12th Biennial Judge Joe Lee Bankruptcy Institute

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JUDGE JOE LEE
BANKRUPTCY INSTITUTE

May 2005

Presented by
OFFICE OF CONTINUING LEGAL EDUCATION
UNIVERSITY OF KENTUCKY COLLEGE OF LAW
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12th Biennial
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RECURRING TAX ISSUES IN BANKRUPTCY

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SECTION A
I. INTRODUCTION

"Taxes," as Justice Holmes informed us long ago, "are what we pay for civilized society." It may surprise many that this price is extracted even from individuals in bankruptcy. Although the right to discharge in bankruptcy ensures an "honest but unfortunate debtor" a fresh start to begin anew his or her economic life, that right is tempered by the federal government's legitimate interest in protecting the public fisc by collecting taxes. The balance struck by the Bankruptcy Code and Internal Revenue Code between the competing interests of an individual debtor and the federal government insulates specific tax claims from the bankruptcy discharge. Under this compromise, only enumerated tax claims will survive a bankruptcy discharge in a chapter 11 case.

Recognizing that nondischargeable tax liabilities are inconsistent with the fresh start policy, Congress further attempted to alleviate some harshness through enactment of the Bankruptcy Tax Act of 1980 (BTA). Among other things, the BTA creates a separate taxable entity where an individual files for relief under either chapter 7 or 11 of the Bankruptcy Code and enables an individual chapter 7 or 11 debtor to elect to shorten and end the taxable year, thus shifting at least part of the current year taxes to the estate as a BC § 507(a)(8) priority claim. Nevertheless, certain tax claims designated as nondischargeable under BC § 523(a)(1) (such as claims for taxes incurred

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1 Compania General de Tabacos de Filipinas v. Collector of Internal Revenue, 275 U.S. 87, 100 (1927)(dissenting opinion).
2 11 U.S.C. § 101 et seq. In these materials, the Bankruptcy Code is referred to as "BC."
3 Title 26, United States Code. In these materials, the Internal Revenue Code is referred to as "IRC."
4 11 U.S.C. § 523(a)(1)(identifying those tax claims that are nondischargeable by an individual debtor in a chapter 7 or 11 case).
6 See IRC § 1398. No separate entity for tax purposes is created where a partnership or corporation files for bankruptcy relief. IRC § 1399.
7 See IRC § 1398(d)(2).
within three years of the bankruptcy petition date) survive the discharge and, thus, significantly affect a debtor's fresh start.

The outline begins with a discussion of the separate entity rules under the Internal Revenue Code. Section 1398 creates much of the confusion; therefore, a thorough understanding of that section is necessary to understand better what is at stake in the abandonment context. The outline then moves on to the issue of abandonment in an individual chapter 7 or 11, discussing both arguments for and against abandonment as a taxable event. Finally, the outline explores the issues of the priority and dischargeability of tax claims, carefully distinguishing between the tax relief a debtor could expect in a chapter 7 or 11 case as opposed to a chapter 13 case. At the end of the outline is a brief discussion of tax changes that are contained in the new Bankruptcy Act of 2005. Of particular note is that the chapter 13 super discharge will no longer work to discharge certain tax claims beyond the discharge one would expect in a chapter 7 case as in the past. Rather, once the 2005 Act goes into effect, the chapter 13 discharge will mirror the chapter 7 discharge for tax purposes.

II. SECTION 1398: THE SEPARATE ENTITY RULES

One of the most important provisions of the Bankruptcy Tax Act of 1980 (BTA) is Internal Revenue Code (IRC) § 1398. Essentially, § 1398 creates a separate entity for purposes of federal income taxes in cases where an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code. Following is a list of common questions and answers regarding the scope, purpose, and effect of § 1398.
A. **When Does § 1398 Apply?**

Section 1398 applies only when an individual debtor files for relief under chapter 7 or chapter 11 of the Bankruptcy Code. Thus, only the bankruptcy estate of an individual debtor in cases under chapter 7 or 11 is treated as a separate taxable entity. A separate taxable entity is not created in chapters 12 or 13 or in any case where the debtor is not an individual. \(^8\)

B. **What Is The Purpose Of § 1398?**

Section 1398 furthers the fresh start policy embodied in the Bankruptcy Code. The Committee Reports recognize that the purpose of bankruptcy is to provide for a debtor's ability to begin his or her economic life anew. \(^9\) Congress recognized that any expenses incurred by the estate should not burden a debtor's fresh start. Consistent with this purpose is the fact that the income and losses of a separate taxable entity are computed separately from the individual debtor. Moreover, any estate tax liability is generally confined to the estate and its assets. Furthermore, by making the short-year election, a debtor may be able to shift at least part of his or her tax liability to the estate as a Bankruptcy Code (BC) § 507(a)(8) priority claim. \(^10\)

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\(^8\) IRC §§ 1398(a), (b), and 1399.


\(^10\) See IRC § 1398(d); see also 1A Collier on Bankruptcy & 9.05 (15th ed. L. King ed.).
C. **How is the Bankruptcy Estate Taxed Pursuant to § 1398?**

Consistent with its separate entity status, an estate computes its own taxable income in the same manner as an individual.\(^{11}\) The estate is taxed at the same rate as a married individual filing separately.\(^{12}\) The chapter 7 or 11 trustee is required to file any returns required by law and to pay any taxes due. The trustee must file a return for each taxable year that the estate’s gross income exceeds the standard deduction and the exemption amount.\(^{13}\)

D. **Must a Trustee File a Federal Tax Return Where the Estate Has Generated No Income?**

Possibly. The estate may be liable for taxes generated by cancellation of indebtedness income or by sale and exchange (i.e., a foreclosure on property that is property of the estate).

