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Problems and Materials on Debtor and Creditor Law

Fourth Edition

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Jeff Morris dedicates this book to C. David Butler, Esq., the Honorable W. Homer Drake, and the Honorable Joe Lee, who have provided him with many opportunities and invaluable guidance in learning about bankruptcy and its impact on people.

Douglas Whaley dedicates this book to his nephews, Adam Latek, Aaron Jeffrie, and Lee Matheson, with the sincere hope that they never need to know anything about bankruptcy.

PREFACE

A knowledge of bankruptcy law is important not only to those attorneys who plan to become members of the bankruptcy bar, but for virtually everyone in legal practice. Whatever commercial plans are being made, the possibility that the various parties might end up in bankruptcy means that the careful advisor will consider what that will mean to the endeavor under consideration and will take steps to minimize the impact a bankruptcy filing will have. Attorneys handling divorces must structure the divorce decree keeping in mind how the possible bankruptcy of one of the ex-spouses might affect the property division. Most attorneys will have clients who become ensnared in bankruptcy matters, even if the attorney him/herself manages to escape such difficulties.

The Bankruptcy Code is complicated, being much amended by Congress and subject to divergent interpretations by the courts. It is supplemented by the Bankruptcy Rules, and also by other federal statutes having to do with jurisdiction, bankruptcy crimes, etc. Outside of the federal bankruptcy arena, the states have enacted statutes dealing with debtor/creditor problems, and this book addresses many of the issues that arise from all of these things.

This fourth edition contains the major cases that address bankruptcy and related laws, and these cases deserve the careful study of anyone who would master this subject. However, the bulk of the rules and issues of this course are addressed through a series of Problems that the student must consider with statute book in hand, being ready to answer the Problems when called on by the instructor. We believe that the Problem method is the superior way to study statutory material and to understand why the statute is written the way it is. We hope you, the student, agree and finish the book with a confidence that the basics of this difficult subject have been covered so that you could practice law in this area feeling that the Bankruptcy Code and related statutes are not as mysterious as they certainly look to someone approaching them for the first time.

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Problems and Materials on Debtor and Creditor Law

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CHAPTER 1

Introduction to Debtor and Creditor Law

I. Overview of Bankruptcy Law

Bankruptcy is entirely a creation of federal law. Article 1, Section 8, Clause 4 of the U.S. Constitution provides that Congress “shall make uniform laws on the subject of bankruptcies throughout the United States.” Over the years, Congress has acted a number of times to create a bankruptcy system. After a series of bankruptcy laws that were generally short-lived, Congress enacted what became our first truly permanent bankruptcy law system in 1898. Forty years later, during the Great Depression, Congress enacted substantial amendments to the bankruptcy system through the adoption of the Chandler Act, the passage of which greatly expanded the reorganization provisions of the bankruptcy laws.

Another forty years later, Congress passed the Bankruptcy Reform Act of 1978. This Act is commonly referred to as the Bankruptcy Code (to distinguish it from the Bankruptcy Act, as the prior law was known), and it became effective for all cases commenced on or after October 1, 1979. Congress has become a great deal more active in the area of bankruptcy legislation since the Bankruptcy Code was adopted. Rather than waiting another forty years for significant bankruptcy amendments, Congress enacted significant changes to the Code in 1984, 1986, 1990, and 1994. As we shall discuss in detail, in 2005 Congress made major amendments to the Bankruptcy Code, the chief aim of which was to make it more difficult for individuals to file a liquidation bankruptcy under Chapter 7, and therefore to force these people into repayment plans under Chapter 13. Congress also has authored a number of other amendments in between enactment of the more substantial revisions.

The Bankruptcy Code comprises the entirety of Title 11 of the United States Code. It is separated into eight chapters. Until 1986, all of the chapters had odd numbers: 1, 3, 5, 7, 9, 11, and 13. In 1986, Congress added Chapter 12, creating a new chapter for relief for family farmers. The arabic number designation of chapters also serves to distinguish the Bankruptcy Code from the Bankruptcy Act, whose chapters were designated by roman numerals. Therefore, you should be careful in reading older bankruptcy decisions involving Chapter XI or some other chapter

identified by roman numerals. The concepts and policies included in those earlier decisions may still be part of the bankruptcy laws, but you must exercise caution in determining that the provisions of the Bankruptcy Code are consistent with the law being applied in cases under the Bankruptcy Act.

Bankruptcy law has two primary goals: It seeks the orderly and equitable repayment of claims for the benefit of creditors, and it offers an economic fresh start to the proverbial “honest but unfortunate debtor.” *See* *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934) (this is perhaps the most cited bankruptcy decision of the Supreme Court). In some ways, these goals conflict. The more assets we permit a debtor to keep, the “fresher” the debtor’s start. On the other hand, the debtor’s retention of the assets lessens the amount that creditors can recover in satisfaction of their claims. We will see a number of instances where this tension is evident.

