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U. S. Bankruptcy Law

"A Basic Understanding"

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Introduction

At the heart of any substantive discussion about U.S. bankruptcy law are at least two (2), conflicting, perhaps even diametrically opposed, issues. The first is reconciling the use of insolvency law to benefit both the insolvent and its creditors. The second is finding a way to distribute the debtor's inadequate assets among competing meritorious claims. Simply stated, such problems arise from the fact there are not enough assets in a bankruptcy proceeding to satisfy everyone. On one hand, bankruptcy is a way out of trouble for hopelessly troubled debtors. On the other hand, it is an efficient means of collecting obligations. Unfortunately, however, what often times is "escape" to a debtor may be viewed as a "swindle" to a creditor.

The U. S. Congress historically has given favored treatment to a variety of creditor groups. In recent years, these favored groups have included, *inter alia*, labor unions, retirees, the victims of drunk (or drugged) drivers, government agencies that guarantee student loans, consumers who buy on layaway plans, ex-spouses, landlords, shopping mall operators, farmers, and the Federal Reserve System. There is sometimes little logic, other than political logic,

behind the rationale as to who is granted a favored position. Moreover, there is little consistency in the favors granted. For example, some tax claims are protected by giving them priority and by making them non-dischargeable in some, but not all, forms of bankruptcy. Wage claims are given a priority but are dischargeable. Drunk driving claims are given no priority, but are not dischargeable. Student loan claims have no priority but are sometimes dischargeable and sometimes not. Labor contracts are protected in an entirely different way: unlike most other contracts, the debtor must honor them except in limited circumstances. Why a particular creditor is given favored treatment is only part of the mystery. Why it is given one form of favored treatment and not another is often equally baffling.

Historical Analysis of the U.S. Bankruptcy Code

Laws governing financial relationships and maritime transactions have common roots in the Roman times and the English legal system.[1] Although the United States Constitution provided Congress with the power to create uniform bankruptcy laws,[2] federal legislation modeled on English law was not enacted until 1800.[3] Temporary Bankruptcy laws were enacted and subsequently replaced in 1800-1803, 1841-1843, and 1867-1878.[4] Bankruptcy laws during the 19th century were created periodically to meet the various needs of the expanding market economy. Ultimately, the 1878 Act was replaced with the enactment of the first permanent bankruptcy law, the Bankruptcy Act of 1898.[5]

Following a depression in the 1890's, the 1898 Act created both voluntary and involuntary forms of bankruptcy, and provided a new means of collection for lenders and a "fresh start" for debtors.[6] This Act was amended by the Chandler Act of 1938[7] as a reaction to

[1] Continental Illinois Nat'l Bank & Trust Co. v. Chicago R.I. & P.R. Co., 294 U.S. 648 (1935).
[2] U.S. Const. Art 1, Sec. 8 cl. 4.
[3] Act of April 4, 1800, ch. 19, 2 Stat. 19 (repealed 1803).
[4] Collier on Bankruptcy, 15th ed. (1995), § 1.02[4].
[5] Act of July 1, 1898, ch. 541, 30 Stat. 544 (repealed 1978).
[6] Collier on Bankruptcy § 1.03[2].

economic problems resulting from the 1929 stock market crash. These amendments provided for the treatment of business and individual reorganization.

By the 1960's, dissatisfaction with the Act intensified, and in 1970, the Burdick Commission for Bankruptcy Law Reform was created. Its findings led to the enactment of The Bankruptcy Reform Act of 1978,[8] the Bankruptcy Code and numerous jurisdictional and procedural rules. Among the many issues addressed by the U. S. Bankruptcy Code are: (1) creation of independent bankruptcy court with nationwide jurisdiction to deal with all matters arising under bankruptcy laws; (2) Presidential appointment of bankruptcy judges; (3) abolition of filing of bankruptcy proceedings as grounds for default; and (4) establishment of a broad "automatic stay" combined with the new concept of adequate protection of creditors.

Subsequently, in 1982, jurisdictional provisions of the Bankruptcy Reform Act were deemed "unconstitutional" by the U. S. Supreme Court in *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co*[9] (hereinafter "*Marathon*"). Specifically, the U. S. Supreme Court was concerned with the Act's grant of jurisdiction to bankruptcy judges to rule on state law issues. Following almost two (2) years of Congressional attempts to resolve the problematic provisions, the Bankruptcy Amendments and Federal Judgeship Act of 1984, a/k/a BAFJA, was enacted in 1984.[10] Some of the significant changes from BAFJA include: the resting of jurisdiction in Title 11 bankruptcy cases with the district courts; the appointment of bankruptcy judges by the court of appeals for a fourteen year term in "bankruptcy unit" of each district court; and the diminution power and status of the bankruptcy judges. In 1994, the Bankruptcy Reform

[7] Chandler Act, ch. 575, 52 Stat. 840 (1938).
[8] Pub. L. No. 95-598, 92 Stat. 2549 (1978).
[9] Northern Pipeline Constr. Co. v. Marathon Pipe Line Co., 458 U.S. 50 (1982).
[10] Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (1984).

