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THE BANKRUPTCY REFORM ACT OF 1978—A REVIEW AND COMMENTS

Glenn E. Pasvogel, Jr.*

Introduction

October 1, 1979 marked the beginning of a new era in the American law of bankruptcy. It was on that day that the Bankruptcy Act of 1898 was superceded by the Bankruptcy Reform Act of 1978. The culmination of over eight years of legislative study, debate, and compromise, the 1978 Act was the first major revision of American bankruptcy law in over 40 years. Substantively, the new Bankruptcy Act modernizes bankruptcy law to cope with the ever-increasing bankruptcy caseload, the expansion of the consumer and commercial credit industry, and changes in related substantive law, such as the near-universal adoption of the Uniform Commercial Code. Additionally, the Act makes important structural changes in the bankruptcy court system by increasing the jurisdiction, authority, and status of bankruptcy courts. This article represents a summary of those substantive and structural provisions generally applicable to bankruptcy administration and specifically applicable to bankruptcy liquidation. A future article will treat those substantive changes applicable only to debtor rehabilitation and reorganization.

Legislative History

In July, 1968, the Subcommittee on Bankruptcy of the Senate Committee on the Judiciary held hearings on the status and adequacy of bankruptcy law and administration in the United States.\(^1\) Similar hearings were conducted by Subcommittee No. 4 of the House Committee on the Judiciary in October of the following year.\(^2\) The hearings uncovered numerous problems with the then

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1. *Hearings on Senate Joint Resolution 100 Before The Subcomm. on Bankruptcy of the Senate Comm. on the Judiciary, 90th Cong., 2d Sess.* (1968).

existent bankruptcy system. The rising tide of consumer bankruptcies, a system of administration that was costly, inefficient, and unnecessarily time-consuming, a lack of adequate protection of the debtor's discharge, and a lack of uniformity in treatment of debtors and creditors among the various judicial districts all pointed toward a need for substantial revision of the bankruptcy laws.\(^3\) As a result of these hearings, Public Law 91-354 created the Commission on the Bankruptcy Laws of the United States with the charge to "study, analyze, evaluate, and recommend changes" in the Bankruptcy Act.\(^4\)

The Commission, consisting of nine members and a staff of twenty-seven, conducted its investigation over a period of more than two years and issued its final report on July 30, 1973.\(^5\) The report was in two parts. Part I contained the Commission's findings concerning the status and administration of bankruptcy law and its recommendations for legislative change. Part II consisted of a draft bill (with a comprehensive commentary and explanation) designed to implement those changes. The major recommendations of the Commission may be summarized as follows:\(^6\)

1. Sever the administrative responsibilities from the judicial functions of the bankruptcy judge so as to preserve actual as well as apparent impartiality among the participants in a bankruptcy proceeding.\(^7\)

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3. Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137, 93d Cong., 1st Sess., pt. I, 2-5 (1973) [hereinafter cited as Commission Report]. During the period between 1946 and 1967, the number of cases commenced under the Bankruptcy Act rose from 10,196 to 208,329. During the same period of time, the number of referees increased from approximately 50 full-time and 100 part-time to 174 and 40 respectively. The average caseload of a referee increased from approximately 132 to 1,074 cases. Id. at 2.


6. Id. at 5-31.

7. The Commission found no justification at all for bankruptcy judges to be involved in the administrative paper shuffling which formed the largest part of bankruptcy administration. Where litigation did arise, the Commission felt it to be particularly important that the judge not have had prior administrative contact with the case:

The Commission is convinced that referees' participation in administrative aspects of bankruptcy proceedings tends to impair the litigants' confidence in the impartiality of the tribunal's decision. In particular, adversaries of the trustee in bankruptcy tend to doubt that the referee who appointed the trustee can insulate himself from at least a suspicion of partiality when he may have previously been involved in any or all of the following actions regarding the same estate: determining that the debtor had committed an act of bankruptcy; the appointment, or
(2) Expand the jurisdiction and powers of the bankruptcy court to alleviate inefficiency and delay caused a) by needless overlap in jurisdiction between the bankruptcy court, the federal district court, and the various state courts, and b) by current statutory requirements that the trustee litigate many adverse claims to estate property in nonbankruptcy forums.  

(3) Create an administrative agency to handle cases involving no litigation and to assume all administrative duties in cases where litigation does arise.  

(4) Provide increased relief for consumer debtors through waiver of the filing fee for indigent debtors, making debt counseling available to debtors with regular income, creation of a uniform set of federal exemptions, abolition of reaffirmation as a means of enforcing discharged debts, modification of the six-year bar on a subsequent bankruptcy discharge, and substantial modification of Chapter XIII to expand debtor eligibility, permit confirmation of a plan without creditor consent, and permit a plan to provide for cure of default and payment of secured debt over a reasonable period of time.  

(5) Make it easier for creditors of business debtors to force involuntary liquidation before dissipation of assets. This should be done by abolishing the "act of bankruptcy" as a jurisdictional requisite and substituting either an insolvency standard

approval of the election, of the trustee; the scrutiny of the petition, schedules, statement of affairs, and other papers filed in the case; the conduct of the first meeting of creditors and other meetings at which examination of the debtor and other witnesses took place; and conferences with the trustee regarding collection of the assets of the estate and litigation on its behalf.

COMMISSION REPORT, supra note 3.

8. Section 23b. of the 1898 Bankruptcy Act required the trustee to litigate such claims in nonbankruptcy courts unless the adverse party consented to the bankruptcy court's summary jurisdiction. For an analysis of § 23b. as it affected the availability of summary jurisdiction in the bankruptcy court, see generally MacLachlan, HANDBOOK OF THE LAW OF BANKRUPTCY §§ 193-197 at 203-14 (1956) and 2 COLLIER, BANKRUPTCY 443 (14th ed. 1943).

9. In United States v. Kras, 409 U.S. 434 (1973), the United States Supreme Court held that it was not a violation of the fifth amendment due process clause for Congress to deny a debtor a discharge for failure to pay the filing fee.

10. The Commission felt that the failure of the Bankruptcy Act to deal effectively with reaffirmation frustrated the policy of providing the debtor with a "fresh start." Creditors often made reaffirmation of discharged debts a condition of extending postbankruptcy credit, leaving debtors with something of a Hobson's choice. Additionally, creditors were using bad faith threats of litigation to determine the nondischargeability of debts associated with false financial statements as leverage to obtain reaffirmation. The Commission recommended the abolition of reaffirmation of unsecured debts as the only effective means of guaranteeing a fresh start. COMMISSION REPORT, supra note 3, at 10-11, and 177.
of inability to pay debts or the suffering of a general assignment or receivership without regard to solvency.\(^{11}\)

(6) Allow a bankruptcy administrator to take possession of a debtor's business between the time an involuntary petition is filed and a subsequent adjudication to better preserve assets from depletion.

(7) Comprehensively define "estate property" and provide for less cumbersome liquidation.

(8) Abolish the \textit{Moore v. Bay}\(^ {12}\) doctrine so that the trustee would only be subrogated to the actual avoidance rights of any creditor as to whom a transfer of the debtor was voidable under federal or state law.

(9) Make it easier for a trustee to avoid preferential transfers by creating a presumption of insolvency during the applicable period before bankruptcy (reduced from four months to three months) and removing any requirement that the preferred transferee have had reasonable cause to believe the debtor was insolvent at the time of transfer.\(^ {13}\)

11. The Commission found little support for the necessity of proving an "act of bankruptcy" as a prerequisite to subjecting a debtor's assets to payment of creditor's claims. The necessity and difficulty of proving a balance-sheet type of insolvency in conjunction with most of the acts and the right to trial by jury that § 19a. gave every debtor on the issues of insolvency and the commission of the act had the effect of delaying "liquidation until assets [were] largely depleted" and was "a major factor in explaining the smallness of distributions in business bankruptcies." \textit{Commission Report, supra} note 3, at 14.

12. 284 U.S. 4 (1931). \textit{Moore v. Bay} was a case construing the applicability of § 70c. of Bankruptcy Act which gave the trustee the avoidance rights of any creditor as to whom a transfer of the debtor was voidable. In \textit{Moore}, the holder of a chattel mortgage executed by the debtor delayed filing. Under applicable state law, the mortgage was void as against creditors existing at the time the mortgage was entered into and those arising during the gap between execution of the mortgage and filing. The value of the collateral was greater than the amount of claims held by preexisting and gap creditors. The Court, in an opinion by Justice Holmes (who was over 90 at the time), held that the mortgage was void \textit{in toto} as against the trustee, and the proceeds of liquidation were available for distribution among all creditors. \textit{Id.} at 4-5. Thus, the existence of one inconsequential creditor as to whom a transfer of the debtor was voidable gave the trustee total avoidance power and provided all other creditors with an advantage they would not otherwise have had. The Commission on the Bankruptcy Laws of the United States termed this "unfair and unjustified" and called for abolition of the rule. \textit{Commission Report, supra} note 3, at 18.

13. Bankruptcy law accords the trustee the power to avoid certain pre-petition transfers for antecedent debt in order to "achieve a fair and equitable distribution among creditors" and discourage "a scramble among the most diligent creditors, those with inside information, and those with the greatest leverage over the debtor to obtain payment immediately before an impending bankruptcy, which would frequently leave nothing for the less favored creditors." \textit{Commission Report, supra} note 3, at 19. The Commission felt that these goals were being frustrated under § 60a. of the Bankruptcy Act by requirements that 1) the trus-
(10) Remove certain classes of transfers from the definition of a preference where such transfers are in the ordinary course of business, do not result from creditor advantage or leverage, and the sanctioning of which would not encourage the dismembering of a financially troubled debtor and thus precipitate bankruptcy.

(11) Simplify and make distribution of the estate more equitable by abolishing the concept of provability and making virtually all debts enforceable against the debtor allowable, invalidating most statutory liens as being merely disguised priorities, and reducing the number of priority general claims to those for administrative expenses, wages (increased to $1200 per employee), and taxes arising within one year prior to bankruptcy.

(12) Revise and consolidate into one chapter the three business reorganization chapters (X, XI, and XII).

The Commission's draft bill was introduced in the 93d Congress as H.R. 10792. An alternative bill, tracking the Commission's bill in many respects but differing significantly in others, was drafted by the National Conference of Bankruptcy Judges and also submitted to the 93d Congress as H.R. 16643. Both bills were reintroduced in the 94th Congress as H.R. 31 and H.R. 32 respectively and were the subject of comprehensive hearings. Thirty-five days of hearings produced over 2700 pages of testimony from more than 100 witnesses. After the hearings, H.R. 31 and H.R. 32 were redrafted and consolidated into a single bill which was introduced into the 95th Congress as H.R. 6.

H.R. 6 was sent to the Subcommittee on Civil and Constitutional Rights of the House Committee on the Judiciary. Over 100
amendments were adopted by the Subcommittee and numerous other technical and stylistic changes were made. The amended bill was introduced as H.R. 8200 on July 11, 1977.20 H.R. 8200 was passed by the House on February 1, 1978,21 and sent to the Senate. Last minute compromise resulted in H.R. 8200 as amended which was passed by both House and Senate and signed by President Carter as Public Law 95-598 on November 6, 1978.22

Structure of the Code

Public Law 95-598 is divided into four titles. Title I contains the substantive law of bankruptcy liquidation and reorganization which was codified as Title 11 of the United States Code. Title II contains a series of amendments to Title 28 of the United States Code. The amendments create the new United States Bankruptcy Court and define its powers and jurisdiction, provide for the appointment, tenure, and salary of bankruptcy judges, and establish the office of United States trustee on a five-year experimental basis in selected judicial districts. Title III amends various federal statutes which refer to bankruptcy law as to make them correspond to changes brought about by Public Law 95-598. Finally, Title IV repeals old bankruptcy law and provides that certain provisions of Public Law 95-598 not take effect immediately, but have delayed applicability over a five-year transition period.

Title I, hereinafter referred to as the “Bankruptcy Code,” contains the substantive law of bankruptcy23 and is divided into eight

20. COMM. ON THE JUDICIARY, supra note 18, at 3.
22. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2594 (1978). Section 101 of the Bankruptcy Reform Act enacts into positive law Title 11 of the United States Code and embodies the substantive law of bankruptcy. In this article citations to section 101 are hereinafter cited as “Bankruptcy Code of 1978” and include the appropriate section number from Title 11, United States Code.

Other parts of the Bankruptcy Reform Act of 1978 will hereinafter be cited as “Bankruptcy Reform Act of 1978” followed by the appropriate section number from that act. In addition, when a section of the Act amends or adds a new section of the United States Code, that amendment or addition will also be cited to the appropriate United States Code section.

23. The Bankruptcy Code consists mostly of substantive law. Under 28 U.S.C. § 2075, as amended by § 247 of Title II of the Bankruptcy Reform Act of 1978, the Supreme Court will retain rulemaking authority to define relevant procedure (e.g., defining who is an “interested party” for purposes of raising objections, establishing time limits for filing proofs of claims, and establishing the ground rules for various hearings). Prior to the 1978 amendment, § 2075 authorized the Supreme Court to promulgate rules which would supercede the
chapters (1, 3, 5, 7, 9, 11, 13, and 15; there are no even-numbered chapters). Chapters 1, 3, and 5 apply generally to all types of bankruptcy proceedings and deal with such matters as definitions and rules of construction, powers of the court, case administration, powers of the trustee, procedures for filing a case, creditors' rights and duties, and the rights and duties of debtors. Chapter 15 establishes the powers and duties of the United States trustee in those specified jurisdictions wherein the office is created. In general, the last three digits of a chapter 15 section number refer to another section of the Bankruptcy Code that is amended, supplemented, or replaced by the particular chapter 15 section.

Chapters 7, 9, 11, and 13 deal with substantive law applicable to each of the four different types of bankruptcy proceedings. Chapter 7 governs liquidation or "straight bankruptcy," wherein the debtor's assets are surrendered to the court, exempt assets returned to the debtor, the remaining assets either liquidated or set aside to secured creditors, and the proceeds distributed among creditors according to a statutorily prescribed scheme. In return, the debtor is accorded a discharge of all but a few enumerated types of debts unless he or she has committed one of a few specified acts.

Chapters 9, 11, and 13 all involve debtor rehabilitation proceedings which, as distinguished from liquidation, look toward reorganization of the debtor's financial structure, payment of debts out of future earnings, and generally result in a discharge of debts

1898 Act to the extent of any inconsistency. By order of April 24, 1973, the Court promulgated a comprehensive set of official rules and forms which, in many cases, made substantial changes in substantive bankruptcy law. Amended § 2075 limits the Court's rulemaking authority to rules that are consistent with the Bankruptcy Code and, until such new rules are promulgated, § 405(d) of the Reform Act provides that the old rules will apply to the extent not inconsistent with the Bankruptcy Code. The Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States has promulgated for local adoption a set of Suggested Interim Bankruptcy Rules designed to aid parties "applying existing bankruptcy rules where appropriate under the new code, and in filling gaps in present rules created by the new legislation." ADVISORY COMMITTEE ON BANKRUPTCY RULES OF THE JUDICIAL CONFERENCE OF THE UNITED STATES, SUGGESTED INTERIM BANKRUPTCY RULES 1 (1979).

