparison re procedures
- Extraordinary use of third parties

Factors cont'd

- Meeting with customer
- Classified as distressed credit
- Appropriate model
 - No distress
 - Distress
 - Entire market

Methodology: Preferences – OCB

- At some point, the expert, or someone working under the supervision of the expert (collectively, the “expert”), visits by phone or in person with the employees and/or professionals of the client to discuss the operations and procedures of the defendant and debtor.
- The expert analyzed the complaint and exhibits thereto filed by the debtor in the preference action to determine the alleged preference payments, including the gross preference amount, net discounts, net chargeback, net credits and other adjustment, to arrive at the net alleged preference amount.

OCB cont'd

- The expert assessed the available check posting and clearing (final payment) records to determine the date checks were posted to the defendant's records or cleared the debtor's bank.
- The expert prepared and/or analyzed preference detail, including check amounts and dates, invoice amounts and dates, any chargebacks, discounts, aging of invoices, and other relevant data.

OCB cont'd

- The expert analyzed the historical transactions between the debtor and the defendant to determine the payment experience with the debtor.
- The expert explicitly identified the testing period, that is, the time period of interest to and consideration by the expert;
- The expert identified the relevant industry;

OCB cont'd

- The expert studied and/or consulted relevant publications, trade journals, and other industry sources to help inform about collection practices and ordinary business terms.
- The expert, through experience in the relevant industry and/or through an analysis of comparable companies and/or other accounts maintained by the parties, formulated an opinion as to what constitutes ordinary business terms, considering the manner and amount of payment, the stated terms between the parties, the timing of payments, account status, and other common credit management practices and procedures; and

OCB cont'd

- To the extent practicable, the expert cross-validated the expert opinion based on a number of sources or methods, including research (preferably published), experience (including third-party experience), proprietary sources, and an assessment of the actual performance between the debtor and the defendant

Fourth Defense

- Subsequent new value defense (trade defense)
 - Transfer to or for benefit of creditor
 - After transfer creditor gave new value to debtor
 - Not secured
 - Not otherwise unavoidable
 - Paid v. unpaid

Example

CR1 owed \$6000 90 days before filing

90 days DR owed 6000

75 days CR1 Extends 2000

60 days CR1 Receives OCB of 2500

50 days CR1 Receives pay of 2500

45 days CR1 Receives 2500

30 days CR1 extends 2000

15 days CR1 extends 2000

Fifth Defense

- Floating lien defense
- Bank defense
- Protects AAP clause in inventory or receivables
 - Improvement in position from Petition date to 90 days before bankruptcy

Sixth Defense

- Protects certain statutory liens from preference attack
 - Tax lien

Seventh Defense

- Family law obligation payments in the nature of support or in the nature of property settlements

Eight Defense

- Consumer exception
 - Individual debtor
 - Debts primarily consumer
 - Aggregate transfers of less than specific dollar amount

Recovery §550

- Return of property or money judgment (with court order)
- (a)(1) – remedy against initial transferee
- (a)(2) – remedy against immediate or mediate transferee

Defenses §550(b) and (e)

- Initial transferee – absolute liability
 - Section 548(c) – Value and good faith lien for fraudulent transfers
- Other transferees – good faith, value, and without knowledge of the voidability defense
- Improvements – All transferees but only to extent of cost of improvements or increased value, whichever is less

Section 551

- Preservation of transfer for benefit of estate

Trustee's Strong-Arm Powers

Strong-Arm Powers

- Powers exist as of the petition date
- §544(a)(1) and (a)(2) – status of hypothetical judicial lien creditor under applicable nonbankruptcy law
 - Avoid any unperfected liens or security interests
- §544(a)(3) – status of hypothetical BFP or real property
 - Avoid any unrecorded or mortgage

Setoff and Recoupment

Setoffs

- No bankruptcy right to setoff
- Setoff violates the automatic stay
- What is setoff?
 - Fund is property of the debtor
 - Fund is deposited without restriction
 - Debt is due
 - Mutuality of debts

Setoff v. recoupment

- Recoupment is not a stay violation
 - Compulsory counterclaim under Rule 13
- Setoff right preserved in bankruptcy

Limitations on Setoff

- Four limits –
 - Can't setoff against a disallowed claim
 - Obtaining a setoff right through transfer while debtor was insolvent
 - Obtaining a setoff right through incurrence of debt at time of insolvency
 - Improvement in position -- §553(b) and prepetition setoff

Improvement in Position

- Methodology –
 1. Calculate insufficiency at time of setoff
 2. Calculate insufficiency at 90th day
 3. Calculate insufficiency at Petition Date
 4. If insufficiency at Setoff is greater than at time of Petition Date, then calculate insufficiency at each successive date from Petition Date to 90th day
 5. Recover rule

Freeze

- Role of automatic stay
- Secured claim definition
- Adequate protection
- Use of cash collateral
- Turnover action §542
- What result?
- Procedural context

Post-Petition Transfers

Postpetition Transfers

- Pre – v. Post – Petition transfers
- §549 designed to protect stay purposes and distributional scheme in bankruptcy

Substantive Consolidation

Administrative Consolidation

- Separate estates
- Administrative ease

Substantive Consolidation

- Not in Bankruptcy Code
- Equitable remedy
- Fact-intensive inquiry

Factors Analysis

- Factor 1: Determine the presence or absence of consolidated financial statements or separate financial statements.
- Factor 2: Determine the unity of ownership and interests between and among the various corporate entities.
- Factor 3: Determine the existence of parent and inter-company guarantees on loans or any evidence of cross collateralization.

Factors (cont'd)

- Factor 4: Ascertain the degree of difficulty in segregating individual corporate assets and liabilities.
- Factor 5: Determine if transfers of assets have occurred without the observance of corporate formalities.
- Factor 6: Determine the existence and extent of any commingling of assets and business functions and an indication as to whether any such commingling occurred pre-petition or post-petition.

Factors (cont'd)

- Factor 7: Determine the profitability of consolidation at a single physical location or as a single entity regardless of location.
- Factor 8: Assumption by the parent of contractual obligations of its subsidiaries.
- Factor 9: The sharing of overhead, management, accounting and other related expenses among the different corporate entities.

Factors (cont'd)

- Factor 10: The existence of inter-company guarantees on loans.
- Factor 11: Failure to distinguish between properties of each entity.
- Factor 12: Shifting of funds from one company to another without observing corporate formalities.
- Factor 13: Parent paying salaries to employees of subsidiaries.

Factors (cont'd)

- Factor 14: The subsidiary having grossly inadequate capital.
- Factor 15: The degree of difficulty in segregating and ascertaining individual assets and liabilities.
- Factor 16: The presence of consolidated financial statements.
- Factor 17: The parent owning all or a majority of the capital stock of the subsidiary.

Factors (cont'd)

- Factor 18: The parent, its affiliates, and subsidiaries having common directors or officers.
- Factor 19: The parent or its affiliates financing of the subsidiaries.
- Factor 20: The parent shifting people on and off the subsidiaries' board of directors.

Factors (cont'd)

- Factor 21: The subsidiaries having substantially no business except that with the parent or its affiliates or no assets except those conveyed to it by the parent or the affiliate.
- Factor 22: The parent referring to the subsidiary as a department or division.
- Factor 23: The directors of the subsidiary not acting independently in the interest of the subsidiary, but taking direction from the parent.

Factors (cont'd)

- Factor 24: The parent, its affiliates, and the subsidiary acting in the same business location.
- Factor 25: Whether prejudice resulting from consolidation is outweighed by greater prejudice posed by continued separation of the bankruptcy estates.

Conclusion

- Observations
- Questions
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