As with most statutory schemes, definitions are vitally important. The Bankruptcy Code is no exception. Section 101 contains a lengthy list of definitions that apply generally throughout the Code. Specific provisions of the Code often contain their own definitions (*see, e.g.*, §547(a)), which you should become familiar with in addition to the listing of definitions in §101. In fact, it is always prudent to check back with §101’s listing of definitions before offering advice or making an argument on a bankruptcy matter.

The provisions of Chapters 1, 3, and 5 apply generally in all bankruptcy cases except to the extent that specific provisions of the other operative chapters override the general provisions. For example, the automatic stay created under §362 applies in cases under Chapters 7, 11, and 13. By way of contrast, an objection to a Chapter 7 discharge under the terms of §727 would be inappropriate in a Chapter 13 case.

More than 1,590,000 bankruptcy cases were filed in the year 2004. In the bankruptcies filed by individuals, 55 percent were by women, and the average filer had 2.7 dependants to support. Many had had major medical difficulties in the period before filing, and had often lost their jobs and/or their homes. The median age of the filers was 41, and 54 percent had had some college education. Bankruptcy filings increased in 2005 to over 2,000,000 cases as debtors filed for relief in advance of the effective date of the substantial revisions to the Code that became effective on October 19, 2005. After the surge in filings, only 677,000 cases were filed in 2006. Problems with the economy have caused the filings to increase, and estimates are that approximately 1,700,000 cases will be filed in 2009. It seems that the rate of bankruptcy filings might ultimately be more closely correlated to economic factors than to legislative enactments.

There are two generic forms of bankruptcy relief, liquidation and reorganization, but debtors may proceed under five different chapters of the Bankruptcy Code to obtain that relief. Cases may be filed under Chapters 7, 9, 11, 12, or 13. Chapter 9 is available only to municipalities, and it is used only infrequently.¹ Chapter 12 relief is

1. The leading treatise on bankruptcy law of course treats the matter; *see* Collier on Bankruptcy Chapters 900-946 (15th ed. 1997); *see also* Michael W. McConnell & Randal C. Picker, *When Cities Go Broke: A Conceptual Introduction to Municipal Bankruptcy*, 60 U. Chi. L. Rev. 425 (1993).

limited to family farmers, and there are usually fewer than one thousand Chapter 12 cases commenced in any one year nationwide. The vast bulk of bankruptcy proceedings are brought under Chapter 7, Chapter 11, or Chapter 13.

The most common form of bankruptcy relief is under Chapter 7. In the typical case, the debtor files a petition for relief under Chapter 7 along with supporting documents setting out all of the debtor's assets and liabilities. The commencement of the case creates an automatic stay against creditor collection efforts (Bankruptcy Code §362), and it also operates to create a bankruptcy estate comprised, *inter alia*, of all of the debtor's interests in property as of the commencement of the case. Bankruptcy Code §541(a)(1). The creditors listed in the bankruptcy schedules soon receive notices from the court that the case has been filed. The creditors are given a limited amount of time in which to file objections to the debtor's discharge or to file complaints to have their individual claims excepted from the discharge. Simultaneously, a trustee is appointed or elected to represent the interests of the bankruptcy estate. The trustee may also object to the debtor's discharge, but his or her most regularly performed duty is to collect and liquidate the assets of the estate so they may be redistributed to creditors according to the priority established by the Bankruptcy Code. In evaluating the assets of the estate, the trustee will likely scrutinize the list of property the debtor claims as exempt from the estate. If the property is exempt, it is returned to the debtor free of most claims that creditors might assert. The trustee also will review the debtor's financial affairs to determine if the debtor improperly preferred one creditor over others or perhaps transferred property in a manner that remains vulnerable to attack by the trustee. If the trustee is successful in challenging those transactions, the property is returned to the estate and thereafter liquidated and distributed to the creditors. In that position, the trustee acts as a representative of the unsecured creditors of the debtor.

Obtaining a discharge of debts is the debtor's primary goal in seeking bankruptcy relief. The initial notice to creditors will inform them that they have a limited amount of time in which to object to the entry of a discharge for the debtor (or to make a motion to dismiss the case or convert it to another chapter per §707(b)). Additionally, there are a number of specific claims that might be excepted from the discharge. These include obligations for alimony and child support, taxes, and student loans. Debts from fraud, willful and malicious injuries inflicted by the debtor, and similar claims might also be excepted from the discharge. Once the property of the estate has been liquidated and distributed to the creditors, and either no objections to discharge are filed or all objections have been resolved, then the case is closed.

In most instances Chapter 7 cases are nominal or no asset cases involving very limited administration by a trustee. The cases pass through the system relatively expeditiously. That is especially important given that approximately 1,138,000 Chapter 7 cases were filed in 2004.

Cases under Chapters 11, 12, and 13 are fundamentally different from Chapter 7 cases. These reorganization chapters anticipate the payment of a debtor's obligations (in whole or in part) out of the debtor's future income. As indicated previously, Chapter 12 cases are available only to family farmers, and only individuals with