## Online Retail Competition Causes Yet Another Brick-and-Mortar Retailer to File for Bankruptcy

**Business Web Log**


The online world did not significantly affect consumers and brick-and-mortar competitors for quite a few years after the invention of the Internet. But as online retailers become more aggressive and consumers become more comfortable ordering online, the inevitable is finally happening. More and more large retailers are filing for bankruptcy. One of the latest is Toys R Us. Toys R Us is just one of more than thirty-five major retailers that have filed for either Chapter 7 or Chapter 11 bankruptcy in recent years. Others include Radio Shack, Payless ShoeSource, and Vitamin World.

Toys R Us initially filed for Chapter 11 bankruptcy protection, indicating that it wanted to come to terms with its debt holders and other creditors. At issue was $5 billion of debt. The company promised consumers that its stores would stay open for the 2017 Christmas holidays, which they did, but its holiday sales were disappointing. Ultimately, the company's enormous debt and growing losses proved too much to overcome with reorganization. Toys R Us then announced that it was filing for Chapter 7 liquidation and was closing (or selling) all of its retail stores in the United States.

Shopping malls throughout America are struggling, too. Many of their anchor stores, such as Nordstrom, are closing money-losing locations. Others are filing for bankruptcy. Retailers in malls are not suffering because of cyclical downturns in spending. The reality is that many younger purchasers do not frequent shopping malls and instead do their shopping primarily on the Internet.

Although online competition has affected department stores more than any other retail sector, other retailers are feeling pressure as well, as shown by the example of Toys R Us. As one commentator stated, "Virtually every sub-segment of retail, other than auto retail and pharmacy, is caught in the cross-hairs of Amazon's growing online presence."

**Key Point**

*We can expect to see brick-and-mortar retailers forced into Chapter 11 reorganization for many years to come. Not only is Amazon, the Internet's biggest retailer, expanding every year, but traditional retailers are shifting resources away from physical stores and learning how to increase their online presence.*


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What are some factors that can cause large retail chains, such as Toys R Us, to file for bankruptcy?

**Learning Objective 1**

What are the two main goals of bankruptcy?

legislation was first enacted in 1898 and since then has undergone several modifications, most recently in the Bankruptcy Reform Act.[1] Federal bankruptcy laws are called the Bankruptcy Code or, more simply, the Code.

### 26–1a Goals of Bankruptcy Law

Bankruptcy law in the United States has two main goals:

1. To protect a debtor by giving him or her a fresh start without creditors' claims.
2. To ensure equitable treatment of creditors who are competing for a debtor's assets.

Thus, the law attempts to balance the rights of the debtor and the creditors.

Although the twin goals of bankruptcy remained the same, the balance between them shifted somewhat after the reform legislation. Because of its significance for creditors and debtors alike, we present the Bankruptcy Reform Act as this chapter's *Landmark in the Law* feature.

1. The full title of the act is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (April 20, 2005).

## The Bankruptcy Abuse Prevention and Consumer Protection Act


When Congress enacted the first Bankruptcy Reform Act in 1978, many claimed that the law made it too easy for debtors to file for bankruptcy protection. The 2005 Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) was passed, in part, in response to businesses' concerns about the rise in personal bankruptcy filings.

From 1978 to 2005, personal bankruptcy filings increased dramatically. Various business groups—including credit-card companies, retailers, and banks—claimed that the bankruptcy process was being abused and that reform was necessary.

**More Repayment Plans, Fewer Liquidation Bankruptcies** One of the major goals of the BAPCPA is to require consumers to pay as many of their debts as they possibly can instead of having those debts fully discharged in bankruptcy. Before the reforms, the vast majority of bankruptcies were filed under Chapter 7 of the Bankruptcy Code, which permits debtors, with some exceptions, to have *all* of their debts discharged in bankruptcy. Only about 20 percent of personal bankruptcies were filed under Chapter 13 of the Bankruptcy Code.

As you will read later in this chapter, Chapter 13 of the Bankruptcy Code requires the debtor to establish a repayment plan and pay off as many of his or her debts as possible over a maximum period of five years. Under the BAPCPA, more debtors have to file for bankruptcy under Chapter 13.

**Other Significant Provisions of the Act** The BAPCPA also made a number of other changes. One important provision involves the homestead exemption. Before the passage of the act, some states allowed debtors petitioning for bankruptcy to exempt all of the *equity* (the market value minus the outstanding mortgage owed) in their homes during bankruptcy proceedings. The act leaves these exemptions in place but puts some limits on their use.

Another BAPCPA provision gives child-support obligations priority over other debts and allows enforcement agencies to continue efforts to collect child-support payments.

**Application to Today's World** *Under the 2005 bankruptcy reforms, fewer debtors are allowed to have their debts discharged in Chapter 7 liquidation proceedings. At the same time, the act makes it more difficult for debtors to obtain a "fresh start" financially—one of the major goals of bankruptcy law in the United States. Today, more debtors are forced to file under Chapter 13.*

*Additionally, the bankruptcy process has become more time consuming and costly because it requires more extensive documentation and certification. These changes in the law have left many Americans unable to obtain relief from their debts.*

### 26–1b Bankruptcy Courts

Bankruptcy proceedings are held in federal bankruptcy courts, which are under the authority of U.S. district courts. Rulings by bankruptcy courts can be appealed to the district courts.

A bankruptcy court can conduct a jury trial if the appropriate district court has authorized it and the parties to the bankruptcy consent. Bankruptcy courts follow the Federal Rules of Bankruptcy Procedure rather than the Federal Rules of Civil Procedure. Bankruptcy court judges are appointed for terms of fourteen years.

### 26–1c Types of Bankruptcy Relief

The Bankruptcy Code is contained in Title 11 of the *United States Code* (U.S.C.) and has eight "chapters." Chapters 1, 3, and 5 of the Code include general definitions and provisions governing case administration and procedures, creditors, the debtor, and the estate. These three chapters of the Code normally apply to all types of bankruptcies.

Four chapters of the Code set forth the most important types of relief that debtors can seek.

**Know This**

Congress regulates the jurisdiction of the federal courts within the limits set by the U.S. Constitution. Congress can expand or reduce the number of federal courts at any time.

Design Pics Inc/Alamy

Under which chapter of the Code may family farmers seek bankruptcy relief?

1. Chapter 7 provides for *liquidation* proceedings—that is, the selling of all nonexempt assets and the distribution of the proceeds to the debtor's creditors.
2. Chapter 11 governs reorganizations.
3. Chapter 12 (for family farmers and family fishermen) and Chapter 13 (for individuals) provide for adjustment of the debts of parties with regular income.[2]

Note that a debtor (except for a municipality) need not be insolvent[3] to file for bankruptcy relief under the Bankruptcy Code. Anyone obligated to a creditor can declare bankruptcy.

### 26–1d Special Treatment of Consumer-Debtors

**Consumer-Debtor** One whose debts result primarily from the purchase of goods for personal, family, or household use.

A **consumer-debtor** is a debtor whose debts result primarily from the purchase of goods for personal, family, or household use. The Bankruptcy Code requires that the clerk of the court give all consumer-debtors written notice of the general purpose, benefits, and costs of each chapter of bankruptcy under which they may proceed. In addition, the clerk must provide consumer-debtors with information on the types of services available from credit counseling agencies. Consumer-debtors are also required to confirm the accuracy of certain information filed with the court (their attorney must do so if they are represented).

## 26–2 Chapter 7—Liquidation

**Liquidation** The sale of the nonexempt assets of a debtor and the distribution of the funds received to creditors.

**Bankruptcy Trustee** A person appointed by the court to manage the debtor's funds.

**Discharge** The termination of a bankruptcy debtor's obligation to pay debts.

**Liquidation** under Chapter 7 is the most familiar type of bankruptcy proceeding and is often referred to as an *ordinary,* or *straight, bankruptcy.* Put simply, a debtor in a liquidation bankruptcy turns all assets over to a **bankruptcy trustee,** a person appointed by the court to manage the debtor's funds. The trustee sells the nonexempt assets and distributes the proceeds to creditors. With certain exceptions, the remaining debts are then **discharged** (extinguished), and the debtor is relieved of the obligation to pay the debts.