Act was enacted, creating a Bankruptcy Review Commission to investigate problems and formulate recommendations for needed reforms.[11]

In brief, it is fair to say that the U.S. Bankruptcy Code is fundamentally a politically motivated document which, like most statutes, represents a series of "horse-trades" among legislators. For those so inclined, it is possible to trace many of these historical "horse-trades," as the legislative history of the U.S. Bankruptcy Code is fairly well reported and complete.

General Overview of U. S. Bankruptcy Law

One of the central concepts of bankruptcy law is a "fresh start," whereby a debtor who has surrendered non-exempt assets to the trustee receives another chance to succeed. However, as stated above, the U. S. Bankruptcy Code has traditionally afforded special status to "property" interests such as mortgages, security interests, and leasehold rights, and, as such, a debtor cannot claim a "fresh start" free of property interests unless their holders have so agreed or have been fully compensated.[12] Accordingly, the "fresh start" label is somewhat misleading. Moreover, in theory, although private companies are prevented from discriminating on the basis of the debtor's bankruptcy, lenders can, in reality, (and often do) refuse to provide credit or restrict such lending to conform to discriminating terms.[13] Nevertheless, bankruptcy proceedings are, generally speaking, intended to be for the benefit of both debtors and creditors. As stated above, debtors are intended to benefit from discharge and the fresh start, and the creditors from the presumably efficient and even-handed administration and distribution of the debtor's non-exempt property.

In virtually all bankruptcy cases, most creditors play a passive role. Simply stated, besides filing a "proof of claim" in hopes of later receiving a potential distribution, the typical

[11] Bankruptcy Reform Act of 1994, §§ 601-610 (1994).
[12] MICHAEL J. HERBERT, UNDERSTANDING BANKRUPTCY §1.01[B] (2000).
[13] *Id.* at 1.01[D] (noting that one's bankruptcy remains on the debtor's credit report for 10 years, possibly reducing credit access).

creditor does nothing. The reason for this is simple economics; the bankruptcy value of the typical claim is negligible. Most times, creditors who have already given up hope of collection are rarely interested in paying "good money after bad" to participate in the bankruptcy proceeding. In most cases, only creditors with priority secured claims will have claims with any *potential* "real value."

Commencement of the Bankruptcy Case

Bankruptcy cases are commenced by the filing of a bankruptcy petition in the proper form, with the proper fee, in the proper district. The petition may either be voluntary (that is, filed by the debtor) or involuntary (that is, filed by the creditors). There are detailed requirements for each type of petition, and detailed eligibility requirements for each "Chapter" filing, as detailed below. For your guidance, we note that not all persons and/or entities are eligible for relief under all Chapters. Nor are involuntary petitions always permitted. There is a general requirement that the debtor must have a significant nexus with the United States. Individual and business entities must either reside in, or have a domicile, place of business, or property in the United States.[14] There is no requirement, however, that the debtor be a United States citizen.

The filing of the petition constitutes an "order for relief,"[15] and no further action is required for the case to begin. The filing of a bankruptcy petition has many other implications. Perhaps most notably, the filing of a bankruptcy petition triggers the "automatic stay" of other proceedings against the debtor and serves to determine many time limits, such as the ninety (90) day preference period, the fraudulent transfer period, and the time the debtor has to file various documents with the court.

[14] Bankruptcy Code §109(a).
[15] Bankruptcy Code §301.

The eligibility of a person or entity to be either a voluntary or an involuntary debtor under the Code varies from Chapter to Chapter. The main eligibility rules relating to voluntary filings are as follows:

> **Chapter 7 (Liquidation)** Virtually any individual or business entity may be a voluntary debtor in a Chapter 7 proceeding. The only exceptions are (1) railroads, (2) most domestic financial institutions, (3) most foreign financial institutions[16] and (4) governmental units.[17] Each of the exclusions reflects the fact that there are other methods for dealing with their insolvencies. For example, there are state and federal institutions and structures, such as the FDIC, to deal with the most insolvent financial institutions. There is a special subchapter in Chapter 11 of the Bankruptcy Code for railroads; and Chapter 9 of the Code deals with insolvent municipalities.
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> **Chapter 9 (Adjustment of Debts of a Municipality)** Chapter 9, which is rarely used, is available only to a municipality, and only under limited circumstances. The debtor must have been authorized to be a debtor under the law of the state that created it, must be insolvent, and must "desire to affect a plan to adjust" its debts.[18] In addition to those requirements, the debtor must have either (1) have obtained creditor agreement to the filing, (2) have failed to obtain creditor agreement after good faith negotiation, (3) be unable to negotiate with its creditors or (4) reasonably believe that a creditor may attempt to obtain a preference.[19]
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> **Chapter 11 (Reorganization)** The eligibility requirements of Chapter 11 are virtually the same as those for Chapter 7. There are only two (2) differences. First, a stockbroker or commodity broker is eligible for Chapter 7 but not for Chapter 11.[20] Second, a railroad, which is not eligible