E. **How is the Gross Income of a Bankruptcy Estate Determined?**

The bankruptcy estate’s gross income includes the gross income of the debtor to which the estate is entitled under §§ 541(a)(1) through (a)(7). Property of the estate includes all of the debtor’s legal or equitable interest in property wherever located. Section 1398 does not permit double counting of income or losses by both the estate and the debtor. Thus, § 1398(c)(2) provides that a debtor’s gross income for any taxable year does not include any item to the extent it is included in the estate’s gross income.\(^{14}\)

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\(^{11}\)IRC § 1398(c)(1).

\(^{12}\)IRC §§ 1398(c)(2) and (c)(3).

\(^{13}\)See Van Amburgh, supra note 9, at 122.

\(^{14}\)See generally 1A Collier on Bankruptcy at ¶ 9.04[3].
F. **How is Income Treated Where the Income Was Earned Prepetition, But the Income Was Received Postpetition?**

Section 1398(e)(1) provides that gross income of the estate does not include any amount received or accrued by the debtor before the commencement of the case. Thus, § 1398 was intended to override the assignment-of-income principles under tax law. An example may clarify the effect. Assume that a cash-basis individual who draws a weekly salary nonexempt under applicable state law earns one payment prior to the commencement of his or her chapter 7 case, but it is received by the estate after commencement. In that case, the estate and not the debtor would report the income.\(^\text{15}\)

G. **How is Cancellation of Indebtedness Income Treated Under the Separate Entity Rules?**

Whether the debtor or the estate reports cancellation of indebtedness income will depend on when the taxable event occurs. If the taxable event, e.g., complete or partial discharge, modification of principal amount, etc, occurs before the commencement of the case, generally the debtor should recognize the income under § 61(a) unless it can be excluded under § 108(a). (There is a means by which to shift at least some of the tax consequences from the debtor to the estate through a § 1398 short-year election by the debtor). If the taxable event occurs after commencement of the case, then the estate should recognize the income under § 61(a) unless it can be excluded under § 108(a).

H. **How are Deductions Treated Under the Separate Entity Rules?**

Section 1398(e)(3) provides that the determination whether any amount paid or incurred by the estate is allowable as a deduction shall be made as if paid by the debtor and the debtor was still engaged in the trade or business that the debtor was engaged in before the commencement of the

\(^{15}\)See Van Amburgh, supra note 9, at 123 (provides examples of cash-basis and accrual-basis debtors).
case. It would appear that the same accounting method used for income should be used for deductions. Additionally, § 1398(e)(3) permits the estate to characterize some of its expenditures as trade or business expenses which can be used to offset current income of the estate. Furthermore, administrative expenses and any fees under chapter 123, Title 28, United States Code, are deductible by the estate to the extent not disallowed under another IRC section.\textsuperscript{16} If the administrative expenses cannot be used in the current year then they may be carried back three years and carried forward seven years.\textsuperscript{17}

I. **ARE TRANSFERS OF ASSETS BETWEEN THE DEBTOR AND THE ESTATE TAXABLE EVENTS?**

No. Transfers of assets from the debtor to the estate upon commencement of the case and from the estate to the debtor upon termination of the estate are not taxable events.\textsuperscript{18}

J. **DOES THE ESTATE SUCCEED TO THE DEBTOR’S TAX ATTRIBUTES?**

Yes. The estate succeeds to certain enumerated tax attributes of the debtor upon commencement of the case.\textsuperscript{19} Presently, these tax attributes include net-operating loss carryovers as determined under IRC § 172; excess charitable contribution carryovers as determined under IRC § 170(d)(1); the recovery of tax benefit items under IRC § 111; certain credit carryovers; capital loss carryovers determined under IRC § 1212; the basis, holding period, and character of property; the debtor’s method of accounting; and other tax attributes of the debtor, to the extent provided in regulations carrying out the purposes of § 1398.\textsuperscript{20} The

\textsuperscript{16}IRC § 1398(h)(2).
\textsuperscript{17}IRC § 398(h)(2)(C).
\textsuperscript{18}IRC § 1398(f).
\textsuperscript{19}See IRC § 1398(g).
\textsuperscript{20}See C. Richard McQueen and Jack F. Williams, *Tax Aspects of Bankruptcy Law and Practice* (2nd ed.)
K. WHAT IS A “SHORT-YEAR” ELECTION? HOW IS THE ELECTION MADE?

Section 1398(d)(2) creates an election that a debtor may make to split his or her taxable year into two taxable years. This election is an important pre-bankruptcy planning tool that cannot be overlooked. The first taxable year ends on the day before the day the bankruptcy case was commenced. The second taxable year begins on the commencement date. Assume an individual debtor files for relief under chapter 7 on March 8 and shortly thereafter makes the IRC § 1398(d) election. As a consequence of the election, the debtor has two tax years. The first year spans from January 1 through March 7; the second year spans from March 8 through December 31. If the election is not made the debtor would have one taxable year spanning from January 1 through December 31. In other words, absent the election, the commencement of the case will not interrupt the debtor’s taxable year. The short-year election is considered made if the complete tax return for the short period is timely filed. In our working example, the return for the short period ending March 7 should be filed by July 15. The debtor should conspicuously write “SECTION 1398 ELECTION” at the top of the return.

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2002)(helpful explanation of the listed attributes).