Any "person"—defined as including individuals, partnerships, and corporations[4]—may be a debtor under Chapter 7. Railroads, insurance companies, banks, savings and loan associations, investment companies licensed by the U.S. Small Business Administration, and credit unions *cannot* be Chapter 7 debtors. Other chapters of the Code or other federal or state statutes apply to them. A husband and wife may file jointly for bankruptcy under a single petition.

**Petition in Bankruptcy** The document that is filed with a bankruptcy court to initiate bankruptcy proceedings.

A straight bankruptcy may be commenced by the filing of either a voluntary or an involuntary **petition in bankruptcy**—the document that is filed with a bankruptcy court to initiate bankruptcy proceedings. If a debtor files the petition, then it is a *voluntary bankruptcy.* If one or more creditors file a petition to force the debtor into bankruptcy, then it is an *involuntary bankruptcy.*

### 26–2a Voluntary Bankruptcy

To bring a voluntary petition in bankruptcy, the debtor files official forms designated for that purpose in the bankruptcy court. The law now requires that before debtors can file a petition, they must receive credit counseling from an approved nonprofit agency. Debtors

2. There are no Chapters 2, 4, 6, 8, or 10 in Title 11. Such "gaps" are not uncommon in the *United States Code.* They occur because, when a statute is enacted, chapter numbers (or other subdivisional unit numbers) are sometimes reserved for future use. (A gap may also appear if a law has been repealed.)
3. The inability to pay debts as they come due is known as *equitable* insolvency. A *balance-sheet* insolvency, which exists when a debtor's liabilities exceed assets, is not the test. Thus, it is possible for debtors to petition voluntarily for bankruptcy even though their assets far exceed their liabilities. This situation may occur when a debtor's cash-flow problems become severe.
4. The definition of *corporation* includes unincorporated companies and associations. It also covers labor unions.

filing a Chapter 7 petition must thus include a certificate proving that they have received individual or group counseling from an approved agency within the last 180 days (roughly six months).

A consumer-debtor who is filing a voluntary petition must confirm the accuracy of the petition's contents. The debtor must also state in the petition, at the time of filing, that he or she understands the relief available under other chapters of the Code and has chosen to proceed under Chapter 7.

Attorneys representing consumer-debtors must file an affidavit stating that they have informed the debtors of the relief available under each chapter of the Code. In addition, the attorneys must reasonably attempt to verify the accuracy of the consumer-debtors' petitions and schedules (described next). Failure to do so is considered perjury.

**Chapter 7 Schedules** The voluntary petition contains the following schedules:

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

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

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

**Tax Returns during Bankruptcy** A debtor may be required to file a tax return at the end of each tax year while the case is pending and to provide a copy to the court. A request for a copy of the debtor's tax return may be made by the court or the **U.S. Trustee**—a government official who performs administrative tasks that a bankruptcy judge would otherwise have to perform. In addition, any *party in interest* (a party, such as a creditor, who has a valid interest in the outcome of the proceedings) may make this request. Debtors may also be required to file tax returns during Chapter 11 and 13 bankruptcies.

**U.S. Trustee** A government official who performs administrative tasks that a bankruptcy judge would otherwise have to perform.

**Substantial Abuse and the Means Test** A bankruptcy court can dismiss a Chapter 7 petition if the use of Chapter 7 constitutes a "substantial abuse" of bankruptcy law. The revised Code provides a *means test* to determine a debtor's eligibility for Chapter 7. The purpose of the test is to keep higher-income people from abusing the bankruptcy process, as was thought to have happened in the past. The test forces more people to file for Chapter 13 bankruptcy rather than have their debts discharged under Chapter 7.

***The Basic Formula.*** A debtor wishing to file for bankruptcy must complete the means test to determine whether she or he qualifies for Chapter 7. The debtor's average monthly income in recent months is compared with the median income in the geographic area in which the person lives. (The U.S. Trustee Program provides these data at its website, www.justice.gov/ust.)

**Learning Objective 2**

In a Chapter 7 bankruptcy, what happens if a court finds that there was "substantial abuse"? How is the means test used?

If the debtor's income is below the median income, the debtor usually is allowed to file for Chapter 7 bankruptcy, as there is no presumption of bankruptcy abuse.

***Applying the Means Test to Future Disposable Income.*** If the debtor's income is above the median income, then further calculations must be made to determine the debtor's future disposable income. As a basis for the calculations, it is presumed that the debtor's recent monthly income will continue for the next sixty months. *Disposable income* is then calculated by subtracting living expenses and interest payments on secured debt, such as mortgage payments, from monthly income.

*Living expenses* are the amounts allowed under formulas used by the Internal Revenue Service (IRS). The IRS allowances include modest allocations for food, clothing, housing, utilities, transportation (including car payments), health care, and other necessities. (The U.S. Trustee Program's website also provides these amounts.) The allowances do not include expenditures for items such as cell phones and cable television service.

***Can the Debtor Afford to Pay Unsecured Debts?*** Once future disposable income has been estimated, that amount is used to determine whether the person will have sufficient income in the future to repay at least some of his or her unsecured debts. The court may also consider the debtor's bad faith or other circumstances indicating abuse.

**Case Example 26.1** John and Sarah Buoy filed for Chapter 7 bankruptcy. For the past three months, John's gross monthly income was $4,900, and Sarah's was $6,761. They had five children. They owed secured debts of $34,321 on a Subaru Impreza and a BMW 328i, on which they intended to continue making loan payments (this is called reaffirmation, as will be discussed later). They owed $123,000 on a mortgage and $19,000 in student loans, and their unsecured debts were $4,900.

An auditor for the U.S. Trustee Program reviewed the Buoys' Chapter 7 schedule and concluded that the family's gross income figures were understated. Because of a mistake in the math, the Buoys had miscalculated their biweekly income by approximately $800 a month (or nearly $650 after taxes). The debtors claimed that they had incurred additional expenses after the petition, including orthodontic braces and another car. Even with those expenses, however, the court found that they would have an additional $400 a month in future disposable income and would receive sizeable tax refunds. The court concluded that the Buoys could afford to pay their debts and dismissed the Chapter 7 petition for substantial abuse.[5]

**Order for Relief** A court's grant of assistance to a debtor in bankruptcy that relieves the debtor of the immediate obligation to pay debts.

Blend Images/Alamy

How does family size affect the calculation and application of the means test?

**Additional Grounds for Dismissal** As noted, a debtor's voluntary petition for Chapter 7 relief may be dismissed for substantial abuse or for failure to provide the necessary documents (such as schedules and tax returns) within the specified time. In addition, a motion to dismiss a Chapter 7 filing may be granted in two other situations.

1. If the debtor has been convicted of a violent crime or a drug-trafficking offense, the victim can file a motion to dismiss the voluntary petition.[6]
2. If the debtor fails to pay postpetition domestic-support obligations (which include child and spousal support), the court may dismiss the petition.

**Order for Relief** If the voluntary petition for bankruptcy is found to be proper, the filing of the petition will itself constitute an **order for relief.** (An order for relief is the court's grant of assistance to a debtor.)

5. *In re Buoy*, ___ Bankr. ___, 2017 WL 3194755 (N.D. Ohio 2017).
6. Note that the court may not dismiss a case on this ground if the debtor's bankruptcy is necessary to satisfy a claim for a domestic-support obligation.

Once a consumer-debtor's voluntary petition has been filed, the clerk of the court (or other appointee) must give the trustee and creditors notice of the order for relief by mail not more than twenty days after the entry of the order.

## 26–2b Involuntary Bankruptcy

An involuntary bankruptcy occurs when the debtor's creditors force the debtor into bankruptcy proceedings. An involuntary petition cannot be filed against a charitable institution or a farmer (an individual or business that receives more than 50 percent of its gross income from farming operations).

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

**Requirements** For an involuntary action to be filed, the following requirements must be met:

1. If the debtor has twelve or more creditors, three or more of those creditors having unsecured claims totaling at least $15,775 must join in the petition.
2. If the debtor has fewer than twelve creditors, one or more creditors having a claim of $15,775 or more may file.[7]

"I hope that after I die, people will say of me: 'That guy sure owed me a lot of money.'"