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[16] Bankruptcy Code §109(b)(1),(2),(3).

[17] This last exception arises from the fact that only a "person" may file Chapter 7 (Bankruptcy Code § 109(b)) and, with one exception not here relevant, the term "person" does not include a governmental unit. Bankruptcy Code §101(41).

[18] Bankruptcy Code § 109(c)(2), (3), (4). The requirements for a municipal bankruptcy were tightened by the 1994 amendments. The authorization under state law must be specific rather than general; for example, by naming the specific municipality seeking relief in the authorizing legislation.

[19] Bankruptcy Code §109(c)(5). Generally speaking, a preference is a payment that benefits one creditor at the expense of others.

[20] Bankruptcy Code §109(d).

for Chapter 7, is eligible for Chapter 11.[21] Note, however, that railroad reorganizations are subject to a somewhat different set of Chapter 11 rules.

Chapter 12 (Adjustment of Debts of a Family Farmer with Regular Annual Income) With the possible exception of Chapter 9, Chapter 12 has the most complex eligibility requirements under the Code, and is available only to "a family farmer with regular income."[22] A family farmer with regular income is defined as a "family farmer whose annual income is sufficiently stable and regular to enable such family farmer to make payments under" a Chapter 12 plan.[23] Generally speaking, to qualify for Chapter 12 protection, an individual (or individual and spouse) must be engaged in farming operations and must have no more than $1,500,000 in debt. Generally, at least eighty percent (80%) of those debts must arise from the farming operation and more than fifty percent (50%) of the income must come from the farming operation. Corporations and partnerships may also qualify for Chapter 12, but only if they are controlled by a single family.

Chapter 13 (Adjustment of Debts of an Individual with Regular Income) Chapter 13 eligibility is also somewhat restricted, but by no means as much as Chapter 12 eligibility. Several requirements must be met including, but not limited to, the debtor must be either an individual or an individual and spouse. Corporations, partnerships, and other legal entities are not permitted to file under this Chapter.

Petition and Schedules

Along with the petition, the debtor must file a number of other documents. All of these documents are standard forms provided in the Bankruptcy Rules and Forms. The main purpose of filing such other documentations is to provide the court, the trustee, and the creditors with information about the debtor's financial situation. These documents include, among other

[21] Bankruptcy Code §109(d).
[22] Bankruptcy Code §109(f).
[23] Bankruptcy Code §101(19).

things, a list of creditors, along with various "schedules" of assets, obligations, and other pertinent information. Generally, the schedules to be filed are the following:

Schedule A –	All real property interests of the debtor other than leasehold interests and any encumbrances.
Schedule B –	All personal property other than leases or executory contracts. Encumbrances on the property are not included on Schedule B.
Schedule C –	All property that the debtor claims as exempt.
Schedule D - F –	All Secured, Priority, and General Unsecured Claims.
Schedule G –	Executory contracts and unexpired leases.
Schedule H –	Co-obligors of the debtor.
Schedule I and J –	Current income and expenses (for individual Debtors only).

The Automatic Stay

"Automatic stay" refers to the stay of all civil actions involving the debtor, debtor's property and/or property of the bankruptcy estate. Pursuant to section 362 of the Code, the filing of a bankruptcy petition operates as a stay of nearly all non-criminal actions against the debtor, debtor's property and/or property of the estate.[24] The stay functions to further bankruptcy law's goal of orderly reorganization of the debtor's property by giving the debtor and the liquidating trustee "breathing room" to organize the assets of the estate. In certain limited circumstances, a creditor can move to have the stay lifted.

There are, of course, numerous implications of the automatic stay. The stay blocks the commencement or continuation of any judicial or administrative action against the debtor that

[24] *See* Bankruptcy Code §362 (a).

was or could have been initiated before the commencement of the case.[25] The stay also prohibits any action to obtain possession of the estate; to obtain possession of property from the estate; or to exercise control over the property of the estate.[26] Any action to create, perfect, or enforce any lien against property of the estate is also stayed pending bankruptcy actions.[27]

Although the automatic stay affects numerous proceedings, there are some limitations on its application. The stay ceases to exist once the bankruptcy case is over (or property is abandoned), and does not apply to collection of alimony, maintenance, or support from property that does not belong to the estate.[28] Certain governmental actions are also immune to the prejudicial effects of the automatic stay.[29]

While the automatic stay may adversely impact the substantive rights of the creditors, the purpose of the automatic stay is merely procedural. The automatic stay is intended as a form of procedural protection under which the debtor can prepare and present a proposed plan free from unauthorized creditor pressure.