22 IRC § 1398(1).
23 A bankruptcy case is commenced upon the filing of the petition under BC §§ 301, 302, 303, and 304.
24 See IRC § 1398(d)(1). The debtor cannot make the short-year election if he or she has no assets other than exempt property. IRC § 1398(d)(2)(C).
L. **WHEN MUST THE SHORT-YEAR ELECTION BE MADE BY A DEBTOR?**

The short-year election must be made by the debtor on or before the date for filing his or her return for the short-taxable year.\(^{27}\) IRC § 6072 requires that returns be made on or before the fifteenth day of the fourth month following the close of a fiscal year. A Treasury Regulation places a gloss on § 6072 in this context by requiring that the short-term return be filed on or before the fifteenth day of the fourth full month following the close of the taxable year.\(^{28}\) Again, the election must be made on the return. Once made, the election is irrevocable.\(^{29}\)

M. **WHAT IS THE EFFECT OF MAKING THE SHORT-YEAR ELECTION?**

The short-year election may be the most potent pre-bankruptcy planning tool because of its wide availability to individual debtors. The most significant effect of the election is that any tax liability for the first short-year becomes an allowed BC § 507(a)(8) priority claim against the estate. Thus, the debtor may essentially force his or her unsecured creditors to pay all or a portion of the first short-year tax claim. Of course, if there are insufficient assets to pay the short-year tax claims in full, they do survive the bankruptcy as a non-dischargeable claim under BC § 523(a)(1). If the debtor fails to make the election, then any tax liability for the complete year is not an allowable claim against the estate.\(^{30}\) Moreover, if a debtor makes the election, then a debtor’s tax attributes as of the end of the first taxable year are transferred to the estate to be used by the estate to shelter income. If the election is not made, a debtor’s tax attributes as of the end of the full taxable year carryover.

\(^{27}\) IRC § 1398(d)(2)(D).

\(^{28}\) Temp. Treas. Reg. § 7a. 2(d).

\(^{29}\) IRC § 1398(d)(2)(D).

N. WHEN IS IT ADVISABLE FOR A DEBTOR TO MAKE THE SHORT-YEAR ELECTION? WHEN IS IT NOT?

There is no easy answer to the questions posed. Whether a debtor should make the IRC § 1398 election depends on the particular facts and circumstances at hand. As a general rule it appears that in most cases the election should be made.31 By making the election, a debtor is able to shift at least some of the tax liability to the estate as an allowable BC § 507(a)(8) priority claim. However, if the claim is not satisfied it will be nondischargeable and survive the bankruptcy. There may be circumstances present to dissuade a debtor from making the election when substantial net operating losses are involved. Although that discussion is beyond the scope of this article, a rule of thumb provided by Van Amburgh may be useful:

If the debtor will benefit more from (I) the use of a net operating loss carried forward from the first short year (if he makes the election) to directly or indirectly reduce nondischargeable tax liabilities than from (ii) the use of the net operating loss against projected income of the debtor after the filing of the petition, then the election should be made. Otherwise the election should not be made.32

Nondischargeable taxes are the antithesis of an individual's fresh start. Yet, the drafters of the Bankruptcy Code struck the synthesis in favor of the taxing authorities at least as to those tax claims identified in § 523(a)(1). Nevertheless, all is not lost for an individual debtor and his or her bankruptcy counsel in reducing possible tax consequences in contemplation of a bankruptcy filing. Although experience has shown that an individual debtor should most often make the short-year election, there are many instances where the election should not be made. Counsel must be aware of when a debtor should make the election and when a debtor should not. Often times, there are no

31Van Amburgh, supra note 9, at 144; see also Shepard, supra note 26, at 150-57.
32Van Amburgh, supra note 9, at 145; see also 1A Collier on Bankruptcy at & 9.05(3); Shepard, supra note 26, at 150-157.
easy rules, no easy answers. Nevertheless, § 1398 with all its nuances and ramifications cannot be
ignored before and during bankruptcy.

Example 1: THE MALPRACTICE TRAP

Example 1-1:
A partnership applies for relief under chapter 7. May the partnership make a § 1398 election?

No. Only individual debtors may benefit from IRC § 1398. See IRC § 1399.

Example 1-2:
Elrod, a partner in the partnership identified above, seeks relief under chapter 13. May Elrod
benefit from the § 1398 election.

No. An individual debtor must file for relief under chapter 7 or 11 only to benefit from § 1398.

Example 1-3:
Assume Debtor is a cash basis taxpayer with a calendar year tax year (January 1 – December 31).
Debtor filed for chapter 7 bankruptcy relief on August 1, 20XX. In the seven months before the
commencement of a bankruptcy case, Debtor had income giving rise to a tax of $25,000.

If Debtor fails to make the election, there is no interruption in her tax year. The tax would be due at
the end of her tax year (31 December) and payable by the fifteenth day of the fourth month
following the close of her tax year (15 April). The tax claim would not participate in the chapter 7
distribution in that it is a postpetition claim. However, it would not be discharged in the chapter 7
case. If the Debtor makes the election, she will have two tax years. The first short year runs from 1
January to 31 July. The second runs from August 1 to December 31. Now, the postpetition claim
magically becomes a prepetition one due as of the end of the new short tax year. This is also a §
507(a)(8) priority claim that is nonetheless not subject to discharge as delineated in § 523(a).

**Practice pointer: Make the election.**

**Example 1-4:**

Same facts as above. However, in the previous tax years, Debtor had generated net operating losses
(NOLs) that can be carried forward or back to other tax years. An NOL is a surplus deduction that
tax law allows you to apply to other tax years.