24. Bankruptcy Code of 1978, § 726. Section 726 generally governs the priority of distribution of liquidation proceeds among general creditors. Creditors with secured claims will receive prior distribution of collateral or its value under § 362 (relief from the automatic stay), § 554 (abandonment of estate property), or § 725 (distribution of certain property in which an entity other than the estate has an interest).

25. Section 727 of the Bankruptcy Code of 1978 accords the debtor a general discharge of debts unless 1 of 10 enumerated conditions exist. Section 523 of the Code lists nine types of debts which are excepted from the § 727 discharge.
upon compliance with a court-approved rehabilitation plan.²⁶ Chapter 9 applies to rehabilitation of municipalities, chapter 11 to reorganization of business entities, and chapter 13 to rehabilitation of individuals with regular income. While, unless otherwise specified, the provisions of chapters 1, 3, and 5 apply generally to proceedings brought under chapters 7, 9, 11, and 13, the provisions of 7, 9, 11, and 13 only apply to proceedings under each respective chapter.

Jurisdiction of the Bankruptcy Court

One of the more serious defects of the Bankruptcy Act of 1898²⁷ as amended by the Chandler Act in 1938,²⁸ and principal reason for the reform movement, was its failure to vest in the bankruptcy court pervasive jurisdiction to decide all issues arising in or relating to the administration of a bankruptcy proceeding. Section 2 of the 1898 Act sought to describe comprehensively bankruptcy court jurisdiction as “original” (but not exclusive) to decide certain enumerated issues and exercise certain enumerated powers in a bankruptcy proceeding—including the power to “[c]ause the estates of bankrupts to be collected.”²⁹ Problems did not arise with respect to collecting estate property in possession of the bankrupt or deciding adverse claims against such property since jurisdiction over the property emanated from personal jurisdiction over the bankrupt. However, section 23 provided that disputes over property held adversely to the trustee or receiver were to be decided “in the same manner and to the same extent as though such [bankruptcy] proceedings had not been instituted and such controversies had been between the bankrupts and such adverse claimants,” and that such suits “be brought or prosecuted only in the courts where the bankrupt might have brought or prosecuted them if proceedings under this Act had not been initiated,

²⁶. Bankruptcy Code of 1978, § 944(b) (municipal debt adjustment), § 1141 (business reorganization), and § 1328 (individual debt adjustment).
unless by consent of the defendant. Thus, the trustee was compelled to bring a plenary action in a nonbankruptcy forum.

The result of the above allocation of jurisdiction was devastating to the efficiency of the bankruptcy court. Unnecessary delay was caused by a trustee having to litigate in state or federal nonbankruptcy courts to recover property in the possession of an adverse claimant. Bankruptcy courts wasted much time over litigation to determine whether property was in the actual or constructive possession of the bankrupt so as to fall within the summary jurisdiction of the court, or whether the adverse claimant had actually or impliedly consented to the jurisdiction of the bankruptcy court. It was apparent that a more comprehensive grant of jurisdiction to the bankruptcy court would serve to reduce the time and money spent on litigation of jurisdictional issues and “foster the development of a more uniform, cohesive body of substantive and procedural law.”

Section 1471 of Title 28 of the United States Code cures the jurisdictional overlap created by the 1898 Act by granting the bankruptcy court greatly expanded jurisdiction. Section 1471 provides that bankruptcy courts shall exercise original and exclusive jurisdiction over all cases filed under the Code and original but not exclusive jurisdiction over all proceedings “arising in or related to” bankruptcy cases. The non-exclusivity limitation is not intended as a jurisdictional restriction but rather legitimates the court’s power to abstain from hearing a particular proceeding if it feels some other forum should more appropriately decide the dispute. That the bankruptcy court has complete discretion whether to abstain or not is made clear by the nonreviewability of the abstention decision. Since section 362 of the Bankruptcy Code automatically stays the commencement or continuation of any judicial or administrative action against the debtor or his property, the bankruptcy court is assured of unfettered power to decide all bankruptcy related issues unless and until it decides not to.

30. Id. § 23.
31. See generally Commission Report, supra note 3, at 88-91; Comm. on the Judiciary, supra note 18, at 43-52; MacLachlan, supra note 8, at 203-14.
34. Id. § 1471(b).
35. Id. § 1471(d).
36. Since 1) 28 U.S.C. § 1471 vests in the bankruptcy court original and exclusive jurisdiction over all cases filed under Title I of the Reform Act, and 2) relief from the auto-
Along with the grant of pervasive jurisdiction, the powers of the bankruptcy court are greatly expanded. Section 1481 of the amendments to Title 28 of the United States Code grants the bankruptcy court all the "powers of a court of equity, law, and admiralty," the only exceptions being that it cannot enjoin another court nor punish most cases of criminal contempt.³⁷ Section 105 of the Code prohibits the court from appointing a receiver.³⁸ The same section, however, rounds out the comprehensive grant of power to bankruptcy courts by making it clear that they "may issue any order, process, or judgment" appropriate for exercising their functions under the Code.³⁹ Thus, the new bankruptcy court will assume an elevated status under the Code as a truly independent court fully equal to the responsibilities of expeditiously resolving all disputes arising in the administration of bankruptcy estates.

The Commission on the Bankruptcy Laws of the United States felt that concomitant with the expanded jurisdiction of the court, referees should be elevated in status and made independent of district court judges.⁴⁰ H.R. 8200 implemented these recommendations by providing for executive appointment, life tenure, and a salary equivalent to that paid to district court judges.⁴¹ Senate concerns over excessive elevation in status resulted in the compromise embodied in sections 152, 153, and 154 of the amendments to Title 28 of the United States Code. Bankruptcy judges will be appointed by the President, subject to Senate confirmation, for four-

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38. Bankruptcy Code of 1978, § 105. The prohibition amounts somewhat to a change of form over substance. Under § 2a.(3) of the 1898 Act, the bankruptcy court was authorized to appoint a receiver to manage the debtor's property between the time an involuntary petition was filed and the time of a subsequent order of relief. Because § 303(g) in a liquidation case and § 1104 in a reorganization case authorizes the court to appoint an interim trustee to manage a debtor's business pending action on an involuntary petition, appointment of a receiver would be unnecessary.
teen-year terms at a salary of $50,000 per year. The Judicial Councils within each circuit may make nonbinding recommendations to the President concerning judges to be appointed within the circuit. During the five-year transition period, current referees will serve as bankruptcy judges. Appointed judges will take office March 1, 1984.

The Commission also felt that the unnecessary involvement of the referee in administrative matters (e.g., having to give formal approval to routine actions of the trustee as to which no interested party had objected) was a waste of judicial time and caused needless delay in closing estates. Additionally, and perhaps more importantly, administrative duties often brought the referee into ex parte contact with the debtor, the creditors, and the trustee creating, at a minimum, the appearance of partiality. H.R. 8200 proposed a complete separation of administrative and judicial responsibilities. The function of the judge would be confined largely to dispute resolution, and trustees would have greater administrative powers and responsibilities to be exercised, to a large extent, free from judicial supervision. To upgrade the quality of administrative services and make trustees independent of judges, H.R. 8200 would have established the office of United States trustee in each district to supervise estate administration and serve as trustee in cases where private trustees were unable or unwilling to serve. The Senate Bill, S. 2266, contained no such provision, demonstrating a preference to retain the system of judicially appointed private trustees under the supervision of the referee. The compromise effected by the Code is that the United States trustee system was implemented in selected judicial districts as a five-year pilot project. At the end of that time, the project will be evaluated and if successful, expanded, if not, dropped.

44. Bankruptcy Reform Act of 1978, § 404(b).
45. Id.
46. COMMISSION REPORT, supra note 3, at 3 and 5-8.
47. Id. at 92-4.
Section 586 of the amendments to Title 28 of the United States Code lists the duties of the United States trustee. His initial responsibility under the Code is to establish, maintain, and supervise a panel of private trustees who will serve in cases under chapters 7 and 11 of the Code (unless creditors elect a trustee from outside the panel). The United States trustee will serve as trustee in chapter 7 cases where no private trustee is willing or able to serve (e.g., "no asset" cases), but is prohibited from serving in a chapter 11 case. Trustee appointments (except in chapter 11 cases) will be made by the United States trustee rather than the judge. In chapter 13 cases, the United States trustee has the option either to appoint a private standing trustee or designate one or more of his assistants as standing trustee. Perhaps most important, the general supervision of case administration under all chapters of the Code is vested in the United States trustee rather than the bankruptcy judge.

In jurisdictions not within the pilot project, the court will continue to be responsible for appointing trustees (unless creditors choose to elect one) and supervising them in administering cases. In two important respects, however, the judge is relieved from administrative duties. Under section 341, the bankruptcy judge is prohibited from attending the first creditors' meeting so as to avoid being influenced by the debtor's petition, statement of affairs, schedules, and answers to questions given during the creditors' examination when later called upon to rule in litigation over exemptions, claims, or discharge. A second provision which should serve to remove much administrative burden from the bankruptcy judge involves a rule of construction found in section 102 of the Code. Numerous sections of the Code give the trustee authority to take various administrative actions "after notice and hearing." Section 102 construes that phrase to mean only notice and an opportunity for a hearing. Therefore, if notice of proposed action is

54. Id. § 151302.
55. See, e.g., § 363(b) (power of the trustee to sell or lease business property other than in the ordinary course of business "after notice and hearing") and § 554(a) (power of trustee to abandon estate property "after notice and hearing").
56. Section 102 of the Bankruptcy Code of 1978 provides in part:
In this title—
(1) "after notice and a hearing", or a similar phrase—(A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a
given by the trustee to interested parties and no objection to the action is lodged in the form of a request for a hearing, the action may be taken without securing the pro forma approval of the judge. The administrative workload of the bankruptcy judge should be lightened considerably even in those jurisdictions not included within the United States trustee pilot project.

**Commencement of a Case**

A person or entity who files a petition to take advantage of any chapter of the Bankruptcy Code, or against whom a petition is filed, is referred to as a "debtor" rather than a "bankrupt" under the Code. Section 109 provides that any "person" (defined by section 101 to include an individual, partnership, or corporation which is not a governmental unit) except a railroad, bank, savings and loan association, or insurance company may be a debtor in a chapter 7 liquidation case. Any person who may be a debtor under chapter 7 (except a stockholder or commodity broker) and additionally, a railroad, may be a debtor under a chapter 11 reorganization. Debtor qualifications under chapter 13 represent a major change over the 1898 Act insofar as debtor rehabilitation protection is extended to virtually all salaried individuals, and may now, for the first time, be invoked by sole proprietor businesses. Any "individual with regular income" (regardless of source) who owes fixed unsecured debts of less than $100,000 and fixed secured debts of less than $350,000 may file a chapter 13 petition. Joint petitions by spouses are authorized provided one spouse has regular income and the aggregate debts of both spouses do not exceed the above dollar amounts.

A voluntary case is commenced, as under the 1898 Act, by the filing of a petition with the bankruptcy court requesting relief under the appropriate chapter. The filing of a petition now constitutes "an order for relief" rather than an "adjudication of bankruptcy." An involuntary petition may only be filed under chapters 7 or 11 of the Code, but may not be filed against a charitable

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hearing as is appropriate in the particular circumstances.[1]

57. See, e.g., §§ 109, 521, and 1321.
59. Id. § 109(d).
60. Id. § 109(e).
61. Id.
62. Id. § 301.
corporation or a person (including a corporation or partnership) who earns at least 80% of its income from a farming operation.⁶³

The creditors filing an involuntary petition must meet certain qualifications. Section 303 of the Code follows prior law insofar as only one creditor holding a noncontingent claim (which need not be allowable) need file if the debtor has less than twelve such creditors.⁶⁴ If the debtor has twelve or more creditors, three or more creditors holding noncontingent claims must sign. In either case, the creditors signing the petition must hold noncontingent claims of at least $5000 in the aggregate, in excess of any security or collateral. Section 303(b)(2) provides that for purposes of computing the requisite number of creditors signing the petition, insiders (creditors generally having either a close business or personal relationship to the debtor), fully secured creditors, and creditors who have received voidable transfers of property from the debtor may not be counted.

Under the 1898 Act, creditors seeking to force a debtor into bankruptcy had to prove that the debtor committed one of six acts of bankruptcy within four months prior to the petition.⁶⁵ The Commission on the Bankruptcy Laws of the United States criticized this requirement as being an unwarranted burden on creditor interests which caused unnecessary delay and dissipation of the estate between the time the debtor first ceased paying his bills and the filing of a petition, and recommended its abolition.⁶⁶ The Code followed this recommendation by abolishing all acts of bankruptcy. Instead, all the Code requires is that the debtor currently not be paying his debts as they become due or, in the alternative, that an assignee for benefit of creditors, a receiver, or an executing creditor has taken possession of substantially all the debtor's property.⁶⁷ Section 305 gives the court discretion to dismiss a petition, notwithstanding the existence of grounds for relief, if the interests of both the debtor and creditors would better be served.⁶⁸ This discretion will likely be exercised where a pre-petition general receivership, general assignment for benefit of creditors, or contractual arrangement promises to result in a more efficient liquidation and

⁶³ Id. § 303(a).
⁶⁴ Id. § 303(b).
⁶⁵ Bankruptcy Act of 1898, §§ 3a. and 3b.
⁶⁷ Bankruptcy Code of 1978, § 303(h).
⁶⁸ Id. § 305(a)(1).
distribution if left undisturbed.\textsuperscript{69}

Section 303(f) and (g) give the court discretion either to allow the business debtor to remain in possession of his business between the time the petition is filed and the time it is acted upon, or, after notice and hearing, appoint a trustee to take possession of and manage the business.\textsuperscript{70} To protect the debtor against irreparable damages caused by ultimately unsuccessful petitions, section 303(i) provides that petitioning creditors may be assessed costs, damages, and attorney's fees if a petition is dismissed.\textsuperscript{71} Punitive damages may be assessed if the court finds that a petition was filed in bad faith.\textsuperscript{72} Furthermore, to facilitate the debtor-in-possession effectively continuing his business after an involuntary petition has been filed, section 502(f) and section 507(a) together grant second priority status to creditors who extend unsecured credit to the debtor between the time the petition is filed and the order of relief.\textsuperscript{73}

\textsuperscript{69.} COMM. ON THE JUDICIARY, supra note 18, at 325.