<u>Enforcement of the Stay</u>

The great majority of U. S. courts have held that actions in violation of the automatic stay are entirely void, even if the party taking the action had no notice of the stay. Even actions taken by the government, such as a foreclosure sale, may be entirely without legal effect. The fact that the action taken may have been entirely innocent and in good faith may be a defense against sanctions, however, does not protect the underlying action itself.

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[25] *See* Bankruptcy Code § 362(a).
[26] Bankruptcy Code § 362 (a)(1).
[27] Bankruptcy Code § 362 (a)(4).
[28] Bankruptcy Code § 362 (b)(2)[B]
[29] *See, e.g.* Bankruptcy Code § 362 (b)(1), (4), (5) (stating that criminal actions against the debtor are not stayed, stay does not apply to government actions to enforce police or regulatory power, or to enforce non-money judgments acquired in such police or regulatory actions).

Claims and Interests

In addition to the debtor, rights in the property of the bankruptcy estate are classified as either "claims" or "interests." A "claim" refers to either (i) a debt owed or potentially owed; or (ii) a right against the debtor to an equitable remedy that arises from the breach of contract. The term "interest" also has two (2) meanings: it can refer to a right to specific property of an estate or a right to the remainder of the estate after all claims have been satisfied.[30]

Claims can either be "secured" or "unsecured." A secured claim exists where the claimant is owed a debt and has collateral securing the debt. An unsecured claim, however, exists where there is merely a debt and the creditor has no interest in any debtor property in the event that the debt is not paid. The distinctions between secured debt, unsecured debt and equity are not created by the Bankruptcy Code. Rather, the Code largely, but not entirely, preserves the traditional common-law priority structure, which is founded upon the basic principle that debt always precedes equity, and that secured debt precedes unsecured debt.

Allowance of Claims

The broad definition of "claim" in Code section 101 is somewhat narrowed by section 502. Generally speaking, for a claim to be given status in the bankruptcy, and for its holder to exercise rights based on the claim, the claim must be "allowed." In most cases, claims are allowed perfunctorily. Claims are "deemed allowed" if a Proof of Claim is filed and a party in interest (such as the debtor, the trustee, or another creditor) fails to object. If there is an objection, the court, after notice and an opportunity for a hearing, determines the amount of the claim (if any) to be allowed.

Exemptions and Redemption

[30] Bankruptcy Code § 101(5).

Some property is "exempt," meaning that it is not subject to seizure. Other property is subject to "redemption," meaning that the debtor has the right to purchase it for a lump sum from lien holders. "Exemptions" are based upon the principle that no individual should be totally deprived of the basic necessities of life, no matter how severe his/her financial troubles. Exemptions are primarily governed by state law. Due to the high degree of variety among state exemptions, the Bankruptcy Code added federal exemptions (but authorizes individual states to "opt out" and thereby limit their residents to state-mandated exemptions). In addition to state and federal exemptions, section 522(b)(2) of the Bankruptcy Code provides debtors exemptions for property protected under the non-bankruptcy federal law.[31] The debtor is permitted to choose between federal exemptions within section 522(d) of the Bankruptcy Code or the federal non-Bankruptcy Code exemptions and the law of the debtors domicile state.[32] However, if the domicile state of the debtor has "opted out" of federal exemptions, the debtor must use state exemption provisions.[33]

In the few states that have not opted out, the debtor can choose federal exemptions instead of state exemptions. Federal exemptions consist of a "homestead" exemption,[34] a "wildcard" exemption,[35] and various specific exemptions. Under the homestead exemption a debtor can exempt up to $17,425 in qualifying property. Qualifying property includes, for example, real property that the debtor or his dependent use as a residence; personal property the debtor or his dependent use as a residence; an interest in a cooperative that the debtor or his dependent use as a residence; or a burial plot for the debtor or his dependent. The debtor is also provided with a wildcard exemption of $925 plus up to $8,725 of any unused homestead

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[31] Bankruptcy Code § 522(b)(2)(A) (providing, e.g., alternative federal exemptions for retirement and health benefits).
[32] *See* 14 Collier on Bankruptcy § 522.02.
[33] *See Id.*
[34] Bankruptcy Code § 522(d)(1).
[35] Bankruptcy Code § 522(d)(5).