*If Debtor does not make the election, then these tax attributes will pass to the bankruptcy estate and
can be used by the trustee to reduce the estate’s tax liability. Any unused losses would then pass
back to Debtor upon termination of the case. If Debtor makes the election, then she is entitled to
use them herself. Practice pointer: Make the election.*

**Example 1-5:**

Same facts as above except that the NOLs arose in the seven months preceding the commencement
of the case. Further assume that she had no income in the first seven months of the tax year and
expects substantial income in the last five months of the year.

*Without the election, Debtor will be able to use the deductions against postpetition income. With
the election, the bankruptcy trustee gets to use the losses and Debtor’s income cannot be offset by
the deductions. Practice pointer: Do not make the election.*
III. ABANDONMENT

The issue of the tax consequences of abandonment is limited to individual bankruptcies under chapter 7 or chapter 11 because IRC § 1398 creates a separate entity for tax purposes only in those types of cases -- the bankruptcy estate. The engine that drives the controversy surrounding the tax consequences of abandonment is a debtor’s desire to avoid the deferred taxes on overencumbered property with a low basis. Ideally, a debtor seeks to capture the consequences of foreclosure in the estate so that pursuant to IRC § 1398, the tax is a liability of the estate and not the debtor. In other words, a debtor hopes to force its priority claimants and unsecured creditors to pay the tax while walking away from any personal liability for any deficiency.

Neither the Bankruptcy Code nor the Internal Revenue Code considers the federal tax implications of property abandoned by the estate before the close of the case. The conflicting interests at stake, however, may be understood easily with an example. Assume that an individual debtor owns an office building subject to nonrecourse indebtedness of $1 million. The fair market value of the property is $500,000. The adjusted basis in the property has been reduced over time to $250,000. The debtor has incurred net-operating losses and carryovers of $250,000 related to the business property. If the lender forecloses on the property in full satisfaction of the debt, the foreclosure is a taxable event giving rise to a gain or loss. Here, the amount realized is a gain of

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34 Authorities often refer to this as “midstream” abandonment. Nonetheless, 11 U.S.C. § 346(g)(1)(B) does provide that for state and local tax purposes, a midstream abandonment is not a taxable event.
35 Crane v. Comm’n, 331 U.S. 1 (1946). Because the debt is nonrecourse, no cancellation of indebtedness income will arise when property is used to satisfy the debt in full. See Comm’n v. Tufts, 461 U.S. 300 (1983). Tufts treats the nonrecourse debtor as having sold the underlying collateral for the amount of the debt.
$750,000, the difference between the amount of nonrecourse debt and the adjusted basis.\textsuperscript{36} Often, this gain represents nothing more than phantom income.\textsuperscript{37}

If the foreclosure occurs while the property is property of the estate, then the estate must recognize the gain and pay the tax. In fact, the tax claim is a BC §§503(b)(1)(B) and 507(a)(1) priority claim, which is paid in full ahead of all other claims (such as employee wages, pension plan claims, and tort claimants) except secured claims and other administration expense claims (the latter sharing pro rata with the tax claim.)\textsuperscript{38} If there are insufficient assets in the estate to pay the tax, then the tax goes unpaid; the debtor is not liable for any deficiency. If the property is abandoned by the trustee before foreclosure, then the debtor must recognize the gain and pay the tax even though the tax attributes associated with the property remain with the estate to shelter estate tax liability. The opportunity to jettison burdensome or inconsequential property in these circumstances helps the trustee in his or her efforts to maximize the recovery of the unsecured creditors but at the expense of the debtor. Courts that have addressed the issue have fallen into two camps. The majority camp largely follows the reasoning of the Eighth Circuit in In re Olson,\textsuperscript{39} which concludes that no federal tax consequences attach to abandonment of property by the trustee in bankruptcy. The other camp follows the reasoning of Bankruptcy Judge Queenan in In re Lane,\textsuperscript{40} that suggests that bankruptcy abandonment under BC § 554 is a taxable event which must be shouldered by the bankruptcy estate.

\textsuperscript{36} See Comm'n v. Tufts, 461 U.S. 300 (1983)(the one-step analysis is used for nonrecourse debt satisfied by property; the fair market value of the property is irrelevant to the calculation of the amount realized).


\textsuperscript{38} See generally Mark Wallace, Is a Midstream Abandonment of Property by a Bankruptcy Trustee Taxable to the Estate? J. Tax. 26, 26 (July 1992).

\textsuperscript{39} 930 F.2d 6 (8th Cir. 1991).

\textsuperscript{40} 133 BR 264 (Bankr. D. Mass. 1991).
A. **Olson Model**

The model of bankruptcy abandonment embraced by most courts and the Service is explicated by the Eighth Circuit in *In re Olson*. In *Olson*, the court held that abandonment was not a taxable event, rejecting the fresh start argument embraced later by the court in *In re A.I. Lane & Co.* After the debtors filed a chapter 7 petition, the chapter 7 trustee abandoned certain property that was subsequently sold by a secured creditor under state foreclosure proceedings. The individual debtors hired an accountant to prepare federal and state income tax returns for the bankruptcy estate. These returns reported a gain realized from the sale of the property as a liability of the bankruptcy estate. The debtors claimed that the estate was nevertheless liable for the tax. The trustee did not authorize the debtors to prepare and file the tax returns for the estate.