**Jack Handey**
1949–present
(American humorist)

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

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

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

## 26–2c Automatic Stay

The moment a petition, either voluntary or involuntary, is filed, an **automatic stay,** or suspension, of almost all actions by creditors against the debtor or the debtor's property normally goes into effect. Until the bankruptcy proceeding is closed or dismissed, the automatic stay prohibits a creditor from taking any act to collect, assess, or recover a claim against the debtor that arose before the filing of the petition.

**Automatic Stay** In bankruptcy proceedings, the suspension of almost all litigation and other actions by creditors against the debtor or the debtor's property. The stay is effective the moment the debtor files a petition in bankruptcy.

If the debtor had two or more bankruptcy petitions dismissed during the prior year, the Code presumes bad faith. In such a situation, the automatic stay does *not* go into effect until the court determines that the petition was filed in good faith.

If a creditor *knowingly* violates the automatic stay (a willful violation), any injured party, including the debtor, is entitled to recover actual damages, costs, and attorneys' fees and may be entitled to punitive damages as well. **Example 26.2** Richard Anderson and his wife filed for bankruptcy. One of the debts listed on their Chapter 7 schedule was a JCPenney credit card with a balance of $630. Even after it is notified of the bankruptcy, Recovery Management

7. 11 U.S.C. Section 303. The amounts stated in this chapter are in accordance with those computed on April 1, 2016. The dollar amounts are adjusted every three years on April 1.

Systems Corporation (RMSC), a debt collection service, continues to send letters to Richard Anderson in an attempt to collect the balance on the card. In this situation, RMSC is willfully violating the automatic stay. The Andersons are entitled to seek actual damages, costs, attorneys' fees, and even punitive damages for RMSC's conduct. ■ (See this chapter's *Business Law Analysis* feature for further clarification.)

**Adequate Protection Doctrine**
A doctrine that protects secured creditors from losing the value of their security (because the collateral depreciates, for instance) as a result of an automatic stay in a bankruptcy proceeding.

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

**Exceptions to the Automatic Stay** The Code provides the following exceptions to the automatic stay:

1. Collection efforts can continue for domestic-support obligations, which include any debt owed to or recoverable by a spouse, a former spouse, a child of the debtor, that child's parent or guardian, or a governmental unit.
2. Proceedings against the debtor related to divorce, child custody or visitation, domestic violence, and support enforcement are not stayed.
3. Investigations by a securities regulatory agency can continue.
4. Certain statutory liens for property taxes are not stayed.

**Requests for Relief from the Automatic Stay** A secured creditor or other party in interest can petition the bankruptcy court for relief from the automatic stay. If a creditor

## Violations of the Automatic Stay

**Business Law Analysis**

Michelle Gholston leased a Chevy Impala from EZ Auto Van Rentals. On November 8, Gholston filed for bankruptcy. On November 21, the bankruptcy court notified EZ Auto of Gholston's bankruptcy and the imposition of an automatic stay. Nevertheless, because Gholston had fallen behind on her payments, EZ Auto repossessed the vehicle on November 28.

Gholston's attorney reminded EZ Auto that it could not take this action because of the automatic stay, but the company failed to return the car. As a result of the car's repossession, Gholston suffered damages that included emotional distress, lost wages, attorneys' fees, and car rental expenses. Can Gholston recover from EZ Auto?

**Analysis:** A debtor may be entitled to recover damages if a creditor knowingly or willfully violates the automatic stay. The test is whether EZ Auto knew about Gholston's bankruptcy at the time it repossessed her car. The bankruptcy court and the debtor's attorney had, in fact, notified EZ Auto about the bankruptcy and the automatic stay a week before the car was repossessed.

**Result and Reasoning:** Gholston can recover damages because EZ Auto willfully violated the automatic stay. EZ Auto repossessed the car even though it received notice of the automatic stay from the bankruptcy court. In addition, EZ Auto refused to return the car even after Gholston's attorney had reminded it of the stay. Thus, EZ Auto knew about the automatic stay and violated it willfully. Because Gholston suffered direct damages as a result, she can recover from EZ Auto. She may also be awarded punitive damages for EZ Auto's wrongful conduct.

or other party requests relief from the stay, the stay will automatically terminate sixty days after the request, unless the court grants an extension or the parties agree otherwise.

**Secured Property** The automatic stay on secured property terminates forty-five days after the creditors' meeting unless the debtor redeems or reaffirms certain debts. (Creditors' meetings and reaffirmation will be discussed later in this chapter.) In other words, the debtor cannot keep secured property (such as a financed automobile), even if she or he continues to make payments on it, without reinstating the rights of the secured party to collect on the debt.

Darren Brode/Shutterstock.com

If a collection agency knowingly repossesses a car when there is an automatic stay in effect, what can a debtor do?

## 26–2d Estate in Bankruptcy

On the commencement of a liquidation proceeding under Chapter 7, an **estate in bankruptcy** is created. The estate consists of all the debtor's interests in property currently held, wherever located. The estate in bankruptcy includes all of the following:

**Estate in Bankruptcy** All of the property owned by a person, including real estate and personal property.

1. *Community property* (property jointly owned by a husband and wife in certain states).
2. Property transferred in a transaction voidable by the trustee.
3. Proceeds and profits from the property of the estate.

Certain after-acquired property to which a debtor becomes entitled *within 180 days after filing* may also become part of the estate. Such after-acquired property includes gifts, inheritances, property settlements (from divorce), and life insurance death proceeds. Generally, though, the filing of a bankruptcy petition fixes a dividing line. Property acquired prior to the filing of the petition becomes property of the estate, and property acquired after the filing of the petition, except as just noted, remains the debtor's.

## 26–2e The Bankruptcy Trustee

Promptly after the order for relief has been entered, a trustee is appointed. The basic duty of the trustee is to collect the debtor's available estate and reduce it to cash for distribution, preserving the interests of both the debtor and the unsecured creditors. This requires that the trustee be accountable for administering the debtor's estate. To enable the trustee to accomplish this duty, the Code gives the trustee certain powers. These powers must be exercised within two years after the order for relief has been entered.

**Review for Substantial Abuse** The trustee is required to review promptly all materials filed by the debtor to determine if there is substantial abuse. Within ten days after the first meeting of the creditors, the trustee must file a statement as to whether the case is presumed to be an abuse under the means test. The trustee must provide all creditors with a copy of this statement.

When there is a presumption of abuse, the trustee must either file a motion to dismiss the petition (or convert it to a Chapter 13 proceeding) or file a statement explaining why a motion would not be appropriate. If the debtor owes a domestic-support obligation (such as child support), the trustee must provide written notice of the bankruptcy to the claim holder (a former spouse, for instance).

**Trustee's Powers** The trustee has the power to require persons holding the debtor's property at the time the petition is filed to deliver the property to the trustee.[8] To enable the trustee to implement this power, the Code provides that the trustee has rights *equivalent* to those of certain other parties, such as a creditor who has a judicial lien. This power of a trustee, which is equivalent to that of a lien creditor, is known as the *strong-arm power.*

8. Usually, the trustee takes constructive, rather than actual, possession of the debtor's property. For instance, to obtain possession of a business's inventory, a trustee might change the locks on the doors and hire a security guard.

In addition, the trustee has specific *powers of avoidance*. They enable the trustee to set aside (avoid or cancel) a sale or other transfer of the debtor's property and take the property back for the debtor's estate. These powers apply to voidable rights available to the debtor, preferences, and fraudulent transfers by the debtor (as discussed in more detail next). The trustee can also avoid certain statutory liens.

The debtor shares most of the trustee's avoidance powers. Thus, if the trustee does not take action to enforce one of these rights, the debtor in a liquidation bankruptcy can enforce it.

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

**Example 26.3** Ben sells his RV trailer to Inga. Inga gives Ben a check, knowing that she has insufficient funds in her bank account to cover the check. Inga has committed fraud. Ben has the right to avoid that transfer and recover the RV trailer from Inga. If Ben files for bankruptcy relief under Chapter 7, the trustee can exercise the same right to recover the RV trailer from Inga, and the RV trailer becomes part of the debtor's estate. ■

turtix/Shutterstock.com

Just before filing Chapter 7 bankruptcy, a debtor sells his RV trailer, but the buyer's check is no good. What, if anything, can the trustee do to recover the RV trailer on the debtor's estate's behalf?