exemptions which can be used for anything. Additionally, the numerous specific exemptions are aimed at the protection of particular pieces of property up to a pre-determined value. In the event the property is worth more than the cap and the debtor cannot subsidize the remaining portion, the property is sold and the debtor will receive the portion of the proceeds equal to the corresponding exemption amount.[36]

State exemptions are generally divided into three categories: homestead exemptions, specific exemptions of tangible property, and specific exemptions of income equivalents. Although the homestead exemption protects the value of the debtor's home, the exemption amount is relatively small and usually only allows for the debtor to keep a portion of the proceeds from selling his house. The specific exemptions in tangible personalty are capped at a low amount, while exemptions covering earned income substitutes can be more generous.[37]

The third exemption option for debtors is the alternative federal exemptions. Any debtor who either chooses or is compelled to use the state exemptions is also entitled to these alternative federal exemptions. However, many of the alternative federal exemptions are included in the state exemptions[38] so that the alternative federal exemptions, ostensibly, have little effect.

In most circumstances, the debtor must claim exemptions by filing a list of exemptions with the bankruptcy court. Pursuant to bankruptcy procedural rules, this list of exemptions should be filed with the debtor's schedule of assets.[39] If the debtor fails to file the exemptions, a dependent of the debtor is given thirty (30) days from the time required for filing such schedules

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[36] *See* Bankruptcy Code §§ 522(d).
[37] *See* MICHAEL J. HERBERT, UNDERSTANDING BANKRUPTCY § 2.09 (2000). The exemptions covering earned income substitutes such as pension or life insurance are purposely more generous in recognition of the need for a debtor to maintain some source of income for his own needs and those of his dependents.
[38] *See* HERBERT, *supra* note 35, at 11.4.(noting that most of the alternative federal exemptions involve retirement and death benefits).
[39] Bankruptcy Rule 4003(a).

to file the list.[40] Exemptions, however, only provide protection for unencumbered property. Any liens on exempt property remain unaffected.[41]

"Redemption" refers to the debtor's right to "redeem" property from a lienholder, whereby a debtor can buy out the lien and become the property owner. Although many states include rights of redemption, the Bankruptcy Code additionally includes a right of redemption for individual Chapter 7 debtors trying to hold on to encumbered but exempt or abandoned personal property.[42] Redemption eligibility is only possible with property that is either exempt under Bankruptcy Code section 522 or has been abandoned by the trustee to the lien holder.

Discharge and Reaffirmation

The main bankruptcy goal of nearly all debtors is discharge. Discharge is also the primary distinguishing feature of bankruptcy, and what most clearly separates bankruptcy proceedings from state insolvency proceedings. Simply stated, discharge means that those obligations not satisfied through or in conjunction with the bankruptcy proceeding cease to be binding on the debtor. A creditor may take no action to collect discharged debts from the debtor. In this regard, although the debtor may feel and/or otherwise have a moral obligation towards discharged debts, it has no legal obligation to pay them.

Non-Dischargeable Debts

Section 523 lists a number of debts which are not dischargeable in most bankruptcies. These non-dischargeable debts have little in common beyond the obvious fact that U. S. Congress has found them to be unworthy of discharge. Whether these debts actually will be paid is, at best, speculative, as practically speaking, most non-dischargeable debts are seldom recovered.

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[40] *See Id.*
[41] Although the federal Code's exemptions allow for the avoidance of some liens on exempt household goods.
[42] *See* Bankruptcy Code § 722 (providing that an individual debtor may redeem from a lien certain tangible personal property intended primarily for personal, family, or household use. To be eligible, the property must: be exempt under § 522 or must be abandoned by trustee to the lienholder).

At present, there are more than a dozen types of debt that are classified non-dischargeable under section 523. The most noteworthy non-dischargeable debts are:

Taxes: A number of tax obligations are non-dischargeable, including those given priority under section 507, some of those for which a return was filed late or not at all, and those for which the debtor filed a fraudulent return or otherwise evaded. In addition, if the debtor borrows money to pay a non-dischargeable tax obligation it owes to the United States, the debtor's obligation on the loan is itself non-dischargeable.

Fraud: Generally, debts arising from fraudulent actions by the debtor to obtain property, money, services, or credit are non-dischargeable. The same is true with regard to fraudulent actions to obtain an extension, renewal, or refinancing of credit; thus, the debt may be non-dischargeable either because it was initially obtained by fraud or because the lender was induced to extend the due date by fraud. The statutory provision is written broadly, to encompass many actions that have been labeled "fraud." These include false pretenses, false representations, and actual fraud.