\textsuperscript{70.} Section 303(f) of the Bankruptcy Code of 1978 makes it clear that during the time between the filing of an involuntary petition under either chapter 7 or 11 and subsequent action on the petition, a debtor may continue to manage and operate a business unless and until the bankruptcy court orders otherwise. Furthermore, an interim trustee may only be appointed if certain conditions exist. Section 303(g) provides that in a chapter 7 liquidation case, such appointment may be made only "if necessary to preserve the property of the estate or to prevent loss to the estate." In a chapter 11 case, a trustee may be appointed only pursuant to the following standards:

1. for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

2. if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor. Bankruptcy Code of 1978, § 1104(a).

\textsuperscript{71.} Bankruptcy Code of 1978, § 303(i)(1). The court, upon dismissing a petition, has discretion to assess actual damages against petitioning parties unless the petition was dismissed upon consent of all petitioners and the debtor or unless the debtor has waived his right to damages. Damages are measured by costs, a reasonable attorney's fee, or "any damages proximately caused by the taking of possession of the debtor's property by a trustee" under § 303(i)(1)(c) or § 1104 of the Code. While the wording of 303(i) would indicate that the three types of damages are to be awarded in the alternative, the House Judiciary Committee Report indicates that damages are cumulative and the word "or" should be read as conjunctive. "Or' is not exclusive in this paragraph. The court may grant any or all of the damages provided for under the provisions." COMM. ON THE JUDICIARY, supra note 18, at 324.

\textsuperscript{72.} Bankruptcy Code of 1978, § 303(i)(2).

\textsuperscript{73.} Section 502(f) of the Code renders allowable in the same manner as any pre-petition claim, a claim that arises in the ordinary course of the debtor's business during the interim between the filing of an involuntary petition and the earlier of the appointment of a
It is essential to efficient and equitable bankruptcy administration that the trustee be able to collect and liquidate the debtor's estate free from the interference of creditors scrambling for advantage. To this end, section 362 provides that a bankruptcy petition under any chapter, voluntary or involuntary, operates as an automatic stay against virtually all creditor collection activity. Creditors are prohibited from 1) beginning or continuing legal actions to collect debts, 2) employing legal process to collect debts or enforce judgments or liens against estate property, 3) doing any act to create, perfect, or enforce security interests in connection with claims that arose before the filing of the petition, 4) doing any act to collect or recover a pre-petition claim against the debtor, 5) setting off mutual debts, or 6) commencing or continuing any action against the debtor in the United States Tax Court. Calling a debtor to request payment of a claim would fall within the prohibition of the section 362 stay.

Section 362(b) exempts from the stay certain activity which either poses no threat to the estate or which is predicated on state law upon which a creditor could have relied and which would have supported the action but for the intervention of bankruptcy. Exempted from the stay are 1) commencement or continuation of criminal actions against the debtor, 2) actions to collect maintenance, support, or alimony from non-estate property, 3) actions (other than taking possession of property) to perfect interests in property under state laws granting grace periods within which perfection may be made and protection against intervening inter-

trustee or an order of relief. Section 507(a)(2) accords such allowable unsecured claims second priority after administrative expenses.

74. Bankruptcy Code of 1978, § 362(a). The purpose of the § 362 automatic stay is described by the House Judiciary Committee as follows:

The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan or simply to be relieved of the financial pressures that drove him into bankruptcy. The automatic stay also provides creditor protection. Without it, certain creditors would be able to pursue their own remedies against the debtor's property. Those who acted first would obtain payment of the claims in preference to and to the detriment of other creditors. Bankruptcy is designed to provide an orderly liquidation procedure under which all creditors are treated equally. A race of diligence by creditors for the debtor's assets prevents that. COMM. ON THE JUDICIARY, supra note 18, at 340.

An additional function of the stay, not mentioned by the Committee on the Judiciary, is to give the trustee in a liquidation case time to assess the estate and claims of creditors free from the pressures of creditors.
ests in the property effectuated, 4) any generally applicable right of a seller to recover goods received by the buyer while insolvent (e.g., section 2-702 of the Uniform Commercial Code) provided written demand for the goods is made within ten days of receipt, 5) commencement or continuation of governmental police power actions to the extent regulatory in nature rather than for collection of claims, 6) certain commodity futures setoffs, 7) certain mortgage foreclosure actions by the Secretary of Housing and Urban Development, and 8) the issuance of tax deficiency notices by governmental units.\(^7\)

The comprehensive prohibition of creditor collection activity under section 362 is not designed to cut off irrevocably all collection activity against estate property, but rather, to give the trustee breathing space within which to collect the estate and evaluate claims of secured creditors to estate property. Subsections (c), (d), (e), and (f) of section 362 establish rules governing termination of the stay.\(^8\) Subsection (c) automatically terminates the stay of actions against estate property when such property ceases to be property of the estate (e.g., by sale, abandonment, or exemption), and terminates as to any other act at the earlier of closing the case, dismissing the case, or the granting or denial of a discharge (unless the debtor in a chapter 7 case is a partnership or corporation).

Creditors may receive earlier relief from the stay by application to the court. Subsection (d) of section 362 requires the court, after notice and opportunity for a hearing, to terminate or modify a stay “for cause” including inadequate protection of a secured creditor’s interest in property and, with respect to fully secured creditors who wish to repossess collateral, to terminate the stay of acts against estate property if the debtor has no equity in the property and the property is not needed to effectuate a reorganiza-

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75. Bankruptcy Code of 1978, § 362(b). The House Judiciary Committee emphasized that while such actions are not stayed automatically by the filing of the petition the bankruptcy court has ample power to enjoin any action not covered by the stay: 1) Section 105 authorizes the court to issue orders necessary or appropriate to carry out the provisions of Title I, 2) bankruptcy courts fall within the coverage of the federal All Writs Statute [28 U.S.C. § 1651 (1976)], and 3) under Title II, § 241 of the Bankruptcy Reform Act [28 U.S.C. § 1481 (Supp. 1976)] bankruptcy courts are given all powers of a court of law, equity, or admiralty. Removing the enumerated actions from the scope of the automatic stay serves to require the court, upon motion of an interested party, to determine on a case-by-case basis whether such action should be stayed. COMM. ON THE JUDICIARY, supra note 18, at 342.

tion. To encourage expedited hearings on secured creditor motions for relief, the Code provides that a stay of acts against property of the estate terminates automatically thirty days after a request for relief unless a hearing is held and the stay is ordered continued.

Collecting and Liquidating the Estate

The filing of a petition under any chapter of the Bankruptcy Code creates an estate over which the bankruptcy court and trustee will have certain powers of alienation and supervision which will vary depending upon the particular chapter. The principal duty of a trustee in a chapter 7 case is to collect and liquidate the estate and make final distribution to creditors. These duties are more specifically described by section 704 of the Code as 1) collecting the debtor's property, 2) setting aside exempt property to the debtor and fully-encumbered property to creditors whose claims cannot be avoided, 3) liquidating the remainder, 4) accounting for all property received, 5) investigating the debtor's financial affairs, 6) opposing the debtor's discharge if warranted, 7) filing periodic financial statements with the court and governmental taxing entities in the case of a business that is authorized to be operated during administration, 8) making final distribution, and 9) filing with the bankruptcy court a final accounting of all collections and disbursements. The duties of the trustee under other chapters are specifically described in those chapters, but generally involve administering or supervising the administration of the debtor's estate under a plan of business or financial reorganization.

Regardless of the chapter under which a case is filed, one of the first duties of the trustee will be to identify that property which is included in the estate. Under the 1898 Act, whether or not property was included within the estate under section 70a.

77. The automatic stay is not intended to cut off secured party interests in estate property but rather to give the trustee time to evaluate and deal with secured claims in an orderly fashion. The trustee is empowered by § 363 of the Code to use or sell estate property, including fully-encumbered property, provided the secured party is given protection against depreciation of his interest. A secured creditor is entitled to relief from the stay if adequate protection is not provided, or if collateral the secured party wishes to repossess is not needed by the estate and is not subject to any equity of the debtor. In a liquidation case, the trustee will likely wish to liquidate collateral in which the debtor has equity and pay over to the secured party the value of the secured claim.


79. Id. § 704.
pended largely upon whether it was exempt under state law (and if so, excluded from the estate), and whether the property was alienable by the debtor or subject to creditors' process under state law (and if so, included in the estate unless exempt). Tying the bankruptcy estate so closely to state law, with all its variances, had the effect of creating inconsistencies and conflicts in a body of national law intended to be uniform. The philosophy behind section 541 of the Code is to bring all property interests of the debtor within the jurisdiction of bankruptcy administration, whether or not exempt and without reference to state laws respecting transferability or amenability to collection process.

Section 541 provides that the estate shall consist of the following property:

(1) All legal and equitable interests of the debtor existing as of the day the petition is filed except a power of appointment that the debtor may not exercise in his own behalf or the debtor's equitable interest in a spendthrift trust. This would include documents, tangible and intangible interests, causes of action, exempt property, possessory interests, title—virtually any property interest that could conceivably be of value to the estate. (Exempt property will later be set aside to the debtor under section 522.)

(2) All interests of the debtor and the debtor's spouse in community property under sole or joint control of the debtor, or subject to a claim against the debtor. (The spouse and creditors will both then participate in distribution and the bankruptcy court will decide the extent to which the property should be subjected to creditors' claims.)

(3) Any interest in property that the trustee recovers under sections 542 and 543 (property acquired from a receiver, assignee for benefit of creditors, or other custodian of the debtor's property), section 544 (transfers voidable under federal or state law), section 547 (preferential transfers), and section 548 (fraudulent transfers).

(4) Any property acquired by the debtor within 180 days after the petition a) by devise, bequest, or inheritance; b) under a divorce decree or settlement; or c) as beneficiary of a life insurance plan.

80. Bankruptcy Act of 1898, § 70a.
81. Comm. on the Judiciary, supra note 18, at 175-77.
Proceeds, offspring, rents, or profits of estate property.

Any interest in property acquired by the estate after the petition is filed. 82

It is important to note that what is acquired by the trustee as part of the estate is the "debtor's interest" in property. Any title acquired as part of the estate is of the same quality as that of the debtor. If the debtor owns a joint interest, the trustee acquires a joint interest. Any defects in title are defects as to the trustee. Property encumbered by mortgages or security interests in favor of third parties is acquired subject to those encumbrances and the trustee acquires only the debtor's equity. If property is fully encumbered, the trustee acquires only the debtor's possessory interest. The trustee, of course, may later improve upon the debtor's interest through his avoidance powers under sections 544, 545, 547, and 548 of the Code.

It is not uncommon for a lease, security agreement, or club membership to contractually restrict transfer of the property or provide for the termination of the lessee's, debtor's, or member's interest in such property upon the event of insolvency or bankruptcy. Section 70b. of the 1898 Act specifically validated forfeiture provisions in leases. 83 Section 541(c) of the Code assures that all of the debtor's interests in property become part of the estate for a "coherent evaluation of its value and transferability" 84 by including such property notwithstanding restrictions on transfer or provisions terminating the debtor's interest upon insolvency or bankruptcy. 85 It should be emphasized that section 541(c) serves merely to bring property into the estate and does not guarantee that the trustee will be able to dispose of the property. The trust-

82. Bankruptcy Code of 1978, § 541. In addition to bringing exempt and inalienable property into the estate, § 541 expands the definition of estate property over old § 70a. in other significant respects. Section 541(a)(2) brings into the estate both the interests of the debtor and the debtor's spouse in most community property. The bankruptcy court will then determine the extent to which such property should be subjected to claims against the debtor and abandon the rest to the spouse. Under § 541(a)(3), property recovered by the trustee under his avoidance powers becomes estate property. Section 541(a)(5) continues the policy of capturing inheritances of the debtor acquired within 6 months of bankruptcy but enlarges the types of property subject to capture if acquired within 6 months of the petition to include property acquired under a divorce decree or property settlement and proceeds acquired as beneficiary of a life insurance policy.

83. Bankruptcy Act of 1898, § 70b.

84. COMM. ON THE JUDICIARY, supra note 18, at 176.

tee's power of sale or lease of estate property is covered by section 363(1) which invalidates only forfeitures conditioned upon bankruptcy or insolvency. Thus, while general restrictions on transferability will not prevent property from becoming part of the estate, they will be effective against the trustee so as to prevent his liquidating the property.

Section 541 creates the bankruptcy estate. Since inclusion of an asset within the estate is not dependent upon possession, the trustee must acquire possession of property for purposes of use, sale, or lease under section 363 or distribution under sections 725 and 726. Under section 521, a debtor is required to turn over to the trustee property in his possession. Property is acquired from third persons under the turnover provisions of sections 542 and 543. Section 543 deals with property in the possession of a "custodian" which is defined by section 101(10) to mean a receiver, assignee for benefit of creditors, or any other person appointed to take possession of the debtor's property and administer it for the benefit of creditors. Under section 543, a custodian who acquires knowledge of the commencement of a case is prohibited from taking any action with respect to the property (e.g., administering, liquidating, or distributing it) except as is necessary to preserve it.

86. Id. § 363(l).
87. Id. § 363. Section 363 is the statutory authority for the trustee to either use or dispose of estate property under either chapter 7, 11 or 13.
88. Id. §§ 725 and 726. Section 725 provides for distribution in a liquidation case of estate property in which an entity other than the estate has an interest before final distribution is made to general creditors. Section 726 provides for final distribution of estate property to general creditors. Section 521, 542 and 543 are the three statutory provisions granting the trustee power to acquire possession of estate property so that the § 363, § 725, and § 726 powers and duties can be effectively exercised.
89. Bankruptcy Code of 1978, § 521(3). The debtor's intentional failure to turn over estate property to the trustee would be grounds for denial of a discharge under § 727(a)(2)(B).
(10) "custodian" means—
(A) receiver or trustee of any of the property of the debtor, appointed in a case or proceeding not under this title;
(B) assignee under a general assignment for the benefit of the debtor's creditors; or
(C) trustee, receiver, or agent under applicable law, or under a contract, that is appointed or authorized to take charge of property of the debtor for the purpose of enforcing a lien against such property, or for the purpose of general administration of such property for the benefit of the debtor's creditors.
91. Id. § 543(a). Perishable goods could be sold, for example. Nonperishable goods
The custodian must then turn over to the trustee all property that the trustee can use, lease, or sell under section 363, that is in the custodian's possession on the day he acquires knowledge of the bankruptcy proceeding. Along with that property, he must prepare an accounting of all property of the debtor that ever came into the custodian's possession. Section 543(c) requires the court to compensate the custodian for services rendered and expenses incurred by the custodian in administering the property. Section 543(c) also subjects the custodian to liability for any improper or excessive pre-petition disbursements neither sanctioned by applicable law nor approved by a competent court.