**Preferences** A debtor is not permitted to make a property transfer or a payment that favors—or gives a **preference** to—one creditor over others. The trustee is allowed to recover such payments whether they were made voluntarily or involuntarily.

To have made a recoverable preferential payment, an *insolvent* debtor generally must have transferred property for a *preexisting* debt during the *ninety days* before the filing of the petition in bankruptcy. The transfer must have given the creditor more than the creditor would have received as a result of the bankruptcy proceedings. The Code presumes that the debtor is insolvent during the ninety-day period before filing a petition.

**Preference** In bankruptcy proceedings, a property transfer or payment made by the debtor that favors one creditor over others.

**Preferred Creditor** In the context of bankruptcy, a creditor who has received a preferential transfer from a debtor.

**Insider** In bankruptcy proceedings, any individual, partnership, or corporation with a close personal or business relation with the debtor.

If a **preferred creditor** (one who has received a preferential transfer from the debtor) has sold the property to an innocent third party, the trustee cannot recover the property from the innocent party. The trustee can generally force the preferred creditor to pay the value of the property, however.

***Preferences to Insiders.*** Sometimes, a creditor receiving a preference is an *insider*. An **insider** is any individual (such as a relative or partner), partnership, or corporation with a close relationship with the debtor. In this situation, the avoidance power of the trustee is extended to transfers made within *one year* before filing. (If the transfer was fraudulent, as will be discussed shortly, the trustee can avoid transfers made within *two years* before filing.) However, the trustee must prove that the debtor was insolvent at the time the earlier transfer occurred.

***Transfers That Do Not Constitute Preferences.*** Not all transfers are preferences. To be a preference, the transfer must be made in exchange for something other than current consideration. Most courts do not consider a debtor's payment for services rendered within fifteen days prior to the payment to be a preference. If a creditor receives payment in the ordinary course of business, such as payment of last month's cell phone bill, the trustee in bankruptcy cannot recover the payment. In contrast, a transfer for a preexisting debt, such as a year-old landscaping bill, would be a recoverable preference.

**Case Example 26.4** David Tidd operated a business performing small home repairs as well as house-building projects. Tidd and his son regularly purchased supplies for his business on credit from S.W. Collins. Eventually, Tidd filed for Chapter 7 bankruptcy. Within ninety days preceding his petition, Tidd had made four payments for materials to S.W. Collins,

totaling $46,000. The trustee filed a motion seeking to avoid this transfer as a preference. The court, however, concluded that the transfer was a substantially contemporaneous exchange of value (current consideration) and not a preference. The payments were made in the ordinary course of business. Therefore, the court found in Tidd's favor and denied the trustee's motion.[9]

In addition, the Code permits a consumer-debtor to transfer any property to a creditor up to a total value of $6,425 without the transfer constituting a preference. Payments of domestic-support debts do not constitute a preference. Neither do payments required under a plan created by an approved credit-counseling agency.

**Know This**

Usually, when property is recovered as a preference, the trustee sells it and distributes the proceeds to the debtor's creditors.

**Fraudulent Transfers** A trustee can avoid fraudulent transfers or obligations if (1) they were made within two years of the filing of the petition or (2) they were made with actual intent to hinder, delay, or defraud a creditor. **Case Example 26.5** David Dearmond was a real estate developer who owned interests in two development companies—Briartowne, LLC, and Hillside, LLC. He also owned one-third of Bluffs of Sevier County, LLC, which operated Bluff's Bar & Grill. When Briartowne defaulted on a $623,499 promissory note, SmartBank filed an action against Briartowne, Dearmond, and others.

Five months later, Dearmond sold Boyds Creek Market and Garage, a property he had paid $400,000 for the previous year, to his fiancée, Patricia Harper, for $90,000. Two days after that, Dearmond created two irrevocable trust agreements and transferred all of his interest in Hillside and Bluffs of Sevier County into those trusts. The trusts named Harper as the primary beneficiary. Although SmartBank obtained a judgment against Dearmond (and the other owners of Briartowne), it was unable to collect from these assets.

A year and a half later, Dearmond filed a petition for bankruptcy. The trustee filed a motion seeking to avoid the fraudulent transfers made to benefit Harper. Harper claimed that Dearmond had given her the interest in Hillside as a wedding present. The court concluded that the transfers should be set aside because they were made with actual intent to hinder, delay, or defraud a creditor. Therefore, the trusts no longer owned the properties. The court entered judgment for the trustee in an amount equivalent to the value of the fraudulent transfers.[10]

## 26–2f Exemptions

An individual debtor is entitled to exempt certain property from the bankruptcy under federal or state exemption schemes.

**Federal Exemptions** The Bankruptcy Code exempts the following property up to a specified dollar amount that changes automatically every three years:

1. A portion of equity in the debtor's home (not to exceed $160,375[11] under the federal homestead exemption, even if state law would permit a higher amount).
2. Motor vehicles, up to a certain value (usually just one vehicle).
3. Reasonably necessary clothing, household goods and furnishings, and household appliances (the aggregate value not to exceed a specified amount).
4. Jewelry, up to a specified value.
5. Tools of the debtor's trade or profession, up to a specified value.


Jeff Greenberg/Universal Images Group/Getty Images

During bankruptcy proceedings, when can a trustee claim that the sale of a restaurant was a fraudulent transfer?

9. *In re Tidd*, ___ Bankr. ___, 2017 WL 4011014 (D.Me. 2017).
10. *In re Dearmond*, 2017 WL 4220396 (Bankr. E.D.Tenn. 2017).
11. The amounts stated in this chapter are in accordance with those computed from the Consumer Price Index as of April 1, 2016.

6. A portion of unpaid but earned wages.
7. Pensions.
8. Public benefits, including public assistance (welfare), Social Security, and unemployment compensation, accumulated in a bank account.
9. Damages awarded for personal injury, up to a specified amount.

Property that is *not* exempt under federal law includes bank accounts, cash, family heirlooms, collections of stamps and coins, second cars, and vacation homes.

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

**Homestead Exemption** A law permitting a debtor to retain the family home, either in its entirety or up to a specified dollar amount, free from the claims of unsecured creditors or trustees in bankruptcy.

**Limitations on the Homestead Exemption** Probably the most familiar real property exemption is the **homestead exemption,** the purpose of which is to ensure that the debtor will retain some form of shelter. Each state permits the debtor to retain the family home, either in its entirety or up to a specified dollar amount. The Bankruptcy Code limits the amount that can be claimed in bankruptcy under the homestead exemption of any state, however. In general, if the debtor acquired the home within three years and four months preceding the date of filing, the maximum equity exempted is $160,375, even if state law would permit a higher amount.

In addition, the state homestead exemption is available only if the debtor has lived in the state for two years before filing the petition. A debtor who has violated securities law, been convicted of a felony, or engaged in certain other intentional misconduct may not be permitted to claim the homestead exemption at all.

StanRohrer/Getty Images

How does the homestead exemption help debtors who go into bankruptcy?

## 26–2g Creditors' Meeting and Claims

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

To be entitled to receive a portion of the debtor's estate, each creditor normally files a *proof of claim* with the bankruptcy court clerk within ninety days of the creditors' meeting. The proof of claim lists the creditor's name and address, as well as the amount that the creditor asserts is owed to the creditor by the debtor.

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

## 26–2h Distribution of Property

The Code provides specific rules for the distribution of the debtor's property to secured and unsecured creditors. If any amount remains after the priority classes of creditors have been satisfied, it is turned over to the debtor.

**Distribution to Secured Creditors** Secured creditors have priority. The Code requires that consumer-debtors file a statement of intention with respect to the secured collateral. They can choose to pay off the debt and redeem the collateral, claim that it is exempt, reaffirm the debt and continue making payments, or surrender the property to the secured party.

If the collateral is surrendered to the secured party, the secured creditor can either (1) accept the collateral in full satisfaction of the debt or (2) sell the collateral and use the proceeds to pay off the debt. Thus, the secured party has priority over unsecured parties as to the proceeds from the disposition of the collateral. Should the collateral be insufficient to cover the secured debt owed, the secured creditor becomes an unsecured creditor for the difference.