In addition, the debt will be non-dischargeable if the debtor used a written statement that contains a materially false representation of the debtor's financial condition or an insider's financial condition if (1) the creditor reasonably relied on it and (2) the debtor "caused to be made or publishes with intent to deceive."

This last provision is often used to block discharge of a loan

made in reliance on a false financial statement; the most litigated aspect of the exception is that the statement must be materially false. Minor errors not clearly relevant to the decision to lend are not enough.

Unscheduled Debts: Under some circumstances, debts not scheduled by the debtor are not discharged. Generally speaking, this applies only if the creditor did not have timely notice of the proceeding; if it did, and failed to file a proof of claim, the debt owed to it is discharged.

Fraud by a Fiduciary: Debts arising from the debtor's fraud or defalcation while acting in a fiduciary capacity, as well as debts arising from the debtor's embezzlement or larceny, are not dischargeable.

Alimony, Maintenance and Support; Other Related Obligations: Generally speaking, obligations of the debtor to provide alimony, maintenance, or support of a spouse, former spouse, or child are non-dischargeable. This provision reflects a general policy of preventing bankruptcy from becoming a haven for those who are unwilling to provide for their present or prior families, and who thereby increase the support burdens places on the taxpayer. To be non-dischargeable, these obligations must arise in connection with a separation agreement, divorce decree, or other order of a court of record.

Intentional Torts: A debt arising from a "willful and

malicious injury" by the debtor is non-dischargeable. This provision has been read rather broadly to encompass generally any obligation arising from an intentional tort.

Fines, Penalties, and Forfeitures: Most fines, penalties, and Forfeitures owed to governmental units are non-dischargeable. Those fines that are compensation for pecuniary loss, and certain tax penalties, are excluded from this rule and are thus dischargeable unless made non-dischargeable under another provision.

Education Loans: An outcry about alleged bankruptcy abuse by students who had received government-backed student loans led to the enactment of what is now section 523(a)(8). That section restricts, although it does not entirely prohibit, the bankruptcy discharge of student loans made, insured, or guaranteed by the government. These loans are not dischargeable unless (1) the loan first became due more than seven (7) years before the bankruptcy or (2) excepting the loan from discharge would impose undue hardship on the debtor and the debtors' dependents. The undue hardship exception to non-dischargeability has generated a mass of litigation, most of it fact specific.

Courts are most likely to find undue hardship if the debtor's income is at or near the federal poverty line, especially if there are other circumstances, such as health problems. Some courts have gone so far as to say that even poverty-level income is not enough to demonstrate undue hardship if the debtor has the

capacity to make more money but is refusing to do so. Other courts have been more lenient, requiring only that the debtor need only demonstrate "modest" income an a "no-frills" budget.

DUI Debts: Politics also played a significant role in the enactment of section 523(a)(9). It makes non-dischargeable any obligation for death or personal injury that is caused by the debtor's operation of a motor vehicle while unlawfully intoxicated on alcohol, drugs, or "another substance." Perhaps surprisingly, this provision has engendered little litigation.

Debts Undischarged in Prior Proceedings: Under section 523(a)(10), a debtor may not obtain discharge for an obligation that either was or could have been scheduled in a prior bankruptcy proceeding, if the debtor either waived discharge or (with a few exceptions) was denied discharge. The primary effect of this provision is to prevent a debtor who was denied discharge because of misconduct in one proceeding from obtaining discharge in a subsequent proceeding.

Fraud on Depository Institutions: As part of its reaction to the collapse of a large part of the American financial industry in the late 1980's. Congress added two (2) non-dischargeable obligations. The first of these relates to certain obligations arising out of any act of fraud or defalcation while acting in a fiduciary capacity with respect to any depository institution or insured credit union. This provision appears to be wholly

redundant to section 523(a)(4), which more generally makes debts arising from fraud by a fiduciary non-dischargeable.

Failure to Maintain Capital Requirements: The second addition to section 523 that arose from the collapse of banks and thrift institutions is section 523(a)(12), which applies to debtors for "malicious or reckless" failure by the debtor to fulfill its commitment to a Federal depository institution regulatory agency (such as the F.D.I.C. to maintain the capital of a financial institution.

Criminal Restitution Orders: Finally, the 1994 Amendments added certain criminal restitution Orders as non-dischargeable debts.

Effect of Discharge

Discharge has a number of direct and indirect effects on the debtor and the debtor's obligations. The discharge voids any judgment based on the debtor's liability for a discharged debt.[43] It operates as an injunction against any action to collect, recover, or offset any discharged debt as a personal liability of the debtor.[44] There are also special rules that deal with the effect of the discharge on community property.[45]

Preferences

One of the more controversial powers given in the Bankruptcy Code is the power of the trustee (or debtor in possession) (hereinafter "DIP"), to avoid certain pre-petition transactions as "preferences." Generally speaking, a preference occurs whenever a debtor favors one creditor over another in paying out its limited resources. In bankruptcy, some, but not all, preferences

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[43] Bankruptcy Code § 524(a)(1)
[44] Bankruptcy Code § 524(a)(2)
[45] Bankruptcy Code § 524(a)(3),(b)(e)

may be avoided. Avoidance means that the transferee is forced to return the transferred property or its value.