The bankruptcy court in *Olson* observed that under IRC § 1398(f)(2) a “transfer” includes the release of an estate’s interest in property by abandonment. Nevertheless, the bankruptcy court stopped short of accepting the debtors' argument based on an extension of the holding in *Yarbro v. Commissioner*, which would equate bankruptcy abandonment with tax or property abandonment. In *Yarbro*, the taxpayer abandoned property under principles of property and tax law. Pursuant to those principles, applicable nonbankruptcy law abandonment operates as a sale or exchange and is effective in relinquishing title in the property. The *Yarbro* court suggested that the finding of an exchange requires a giving, a receipt, and a nexus between the two. The bankruptcy court in

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41 930 F.2d 6 (8th Cir. 1991). The Olson model is based, in part, on the opinions in *In re Bentley*, 916 F.2d 431 (8th Cir. 1990), and *In re McGowan*, 95 BR 104 (Bankr. N.D. Iowa 1988).
43 The debtors did not object to the proposed abandonment. Olson, 100 BR 458, 460 (Bankr. N.D. Iowa 1989).
44 For the broad definition of transfer, see 11 U.S.C. § 161 (54).
45 100 BR at 462.
46 737 F.2d 479 (5th Cir. 1984).
47 737 F.2d at 483-84.
48 Id. at 483-84.
Olson found that the bankruptcy abandonment did not transfer title, did not relinquish title in the debtors, and did not result in a "receipt" required for an exchange.49

The Eighth Circuit affirmed. In holding that no taxable event occurred when the trustee abandoned the property, the Eighth Circuit said that it could see no reason why abandonment during the administration of the case should have any different tax consequences than abandonment of property at the close of the bankruptcy case, which is not a taxable event pursuant to IRC § 1398(f)(2).50

The Service’s position is consistent with Olson and its progeny. In a private letter ruling, the Service stated that abandonment during a bankruptcy case has no tax consequences to the estate because “termination of the estate” as it appears in IRC § 1398(f)(2) includes termination of the estate’s interest in property because of abandonment or exemption.51

The Service has issued final regulations under IRC § 1398, which provide that a transfer in an interest in a passive activity loss or credit or an at risk activity loss or credit under IRC § 465 to the debtor as exempt under BC § 522 or if abandoned under BC § 554 is a nontaxable transfer.52 In support of the regulations, the Service cited Olson.

There are several persuasive reasons against taxable abandonment. First, abandonment is a disclaimer of interest by the estate, a release of the trustee’s judicial lien; title and/or possession have remained all along in the debtor. Thus, there was no sale, exchange, or other disposition from the estate to the debtor. Second, the termination of the estate’s interest in property through abandonment is congruous to “termination of the estate” in IRC § 1398(f)(2). To equate “termination” under IRC § 1398(f)(2) with “closing the case” under BC § 350 is improper.

49 Id. at 462-63.
50 This was a point the bankruptcy court also asserted in justifying its holding. 100 BR at 463.
52 See Regs. 1.1398-1 and 1.1398-2.
Although closing a case is a form of termination, it does not exhaust all forms of termination. After all, if Congress sought to equate termination under IRC § 1398(f)(2) with case closings under BC § 350, it could have easily used the term “closing” in IRC § 1398(f)(2) instead of the term “termination.” Congress chose not to even though BC § 350 predates IRC § 1398. Third, requiring foreclosure of the property while part of the estate results in any tax liability being treated as an administrative expense claim that will be paid not only before the unsecured creditors, but also before all priority claims under BC § 507(a)(2) through (a)(7). Therefore, the other administrative expense claims like attorney’s fees of the debtor and trustee, the trustee’s fees, bankruptcy fees, other estate taxes, and certain postpetition tort claims, may not be paid in full; they must share pro rata with the current-year tax claim. Moreover, certain employee wage claims, pension fund claims, and consumer claims may never receive any distribution. Thus, delaying an inevitable property foreclosure through a dilatory bankruptcy filing may reward a debtor at the expense of all his or her creditors. This result makes no sense. Fourth, if there are insufficient assets in the estate to pay the tax liability, it will never be paid. The debtor does not owe the tax. Fifth, it would appear that because abandonment is treated as a taxable event, the basis of the property might be “stepped up” to its fair market value on abandonment. This may result in a windfall to the debtor especially where the foreclosure never occurs. Sixth, as constructed, IRC § 1398 provides a mechanism by which a debtor may shift at least part of any tax liability by allowing the taxable event to occur

53 Accord Shepard, supra note 26, at 88.
54 Accord id. See generally In re Barker, 301 B.R. 892 (Bankr. D. Colo. 2003)(bankruptcy court held that the requirements of the Bankruptcy Code pertaining to the abandonment of estate property was satisfied, and thus the court ordered the abandonment of the property even though as a result of such abandonment, and upon the expected foreclosure, the debtors would be individually liable, as distinguished from the bankruptcy estate, for a capital gains tax of about $186,000). See also Michelle Arnopol Cecil, Abandonments in Bankruptcy: Unifying Competing Tax and Bankruptcy Policies, 88 Minn. L. Rev. 723 (2004)(an excellent treatment of the issues of abandonment combined with a thorough critique of existing competing models; the author offers her own model built on an extension of the model proposed by the author of this outline).
55 IRC §1398(d)(2).
56 Accord id.
before filing the bankruptcy petition and electing to terminate the taxable year.\textsuperscript{57} Thus, the symmetry of IRC § 1398 between liability and attributes may be preserved and settlements between a debtor and creditor before a bankruptcy filing encouraged. Seventh, abandonment is not tantamount to foreclosure. Most often, the automatic stay will prevent the foreclosure at least until the creditor obtains relief from the stay. Meanwhile, the debtor could attempt to settle the matter in a manner minimizing the tax consequences. Finally, although important, a debtor’s fresh start is not absolute. In fact, under the Bankruptcy Code it is a rebuttable presumption.\textsuperscript{58} Congress has subordinated a debtor’s fresh start to several tax claims, including taxes arising within three years of the filing and those arising postpetition.\textsuperscript{59}