Turnover of property in the hands of a third person other than a custodian is governed by section 542. Any entity, other than a custodian, who has possession of estate property that the trustee can use, sell, or lease under section 363(a), must surrender the property to the trustee or account for its value. Such entity is relieved from this responsibility if the property is of inconsequential value or benefit to the estate. Subsection (b) provides that any entity that owes a matured or currently payable debt which is estate property must pay the debt to the trustee unless the debt is subject to setoff under section 553. Subsection (c) protects entities who make good faith transfers of estate property without knowledge of the commencement of a case in violation of subsection (a) or (b). Such transfers are effective and impose no liability on the transferor, the only exception being that any good faith setoff of mutual debts covered by the section 362(a)(7) automatic stay may be set aside by the trustee (although it may later be allowed under section 553). Insurance companies who are contrac-

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92. Id. § 542(a).
93. Section 542(a) distinguishes between use value and monetary value. Turnover of property which is of no monetary value to the estate would be required by § 542(a) if the trustee's use of it would be beneficial in winding down or rehabilitating a business.
94. Under § 541(a)(1), the debtor's choses in action and claims against third parties are estate property. COMM. ON THE JUDICIARY, supra note 18 at 367. Section 553 permits a creditor to offset mutual debts between such creditor and the debtor. Section 542(b) requires a third party who owes a currently payable § 541(a)(1) debt to the debtor to pay it over to the trustee unless the third party has a § 553 claim which may be offset. If this is the case, only the net claim of the debtor against the third party need be paid over under § 542(b). For example, if the debtor had $1,000 in a deposit account at First Bank but owed First Bank $500 on a defaulted promissory note, First Bank would only have to turn over $500 to the trustee.
tually required to automatically make premium loans out of property otherwise within the estate to prevent a policy from lapsing are protected by subsection (d), and under subsection (e), attorneys, accountants, or other persons possessing recorded information (books, documents, and records) relating to the financial affairs of the debtor which is not estate property may be required to turn the information over to the court. The purpose of the subsection (which had no counterpart under the 1898 Act) is to deprive “accountants and attorneys of the leverage they have today, under state law lien provisions, to receive payment in full ahead of other creditors when the information they hold is necessary to the administration of the estate.”

Administrative Powers of the Trustee

The administrative powers needed by a trustee to liquidate an estate in a chapter 7 case or to effectively operate a corporation or business in a chapter 11 or 13 case are granted by sections 361-366 of the Code. The section 362 automatic stay, discussed previously, guarantees that the trustee will be able to collect and administer the estate in an orderly fashion free from annoying and disruptive creditor collection activity. Section 363 gives the trustee broad powers of alienation over estate property, so as to maximize benefit to the estate while at the same time assuring protection to third parties having interests in such property. The specific protection to which third party interests are entitled is described in section 361. The trustee is given powers to enhance his ability to obtain credit while operating or supervising the operation of a debtor's business by section 364, and section 366 lessens the ability of a utility company to frustrate rehabilitation or reorganization by cutting off service. Finally, section 365 continues the trustee's power under the 1898 Act to reject, assume, or assign executory contracts and leases.

96. Id. § 542(d). The loan value of a life insurance policy is property of the estate under § 541(a)(1). To the extent a life insurance company, pursuant to its contractual obligation, automatically applies part of the policy loan value toward payment of a premium, it is reserving to itself estate property that § 542(a) would otherwise require to be paid over to the trustee. Section 542(d) permits such payment since the result ultimately benefits the estate by preserving estate property that would otherwise have been forfeited.

97. COMM. ON THE JUDICIARY, supra note 18, at 369-70.


99. See text at pp. 15-18, supra.

100. Bankruptcy Act of 1898, § 70b.
1. Use, Sale, or Lease of Property

   a. Procedure For Use, Sale, or Lease

      Under section 363(b), the trustee has the unqualified power, after notice and an opportunity for a hearing, to sell, use, or lease estate property other than in the ordinary course of business. So long as no objection to the proposed action is made, normal estate liquidation may be had without court approval.\(^{101}\) If the business of a debtor is authorized to be operated under sections 721, 1108, or 1304, subsection (c) of section 363 authorizes the trustee to sell, use, or lease estate property, other than cash collateral, in the ordinary course of business without notice or opportunity for a hearing. Cash collateral is defined by subsection (a) of section 363 to mean "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents in which the estate and an entity other than the estate have an interest." The trustee may not use, sell, or lease cash collateral unless each party having an interest in the collateral consents or the court approves of the disposition.\(^{102}\) All cash collateral acquired by the trustee and not disposed of must be strictly accounted for and segregated to protect the secured party against loss of security through alienation or commingling.\(^{103}\) Subsection (d) of section 363 expressly conditions the trustee's power of use, sale, or lease of estate property upon the continued life and applicability of the automatic stay as against a creditor seeking to satisfy a claim out of estate property. Should a secured creditor obtain relief from section 362 and be permitted by the court to repossess collateral in the possession of the trustee, the trustee's power of alienation over the collateral under section 363 ceases.\(^{104}\)

   b. Sale of Encumbered Property

      As a general matter, a trustee may sell property free and clear of any third party interest (except that of a joint tenant, tenant in common, or tenant by the entirety) only if one of the following conditions is met:

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102. Id. § 363(c)(2).
103. Id. § 363(c)(4).
104. Relief from the automatic stay is governed by subsections (c), (d), (e), and (f) of § 362 and is discussed at page 17 of the text, infra.
(1) nonbankruptcy law permits the sale free of such interest;
(2) the holder of the interest consents;
(3) the interest is a lien and the sale price of the property is greater than the lien;
(4) there is a bona fide dispute over the validity of the interest; or
(5) the party could legally be compelled to accept money in lieu of its interest.\(^\text{105}\)

Regardless of the existence of one of the above conditions, the trustee is authorized to sell property free of dower or curtesy rights of a spouse.\(^\text{106}\)

c. Sale of Co-owned Property

Subsections (h), (i), and (j) of section 363 provide special rules that apply to sales of property which the debtor co-owns with some other party as a joint tenant, tenant in common, tenant by the entirety, or as community property. Community property may be sold free of a spouse's interest only in accordance with section 363(f), above. Any of the other types of co-owned property may be sold free of the co-owner's interest only if all the following conditions exist:

(1) partition is impracticable;
(2) sale of the estate's undivided interest would produce significantly less for the estate than would sale of the property free of the co-owner's interest;
(3) the benefit to the estate of sale free of the co-owner's interest outweighs any detriment to the co-owner caused by such sale; and
(4) the property is not used for commercial production, distribution, or transmission of electricity or gas.\(^\text{107}\)

Before the sale of any of the above property to a prospective buyer, the co-owner or spouse, as the case may be, is accorded the right of first refusal to purchase the property at the agreed upon price.\(^\text{108}\) After the sale, the trustee must pay to the co-owner or

\(^{105}\) Bankruptcy Code of 1978, § 363(f).
\(^{106}\) Id. § 363(g).
\(^{107}\) Id. § 363(h).
\(^{108}\) Id. § 363(i).
spouse his or her allocable share of the proceeds. 109

2. Forfeiture Clauses

It is not uncommon for a security agreement, lease agreement, or other contract conveying an interest in property to restrict transferability or to provide for automatic termination of an interest upon the insolvency or bankruptcy of a debtor. Section 541(c) of the Code provides that the debtor's interest in such property becomes part of the estate notwithstanding such contractual limitation. Section 363(l), however, renders ineffective against the trustee who wishes to transfer estate property only those contract clauses or substantive laws that automatically terminate a debtor's interest in property in the event of bankruptcy, insolvency, or financial condition. 110 Contractual or statutory restrictions on transfer of property remain effective as against the trustee and may render estate property of no value to the estate.

3. Adequate Protection

Critical to any secured creditor or other party asserting an interest in estate property that the trustee proposes to use, sell, or lease, is some assurance that the party's interest will not be impaired through depreciation of the property. Protection of third party interests is also important during the course of the section 362 automatic stay. Finally, section 364 provides the trustee with the power to subordinate third party interests in return for an extension of credit. All the above actions would be inequitable unless compensatory protection were provided the party whose interest in property is threatened. To protect 1) the third party interest in property to be used, sold, or leased by the trustee under section 363, 2) the third party who is stayed from collecting his claim from property of the estate under section 362, and 3) the third party whose interest is subordinated by the trustee in order to obtain credit to operate the debtor's business, the Code accords such parties the right to demand and receive adequate protection of their interests.111

109. Id. § 363(j).
110. Id. § 361(l).
111. Id. §§ 362(d), 363(e), and 364(d)(1). Under § 363(e), property subject to a third party interest may not be used, leased, or sold over the objection of the party unless adequate protection is provided. A creditor's interest may be subordinated under § 364(d)(1)
Section 361 describes three ways in which a secured party's or co-owner's interest may be adequately protected when placed in jeopardy under sections 362, 363, or 364. First, adequate protection may be provided by requiring the trustee to make periodic cash payments to the party to the extent of the decrease in value of the party's interest in the property. The second method of providing adequate protection is to provide the secured party or co-owner with an additional or compensatory lien in other property to the extent of the decrease in value of the party's interest. Finally, relief from the § 362 automatic stay must be granted unless there is adequate protection of a stayed party's interest in estate property. The House Judiciary Committee comments indicate that the concept of "adequate protection" is designed to provide flexibility for the trustee in dealing with the estate while at the same time assure the secured creditor of the value of his bargain:

Secured creditors should not be deprived of the benefit of their bargain. There may be situations in bankruptcy where giving a secured creditor an absolute right to his bargain may be impossible or seriously detrimental to the bankruptcy laws. Thus, this section recognizes the availability of alternate means of protecting a secured creditor's interest. Though the creditor might not receive his bargain in kind, the purpose of the section is to insure that the secured creditor receives in value essentially what he bargained for.

The section specifies four means of providing adequate protection. They are neither exclusive nor exhaustive. They all rely, however, on the value of the protected entity's interest in the property involved. The section does not specify how value is to be determined, nor does it specify when it is to be determined. These matters are left to case-by-case interpretation and development. It is expected that the courts will apply the concept in light of facts of each case and general equitable principles. It is not intended that the courts will develop a hard and fast rule that will apply in every case. The time and method of valuation is not specified precisely, in order to avoid that result. There are an infinite number of variations possible in dealings between debtors and creditors, the law is continually developing, and new ideas are continually being implemented in this field. The flexibility is important to permit the courts to adapt to varying circumstances and changing modes of financing.

Neither is it expected that the courts will construe the term value to mean, in every case, forced sale liquidation value or full going concern value. There is wide latitude between those two extremes. In any particular case, especially a reorganization case, the determination of which entity should be entitled to the difference between the going concern value and the liquidation value must be based on equitable considerations based on the facts of the case. It will frequently be based on negotiation between the parties. Only if they cannot agree will the court become involved.

Bankruptcy Code of 1978, § 361(2).
The final form of adequate protection, phrased rather open-endedly, provides the trustee and court with discretion to formulate other types of protection (other than granting the claim priority as an administrative expense) that will assure the party of realizing the "indubitable equivalent" of its interest in estate property.\textsuperscript{118}

4. Securing Credit

In cases where the trustee is authorized under section 721 to wind up a business during liquidation or to operate the debtor's business during rehabilitation under sections 1108 or 1304, it will generally be critical that the trustee be able to obtain loans and credit. Inability to do so will likely result in inefficient liquidation or frustrate effective rehabilitation. To increase the chances of securing such credit on behalf of an entity that by definition is a poor credit risk, section 364 of the Code grants the trustee the

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\textsuperscript{115} Id. § 361(3). H.R. 8200 originally proposed that, in addition to providing the secured party with periodic cash payments or a compensatory lien, adequate protection could be afforded by granting the secured party an administrative expense claim or by "granting such other relief as will result in the realization by such entity of the value of such entity's interest in such property." H.R. 8200, 95th Cong., 1st Sess., § 361 (1977). As finally enacted, authorization to grant the secured party an administrative expense claim was deleted and the final section was reworded to define value in terms of the "indubitable equivalent" of a secured party's interest in estate property. Representative Don Edwards explained the reasons for the change as follows:

Section 361 of the House amendment represents a compromise between H.R. 8200 as passed by the House and the Senate amendment regarding the issue of "adequate protection" of a secured party. The House amendment deletes the provision found in section 361(3) of H.R. 8200 as passed by the House. It would have permitted adequate protection to be provided by giving the secured party an administrative expense regarding any decrease in the value of such party's collateral. In every case there is the uncertainty that the estate will have sufficient property to pay administrative expenses in full.

Section 361(4) of H.R. 8200 as passed by the House is modified in section 361(3) of the House amendment to indicate that the court may grant other forms of adequate protection, other than an administrative expense, which will result in the realization by the secured creditor of the indubitable equivalent of the creditor's interest in property. In the special instance where there is a reserve fund maintained under the security agreement, such as in the typical bondholder case, indubitable equivalent means that the bondholders would be entitled to be protected as to the reserve fund, in addition to the regular payments needed to service the debt. Adequate protection of an interest of an entity in property is intended to protect a creditor's allowed secured claim. To the extent the protection proves to be inadequate after the fact, the creditor is entitled to a first priority administrative expense under section 507(b).

\textsuperscript{124} CONG. ROLL. H11092 (Sept. 28, 1978) (statement of Representative Edwards).
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power to provide incentives to a prospective lender. Section 364(a) permits the trustee, unless the court rules otherwise, to incur unsecured debt in the ordinary course of the business he is operating by according such creditor's claim the status of a section 503(b)(1) administrative expense, entitled to first priority of payment under section 507(a)(1). The trustee may likewise obtain unsecured credit not in the ordinary course of business (if needed for liquidation or winding up a business, or an unusually large loan in a rehabilitation case) as an administrative expense, but only after notice to interested parties and an opportunity for a hearing.

Subsection (c) of section 364 authorizes other means of encouraging loans which may only be used if the trustee is unable to obtain a loan as an administrative expense and which the court must approve after notice and opportunity for a hearing. These alternatives are 1) granting the loan priority over administrative expenses, 2) giving the lender a lien or security interest in unencumbered estate property, or 3) securing the loan as a junior lien or security interest in encumbered estate property. If credit still cannot be obtained by any of the above methods, the trustee may secure the loan with a first lien on encumbered estate property provided the subordinated lienholder is given adequate protection as defined by section 361 and the court authorizes the action after notice and opportunity to be heard.

5. Executory Contracts and Unexpired Leases

As was the case under the 1898 Bankruptcy Act, section 365 of the Code authorizes the trustee, subject to court approval and with certain exceptions and limitations, to assume, assign, or reject executory contracts and unexpired leases. The Code does not define an executory contract, but the House Judiciary Committee Report indicates that a contract is executory if some performance remains due by both parties. If one party has completed

117. The court's authority to appoint a trustee to operate a debtor's business is found in § 721 (liquidation), § 1108 (business reorganization), and § 1304 (individual rehabilitation) of the Code.
119. Id. § 364(d).
120. Bankruptcy Act of 1898, § 70c.
122. COMM. ON THE JUDICIARY, supra note 18, at 347.
performance, the contract is not executory. Section 365 applies to all proceedings under the Bankruptcy Code except to the extent that sections 765 and 766 provide for different rules in commodity stockbroker liquidations. Subsections (b), (c), and (d) of section 365 set out the principal limitations on the trustee's power of assumption or rejection.