The Code's primary preference provision is section 547. "Preferences" are defined in section 547 (b). In short, preference is a transfer (i) of property, (ii) to or for the benefit of a creditor, (iii) on an antecedent debt, (iv) made while the debtor was insolvent, (v) made during the preference period (usually the ninety (90) days before the bankruptcy, but one (1) full year for insiders of the debtor), and (vi) that enables to creditor to receive more than it would get in a Chapter 7 liquidation of the debtor.[46]

Preference law is not self-executing. The trustee/DIP must take action to recover the alleged preferential transfer. This is normally done by an "adversary proceeding" in the bankruptcy court.[47] If the creditor has submitted itself to the jurisdiction of the bankruptcy court (as, for example, by filing a proof of claim) there is no right to a jury trial.[48] The trustee/DIP carries the burden of persuasion as to all elements of the preference; however, there is a rebuttable presumption that the debtor was insolvent during the ninety (90) days prior to the filing of the petition.[49] The creditor carries the burden of persuasion as to the applicability of any exception to the avoidance rules.[50]

Preference Period

Section 547 does not avoid all transfers that prefer one creditor over another. Transfers that are relatively remote from the filing of the bankruptcy traditionally have been left

[46] Bankruptcy Code § 547(b)
[47] In re McCombs Properties, VI, Ltd., 88 Bankr. 261 (Bankr. C.D. Ca. 1988); In re Magic Circle Energy Corp., 64 Bankr. 269 (Bankr. W.D. Okl.1986).
[48] Lagencamp v. Culp, 498 U.S. 42 (1990).
[49] Bankruptcy Code § 547(f), (g)
[50] Bankruptcy Code § 547 (g)

untouched. Under the current version of the Code, the preference period generally extends back ninety (90) days.[51]

Exceptions to Avoidance

The U.S. Bankruptcy Code provides that preferential payments may not be treated as a recoverable transaction in eight (8) specific circumstances.[52] Most notably, preferential payments may not be treated as recoverable where the payments are made as part of the parties' "ordinary course of business." Specifically, section 547 of the U.S. Bankruptcy Code provides, in pertinent part, the following:

The trustee may not avoid under this section a transfer - …

(2) to the extent that such transfer was –

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor and the transferee; and

(C) made according to ordinary business terms.[53]

The "ordinary course of business" defense was established as a matter of policy "to induce creditors to continue dealing with a distressed debtor so as to kindle its chances of survival without a costly detour through, or a humbled ending in, the sticky web of bankruptcy."[54] However, in order to successfully establish an ordinary course of business defense, a creditor is required to meet the burden of proving each element of the defense by a preponderance of the evidence.[55] For your guidance, we note that neither the U.S. Bankruptcy Code nor the implementing case law specifically defines the terms "ordinary course of business"

[51] Bankruptcy Code § 547(b)(4)(A)
[52] See Bankruptcy Code § 547(c).
[53] 11. U.S.C. §547 (c) (2)
[54] Fiber Lite Corp. v. Molded Acoustical Prods. Inc., 18 F.3d 217, 219 (3d Cir. 1994).
[55] In re Lan Yik Foods Corp., 185 B.R. 103 (EDNY 1995).

or "ordinary business terms." In fact, "there is no precise legal test which may be applied to determine whether the requirements of section 547(c)(2) have been met."[56] The U.S. Bankruptcy Court has expressly acknowledged that "few issues in Bankruptcy Law are as unsettled as is the question of how one defines the 'ordinary course of business' and 'ordinary business terms' for purposes of 11 USC 547(c)(2)."[57]

Generally speaking, "subjective inquiries will be made as to whether the payment of a debt was made in the ordinary course of business of the debtor and the transferee."[58] In determining whether or not payments were ordinary, the court will look at "several factors, including timing, the amount and manner a transaction was paid and the circumstances under which the transfer was made."[59] Additionally, in determining "ordinary business standards," courts generally will make an objective determination as to whether "the subject payments were ordinary in relation to the prevailing standards in the creditor's industry." [60] Notwithstanding, most courts look most heavily to the ongoing payment practices of the parties.[61] Even quite long time lags between the due date of the obligation and its payment may be excused, if it truly reflects an established practice between the parties.[62] Sporadic and irregular payments may indeed be ordinary course if they are consistent with the parties' mode of dealing.[63] Also of great significance are the actions of the creditor. It is interesting to note that if the creditor exerts