B. \textbf{LANE MODEL}

The case that supports the proposition that the estate should shoulder the tax consequences associated with the abandonment and subsequent foreclosure of property is \textit{In re A.J. Lane & Co.}\textsuperscript{60} \textit{Lane} stands in stark contrast to \textit{Olson}. In \textit{Lane}, the court denied the chapter 11 trustee’s motion to abandon property of the estate essentially because the debtor’s tax liability would impair the debtor’s fresh start. There, the trustee sought to abandon two properties and a partnership interest in a partnership that owned a third property under BC § 554.\textsuperscript{61} The debtor objected, arguing that the substantive grounds in BC § 554 for abandonment were not met and that the abandonment “would shift foreclosure tax consequences from the bankruptcy estates to the debtor and would destroy debtor’s opportunity for a fresh start.”\textsuperscript{62} Clearly, the trustee’s sole reason for abandoning the

\textsuperscript{57} See IRC § 1398(d)(2).
\textsuperscript{58} See 11 U.S.C. 727(a).
\textsuperscript{59} Accord 11 U.S.C. 507(a), 523(a)(1).
\textsuperscript{60} 133 BR 264 (Bankr. D. Mass. 1991).
\textsuperscript{61} The motion was amended to exclude two of the properties that were subsequently refinanced.
\textsuperscript{62} Id. at 266.
property was to avoid the substantial income tax liability upon foreclosure on property that was of inconsequential value to the estate and burdensome to administer. The facts show that the estate would have incurred a tax liability of about $3.27 million on all the properties after using available loss carryovers. The debtor’s tax liability would have been about $13 million. The debtor probably would not have been able to reduce taxable income by loss carryovers because those tax attributes were transferred to the estate pursuant to IRC § 1398(g) and would not be transferred back to the debtor, if at all, until the estate terminated.

The Lane court gave three reasons for denying the trustee’s motion to abandon the property. First, because the facts suggested that foreclosure on the property was imminent, the Court Holding doctrine persuaded the court to view the abandonment as a transfer from the estate directly to the secured lender with the debtor as a mere conduit. Second, the court held that abandonment itself is a taxable event, and that to shift the tax consequences to the debtor would destroy the symmetry of IRC § 1398 that intends to link a tax liability with its tax attributes. Third, the court held that to allow a trustee to abandon overencumbered, low-basis property would

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63 Id.
64 See generally Craig W. Friedrich, Workouts, 1992 J. Real Estate Tax. 94, 95.
65 See IRC § 1398(i). Thus, the substantial difference between the debtor’s and the estate’s tax liability -- a $10 million dollar swing.
66 Aside from the reasons discussed in the text, the Lane court also questioned the merits of the abandonment. Although there existed no equity in the properties, the court observed there, nevertheless, might be value in the properties for the estate. The court based this observation on two points: First, the court suggested that BC § 506(a), which defines a secured claim, applies and made it more likely than not that value existed for the estate; second, a trustee could use the cramdown provisions in chapter 11, see 11 U.S.C. § 1129(b), to retain the property for the benefit of the unsecured creditors. Aside from the time-honored rule that vests in a trustee broad discretion in deciding to abandon property under BC § 554, the Lane court’s observations make no sense. The secured creditors were seeking foreclosure. Section 506(a) would not help, especially where the property is not appreciating. See Dewsnup v. Timm, 502 U.S. 410 (1992). The secured claims completely enveloped the value of the properties. Finally, cramdown is not a panacea; it is also a lot easier to threaten than it is to successfully invoke under BC § 1129(b). Thus, the value the Lane court was alluding to was whimsical at best.
67 See Comm’n v. Court Holding Co., 324 U.S. 331 (1945)(the substance of a transaction viewed as a whole is controlling for tax purposes). In Court Holding, the Supreme Court articulated the “step-transaction” doctrine which requires that we collapse each separate step in the transaction into one transaction, thereby ensuring that the substance of the transaction controls over its form.
severely throttle the fresh start policy of the Bankruptcy Code.\textsuperscript{68} Each rationale for the \textit{Lane} court's holding is addressed in turn.

The court's application of the \textit{Court Holding} doctrine is unpersuasive even on the particular facts in \textit{Lane}.\textsuperscript{69} In essence, the court concluded that the estate would abandon directly to the creditor with the debtor being a conduit. Foreclosure, however, does not necessarily follow abandonment. In fact, most often a creditor could not have foreclosed until it obtained relief from the stay under BC § 362(d). Furthermore, operation of the stay as well as any applicable statutory periods under state law would have permitted a now more motivated debtor to workout the situation with the creditor.\textsuperscript{70} Finally, Professor Jim Shepard cleverly and convincingly dispatches with the \textit{Lane} court's reliance on the \textit{Court Holding} doctrine. Shepard shows that the \textit{Lane} court in fact extracted the abandonment from the "complete" transaction.\textsuperscript{71} According to Shepard, the beginning point in viewing the \textit{Court Holding} doctrine should include the point at which the debtor decided to seek relief under the Bankruptcy Code. Thus, bankruptcy relief is but one step through which the property passed from the debtor to his or her creditors.\textsuperscript{72} In other words, where we begin the step-transaction analysis under the \textit{Court Holding} doctrine is not as self-evident as the \textit{Lane} court appears to suggest.