Section 365(b)(1) protects the other party to an executory contract under which a debtor is in default. Before the trustee may assume or assign the contract (and thus enforce performance), he must cure the default (or provide assurance of a prompt cure), provide adequate assurance of future performance, and compensate (or provide assurance of prompt compensation) any party who has suffered pecuniary loss caused by such default.\(^{123}\) Section 365(b)(2) relieves the trustee from the above requirements if default arose out of a contractual provision defining breach as the debtor's insolvency or financial condition, the initiation by or against the debtor of a bankruptcy proceeding, or the appointment of a trustee or custodian to take possession of the debtor's property. In other words, a trustee need not cure a breach of a so-called ipso facto bankruptcy clause as a condition of assuming or assigning the contract. Subsection (3) of section 365(b) provides specific assurances that must be given a landlord before the trustee will be permitted to assume a shopping center lease.\(^{124}\)

Unless the other party to the contract consents to the assumption or assignment, the trustee may assume or assign performance of an executory contract only where applicable nonbankruptcy law would require the other party to accept such performance.\(^{125}\)

\(^{123}\) While § 365(b)(1) imposes these duties upon the trustee only as conditions precedent to assumption, that they must also be complied with prior to an assignment is made clear by § 365(f)(2) which requires that a contract or lease be assumed by the trustee before it may be assigned.

\(^{124}\) Section 365(b)(3) provides:

(3) For the purposes of paragraph (1) of this section, adequate assurance of future performance of a lease of real property in a shopping center includes adequate assurance—

(A) of the source of rent and other consideration due under such lease;

(B) that any percentage rent due under such lease will not decline substantially;

(C) that assumption or assignment of such lease will not breach substantially any provision, such as a radius, location, use, or master agreement relating to such shopping center; and

(D) that assumption or assignment of such lease will not disrupt substantially any tenant mix or balance in such shopping center.

\(^{125}\) Bankruptcy Code of 1978, § 365(c)(1).
thermore, the trustee is specifically precluded from assigning or assuming a contract committing a lender to make a loan or extend credit to or for the benefit of the debtor. 126 Certain other restrictions are placed on assignments of executory contracts and unexpired leases by section 365(f). Notwithstanding any applicable law or clause in a contract or lease restricting, conditioning, or prohibiting assignment of the contract or lease, the trustee may make such assignment but only if he first assumes the contract or lease and provides adequate assurance of performance by the assignee. 127 Any law or contractual provision that provides for automatic termination or modification of a contract in the event of assignment is ineffective against the trustee. 128

Section 365(e)(1) substantially limits the enforceability against the trustee of ipso facto bankruptcy clauses in contracts the trustee wishes to assign—a change over prior law. 129 No executory contract or unexpired lease may be terminated or modified after the commencement of a case solely by reason of an applicable law or contractual provision according such rights in the event of insolvency or financial condition of the debtor, the commencement of a bankruptcy proceeding by or against the debtor, or the appointment of a receiver or custodian to take possession of the debtor's property. However, subsection (2) of section 365(e) relieves the other party from accepting the assignment or assumption if applicable law excuses the party from accepting performance from, or rendering performance to, any party other than the debtor. Subsection (e)(2) also relieves a lender from accepting an assignment or assumption of its commitment to loan money or extend credit to the debtor.

Section 365(d) provides time limits within which a trustee must decide whether to assume or reject an executory contract or unexpired lease. In a liquidation case, unless the court for cause

126. Id. § 365(c)(2).
127. Id. § 365(f)(2).
128. Id. § 365(f)(3).
129. Id. § 365(e)(1).
130. Bankruptcy Act of 1898, § 70b. expressly sanctioned such claims:
A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same is enforceable.
grants an extension, a contract or lease not assumed within sixty days of the order for relief is deemed rejected.\textsuperscript{131} In a rehabilitation case under chapter 9, 11, or 13 the trustee may make his election any time before confirmation of the plan; however, in order to provide relief to parties in doubt as to their status under contracts with the debtor, section 365(d)(2) allows such parties to request the court to order an earlier time within which the trustee must make an election.

Sections 365(h) and 365(i) provide special protection to lessees of real property from a debtor-lessee,\textsuperscript{132} and executory contract purchasers of real property from a debtor-seller.\textsuperscript{133} Subsection (h)(1) permits the lessee under a rejected lease to remain in possession for the term of the lease and any enforceable extension provided thereunder. If the lessor elects to remain in possession, he may offset against rent any post-rejection damages suffered as the result of the debtor's post-rejection nonperformance of any lease obligation, but may not recover additional damages from the estate should damages exceed rent.\textsuperscript{134} Subsection (i) grants a purchaser of real estate from the debtor under an executory contract that the trustee has rejected the right to refuse the rejection provided he has taken possession at the time of rejection. In such case, the trustee is relieved of all other contractual obligations other than delivery of title.\textsuperscript{135} The exclusive remedy of the buyer for post-rejection damages is by way of offset against payments due under the contract.\textsuperscript{136} If the purchaser is not in possession, or elects to accept the rejection, he is accorded a lien against the debtor's interest in the property for the amount of the purchase price already paid.\textsuperscript{137}

As under prior law, rejection of an executory contract or unexpired lease constitutes a breach of the contract under section 365(g) and gives rise to a general unsecured claim against the estate.\textsuperscript{138} A breach after an assumption by the trustee would give rise to an administrative expense claim;\textsuperscript{139} the estate is not liable for
any breach occurring after an assignment.\textsuperscript{140} While the time of breach will generally be immediately before the filing of the petition, section 365(g)(2) specifies different times in cases converted from one chapter to another.

6. Utility Service

A business debtor against whom a petition is filed, or a trustee (or debtor in possession) charged with running the debtor's business is particularly dependent upon suppliers of utilities who typically hold a monopoly and who consequently possess considerable leverage to force payment of past due bills. The cutting off of utilities is likely to either result in inefficient liquidation or an aborted rehabilitation. Section 366, having no counterpart under prior law, attempts to cut away some of this leverage by restricting the right to cut off service because of unpaid pre-petition debts.\textsuperscript{141} Section 366(a) broadly prohibits utilities from altering, refusing, or discontinuing service to, or discriminating against, the debtor or trustee solely because bills for prebankruptcy service were not timely paid. The prohibition is conditional under subsection (b) upon the trustee providing, within twenty days of the order for relief, adequate assurance that post-bankruptcy bills will be paid. The Code specifically permits assurance in the form of a security deposit;\textsuperscript{142} the House Judiciary Committee comments include allowance of the claim as an administrative expense as an alternative form of security.\textsuperscript{143}

\textit{Trustee's Avoidance Powers}

At the heart of bankruptcy law is the policy of assuring fair and equitable distribution of the debtor's estate among creditors. While for the most part, rights of the debtor and creditors are fixed as of the day the petition is filed, principles of fairness and equity demand that a trustee have ample power to upset actions of the debtor or creditors that occurred before the filing of the petition and which, if left undisturbed, would have the effect of un-

\textsuperscript{140.} Bankruptcy Code of 1978, § 365(k). The other party to the contract is protected by § 365(f)(2)(B) which requires the trustee to provide adequate assurance of future performance by the assignee as a condition precedent to assignment.

\textsuperscript{141.} Bankruptcy Code of 1978, § 366.

\textsuperscript{142.} Id. § 366(b).

\textsuperscript{143.} Comm. on the Judiciary, supra note 18, at 350.
fairly depleting the estate to the advantage of some creditors and the disadvantage of others. To this end, the Bankruptcy Code carries over largely intact the trustee’s avoidance powers under the 1898 Act to recover the debtor’s fraudulent and preferential transfers (including acquisition of judicial liens), and defeat the secured status of certain creditors who are unperfected on the day of bankruptcy or who acquire their interests in certain ways within prescribed periods of time before bankruptcy. The most substantial change over old law is the revision in the law of preference which simplifies the trustee’s burden of proof and specifically removes from the definition of a preference certain transactions which are not intended as credit transactions.

1. Hypothetical Lien Creditor Status

Perhaps the most powerful weapon possessed by the trustee under the 1898 Act was his section 70c. status, on the day the petition was filed, of a lien creditor against all the debtor’s property.\(^{144}\) This power, used principally to defeat secured parties whose interests remained unperfected or otherwise vulnerable to a lien creditor on the day of bankruptcy,\(^{145}\) is continued under section 544(a) of the Code.\(^{146}\) The trustee is accorded, on the day of bankruptcy, all the rights and powers of 1) a creditor who obtains a judicial lien (e.g., judgment lien, execution lien, garnishment lien)\(^ {147}\) on all the debtor’s property, 2) a creditor who has a writ of execution returned unsatisfied as against the debtor or 3) a bona fide purchaser of the debtor’s real property. This last power is new under the Code and allows the trustee to prevail over secured creditors whose vulnerability under state law is measured against intervening bona fide purchasers rather than lien creditors (e.g., unrecorded statu-

\(^{144}\) Bankruptcy Act of 1898, § 70c. provided in relevant part:
The trustee shall have as of the date of bankruptcy the rights and powers of:
(1) a creditor who obtained a judgment against the bankrupt upon the date of bankruptcy, whether or not such a creditor exists, (2) a creditor who upon the date of bankruptcy obtained a writ of execution returned unsatisfied against the bankrupt, whether or not such a creditor exists, and (3) a creditor who upon the date of bankruptcy obtained a lien by legal or equitable proceedings upon all property, whether or not coming into possession or control of the court, upon which a creditor of the bankrupt upon a simple contract could have obtained such a lien, whether or not such a creditor exists.


\(^{146}\) Bankruptcy Code of 1978, § 544(a).

\(^{147}\) The Code defines “judicial lien” to mean a “lien obtained by judgment, levy, sequestration, or other legal or equitable process or proceeding.” Id. § 101(27).
2. Transfers Voidable Under Nonbankruptcy Law

Under section 544(b) of the Code, as under section 70c. of the 1898 Act, the trustee is subrogated to the avoidance rights of any existing unsecured creditor with an allowable claim as to whom a transfer by the debtor of any interest in the debtor's property is voidable. Thus, the trustee may use any federal or state law rendering transfers voidable as to a creditor to bring property back into the estate. The trustee's avoidance power under section 544(b), however, is greater than that of the creditor from whom it is acquired. Since the trustee is viewed as representing the claims of all general creditors, the measure of the avoidance would be the amount of those claims. Thus, the Moore v. Bay doctrine is followed and the trustee may still defeat in toto a transfer of $100,000 to a creditor as to whom it is voidable only as against one unsecured creditor with a relatively small claim. While the applications of section 544(b) are many and varied, limited only by the number of state and federal laws creating creditor avoidance powers, a principal importance is to continue to bring state fraudulent conveyance law within the compass of the Bankruptcy Code.

3. Avoidance of Statutory Liens

Section 545 of the Code makes four types of statutory liens (defined by section 101(38) to exclude judicial liens, e.g., liens of judgments, executions, or garnishments, etc.) against property of the debtor voidable by the trustee:

1. Any statutory lien which arises when a bankruptcy peti-
tion is filed, when other insolvency proceedings are commenced against the debtor, when an assignee for benefit of creditors, receiver, or other custodian takes possession of the debtor's property, when the debtor becomes insolvent or his financial condition fails to meet a certain standard, or when certain third party executions are levied against the debtor.

(2) Any lien not enforceable on the day of bankruptcy as against a bona fide purchaser of the property.

(3) Any statutory lien for rent.

(4) Any statutory lien of distress for rent.\textsuperscript{153}

Judicial liens, formerly void per se under section 67a.(1) of the 1898 Act if acquired within four months of bankruptcy while the debtor was insolvent, will have to be dealt with as preferences under section 547 of the new Code.

4. Fraudulent Transfers

Section 548 of the Bankruptcy Code continues the trustee's power to set aside fraudulent transfers of the debtor.\textsuperscript{154} Under section 548(a), the trustee may avoid any transfer of the debtor's property or obligation incurred by the debtor if made or incurred within one year of bankruptcy with actual intent to hinder, delay, or defraud creditors. This represents no change over old law.\textsuperscript{155} Additionally, the trustee may set aside certain constructively fraudulent transfers made within one year of bankruptcy. If the debtor "received less than a reasonably equivalent value in exchange"\textsuperscript{156} for a transfer, the trustee may set it aside if one of the following three conditions exists:

(1) The debtor was insolvent when the transfer was made or obligation incurred, or become insolvent as the result of the transfer or obligation.\textsuperscript{157} Insolvency is defined by section 101(26) as a financial condition such that the sum of the debtor's property, excluding exempt property and property conveyed with actual intent to delay, hinder, or defraud creditors, valued at fair valuation (as opposed to the liquidation valuation required under old section 67d.(1)) would be insufficient.

\textsuperscript{153} Id. § 545.
\textsuperscript{154} Id. § 548.
\textsuperscript{155} Bankruptcy Act of 1898, § 67d.(2)(d).
\textsuperscript{157} Id. § 548(a)(2)(B)(i).
to pay existing debts.
(2) Regardless of the debtor's solvency, the debtor was engaged or about to engage in a business or a transaction for which the amount of property remaining after the transfer was an unreasonably small capital.\(^{158}\)

(3) Regardless of the debtor's solvency, the debtor believed he would incur or intended to incur debts that would be beyond his ability to pay as they matured.\(^{159}\)

Aside from the new definition of insolvency noted above, section 548 embodies two other substantial changes over old law. First, the requirement of section 67d.(1)(e) that constructively fraudulent transfers not have been made in good faith is deleted. Second, section 548 deletes the old section 67d.(3) type of fraudulent transfer. Transfers made in contemplation of bankruptcy or liquidation for the purpose of obtaining funds with which to make a preferential transfer will no longer be fraudulent provided they are made while solvent for reasonably equivalent value.

The time a transfer is made, for purposes of beginning the one-year statute of limitations, is measured under section 548(d) from the day that the transferor-debtor could no longer convey to a bona fide purchaser as to defeat or subordinate the interest of the transferee. This is important in cases where a filing is required to protect the transferee's interest against third parties (e.g., real estate conveyances, mortgages, security interests). In such cases, delayed perfection occurring within one year of bankruptcy may bring within the trustee's avoidance powers transfers nominally outside of the one-year period.\(^{160}\) If the applicable steps for perfection have not been taken on the day of bankruptcy, the transfer is deemed made immediately prior to the filing of the petition.\(^{161}\)

Section 548(c) protects the good faith purchaser for value who loses property to the trustee under section 548(a). Unless the transfer is also voidable for some reason other than its being fraudulent, the transferee is entitled to a return of his consideration and

\(^{158}\) Id. § 548(a)(2)(B)(ii).

\(^{159}\) Id. § 548(a)(2)(B)(iii).