[56] Id.
[57] Wallach v. Vulcan Steam Forging Co.,Inc., 164 B.R. 831, 833 (WDNY 1994).
[58] In re Lan Yik Foods Corp., supra at 109.
[59] Yurika Foods Corp. v. United Parcel Service 888 F.2d 42, 45 (6th Cir. 1989)
[60] In re Lan Yik Foods Corp., supra at 114.
[61] See In Re Ajayem Lumber Corp, 145 Bankr. 813 (S.D.N.Y. 1992) (delay of 34 days within range of parties'prior practice and industry norm); In re Steel Improvement Co., 79 Bankr. 681 (Bankr. E.D. Mich 1987); Collier on Bankruptcy ¶ 547.10. Cf. In re Xonics Imaging, Inc., 837 F.2d 763 (7th Cir. 1988) (transferee must show a pattern of late paymens for such payments to constitute ordinary course transfers).
[62] In re Gardiner Matthews Plantation Co., 118 Bankr. 384 (Bankr S.C. 1989) (payments protected under ordinary course of business exception even though time lag between delivery and payment ranged from 108 to 191 days).
[63] In re National Office Products, Inc., 119 Bankr 896 (D.R.I. 1990)

pressure on the debtor to make payments, most courts hold that the payments are not in ordinary course.[64]

Additionally, the Code provide an exception for "substantially" contemporaneous exchanges for new value.[65] This exception protects transfers to the extent they were intended by the debtor and the creditor to be a contemporaneous exchange for new value and were in fact substantially contemporaneous.[66] The legislative history of section 547(c)(1) indicates that Congress had in mind the technical preference problem created when the debtor pays by check. As you may be aware, payment by check is not complete until the check is paid by the bank on which it is drawn.

International Bankruptcy

Insolvency is not a problem limited to the United States. Courts around the world, must deal with it. In today's world of international business, and globalization, this inevitably creates problems of overlapping legal systems and legal rules. As there is no overriding sovereignty to force any one nation's courts to defer to another's, either in procedural or substantive matters, the resolution of these problems is left to the vagaries of international law and the hopeful application of "comity.".

In reality, most issues are resolved by what is colloquially known as the "grab" rule. Generally, the courts of any given country will grab whatever assets are within its borders, and thus subject to its sovereignty, administer them. This often means that the multinational insolvent will be administered piecemeal, in multiple proceedings, with duplicated expenses and inconsistent results. Although it is widely recognized that the grab rule is inefficient, many U. S. bankruptcy commentators opine that it is likely to remain predominant. The most fundamental

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[64] Xtra,Inc. v. Seawinds, Ltd. (In re Seawinds), 888 F.2d 1563 (11th Cir. 1986) (whenever the debtor's "normal" payments are the result of unusual collection activity by the creditor, the exception does not apply).
[65] Bankruptcy Code § 547(c)(1)
[66] Bankruptcy Code § 547(c)(1)

reason for this is that there is a wide divergence among countries concerning their respective bankruptcy policy. Indeed, in the eyes of many, U.S. bankruptcy laws are absurdly tilted toward debtors and necessarily result in huge and unnecessary costs to creditors.

The United States Bankruptcy Code has made at least a minor attempt to deal with transnational bankruptcies without employing the grab rule. Under section 304, a representative appointed in a foreign insolvency proceeding[67] may petition for an ancillary proceeding in U.S. Bankruptcy Court. An ancillary proceeding is not a full-blown bankruptcy case; rather, it is a way of facilitating the foreign court's proceeding by requesting assistance in the administration of assets located within the U.S.

Conclusion

In nearly every bankruptcy, there are far more claims than there are assets. In metaphorical terms, in a bankruptcy, there is no such thing as a "free lunch." In fact, most times, there is hardly any lunch, and in some cases, there is nothing to eat at all (except, perhaps, for the bankruptcy lawyers). Nevertheless, in the bankruptcy proceeding, there is only so much to go around, and although the available assets are insufficient, it is all there will ever be. The foregoing text is only intended to provide a basic understanding of U.S. bankruptcy proceeding. However, should you or your colleagues have any specific questions or comments, we stand ready to respond to any specific questions/comments you may have. For your guidance, the author of this paper can be reached by telephone at: +1 516 767 3600); via E-mail (gmc@codus-law.com) or AOH at (+ 1 516 721 4076).

[67] Note that the foreign proceeding need not be a "bankruptcy" proceeding in the U.S. sense, but it must be for the purpose of liquidation or reorganization, and it must be in the country where the debtor has its domicile, residence, principal place of business or principal assets. Bankruptcy Code §101 (23).