There are limited exceptions to these rules. For instance, certain unsecured creditors can sometimes step into the shoes of secured tax creditors in Chapter 7 liquidation proceedings. In such situations, when the collateral securing the tax claims is sold, the unsecured creditors are paid first. This exception does *not* include holders of unsecured claims for administrative expenses incurred in Chapter 11 cases that are converted to Chapter 7 liquidations. In the following case, the plaintiff argued that it should.

## Case 26.1

### *In re* Anderson

United States Court of Appeals, Fourth Circuit, 811 F.3d 166 (2016).

**Background and Facts** Henry Anderson filed a voluntary petition in a federal bankruptcy court for relief under Chapter 11 of the Bankruptcy Code (which governs reorganizations of the debtor's estate). The Internal Revenue Service (IRS) filed a proof of claim against the bankruptcy estate for unpaid taxes of nearly $1 million. This claim was secured by Anderson's property. Stubbs & Perdue, P.A., served as Anderson's counsel. The court approved compensation of $200,000 to Stubbs for its services. These fees constituted an unsecured claim against the estate for administrative expenses.

Later, Anderson's case was converted to a Chapter 7 liquidation. The trustee accumulated more than $700,000 for distribution to the estate's creditors—but this was not enough to pay the claims of both the IRS and Stubbs. The trustee excluded Stubbs's claim. Stubbs objected. The court dismissed Stubbs's objection. A federal district court upheld the exclusion. Stubbs appealed, arguing that the IRS's claim should be subordinated to Stubbs's claim for fees.

**In the Words of the Court**

Pamela *HARRIS,* Circuit Judge:

* * * *

* * * Before any of the events at issue here, Section 724(b)(2) * * * provided all holders of administrative expense claims, like Stubbs, with the right to subordinate secured tax creditors in Chapter 7 liquidations. But that statutory scheme was criticized on the ground that it created perverse incentives, encouraging Chapter 11 debtors and their representatives to incur administrative expenses even where there was no real hope for a successful reorganization, to the detriment of secured tax creditors when Chapter 7 liquidation ultimately proved necessary.

* * * Congress responded with a fix * * * to limit the class of administrative expenses covered by Section 724(b)(2) * * *. *In order to provide greater protection for holders of tax liens * * *, unsecured Chapter 11 administrative expense claims would no longer take priority over secured tax claims in Chapter 7 liquidations.* [Emphasis added.]

* * * *

* * * The Bankruptcy Technical Corrections Act [BTCA] * * * clarified that Chapter 11 administrative expense claimants do not hold subordination rights under Section 724(b)(2).

* * * Eleven months later, the Debtor's bankruptcy case converted from Chapter 11 to Chapter 7, implicating Section 724(b)(2) for the first time.

* * * *

* * * *As a general rule, a court is to apply the law in effect at the time it renders its decision.* [Emphasis added.]

* * * *

Stubbs argues, however, that it would be unjust to apply the BTCA version of Section 724(b)(2) * * * to disallow payment on its unsecured claim for Chapter 11 fees. Prior to the BTCA, Stubbs contends, it was entitled to subordinate the IRS's secured claim.

The problem with Stubbs's argument is its premise: that Stubbs held subordination rights under Section 724(b)(2) before the BTCA was enacted * * *. Before the BTCA was enacted, Section 724(b)(2) had no application to the Debtor's case at all. It afforded Stubbs no entitlement to subordinate the IRS's secured tax claim for the threshold reason that it simply did not apply in the Chapter 11 proceedings that began in this case * * * and did not end until * * * eleven months *after* the BTCA's passage. The pre-BTCA

(*Continues*)

version of Section 724(b)(2) that Stubbs invokes, in other words, never controlled this case.

**Decision and Remedy** The U.S. Court of Appeals for the Fourth Circuit affirmed the dismissal of Stubbs's claim. Under Section 724(b)(2), "it is clear that Stubbs is not entitled to subordinate the IRS's secured tax claim in favor of its unsecured claim to Chapter 11 administrative expenses."

**Critical Thinking**

- **Legal Environment** *Why, as a general rule, should a court apply the law that is in effect at the time the court renders its decision?*
- **Ethical** *If Anderson had filed his initial bankruptcy petition under Chapter 7, not under Chapter 11, the result would have been different—Stubbs would have been able to subordinate the IRS claim. Is this fair?*

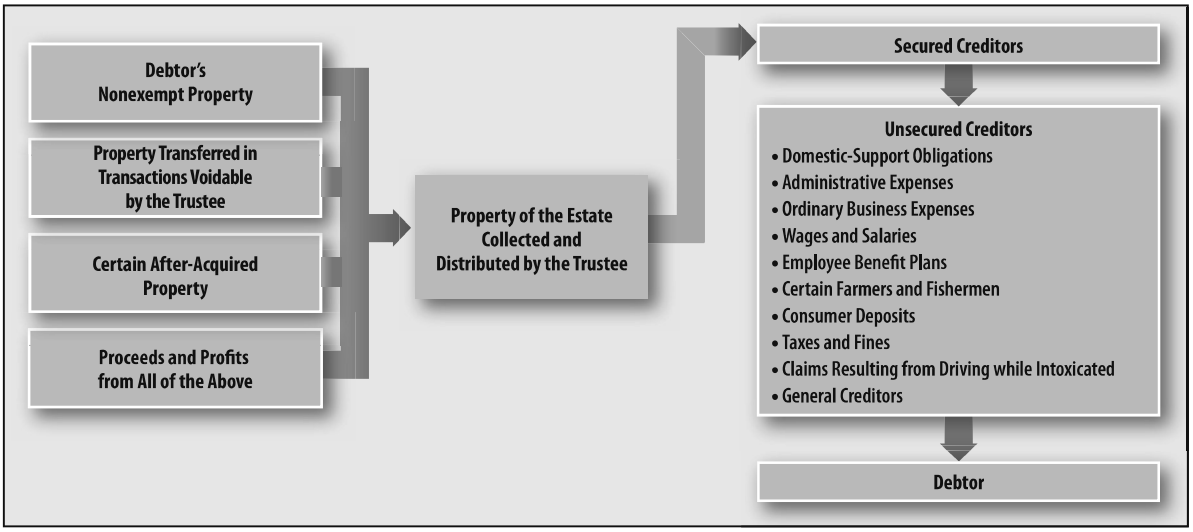
**Distribution to Unsecured Creditors** Bankruptcy law establishes an order of priority for classes of debts owed to unsecured creditors, and they are paid in the order of their priority. Each class must be fully paid before the next class is entitled to any of the remaining proceeds. If there is any balance remaining after all the creditors are paid, it is returned to the debtor.

In almost all Chapter 7 bankruptcies, the funds will be insufficient to pay all creditors. If there are insufficient proceeds to pay the full amount to all the creditors in a class, the proceeds are distributed *proportionately* to the creditors in that class. Creditors in classes lower in priority receive nothing. Claims for domestic-support obligations, such as child support and alimony, have the highest priority among unsecured claims, so these debts must be paid first. In almost all Chapter 7 bankruptcies, the funds will be insufficient to pay all creditors. Exhibit 26–1 illustrates the collection and distribution of property in most voluntary bankruptcies.

## 26–2i Discharge

From the debtor's point of view, the primary purpose of liquidation is to obtain a fresh start through the discharge of debts. A discharge voids, or sets aside, any judgment on a discharged debt and prevents any action to collect it. Certain debts, however, are not dischargeable in bankruptcy. Also, certain debtors may not qualify to have all debts discharged in bankruptcy. These situations are discussed next.

**Exhibit 26–1 Collection and Distribution of Property in Most Voluntary Bankruptcies**



**Debts That Are Not Dischargeable** The most important claims that are not dischargeable under Chapter 7 include the following:

1. Claims for back taxes accruing within two years prior to bankruptcy.
2. Claims for amounts borrowed by the debtor to pay federal taxes or any nondischargeable taxes.
3. Claims against property or funds obtained by the debtor under false pretenses or by false misrepresentations.
4. Claims by creditors who were not notified of the bankruptcy. These claims did not appear on the schedules the debtor was required to file.
5. Claims based on fraud or misuse of funds by the debtor or claims involving the debtor's embezzlement or larceny.
6. Domestic-support obligations and property settlements.
7. Claims for amounts due on a retirement loan account.
8. Claims based on willful or malicious conduct by the debtor toward another or toward the property of another.
9. Certain government fines and penalties.
10. Student loans, unless payment of the loans causes an undue hardship for the debtor and the debtor's dependents (when paying the loan would leave the debtor unable to maintain a minimal standard of living, for instance).
11. Consumer debts of more than $675 for luxury goods or services owed to a single creditor incurred within ninety days of the order for relief.