\(^{160}\) For example, assume that fourteen months before bankruptcy a debtor, with intent to defraud creditors, executed a real estate deed to a third party. The third party recorded the deed three months later. While the actual transfer occurred more than a year before bankruptcy, the delayed recording within 1 year before bankruptcy rendered the transfer vulnerable under § 548.

\(^{161}\) Bankruptcy Code of 1978, § 548(d)(1).
is accorded a lien on the property transferred to enforce repayment.

**Preferential Transfers**

The most substantial change in trustee avoidance powers brought about by the Bankruptcy Code involves the law of preferential transfers. While preferences were valid at common law, bankruptcy law has long recognized that the policy of fair and equitable distribution or management of an insolvent estate would be frustrated if a debtor were allowed to benefit certain creditors over others in anticipation of bankruptcy, or if creditors with inside knowledge of financial difficulty or who occupy positions of undue leverage could use this knowledge or position to squeeze advantage out of a debtor over and above that to which they would be entitled in a bankruptcy liquidation or rehabilitation. To this end, the 1898 Act sought to undo (and thus discourage) the effects of the creditors' scramble for advantage by making certain transfers for preexisting debt, made while the debtor was insolvent and while the creditor had knowledge of insolvency, conclusively unfair and thus avoidable.¹⁶² The new Bankruptcy Code continues this policy, but with substantial modification designed to simplify the trustee's burden, more closely conform to the Uniform Commercial Code, and specifically remove from the definition of a preference certain transfers which, though technically for antecedent debt, are really intended by the parties to be contemporaneous with the creation of debt.¹⁶³

Section 547(b) of the Code defines a preference as any transfer of property of the debtor—

(1) to or for the benefit of a creditor;
(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;
(3) made while the debtor was insolvent;
(4) made—
   (A) on or within 90 days before the date of the filing of the petition; or
   (B) between 90 days and one year before the date of the filing of the petition, if such creditor, at the time of such

¹⁶² Bankruptcy Act of 1898, § 60.
¹⁶³ Bankruptcy Code of 1978, § 547; Comm. on the Judiciary, supra note 18 at 372-75.
transfer—

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under Chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.  

Additionally, subsection (f) of section 547 gives the trustee the benefit of a presumption that the debtor was insolvent during the ninety days before the filing of the bankruptcy petition. The effect of the presumption under Rule 301 of the Federal Rules of Evidence is to place on the transferee the burden of going forward with sufficient evidence of solvency to withstand a motion for a directed verdict. Once this is done, the trustee must still carry the ultimate burden of persuasion.

The above definition of a preferential transfer represents a change over old section 60a.(1) in several respects. First, the period of time before bankruptcy during which transfers for antecedent debts will be vulnerable to later attack as preferences has been shortened from four months to 90 days. On the other hand, transfers to insiders of the debtor (certain persons specified in section 101(25) who have a particularly close business or personal relationship to the debtor) remain vulnerable for one year. Second, to set aside most preferences, the trustee will no longer have to prove the irrelevant, often unprovable, but usually existing fact that the transferee had reasonable cause to know of the debtor’s insolvency at the time the transfer was made. The trustee will, however, be required to prove such reasonable cause with respect to insider transfers made within 90-365 days of bankruptcy. The third major definitional change involves the way in which transfer benefit to the creditor is measured. Under prior law, the test was whether or not the effect of the transfer was to give the transferee a greater percentage of his debt than other members of the same class. This definition contained at least two loopholes. An otherwise pref-

165. Fed. R. Evid. 301; Comm. on the Judiciary, supra note 18 at 375.
166. Bankruptcy Act of 1898, § 60a.(1).
erential pro rata transfer to all creditors within a particular section 64 priority class would not be preferential even though the effect of the transfer was to deplete the estate so that assets became insufficient to fully pay higher priority classes. 167 Second, payment to a creditor whose claim would not have been allowed in bankruptcy was preferential only to the extent it exceeded the percentage of allowed claims paid other creditors of the same class in bankruptcy. 168 The new Code replaces the comparative benefit test with one that focuses simply upon whether the transfer had the effect of improving the transferee's position over and above what a chapter 7 liquidation would have produced had the transfer not been made.

Several of the general bankruptcy definitions found in section 101 of the Code are important to a thorough understanding of the law of preferences. "Transfer" is defined in section 101(40) as broadly as possible to include virtually every voluntary or involuntary disposition of an interest in property—including retention of title as a security interest. 169 Section 101(26) adopts a balance sheet definition of insolvency as a financial condition where the aggregate of the debtor’s property, less exempt property and property transferred with actual intent to hinder, delay or defraud creditors, is at fair valuation, insufficient to pay the debtor’s debts. 170 "Insider" is a term new to bankruptcy. Section 101(25) lists a number of classes of persons whose close relationship to the debtor, either by affinity, consanguinity, or business, suggests that

167. For example, assume that shortly before bankruptcy a sole proprietor used all his nonexempt assets to completely pay all past due taxes. Had the payment not been made, sufficient assets would have fallen into the estate to fully pay administrative expenses and employee wage claims. The payment of the tax claims would not have been preferential since all members of the preferred class received 100% of their claims.

168. The payment would not have been considered preferential even though the effect was to take property out of the estate that would otherwise have been available to creditors because whether or not the preferred creditor's claim would have been allowed in bankruptcy was irrelevant. So long as he received no greater percentage of his claim than those in the same class, it mattered not that bankruptcy would have netted him nothing.

169. The code defines “transfer” as “every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest.” Bankruptcy Code of 1978, § 101(40).

170. Id. § 101(26)(A). The definition of insolvency in § 101(26)(A) applies to all entities other than partnerships. For partnerships, the definition is modified by § 101(26)(B) “to account for the liability of a general partner for the partnership’s debts.” COMM. ON THE JUDICIARY, supra note 18, at 312.
their transactions with the debtor be subjected to close scrutiny.\textsuperscript{171}

Subsection (c) of section 547 specifically exempts from the section 547 avoidance power certain transactions, technically within the definition of a preference, but which practically are not transfers for antecedent consideration, which in no way frustrate equitable distribution among creditors, and which in no way will encourage creditors to preditorily dismember a debtor prior to bankruptcy. The first type of transfer excepted from the trustee's section 547 avoidance power is one that is intended to be and in fact is a contemporaneous exchange for new value.\textsuperscript{172} A cash sale wherein payment is delayed for a short period of time falls within the exception. Likewise, an intended credit transaction where there is a slight delay in preparation of the security document would be protected.

The second exception is for payment of debts within forty-five days of creation in the ordinary course of the business or financial affairs of the debtor and transferee.\textsuperscript{173} Where goods or services are

\textsuperscript{171} Bankruptcy Code of 1978, § 101(25): "insider" includes—

(A) if the debtor is an individual—

(i) relative of the debtor or of a general partner of the debtor;
(ii) partnership in which the debtor is a general partner;
(iii) general partner of the debtor; or 
(iv) corporation of which the debtor is a director, officer, or person in control;

(B) if the debtor is a corporation—

(i) director of the debtor;
(ii) officer of the debtor;
(iii) person in control of the debtor;
(iv) partnership in which the debtor is a general partner;
(v) general partner of the debtor; or
(vi) relative of a general partner, director, officer, or person in control of the debtor;

(C) if the debtor is a partnership—

(i) general partner in the debtor;
(ii) relative of a general partner in, general partner of, or person in control of the debtor;
(iii) partnership in which the debtor is a general partner;
(iv) general partner of the debtor; or
(v) person in control of the debtor;

(D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor;

(E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and

(F) managing agent of the debtor.

\textsuperscript{172} Bankruptcy Code of 1978, § 547(c)(1).

\textsuperscript{173} Id. § 547(c)(2). Both the incurring and payment of the debt must be in the ordinary course of business or financial affairs of both the debtor and transferee.
charged on an ordinary charge account, payment at the end of the applicable billing period is technically a transfer for an antecedent debt. Such ordinary-course-of-business payments, either by a consumer or business debtor, are insulated from avoidance by the trustee. The House Judiciary Committee comments indicate that protection is also extended to taxing entities who receive payment of taxes within forty-five days after the tax is last due without penalty.\footnote{Comm. on the Judiciary, supra note 18, at 373.}

Under section 9-312(4) of the Uniform Commercial Code, a purchase money secured party in collateral other than inventory is given a ten-day grace period after the date the debtor receives possession within which to file a financing statement and have the day of perfection relate back to the date the debtor received possession.\footnote{U.C.C. § 9-312(4) (1978 version).} In cases where the seller finances the sale, the general ten-day grace period provided by section 547(e) of the Bankruptcy Code within which perfection may be had and the day of deemed transfer (the day of perfection) relate back to the day the debt was created would insulate the delayed perfection from being a transfer for an antecedent debt.\footnote{The rules for determining when the Bankruptcy Code deems transfers to have been made are discussed at pp. 43-44 of the text, infra.} In the case of a lender who extends funds to enable the debtor to purchase property, however, the funds will generally be transferred (and the debt created) in advance of the debtor's taking possession. Since the general section 547(e) grace period would not protect the lender in the event the period of time between the extension of the loan and an appropriate Uniform Commercial Code filing exceeded ten days, such a transfer is excepted under section 547(c) provided perfection is had within ten days after the security interest attaches.\footnote{Bankruptcy Code of 1978, § 547(c)(3). Assume, for example, that Lender agreed to finance Debtor's purchase of equipment from Seller. On 1/10/79, Debtor and Lender execute a security agreement and Lender advances Debtor $500.00. Debtor, however, does not get around to purchasing the equipment from Seller until 1/20/79, and Lender files a financing statement on 1/25/79. Since the debt was created on 1/10 and the transfer occurred on 1/25, the transfer is for an antecedent debt. Furthermore, the transfer is not saved by the 10-day grace period of § 547(e)(2) which begins running on the day the transfer becomes effective between the parties—here, 1/10/79. Section 547(c)(3) protects the above enabling Lender by according a 10-day grace period for perfection measured from the time the security interest attached—1/20. Thus, Lender had until 1/20 to file a financing statement and not have such transfer be considered preferential.}

The fourth exception continues the so-called "net result rule"
of section 60c. of the 1898 Act. To the extent a creditor and debtor engage in a series of transactions during the ninety-day period before bankruptcy, the creditor who gives new unsecured value to the estate is entitled to offset such value against preferential payments received during the period. Section 547(c)(4) provides a formula whereby a series of mutual transactions are netted out so that only the net improvement of the creditor's position during the period will be considered preferential.178

Inventory or accounts receivable financing contemplates a mass of collateral, the component parts of which are constantly changing. As inventory is sold, collateral is freed from the security interest, but the interest attaches to proceeds when generated and to new items of inventory when acquired. Technically, attachment of the security interest to new items represents a transfer for an antecedent debt but does not violate any of the policy considerations concerning equity among creditors. A creditor receives no benefit or improvement in secured position unless there is a net gain in the value of the mass during the ninety days before bankruptcy. Section 547(c)(5), the fifth exception, adopts this improvement-in-position test and provides that a perfected security interest in inventory, accounts receivable, or the proceeds of either, will be preferential only to the extent that a creditor enjoys a net improvement in his secured position during the ninety-day period. Improvement is measured by the net reduction in the amount by which the debt exceeded the value of the security between the beginning of the ninety-day period (or a later date, if credit was first extended during the ninety-day period) and the day of bankruptcy.179 The final exception, section 547(c)(6), makes it clear that statutory liens which survive section 545 may not be defeated as preferences.180

178. Bankruptcy Code of 1978, § 547(c)(4). Assume that 90 days before bankruptcy Debtor owes Creditor $1,000 in unsecured debt. Fifty days before bankruptcy Debtor makes a $1,000 preferential transfer to Creditor. Thirty days before bankruptcy, Creditor makes a $1,000 unsecured loan to Debtor. Section 547(c)(4) permits Creditor to offset the $1,000 unsecured transfer of new value to the estate against the $1,000 preferential transfer received by the creditor. The "net result" of the two transfers was that the estate lost nothing and the creditor did not improve his position or gain any advantage. Section 547(c)(4) would not apply if the new value transferred were secured.

179. Id. § 547(c)(5). Cases such as DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1966) and Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co., 408 F.2d 209 (7th Cir. 1969) are overruled. Comm. on the Judiciary, supra note 18, at 374.

Subsection (e) of section 547 establishes rules for determining if the transfer was for an antecedent debt or within the requisite period of time before bankruptcy.\textsuperscript{181} With respect to real property interests, a transfer is deemed made when the transferee has taken all necessary steps to protect himself against a bona fide purchaser of the property from the debtor-transferor (e.g., rendition or filing of a judgment, filing of a lien, recording a mortgage or deed). With respect to transfers of fixtures and other personal property interests, a transfer is deemed made when the transferee has taken whatever action is necessary to protect himself against an intervening lien creditor of the debtor-transferor. If the transfer is of title to personalty, no further action is generally necessary and applicable law respecting passage of title will determine time of transfer. If the transfer is of a security interest or statutory lien, filing is generally required for protection against intervening lien creditors and the day of filing will generally be the day of transfer. Liens which offer protection without filing will usually represent transfers made at the time of attachment.\textsuperscript{182} Section 547(e)(2) cured the confusion inherent in section 60a.(7)(I) of the 1898 Act\textsuperscript{183} by granting a transferee a uniform ten-day grace period within which to take all applicable steps necessary for protection against intervening lien creditors or bona fide purchasers and have the day of deemed transfer relate back to the day of actual transfer of the property interest.\textsuperscript{184} As under prior law, if the steps required for protection have not been taken on the day of the bankruptcy petition, the transfer will be considered to have been made immediately prior to the filing of the petition.\textsuperscript{185}

\textsuperscript{181} Id. § 547(e).
\textsuperscript{182} See, e.g., U.C.C. § 9-303(1) and § 9-302(1) (1978 version).
\textsuperscript{183} Bankruptcy Act of 1898, § 60a.(7)(I) provided:

I. Where (A) the applicable law specifies a stated period of time of not more than twenty-one days after the transfer within which recording, delivery, or some other act is required, and compliance therewith is had within such stated period of time; or where (B) the applicable law specifies no such stated period of time or where such stated period of time is more than twenty-one days, and compliance therewith is had within twenty-one days after the transfer, the transfer shall be deemed to be made or suffered at the time of the transfer.

Confusion existed as to whether the 10-day grace period under § 9-312(4) shortened the above 21-day grace period.