\textsuperscript{68}For a case adopting the \textit{Lane} analysis, see \textit{In re Rubin}, 154 BR 897 (Bankr. B. Md. 1992).
\textsuperscript{69}The \textit{Court Holding} doctrine is always a facts and circumstances test. See Grossberg, \textit{supra} note 37, at 12-8.
\textsuperscript{70}Grossberg, \textit{supra} note 37, at 12-8.
\textsuperscript{71}Shepard, \textit{supra} note 26, at 72.
\textsuperscript{72}Id. at 73. The \textit{Lane} court's reliance on the \textit{Court Holding} doctrine denies the essential factual foundation of \textit{Court Holding}. In \textit{Court Holding}, the Supreme Court characterized the transaction there as an attempt to evade taxes through the negotiations between the parties. 324 U.S. at 708. There a corporation was attempting "to transfer property already the subject of a sales transaction to another party for the sole purpose of having the other taxed on the sale." \textit{Id.} In the abandonment context there is no attempt to evade taxes, merely an attempt to shift liability from the debtor to the estate.
The second reason the court offered is that abandonment is a taxable event, a position inconsistent with all prior authorities. Clearly, a foreclosure or a deed in lieu of foreclosure is a taxable event. But is abandonment a taxable event? I think not. As suggested here, if a debtor's interest has always remained in the property, albeit subordinated to the estate's interest until abandonment, there can be no sale, exchange, or disposition from the estate to the debtor upon abandonment -- the debtor always owned the property. Moreover, a basic tenet of tax law is that form does control sometimes. If bankruptcy law treats abandoned property as if it had never been property of the estate, tax law should acquiesce. If abandoned property is not property of the estate, abandonment cannot be a taxable event.

To justify the conclusion that abandonment is a taxable event, the court reviewed IRC § 1398(f)(2). Section 1398(f)(2) provides that the transfer back to a debtor from the estate is not a disposition when the transfer occurs with the termination of the estate, unless by sale or exchange. In Lane, the court held that the abandonment was not tantamount to the termination of the estate as required by IRC § 1398(f)(2) and must, therefore, be a taxable event. This justification was expressly rejected by the court in In re McGowan, which held that “termination of the estate” for purposes of IRC § 1398(f)(2) included the termination of the estate’s interest in property under BC § 554(a).

The confusion is created by using the word “terminate” in IRC § 1398(f)(2). Does “terminate” mean the case is closed under BC § 350? The Service has taken such a position, I
believe unjustifiably.\textsuperscript{78} Exactly when the estate terminates for IRC § 1398 purposes remains unclear. For example, in a chapter 11 case, confirmation of the plan and post-confirmation operation even for a number of years is not congruous to closing the case under BC § 350.\textsuperscript{79} Thus, something less than a BC § 350 “closing” should satisfy the termination requirement under IRC § 1398(f)(2). Therefore, the better argument is that once the estate’s interest in the property terminates through abandonment, it terminates for IRC § 1398(f)(2) purposes as to the property abandoned.\textsuperscript{80}

The Lane court embraced a “strict” interpretation of IRC § 1398(f)(2) in concluding that abandonment is a “sale or exchange” for tax purposes. This argument, however, proves too much. IRC § 1398(f)(1), which governs the transfer of assets and liabilities from the debtor to the estate upon the filing of the bankruptcy petition, makes the transfer a nonrecognition event unless it is by “sale or exchange.” According to the Lane court, if the transfer -- if one even exists -- from the estate to the debtor pursuant to abandonment under BC § 554 is a “sale or exchange,” then the transfer from the debtor to the estate also would be a “sale or exchange,” taking that transfer out of nonrecognition status under IRC § 1398(f)(1). Thus, the transfer by a debtor to the estate becomes a realization event. Reliance on Lane and the Court Holding doctrine suggests such an analysis.\textsuperscript{81} Of course, this analysis eviscerates the essential purpose behind IRC § 1398.

In suggesting that bankruptcy abandonment is a taxable event, the Lane court also relied on Yarbro v. Commissioner\textsuperscript{82} and similar tax court decisions. In Yarbro, the Fifth Circuit

\textsuperscript{78}See Shepard, supra note 26 at 66 (citing IRS letter for that proposition and noting that position is inconsistent with In re Sonner, 53 BR 859 (Bankr. E.D. Va. 1985)(for tax purposes a chapter 11 case terminates when plan is confirmed).) Shepard defines termination by reference to probate estate and partnership terminations. Shepard, supra note 26, at 66-67.


\textsuperscript{80}Accord Olson, supra.

\textsuperscript{81}See Wallace, supra note 38, at 29 and 30.

\textsuperscript{82}737 F.2d 479 (5th Cir.), cert. denied, 469 U.S. 1189 (1984).
characterized abandonment under tax law as a sale or exchange, and, thus, a taxable event. In a situation where an abandonment under applicable nonbankruptcy law of over-encumbered property has occurred, a taxpayer receives a taxable benefit in the amount the secured debt is discharged.\footnote{Accord 133 BR at 270.} Therefore, applicable nonbankruptcy abandonment becomes an event no different in tax significance than a foreclosure sale or deed in lieu. Asserting that a trustee conveyed property and received a benefit in the form of relief from the secured debt, the court regarded the reasoning in \textit{Yarbro} as "inescapable."