**Case Example 26.6** Anthony Mickletz owned a pizza restaurant that employed John Carmello. One night after Carmello had finished his shift, Mickletz called him back into the restaurant and accused him of stealing. An argument ensued, and Mickletz shoved Carmello, causing him to fall and injure his back. Because Mickletz did not provide workers' compensation coverage as required by law, the state prosecuted him criminally. He was ordered to pay more than $45,000 in restitution to Carmello for his injuries.

Carmello also filed a civil suit against Mickletz, which the parties agreed to settle for $175,000. Later, Mickletz filed a petition for bankruptcy. Carmello argued that these debts were nondischargeable, and the court agreed. The exceptions from discharge include any debts for willful (deliberate or intentional) injury, and Mickletz's actions were deliberate.[12]

## Know This

Often, a discharge in bankruptcy—even under Chapter 7—does not free a debtor of *all* of her or his debts.

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A pizza restaurant owner intentionally injures one of his employees, who then sues and is awarded damages by a civil court. If the owner files for Chapter 7 bankruptcy, can his debt to the injured worker be discharged? Why or why not?

12. *In re Mickletz*, 544 Bankr. 804 (E.D. Pa. 2016).

## Ethical Issue


**Should there be more relief for student loan defaults?** Outstanding student loan balances total $1.4 *trillion* nationally and are growing by approximately $3,000 *per second*. About 20 percent of these loans are ninety or more days' delinquent or are in default. That is the highest delinquency rate among all forms of debt, including credit cards, automobile loans, and mortgages. The average student loan debt is more than $35,000. Any student borrower who has not made regular payments for nine months is in default. The U.S. Department of Education can keep the debtor's tax refund or garnish his

(*Continues*)

or her paychecks or other federal benefits (such as disability benefits) without obtaining a court order. The government can also sue to collect a judgment from the debtor's bank accounts or place a lien on real property.

Politicians and society are increasingly discussing student loan debt and the costs of higher education. Some are suggesting reducing the interest rates that can be charged and imposing student loan debt forgiveness after a certain period of time, such as twenty years. Others advocate making college education free or at least reducing the costs charged to certain students. Another proposal is to prohibit the federal government from profiting from student loan debt (the government brings in more than $41 billion a year from student loans). In addition, some are asking Congress to allow federal student loans to be discharged in most bankruptcy proceedings, rather than only in cases of undue hardship.

**Reasons That a Court Can Deny a Discharge** A bankruptcy court may also deny the discharge based on the debtor's *conduct*. Grounds for denial of discharge of the debtor include the following:

1. The debtor's concealment or destruction of property with the intent to hinder, delay, or defraud a creditor.
2. The debtor's fraudulent concealment or destruction of financial records.
3. The granting of a discharge to the debtor within eight years prior to the filing of the petition.
4. The debtor's failure to complete the required consumer education course.
5. Proceedings in which the debtor could be found guilty of a felony. (Basically, a court may not discharge any debt until the completion of the felony proceedings against the debtor.)

When a discharge is denied under any of these circumstances, the debtor's assets are still distributed to the creditors. After the bankruptcy proceeding, however, the debtor remains liable for the unpaid portions of all claims.

A discharge may be revoked (taken back) within one year if it is discovered that the debtor acted fraudulently or dishonestly during the bankruptcy proceeding. If that occurs, a creditor whose claim was not satisfied in the distribution of the debtor's property can proceed with his or her claim against the debtor.

Whether a bankruptcy court properly denied a discharge based on the debtors' conduct was the issue in the following case.

## Case 26.2

### *In re* Cummings

United States Court of Appeals, Ninth Circuit, 595 Fed.Appx. 707 (2015).

**Background and Facts** Clarence and Pamela Cummings filed a petition for a Chapter 7 bankruptcy in a federal bankruptcy court. After the debtors filed two amended versions of the required schedules, the trustee asked for additional time to investigate. The court granted the request. The debtors then filed a third amended schedule. In it, they disclosed


Carterdayne/Getty Images

*What constitutes a false oath in Chapter 7 proceedings?*

for the first time the existence of First Beacon Management Company, a corporation that they planned to use as part of their postbankruptcy "fresh start." The trustee then claimed that the Cummingses' failure to disclose their interest in First Beacon as debtor property was a "false oath relating to a material fact made knowingly and fraudulently" in violation of the Bankruptcy

Code. The court agreed and denied the debtors a discharge. The Bankruptcy Appellate Panel (BAP) affirmed the court's decision. The Cummingses appealed.

### In the Words of the Court

*MEMORANDUM.*

* * * *

Chapter 7 debtors Clarence Thomas Cummings and Pamela K. Cummings appeal the judgment of the Bankruptcy Appellate Panel ("BAP") affirming * * * the bankruptcy court's order denying discharge on the ground that the debtors made false oaths * * * . The bankruptcy court rejected the explanatory testimony of Mr. Cummings as "not credible" and "beyond not credible" and the BAP found that "there is ample evidence to support the bankruptcy court's findings.

* * * *

* * * Debtors claim that the bankruptcy court failed to consider other "voluminous independent and undisputed documentary evidence" introduced at trial that, they assert, "completely obliterated any suggestion of fraudulent intent."

* * * These materials do not advance debtors' claim of inadvertence [lack of intent] or otherwise suggest bankruptcy court error. To the contrary, *the documents corroborate the obviousness of debtors' fraud and the objective it advanced, [namely], to insulate First Beacon Management Co., * * * the new corporate anchor of their post-petition fresh start, from the stigma of bankruptcy*. [Emphasis added.]

* * * *

Debtors' eventual disclosure of their interest in First Beacon on their third amended Schedule * * * does not negate their initial fraud. To the contrary, the sequence of debtors' filings substantiates the presence of fraud: they elected, twice, to amend their Schedule * * * without adding First Beacon, and disclosed First Beacon only after the issuance of an order granting the Trustee additional time to investigate.

* * * *

The Trustee fully carried its burden of proving by a preponderance of the evidence * * * that under the circumstances, debtors' failure to disclose their interest in First Beacon as debtor property was a "false oath" relating to a material fact made knowingly and fraudulently.

**Decision and Remedy** The U.S. Court of Appeals for the Ninth Circuit affirmed the ruling of the BAP. "The sequence of debtors' filings substantiates the presence of fraud." Thus, the debtors' Chapter 7 petition was denied.

**Critical Thinking**

• **Economic** *Why would a debtor risk the denial of a discharge to conceal assets? Discuss.*

## 26–2j Reaffirmation of Debt

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

**Reaffirmation Agreement** An agreement between a debtor and a creditor in which the debtor voluntarily agrees to pay a debt dischargeable in bankruptcy.

**Procedures** To be enforceable, the reaffirmation agreement must be made before the debtor is granted a discharge. The agreement must be signed and filed with the court (along with disclosure documents, as described next). Court approval is required when the debtor is not represented by an attorney. Even when the debtor is represented by an attorney, court approval may be required if it appears that the reaffirmation will result in undue hardship to the debtor.

When court approval is required, a separate hearing will take place. The court will approve the reaffirmation only if it finds that the agreement is consistent with the debtor's best interests and will not result in undue hardship.

**Required Disclosures** To discourage creditors from engaging in abusive reaffirmation practices, the law provides specific language for disclosures that must be given to debtors entering reaffirmation agreements. Among other things, these disclosures explain that the

debtor is not required to reaffirm any debt, but that liens on secured property, such as mortgages and cars, will remain in effect even if the debt is not reaffirmed.

The reaffirmation agreement must disclose the amount of the debt reaffirmed, the rate of interest, the date payments begin, and the right to rescind. The disclosures also caution the debtor: "Only agree to reaffirm a debt if it is in your best interest. Be sure you can afford the payments you agree to make."

The original disclosure documents must be signed by the debtor, certified by the debtor's attorney, and filed with the court at the same time as the reaffirmation agreement. A reaffirmation agreement that is not accompanied by the original signed disclosures will not be effective.