\textsuperscript{184} Bankruptcy Code of 1978, § 547(e)(2).
\textsuperscript{185} Id. § 547(e)(2)(C).
Limitations of Trustee Avoidance Powers

Section 546 of the Code creates three important exceptions to the trustee's avoidance powers. A statute of limitations, measured by the earlier of the closing of the case or two years from the time a trustee is appointed, is imposed for bringing avoidance actions as a section 544(a) hypothetical lien creditor or section 544(b) subrogee to creditor avoidance powers, or to set aside statutory liens under section 545, fraudulent transfers under section 547, preferential transfers under section 548, and setoffs under section 553. Subsection (b) of section 546 validates as against the trustee generally applicable laws (such as section 9-301 or 9-312(4) of the Uniform Commercial Code) that allow grace periods within which perfection by a secured creditor may be made and intervening interests defeated. Thus, for example, a purchase money secured party whose interest attaches a few days before bankruptcy may perfect within any applicable grace period and avoid a trustee's intervening section 544(a) lien. The purpose of the limitation is to prevent a surprise bankruptcy petition from frustrating a creditor's good faith reliance on state law protection.

Finally, subsection (c) of section 546 is a response to the confusion and conflicting court decisions concerning the applicability in bankruptcy of a seller's common law or statutory reclamation right against a buyer who receives goods while insolvent. The trustee's avoidance powers under sections 544(a), 545, 547, and 549 are subject to such seller reclamation rights but only if the seller makes a written demand within ten days of the buyer's receipt.

The court may nonetheless deny the reclamation, but must award the seller compensatory protection in the form of a secured or administrative expense claim. The major impact of this provision is to validate against the trustee, with some limitation, section 2-702 of the Uniform Commercial Code.

Setoff

Bankruptcy law has long recognized a creditor's right to offset mutual debts between the debtor and the creditor on the theory that it would be unfair to permit the trustee to collect in full from

186. Id. § 546.
187. COMM. ON THE JUDICIARY, supra note 18, at 371.
188. Id. at 372.
the creditor, but to pay the creditor only a dividend. 189 Section 553 generally continues the right of setoff, but with certain exceptions to prevent creditors from acquiring claims for the purpose of reducing or eliminating the amount that would otherwise be owed to the estate. 189

Subject to obtaining relief from the section 362 automatic stay, section 553(a) recognizes the right of a creditor to offset mutual debts between the debtor and creditor that arose before the commencement of the case. Subsection (a) also creates three exceptions. A creditor may not offset 1) a claim that would be disallowed under section 502, 2) a claim that was acquired from someone other than the debtor either after the petition was filed or within ninety days before the petition while the debtor was insolvent, or 3) a debt that was incurred by the creditor to the debtor within ninety days before the petition, while the debtor was insolvent, and for the purpose of obtaining a right of setoff. 191

Section 533 also subjects setoff of certain prebankruptcy debts to close scrutiny as to prevent them from being disguised preferences. To the extent that a creditor's exercise of a right of setoff during the ninety-day period before bankruptcy improves his position vis-à-vis the estate (i.e., reduces his claim against the estate below what it would have been had the right of setoff been exercised more than ninety days before bankruptcy) the amount of the reduction in net claim against the estate is recoverable by the trustee from the creditor. 192 Since after bankruptcy the amount of setoff is not so limited, section 553(b) discourages creditors from precipitating bankruptcy by exercising pre-petition setoff rights.

**Automatic Preservation of Avoided Transfers**

Under prior law, the bankruptcy court was authorized to preserve avoided transfers if preservation would benefit the estate. 193

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189. Bankruptcy Act of 1898, § 68.
191. Since the practical effect of a setoff is payment in full of a part of the creditor's claim (in the sense that the creditor need not pay his debt in full, then be forced to accept only part payment of the debtor's debt), the last two exceptions are necessary to prevent the acquisition of claims for purposes of effecting a setoff which would amount to a preferential transfer.
193. Bankruptcy Act of 1898, § 60b. (preferential transfers, § 67a.(3) (avoided liens), § 67d.(6) (fraudulent transfers), and § 70a. (transfers voidable as to any creditor under state or federal law).
Section 551 changes prior law only to the extent that all avoided transfers are automatically preserved. One effect of section 551 will be to automatically give the estate the benefit of all avoided liens so as to prevent fortuitous elevation of junior lienholders where senior interests in the same property are set aside.

**Setting Aside Exempt Property**

Prior to enactment of the new Bankruptcy Code, property that was exempt from judicial process under state or nonbankruptcy federal law never became a part of the bankruptcy estate and was not subject to bankruptcy liquidation. Section 522 of the new Code creates, for the first time, a set of generous bankruptcy exemptions available to an individual debtor unless a particular state, by legislation, restricts debtors within the state to existing nonbankruptcy exemptions. Unless and until a state so legislates, a debtor may elect under section 522(b)(1) between applicable nonbankruptcy exemptions and those available under section 522. A debtor is prohibited from choosing exemptions from both sets. Section 522(m) provides that the exemptions section applies separately with respect to each debtor in a joint case. This means that joint debtors may cumulate exemptions under section 522 or nonbankruptcy law, or that one may elect section 522 exemptions and the other may choose those available under nonbankruptcy law.

Section 522 exempts the following property from the estate:

1. The debtor's interest, not to exceed $7,500, in real or personal property used as a dwelling by the debtor or his dependent.
2. Up to $1,200 of the debtor's interest in one motor vehicle.
3. The debtor's interest, limited to $200, in any single item in all household goods of the debtor or a dependent of the debtor.
4. The debtor's aggregate interest in up to $500 worth of jewelry held for personal use (as opposed to investment) of the debtor or a dependent.

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195. Bankruptcy Act of 1898, § 70a. The trustee acquired title only to the debtor's nonexempt property. Exempt property never became a part of the estate.
197. Id. § 522(d).
The debtor's aggregate interest not to exceed $400, plus the amount of any unused homestead exemption, in any property.

The debtor's aggregate interest in up to $750 in tools of the trade of the debtor or a dependent.

Any unmatured life insurance contract (except a credit life policy) owned by the debtor.

Up to $4,000 in accrued dividends, loan value, or interest of a life insurance policy under which the insured is either the debtor or a person as to whom the debtor is a dependent.

Professionally prescribed health aids of the debtor or a dependent.

The debtor's right to receive pension, social security, unemployment compensation, local public assistance, veteran's benefits, disability or illness benefits, and alimony, support, or maintenance to the extent necessary for support of the debtor and dependents.

The debtor's right to receive, or property traceable to, a crime victim's reparation award, wrongful death payments on account of the death of one upon whom the debtor was dependent to the extent reasonably necessary for support, proceeds of a life insurance policy on the life of one as to whom the debtor was dependent to the extent reasonably necessary for support, payments not to exceed $7,500 for personal bodily injury (excluding amounts for pain, suffering, or pecuniary loss), and payment in compensation for loss of future earnings of the debtor or one as to whom the debtor is dependent to the extent necessary for support.

Section 522(l) requires that a debtor wishing to claim exemptions file an inventory of property claimed as exempt. A dependent of the debtor may file the inventory on behalf of the debtor if the debtor neglects to do so. Creditors are then notified. Property claimed as exempt will be set aside to the debtor unless a creditor or the trustee objects. Property so exempted may not be subjected to general creditor claims except for alimony, support, maintenance, and taxes, but may be subjected to claims of secured creditors whose liens are not voided by the Code.\(^{198}\)

To fully protect a debtor's exemptions and assure a fresh

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198. *Id.* § 522(c).
start, section 522(e) provides that a waiver of exemptions executed in favor of an unsecured creditor is unenforceable. Additionally, a debtor may avoid any judicial lien on any exempt property and all nonpossessory, nonpurchase money security interests in most exempt consumer goods, all tools of the trade, and prescribed health aids to the extent that the value of an exemption would otherwise be impaired. This may be done notwithstanding a waiver of exemption executed in favor of such creditor. With the above qualifications regarding a debtor's right to avoid certain liens and security interests in exempt property, exemptions measured by "the debtor's interest" are available only to the extent that the debtor has equity in the property claimed as exempt.

Proof and Allowance of Claims

The Bankruptcy Code follows traditional classification of claims as either secured or general. Secured creditors whose secured status is invulnerable as against the trustee will be allowed either to remove their collateral from the estate or will receive payment of their claims for the full amount of the value of the security. After exempt property has been set aside to the debtor and fully-encumbered collateral abandoned to secured parties, the remaining estate is liquidated and proceeds paid to creditors with secured claims that have not yet been satisfied and to general creditors whose claims have been allowed. As under the 1898 Act, but with substantial changes, six classes of general claims are entitled to priority of payment. Claims within each priority class must be fully satisfied within applicable maximum amounts before payment is made to the next lower priority class, and all priority claims must be paid before dividends are paid on general claims not entitled to priority.

To assure participation in liquidation of the estate, a creditor is required by section 501 to file a proof of claim. A proof of claim under currently applicable rules lists the name of the creditor, the amount of money allegedly owed by the debtor, the con-

199. Id. § 522(e).
200. Id. § 522(f).
201. Id. § 507(a).
202. Id. §§ 507(a) and 726(a).
203. Id. § 501.
204. Official Rules of Bankruptcy Procedure 301 and 302; Official Bankruptcy Form 15.
sideration for the claim, whether or not the claim has been reduced to judgment, any setoff or counterclaim to which the claim is subject, a statement that all payments on the claim have been properly credited, and whether the claim is secured, general, or entitled to priority. If the claim is secured, the creditor must describe the property claimed or held as collateral and attach a copy of the security agreement. If the claim is founded upon a writing, a copy of the writing must be attached if available. Subsections (b) and (c) of section 501 provide that the trustee, debtor, or co-obligor on a claim may file a proof of claim if one is not timely filed by the creditor. While generally only pre-petition debts may be treated in bankruptcy, the Code recognizes exceptions for claims arising between the filing of an involuntary petition and subsequent order for relief which, for purposes of filing proofs of claims, are treated by subsection (d) as though they were pre-petition debts.

The term “claim” is defined broadly in section 101(4) to include any “right to payment,” whether or not reduced to judgment, liquidated or unliquidated, contingent or fixed, matured or unmatured, disputed or undisputed, secured or unsecured. The breadth of the term is designed to provide the bankruptcy court with power to deal with all legal obligations of the debtor no matter how remote or contingent they might be. For example, liability of the debtor under an unliquidated, contingent, and unfiled cause of action in tort could be decided by the bankruptcy court, the amount of damages liquidated and paid as a dividend, and a discharge granted.

Once a proof of claim is filed, section 502(a) provides that it automatically be allowed unless some interested party (generally the trustee, debtor, or a creditor) objects. Since the concept of provability has been abolished under the Code, section 502(b) contains the exclusive list of those types of debts which will not be
allowed over the objection of an interested party, but which nonetheless will be discharged unless specifically excepted by section 523 or unless the debtor has committed an act described in section 727 which would bar discharge of all debts. Claims which may be disallowed are as follows: 208

(1) A claim that is unenforceable against the debtor for a reason other than that it is contingent or unmatured. (An interested party may assert any defenses the debtor could assert against any creditor, e.g., usury, statute of limitations, unconscionability, or failure of consideration, etc.)

(2) Any claim for interest that has not yet been earned as of the date of bankruptcy.

(3) That portion of a claim which may be offset under section 553 against a claim of the debtor against the creditor.

(4) Any tax assessed against property of the estate to the extent it exceeds the estate's interest in the property.

(5) A claim for the services of an insider of the debtor or the debtor's attorney to the extent it exceeds the reasonable value of the services.

(6) Claims for unmatured alimony, maintenance, or child support. (Since such claims are excepted from discharge by section 523(a)(5), they will be paid out of the debtor's post-petition earnings.)

(7) A landlord's claim for damages due to a breach of a long-term lease is limited to the greater of (a) one year's rent or (b) rent for 15% of the remaining term not to exceed three years rent. (This does not affect the landlord's claim for delinquent rent.)

(8) An employee's claim for damages due to breach of an employment contract is limited to one year's salary. (This does not affect any separate claim of the employee for unpaid salary due as of the date of bankruptcy.)

(9) A federal tax claim which arises due to late payment of a state unemployment insurance tax.

In addition to the above, section 502(d) follows prior law in providing for the disallowance in toto of the claim of any creditor who fails to turn over to the trustee property or money held under a transfer avoided by the trustee. Section 502(c) requires that all

208. Id. § 502(b).
claims be reduced to a dollar amount. If liquidation of a claim would unduly delay the closing of the estate, the court must estimate the amount for purposes of allowance.

Secured Creditors and Secured Claims

While the Bankruptcy Code is full of risks and perils for the creditor contending to be secured in his claim, and much of the trustee’s avoidance power is designed to defeat secured claims, the secured creditor who has planned carefully will emerge from bankruptcy unscathed. Counterbalanced against the myriad of trustee avoidance powers are the numerous other provisions designed to protect the integrity of secured claims.\textsuperscript{209}

The Bankruptcy Code avoids the use of the ambiguous term “secured creditor,” recognizing that the term is essentially meaningless unless the value of collateral is also known. Focus is instead placed on the concept of “claim.” For purposes of claim classification, section 506 of the Code divides the claim of an undersecured creditor into two parts.\textsuperscript{210} First, such creditor has a secured claim that is measured in amount by the value of the collateral held by the estate. The Code does not define value; the House Judiciary Committee Report indicates that the court will have considerable discretion in valuing collateral:

“Value” does not necessarily contemplate forced sale or liquidation value of the collateral; nor does it always imply a full going concern value. Courts will have to determine value on a case-by-case basis, taking into account the facts of each case and the competing interests in the case.\textsuperscript{211}

As previously noted, section 541 provides that only property in which the debtor has an interest becomes property of the estate.\textsuperscript{212} In the case of a secured claim, only the debtor’s equity in the collateral becomes estate property. If the debtor has no equity, only his possessory interest becomes estate property. If the debtor is not in possession of the collateral on the day of bankruptcy, the secured party must turn over the property to the trustee if the secured party’s possession is successfully avoided or if the debtor re-

\textsuperscript{209} E.g., § 361 and §§ 363-65 of the Code condition exercise of much of the trustee’s administrative powers upon his assuring that secured parties are adequately protected.

\textsuperscript{210} Bankruptcy Code of 1978, § 506(a).

\textsuperscript{211} COMM. ON THE JUDICIARY, supra note 18, at 356.

\textsuperscript{212} Bankruptcy Code of 1978, § 541(a).
tains an interest in the property which is of value or benefit to the estate. In most cases, however, property in which a secured party (or co-owner) has an interest will be in possession of the trustee. The secured party will need to take action to recover possession of the property and foreclose on his interests or take steps to protect that interest should the trustee elect to use, sell, or lease the property under section 363. The Bankruptcy Code offers several avenues of relief to the creditor with a secured claim.

Since the section 362 automatic stay operates to enjoin any creditor action to collect a claim out of estate property, it is clear that any self-help or judicial repossession and foreclosure remedy a secured creditor had prior to bankruptcy is cut off upon the filing of the petition. The first avenue of relief available to the secured creditor would be to obtain relief from the stay under section 362(d). If the security interest is inadequately protected or if the debtor has no equity in collateral which is not needed for an effective reorganization, the court must terminate, annul, modify, or condition the stay.

A second avenue of relief would be to persuade the trustee to abandon the property to the secured creditor under section 554(a) which gives the trustee discretion to abandon property which is burdensome or of inconsequential value to the estate. Subsection (b) of section 554 authorizes the court to order abandonment for either of the above two reasons. Since a secured claim is measured by the value of the collateral held as security, the recovery of collateral from the estate will operate to extinguish the claim. The creditor is free to keep or dispose of the property as he wishes; any deficiency will be considered a general claim.

If the trustee is permitted under section 363 to use, sell, or lease estate property in which a secured creditor has an interest, the secured creditor is entitled to adequate protection against reduction in value of his security. For example, if collateral is sold, the secured creditor may be given a lien in the proceeds; if property is used by the estate, the creditor may be given periodic cash payments as compensation for depreciation. Thus, the creditor

213. Id. § 362(a).
214. Id. § 362(d). The creditor could then pursue available nonbankruptcy remedies in satisfaction of the secured claim.
215. Id. § 554(a).
216. Id. § 363(e).
217. Id. § 361.
with an invulnerable secured claim who is not permitted to recover possession of collateral is assured of ultimately recovering property or cash, equivalent in value to the value of the collateral before sale, use, or lease.

Further protection is given a secured claim in a liquidation case. To the extent that the holder of a secured claim has neither obtained relief from the automatic stay nor procured an abandonment of the property, section 725 requires that before distribution of the estate, the trustee dispose of any property that remains in the estate and in which a party other than the estate has an interest. The House Judiciary Committee Report indicates that the section represents a final, flexible assurance that creditors who have security interests or liens in estate property or proceeds are paid the value of their claims before the estate is distributed to holders of general claims.

Priority Claims

The Bankruptcy Code follows prior law in preferring certain classes of general creditors in payment of claims. As under section 64a of the 1898 Act, claims within each priority class must be fully satisfied (up to a maximum dollar amount in the case of employee compensation claims and certain consumer claims) to the exclusion of payment on claims in the next lower priority classes, and priority claims must be paid before any dividends are paid to nonpriority general creditors. Section 507 departs substantially from old section 64a. in deleting the federal government (except in the case of tax claims) as a creditor entitled to priority, expanding the coverage and increasing the amount of a wage claim entitled to priority, and creating a new fifth priority for consumer down-payments deposited with debtors in connection with undelivered goods and services.

The following priorities are created by section 507:

(1) First. Administrative expenses, (defined by section 503 to include the costs of collecting, managing, preserving, and liquidating the estate, the trustee's commission, certain taxes assessed against the estate, certain creditor's expenses, and rea-

218. Id. § 725.
219. COMM. ON THE JUDICIARY, supra note 18, at 382-83.
220. Bankruptcy Code of 1978, § 507(a) and § 726(a).
221. Id. § 507(a).
sonable costs for professional services rendered to the estate.

(2) Second. Unsecured claims which arise in the ordinary course of a debtor's business between the filing of an involuntary petition and a subsequent order of relief.

(3) Third. Allowed unsecured claims for wages, salaries, or commissions (including vacation, severance, and sick leave pay) not to exceed $2,000 for each claimant (any deficiency becomes a nonpriority general claim), earned within ninety days of the earlier of the filing of the petition or the cessation of the debtor's business.

(4) Fourth. Allowed unsecured claims for contributions to employee benefit plans (pension, insurance, etc.) arising from services rendered within 180 days of the earlier of the filing of the petition or the cessation of the debtor's business, limited in amount for each plan to $2,000 times the number of covered employees less the sum of all third priority wage payments and all other priority benefit plan payments. The net effect of the third and fourth priorities is to limit the total amount of all employee priority claims to $2,000 times the number of employees with priority wage claims.

(5) Fifth. Claims by consumers, limited to $900 per claimant, deposited as full or partial payment for the purchase or lease of property or services, not provided or delivered, which were to be used primarily for personal, family, or household purposes.

(6) Sixth. The following tax claims owed to governmental units:

   a. Income or gross receipts taxes for which a return was due within three years of the petition.
   b. Property taxes assessed before the filing of the petition and due without penalty within one year of the filing of the petition.
   c. Taxes such as a sales or use tax which the debtor is required to collect and for which he is liable.
   d. Taxes on wages, salaries, or commissions (e.g., income or social security) earned by the debtor's employees before the filing of the petition for which a return is due within three years before the petition.
   e. Excise taxes on pre-petition transactions if a return was due within three years of the petition, or if the transaction occurred within three years of the petition if a return was not required to be filed.
f. Customs duties arising within one year before the petition.
g. Penalties associated with the above claims only to the extent they are compensation for actual pecuniary loss.

In a liquidation case, priority claims must be paid in full before general nonpriority claims are paid.\textsuperscript{222} Section 507 will also have importance in chapter 11 or 13 reorganization cases insofar as a plan must provide for full payment of priority claims.\textsuperscript{223} Subsection (d) of section 507 makes it clear that a subrogee of a third, fourth, fifth, or sixth priority claim is subrogated only to the right to payment of the claim and not the priority.

**General Nonpriority Claims**

Section 726 of the Code sets out the order in which an estate is to be distributed after secured and priority claims have been paid.\textsuperscript{224} General claims that are timely filed under section 501 or tardily filed for good cause (such as lack of notice or knowledge of the proceeding) are first paid. Although it is extremely rare for a liquidation estate to have sufficient assets to pay more than a small fraction of the above general claims, the Code is extremely optimistic and provides for further priority of payment of remaining assets. If money is left, unsecured claims tardily filed without cause are next paid, followed by penalties (fines, tax penalties, punitive damages, etc.) which are not compensation for actual pecuniary loss, and finally, post-petition interest. In the case of a solvent estate, any remaining assets are paid to the debtor.

**Discharge**

1. **In General**

A discharge of the debtor's debts is the primary objective of nearly every voluntary bankruptcy and the vehicle through which the law provides the debtor with a fresh financial start free of debt collectors. The new Code continues the policy excepting certain classes of debts from discharge (section 523), and denying a discharge of debts in toto if the debtor is found to have committed certain enumerated acts (section 727). The Code effects a substan-

\textsuperscript{222} Id. § 726(a).
\textsuperscript{223} Id. § 1129(a)(9) and § 1322(a)(2).
\textsuperscript{224} Id. § 726.
tial change over prior law in that a discharge is only available to an individual (corporations and partnerships are specifically excepted by section 727(a)(1)) and an individual debtor engaged in business may no longer be denied a discharge for making a false financial statement in connection with a renewal or extension of credit. In addition, section 524 expands and broadens the effects of a discharge over that contained in old section 14f., and section 525 codifies case law which prohibits state and local governments from discriminating against a person who has been the subject of a bankruptcy proceeding.

2. Denial of a Discharge

Section 727 of the Code directs the court to grant the debtor a discharge in a liquidation case unless one of nine enumerated conditions exists. The first ground for denying a discharge is that the debtor is not an individual. Corporate and partnership debtors are not entitled to a discharge. This represents a change over prior law which is intended to "avoid trafficking in corporate shells and in bankrupt partnerships." Other acts of the debtor which constitute grounds for denying a discharge include 1) transferring property with actual intent to hinder, delay, or defraud creditors within one year before bankruptcy, 2) fraudulently transferring or concealing estate property after the filing of the petition, 3) failing unjustifiably to keep, or concealing, destroying or falsifying books and records from which the debtor's financial condition or business transactions could be ascertained, 4) committing certain fraudulent acts in connection with the particular bankruptcy proceeding, 5) failing to explain any loss or deficiency of assets, 6) failing to obey an order of the bankruptcy court or to respond to a question for a reason other than the properly invoked privilege against self-incrimination, or 7) committing any of the above acts within one year before the petition in another case involving an insider of the debtor. As under prior law, a debtor will be denied a discharge if

225. Section 14c. of the 1898 Bankruptcy Act provided for denial of discharge in the event such statement was made or published by a debtor engaged in business. Section 727 of the Bankruptcy Code omits this ground. Section 523(a)(2) of the Code may, however, except the particular debt from discharge provided the creditor reasonably relied on the statement and the debtor made the statement with intent to deceive.


228. COMM. ON THE JUDICIARY, supra note 18, at 384.
one had previously been obtained in a liquidation case or corporate reorganization case commenced within six years before the filing of the petition.\(^2\) A discharge under a chapter 13 debt adjustment plan obtained within six years of the petition will not bar a discharge if under the plan 100% of the allowed unsecured claims were paid or, alternatively, if 70% of such claims were paid, the plan was entered in good faith, and compliance with the plan constituted "the debtor's best effort."\(^2\) This represents a substantial change over prior law which denied a discharge if a chapter 13 plan had merely been confirmed within the six years prior to the petition.\(^3\) Finally, a debtor may waive his right to discharge, but the waiver must be in writing, must be executed after the order of relief is entered, and must be approved by the court.\(^3\)

Subsection (b) of section 727 makes it clear that the discharge relieves the debtor of liability for all debts not excepted from discharge by section 523 regardless of whether or not a claim has been filed or allowed. Subsection (c) authorizes the trustee or any creditor to object to the discharge and gives the court power to order the trustee to examine a debtor for purposes of determining whether grounds for denying a discharge exist. The court is empowered to revoke a discharge within one year after it is granted if the debtor committed certain fraudulent acts specified in subsection (d).

3. Debts Excepted From Discharge

Section 523(a) lists seven types of debts which are excepted from the general discharge provisions of section 727 and for which the debtor will remain liable after bankruptcy to the extent of any deficiency remaining after distribution of the estate.\(^4\) The following debts are excepted from discharge:

1. Taxes to the extent entitled to priority under section 507, taxes for which a required return was not filed or tardily filed within two years of the petition, and taxes for which the debtor filed a fraudulent return or which he willfully attempted to evade. This does not represent an appreciable change over

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230. Id. § 727(a)(9).
231. Bankruptcy Act of 1898, § 14c.
233. Id. § 523(a).
prior law. The tax claim will survive bankruptcy regardless of whether it was filed or allowed.

(2) A claim for obtaining money, property, services, or credit either through false representation or fraud other than a statement respecting financial condition, or through the use of a materially false written statement respecting the debtor’s financial condition upon which a creditor reasonably relied and which was made with intent to deceive. To discourage abuse of this section against consumer debtors, subsection (d) requires the court to award costs and attorney’s fees (unless to do so would be inequitable) to any debtor against whom an unsuccessful proceeding is brought to have a debt declared nondischargeable for one of the above reasons.

(3) A claim which was not scheduled by the debtor so as to facilitate timely filing by the creditor of a) a proof of claim or b) an objection to discharge, of those debts which are discharged unless objection is made. This exception is inapplicable, however, as against a creditor who had actual knowledge of the proceeding.

(4) A claim for fraud or defalcation while acting in a fiduciary capacity, or a claim for embezzlement or larceny.

(5) A claim for support, alimony, or maintenance owed directly to a spouse, former spouse, or child of the debtor. Section 523(5) codifies case law under section 17a.(7) of the 1898 Act to the effect that obligations incorporated in property settlements will be nondischargeable to the extent intended for support.

(6) A claim for willful and malicious injury to the person or property of another.

(7) A claim which is a fine or penalty owed to a governmental unit and which is not compensation for actual pecuniary loss. Tax penalties associated with dischargeable taxes or with transactions which occurred more than three years before bankruptcy are discharged.

(8) A claim for an educational loan owed to a governmental unit or a nonprofit institution of higher education unless the loan first became due more than five years before bankruptcy or excepting the debt from discharge would impose undue hardship upon the debtor or his dependents. While this exception had no counterpart under section 17 of the 1898 Act, section 439A of the Higher Education Act of 1965 made educa-
tional loans owed to governmental units nondischargeable in bankruptcy. Section 523 expands the coverage of section 493A by making loans owed directly to an educational institution also nondischargeable.\(^234\)

Subsection (c) of section 523 requires a creditor to initiate proceedings in the bankruptcy court to have debts under subsection (a)(2) (obtaining credit fraudulently or on the basis of a false financial statement), (a)(4) (fraud or defalcation as a fiduciary), or (a)(6) (willful or malicious injury) excepted from discharge.\(^235\) If the creditor fails to act, the debt is discharged.

4. Reaffirmation Agreements

Section 524(c) of the Bankruptcy Code, unlike the 1898 Act, substantially restricts the ability of a creditor to obtain reaffirmation of a discharged debt.\(^236\) First, a reaffirmation agreement must be entered into prior to the granting of a discharge and a debtor has the absolute right to rescind the agreement for thirty days after it becomes enforceable. Second, individual debtors are required to personally attend a discharge hearing where the judge must inform the debtor of his right to discharge, the nature and effect of the agreement, and the consequences of default under the agreement.\(^237\) Since the agreement does not become enforceable until approved by the court, an individual debtor will have thirty days from the date of the discharge hearing within which to rescind. Finally, in the case of individual consumer debts not secured by real property, the court cannot approve the agreement unless it finds either 1) that reaffirmation will not impose undue hardship on the debtor or his dependents and is in the best interest of the debtor or his dependents or 2) that it was entered in good faith and either as part of settlement of litigation concerning the dischargeability of a debt under section 523 or as consideration for the debtor’s redeeming personal property from a creditor under section 722.\(^238\)

5. Effect of a Discharge

Section 524 of the Code seeks comprehensively to assure that

\(^{234}\) Id.
\(^{235}\) Id. § 523(c).
\(^{236}\) Id. § 524(c).
\(^{237}\) Id. § 524(d).
\(^{238}\) Id. § 524(c)(4).
a debtor enjoys complete relief from discharged debts and will not be pressured in any way to repay them.239 It effectively prohibits all forms of creditor collection activity. Subsection (a) voids any judgment, retroactively and prospectively, which is a determination of personal liability of a debtor on a discharged debt and enjoins any act by a creditor to collect a discharged debt either from the debtor or his property. This last prohibition is broad enough to bar employment of any type of legal process as well as such informal collection methods as phone calls, personal contact, employer contact, or dun letters. In accordance with the general Code policy disfavoring reaffirmation, the above injunctive effect of a discharge exists regardless of whether or not a debtor has waived discharge.240 Such waivers have no legal effect. Finally, section 525 further guarantees the debtor’s fresh start by broadly prohibiting a state or local governmental unit from discriminating against a person because he has been a debtor under the Code, has not paid a discharge debt, or was insolvent before, during, or after a bankruptcy proceeding.241

Conclusion

The preceding discussion is by no means an exhaustive treatment of the new Bankruptcy Code. It is intended more as a roadmap to guide the general practitioner in coping with the trauma of suddenly being forced to lay down a familiar legal fabric and take up another that is not so well-known. There is, of course, no substitute for a thorough reading and analysis of statutory language and legislative history when faced with the problems of a flesh-and-blood client. This is even more important with a complex and comprehensive new statute: there are no court decisions to offer guidance. Hopefully, this article will have supplied the background and overview to make that analysis a little easier.

239. Id. § 524.
240. Id. § 524(a).
241. Id. § 525.