**Case Example 26.7** The owner of a seafood import business, Howard Lapides, signed a secured promissory note for $400,000 with Venture Bank for a revolving line-of-credit loan. Part of the collateral for that loan was a third mortgage on the Lapideses' home (two other banks held prior mortgages). Eventually, Howard and his wife filed for Chapter 7 bankruptcy protection, and their personal debts were discharged.

Afterward, Venture Bank convinced the Lapideses to sign a reaffirmation agreement by telling them that it would refinance all three mortgages so that they could keep their house. The Lapideses made twelve $3,500 payments to Venture Bank, but the bank did not refinance the other mortgages, so they stopped making payments. Venture Bank filed suit, but a court refused to enforce the reaffirmation agreement because it violated the Bankruptcy Code. The agreement had never been signed by Lapideses' attorney or filed with the bankruptcy court.[13]

## 26–3 Chapter 11—Reorganization

The type of bankruptcy proceeding used most commonly by corporate debtors is the Chapter 11 *reorganization*. In a reorganization, the creditors and the debtor formulate a plan under which the debtor pays a portion of its debts and the rest of the debts are discharged. The debtor is allowed to continue in business. Although this type of bankruptcy is generally a corporate reorganization, any debtor (except a stockbroker or commodities broker) who is eligible for Chapter 7 relief is normally eligible for relief under Chapter 11. Railroads are also eligible.

Congress has established a "fast-track" Chapter 11 procedure for small-business debtors whose liabilities do not exceed $2.56 million and who do not own or manage real estate. The fast track enables a debtor to avoid the appointment of a creditors' committee and also shortens the filing periods and relaxes certain other requirements. Because the process is shorter and simpler, it is less costly. (See the *Linking Business Law to Corporate Management* feature for suggestions on how small businesses can prepare for Chapter 11.)

The same principles that govern the filing of a liquidation (Chapter 7) petition apply to reorganization (Chapter 11) proceedings. The case may be brought either voluntarily or involuntarily. The automatic-stay provision and its exceptions apply in reorganizations as well, as do the provisions regarding substantial abuse and additional grounds for dismissal (or conversion) of bankruptcy petitions.

### 26–3a Workouts

**Workout** An agreement outlining the respective rights and responsibilities of a borrower and a lender as they try to resolve the borrower's default.

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

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**13.** *Venture Bank v. Lapides,* 800 F.3d 442 (8th Cir. 2015).

## What Can You Do to Prepare for a Chapter 11 Reorganization?

Linking Business Law To Corporate Management

Chapter 11 of the Bankruptcy Code expresses the broad public policy of encouraging commerce. To this end, Chapter 11 allows a financially troubled business firm to petition for reorganization in bankruptcy while it is still solvent so that the firm's business can continue. Small businesses, however, do not fare very well under Chapter 11. Although some corporations that enter into Chapter 11 emerge as functioning entities, only a small number of companies survive the process.

### Plan Ahead

If you ever are a small-business owner contemplating Chapter 11 reorganization, you can improve your chances of being among the survivors by planning ahead. To ensure the greatest possibility of success, you should take action before, not after, entering bankruptcy proceedings. Discuss your financial troubles openly and cooperatively with creditors to see if you can agree on a workout or some other arrangement.

If you appear to have no choice but to file for Chapter 11 protection, try to persuade a lender to loan you funds to see you through the bankruptcy. If your business is a small corporation, you might try to negotiate a favorable deal with a major investor. For instance, a small business could offer to transfer ownership of stock to the investor in return for a loan to pay the costs of the bankruptcy proceedings and an option to repurchase the stock when the firm becomes profitable again.

Blend Images/Alamy

What are some strategies a small-business debtor can use to prepare for Chapter 11?

### Consult with Creditors

Most important, you should form a Chapter 11 plan before entering bankruptcy proceedings. Consult with creditors in advance to see what kind of plan would be acceptable to them, and prepare your plan accordingly. Having an acceptable plan prepared before you file will expedite the proceedings and thus save substantially on costs.

**Critical Thinking**

*Filing for bankruptcy under Chapter 11 may involve a time-consuming process. How might this affect the likelihood that a firm will be able to negotiate some type of agreement with its creditors?*

## 26–3b Best Interests of the Creditors

Once a petition for Chapter 11 has been filed, a bankruptcy court can dismiss or suspend all proceedings in a case at any time if dismissal or suspension would better serve the interests of the creditors. Before taking such an action, the court must give notice and conduct a hearing. The Code also allows a court, after notice and a hearing, to dismiss a reorganization case "for cause" when there is no reasonable likelihood that the business can successfully remain in operation. Similarly, a court can dismiss a Chapter 11 petition when the debtor's reorganization plan cannot be effected or when an unreasonable delay by the debtor may harm the interests of creditors. A debtor whose petition is dismissed for these reasons can file another Chapter 11 petition in the future.[14]

**14.** See 11 U.S.C. Section 1112(b).

## 26–3c Debtor in Possession

**Debtor in Possession (DIP)** In Chapter 11 bankruptcy proceedings, a debtor who is allowed to continue in possession of the business and to continue business operations.

**Learning Objective 3**
In a Chapter 11 reorganization, what is the role of the debtor in possession?

On entry of the order for relief, the debtor in Chapter 11 generally continues to operate the business as a **debtor in possession (DIP).** The court, however, may appoint a trustee (often referred to as a *receiver*) to operate the debtor's business if gross mismanagement of the business is shown or if appointing a trustee is in the best interests of the estate.

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

Cancellation of executory contracts or unexpired leases can be of substantial benefit to a Chapter 11 debtor. **Example 26.8** Five years ago, APT Corporation leased an office building for a twenty-year term. Now, APT can no longer pay the rent due under the lease and has filed for Chapter 11 reorganization. In this situation, the debtor in possession can cancel the lease so that APT will not be required to continue paying the substantial rent due for fifteen more years. ■

## 26–3d Creditors' Committees

As soon as practicable after the entry of the order for relief, a committee of unsecured creditors is appointed.[15] The business's supplier may serve on the committee. The committee can consult with the trustee or the debtor concerning the administration of the case or the formulation of the plan. Additional creditors' committees may be appointed to represent special interest creditors. Generally, no orders affecting the estate will be entered without the consent of the committee or a hearing in which the judge is informed of the position of the committee.

As mentioned earlier, businesses with debts of less than $2.56 million that do not own or manage real estate can avoid creditors' committees. In these fast-track proceedings, orders can be entered without a committee's consent.

**Know This**
Chapter 11 proceedings are typically prolonged and costly. Whether a firm survives depends on its size and its ability to attract new investors despite its Chapter 11 status.

## 26–3e The Reorganization Plan

A reorganization plan is established to conserve and administer the debtor's assets in the hope of an eventual return to successful operation and solvency. The plan must be fair and equitable and must do the following:

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

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

**Filing the Plan** Only the debtor may file a plan within the first 120 days after the date of the order for relief. This period may be extended, but not beyond eighteen months from the date of the order for relief. If the debtor does not meet the 120-day deadline or obtain an extension, or if the debtor fails to obtain the required creditor consent (discussed next)

15. If the debtor has filed a plan accepted by the creditors, the trustee may decide not to call a meeting of the creditors.

within 180 days, any party may propose a plan. If a small-business debtor chooses to avoid a creditors' committee, the time for the debtor's filing is 180 days.

zimmytws/iStock/Getty Images

What are some basic criteria a bankruptcy court uses to confirm a Chapter 11 reorganization plan?

**Acceptance and Confirmation of the Plan** Once the plan has been developed, it is submitted to each class of creditors for acceptance. For the plan to be adopted, each class must accept it. A class has accepted the plan when a majority of the creditors, representing two-thirds of the amount of the total claim, vote to approve it.

Even when all classes of creditors accept the plan, the court may refuse to confirm it if it is not "in the best interests of the creditors." In addition, confirmation is conditioned on the debtor's certifying that all postpetition domestic-support obligations have been paid in full. For small-business debtors, if the plan meets the listed requirements, the court must confirm the plan within forty-five days (unless this period is extended).

The plan can also be modified upon the request of the debtor, DIP, trustee, U.S. trustee, or holder of an unsecured claim. If an unsecured creditor objects to the plan, specific rules apply to the value of property to be distributed under the plan. Tax claims must be paid over a five-year period.

Even if only one class of creditors has accepted the plan, the court may still confirm the plan under the Code's so-called **cram-down provision.** In other words, the court may confirm the plan over the objections of a class of creditors. Before the court can exercise this right of cram-down confirmation, it must be demonstrated that the plan is fair and equitable.

**Cram-Down Provision** A provision of the Bankruptcy Code that allows a court to confirm a debtor's Chapter 11 reorganization plan even though only one class of creditors has accepted it.

**Discharge** The plan is binding on confirmation. Nevertheless, the law provides that confirmation of a plan does not discharge an individual debtor. *For individual debtors, the plan must be completed before discharge will be granted,* unless the court orders otherwise. For all other debtors, the court may order discharge at any time after the plan is confirmed.

On completion of the plan, the debtor is given a reorganization discharge from all claims not protected under the plan. This discharge does not apply to any claims that would be denied discharge under liquidation.

## 26–4 Bankruptcy Relief under Chapter 13 and Chapter 12

In addition to bankruptcy relief through liquidation (Chapter 7) and reorganization (Chapter 11), the Code also provides for individuals' repayment plans (Chapter 13) and family-farmer and family-fisherman debt adjustments (Chapter 12).

**Learning Objective 4**

How does a Chapter 13 bankruptcy differ from bankruptcy under Chapter 7 and Chapter 11?

### 26–4a Individuals' Repayment Plan—Chapter 13

Chapter 13 of the bankruptcy code provides for the "adjustment of debts of an individual with regular income." Individuals (not partnerships or corporations) with regular income who owe fixed unsecured debts of less than $394,725 or fixed secured debts of less than $1,184,200 may take advantage of bankruptcy repayment plans.

Among those eligible are salaried employees and sole proprietors, as well as individuals who live on welfare, Social Security, fixed pensions, or investment income. Many small-business debtors have a choice of filing under either Chapter 11 or Chapter 13. Repayment plans offer some advantages because they are typically less expensive and less complicated than reorganization or liquidation proceedings.

**Filing the Petition** A Chapter 13 repayment plan case can be initiated only by the debtor's filing of a voluntary petition or by court conversion of a Chapter 7 petition (because of a finding of substantial abuse, for instance). Certain liquidation and reorganization cases may be converted to Chapter 13 with the consent of the debtor.[16]

A trustee, who will make payments under the plan, must be appointed. On the filing of a repayment plan petition, an automatic stay takes effect. Although the stay applies to all or part of the debtor's consumer debt, it does not apply to any business debt incurred by the debtor or to any domestic-support obligations.

**Good Faith Requirement** The Bankruptcy Code imposes the requirement of good faith on a debtor in both the filing of the petition and the filing of the plan. The Code does not define good faith, but if the circumstances as a whole indicate bad faith (such as when a debtor lies about available assets), a court can dismiss a debtor's Chapter 13 petition.


FuzzMartin/E+/Getty Images

How does good faith play a role in Chapter 13 reorganization plans?

**The Repayment Plan** A plan of rehabilitation by repayment must provide for the following:

1. The turning over to the trustee of future earnings or income of the debtor as necessary for execution of the plan.
2. Full payment through deferred cash payments of all claims entitled to priority, such as taxes.[17]
3. Identical treatment of all claims within a particular class. (The Code permits the debtor to list co-debtors, such as guarantors or sureties, as a separate class.)

The repayment plan may provide either for payment of all obligations in full or for payment of a lesser amount. The debtor applies the means test to determine the amount of disposable income that is available to repay creditors. The debtor is allowed to deduct certain expenses from monthly income to arrive at this amount.

The debtor must begin making payments under the proposed plan within thirty days after the plan has been filed and must continue to make "timely" payments. If the debtor fails to make timely payments or does not commence payments within the thirty-day period, the court can convert the case to a liquidation bankruptcy or dismiss the petition.

***The Length of the Plan.*** The length of the payment plan can be three or five years, depending on the debtor's family income. If the debtor's family income is greater than the median family income in the relevant geographic area under the means test, the term of the proposed plan must be three years.[18] The term may not exceed five years.

***Confirmation of the Plan.*** After the plan is filed, the court holds a confirmation hearing, at which interested parties (such as creditors) may object to the plan. The hearing must be held at least twenty days, but no more than forty-five days, after the meeting of the creditors. The debtor must have filed all prepetition tax returns and paid all postpetition domestic-support obligations before a court will confirm the plan.

The court will confirm a plan with respect to each claim of a secured creditor under any of the following circumstances:

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

In addition, for a motor vehicle purchased within 910 days before the petition is filed, the plan must provide that a creditor with a purchase-money security interest (PMSI) retains its

## Know This

Courts, trustees, and creditors carefully monitor Chapter 13 debtors. If payments are not made, a court can require that the debtor explain why and may allow a creditor to take back the property.

16. A Chapter 13 repayment plan may be converted to a Chapter 7 liquidation either at the request of the debtor or, under certain circumstances, "for cause" by a creditor. A Chapter 13 petition may be converted to a Chapter 11 reorganization after a hearing.
17. As with a Chapter 11 reorganization plan, full repayment of all claims is not always required.
18. See 11 U.S.C. Section 1322(d) for details on when a court will find that the Chapter 13 plan should extend to a five-year period.

lien until the entire debt is paid. For PMSIs on other personal property, the payment plan must cover debts incurred within a one-year period preceding the filing.

**Discharge** After the debtor has completed all payments, the court grants a discharge of all debts provided for by the repayment plan. Generally, all debts are dischargeable except the following:

1. Allowed claims not provided for by the plan.
2. Certain long-term debts provided for by the plan.
3. Certain tax claims and payments on retirement accounts.
4. Claims for domestic-support obligations.
5. Debts related to injury or property damage caused while driving under the influence of alcohol or drugs.

An order granting discharge is final as to the debts listed in the repayment plan. A creditor that willfully continues to attempt to collect on a debt that a court has ordered discharged under Chapter 13 is in violation of the law and can be sanctioned.[19]

In the following case, a Chapter 13 debtor's domestic-support obligations were at issue. Under the Bankruptcy Code, a debt constitutes a domestic-support obligation if it is "in the nature of alimony, maintenance, or support." Did a parent's promise to pay his children's college expenses meet this requirement?

19. See, for example, *In re Vanamann*, 561 Bankr. 106 (D.Nev. 2017).

## Case 26.3

### *In re* Chamberlain

United States Court of Appeals, Tenth Circuit, 721 Fed.Appx. 826 (2018).

**Background and Facts** When Stephen and Judith Chamberlain were divorced, their marital settlement agreement included a "College Education" provision. Stephen promised to "pay the costs of tuition, room and board, books, registration fees, and reasonable application fees incident to . . . an undergraduate college education" for each of their three children, Sarah, Kate, and John. Stephen did not meet this obligation.

Judith obtained an order in a Maryland state court to enforce the agreement and initiated an effort to collect. Stephen filed a petition for bankruptcy under Chapter 13. Judith filed a creditor's claim with the bankruptcy court, contending that the college expenses were domestic-support obligations and thus created priority claims that had to be fully paid. The court agreed. Stephen appealed.

#### In the Words of the Court

Robert E. *BACHARACH*, Circuit Judge

* * * *

* * * Stephen argued that his obligation to pay his children's college expenses did not constitute a domestic support obligation because it was not "in the nature of * * * support."

* * * The court properly conducted a dual inquiry to determine whether these obligations involved support, looking first to the intent of the parties at the time they entered into their agreement, and then to the substance of the obligation.

* * * With respect to the initial issue of intent, the court appropriately considered [1] the language and structure of the college expense obligation in the marital settlement agreement and [2] the parties' testimony regarding surrounding circumstances, including the disparity in Stephen and Judith's financial circumstances at the time of the divorce.

The bankruptcy court found that the parties had intended Stephen's college expense obligation to constitute support because [of the following:]

- the evidence established that Stephen and Judith had viewed a college education as an important part of their children's upbringing,
- the couple had long intended to provide for the children's education, and
- this intent could not be carried out at the time of the divorce, given the couple's relative financial capabilities, without Stephen assuming this obligation.

* * * *

(*Continues*)