Where the \textit{Lane} court erred was to equate tax abandonment with bankruptcy abandonment. The concept of abandonment for general tax purposes borrows heavily from the common law of property. In contrast, bankruptcy abandonment is a creature of statute; it has a specific meaning in bankruptcy law. Bankruptcy abandonment is a disclaimer by the estate of any interest in a specific asset of the debtor. Thus, the debtor's interest in the property remains undisturbed. To attempt to artificially weld the two distinct concepts of abandonment together would deny a rich and vibrant history associated with bankruptcy abandonment and the peculiar nature and purpose of this statutory beast.

A corollary to the second justification relied on by the court in \textit{Lane} is that to allow the trustee to abandon the property would destroy the symmetry between IRC, 1398(f)(2) and 1398(i).\footnote{\textit{Lane}, 133 BR at 273.} This point, I believe, is the most persuasive offered by the court. Section 1398(f)(2) provides that the transfer of property (other than by sale or exchange) from the estate to the debtor upon termination of the estate is not a taxable event. Section 1398(i) provides that the debtor succeeds to the estate's tax attributes on termination of the estate. By allowing the trustee to abandon property, the estate may shift the associated tax liability to the debtor while retain the enumerated tax
attributes that could have been used by the debtor to offset the amount realized from the subsequent foreclosure. Of course, this is also the result where the property is deemed abandoned because it was not administered by the trustee. Moreover, any tax attributes not used by the estate will ultimately revert back to the debtor upon termination of the estate and will be available to offset taxable income in the year of foreclosure, possibly ameliorating some of the harshness. Nevertheless, fairness remains an essential element of bankruptcy and tax law. It is not fair to allow a trustee to abandon property from the estate on the verge of foreclosure while, at the same time, retain for the estate the tax attributes associated with the very property.

One distinguished commentator seizes upon the lack of symmetry as a justification for characterizing abandonment as a taxable event. Although the Olson model suggests this lack of symmetry, that conclusion is not inescapable. One could persuasively argue that if abandonment is congruous to termination under IRC § 1398(f)(2), it should also be congruous to termination under IRC § 1398(i). Termination for one should be termination for the other. Thus, when property is abandoned, the tax attributes listed in IRC § 1398(g) should also remain with the property to the extent they can be reasonably traced. This is the position taken by the Service in final regulations concerning passive activity and at-risk losses and credits.

The third reason offered by the Lane court is that abandonment of the property would shift the tax liability from the estate to the debtor, thus depriving the debtor of a robust fresh start. This is true. If the estate abandoned the property in our example, and the lender subsequently foreclosed the lien, then the postpetition tax would not be dischargeable. The debtor owes the tax. Nevertheless, as discussed previously, many tax claims weaken the fresh start policy.

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85 See 11 U.S.C., 554(c).
86 Accord Shepard, supra note 26, at 74-75.
87 See Lipton, Proposed 1398 Regs Raise Conflict Between Debtors and Bankruptcy Trustees, J. Tax 12, 14 and 15 (July 1993).
523(a)(1) recognizes that the debtor's fresh start is subordinate to the government's interest in collecting certain taxes for its operations, in particular taxes entitled to priority under BC § 507(a).89

89See Shepard, supra note 26, at 75; see also In re Hanna, 872 F.2d 829, 831 (8th Cir. 1989). In an effort to alleviate a perceived lack of symmetry, the Service has recently taken the position that as to those attributes it adds to IRC § 1398(g) by regulation, it would be unfair to saddle a debtor with the tax liability upon abandonment and subsequent foreclosure while to allow the estate to retain the tax attributes associated with the property. Accordingly, if before the termination of the estate (as defined by the Service), the estate transfers an interest in a passive activity, former passive activity, or an unused IRC § 465 loss from an abandoned activity by midstream abandonment, then (1) the estate must allocate to the transferred interest part or all of the estate's unused passive activity loss and unused passive activity credit, determined as of the first day of the estate's tax year in which the transfer occurs, and (2) the debtor succeeds to and takes into account, beginning with the debtor's tax year in which the transfer occurs, the unused passive activity loss and unused passive activity credit allocated to the transferred interest. Lipton, supra note 87, at 15.

In 1993, the Section 108 Real Estate and Partnership Task Force of the Section of Taxation of the American Bar Association published a report on, among other things, the tax consequences posed by bankruptcy abandonment before the close of the case. Report of the Section 108 Real Estate and Partnership Task Force (Part I), 46 Tax Lawyer 209 (Fred Witt ed. 1993); Part II, 46 Tax Lawyer 397 (Fred Witt ed. 1993)(collectively hereafter "ABA Task Force"). After noting judicial disagreement on the subject, the ABA Task Force proceeded to disagree among itself. The majority camp embraced Lane as its working model; the minority camp, Olson as its working model. The consensus of the Task Force is "that an abandonment constitutes a taxable disposition to the bankruptcy estate." Id. at 449. The Task Force based its recommendation on IRC § 1398 and the fresh start policy in bankruptcy. Id. at 449. Although these two justifications may fuel the conclusions reached, they are far too thin a wedge to support the model explicated by the Task Force. Much of the justification for the Task Force's conclusion rests on two related points. First, the Task Force believed that because the estate and the debtor are separate taxable entities, abandonment as a transfer of the property would constitute a taxable disposition. Second, under the principles of Yarbro v. Commissioner, 737 F.2d 479 (5th Cir. 1984), a tax abandonment is a sale or exchange for tax purposes, and, thus, bankruptcy abandonment should also be a sale or exchange for tax purposes. Unfortunately, the Task Force mischaracterized the nature of bankruptcy abandonment and fell victim to the siren song that seeks to equate all types of abandonment. Because a bankruptcy abandonment is a disclaimer by the trustee of the estate's interest in the property, the fact that the estate and the debtor are separate tax entities is really beside the point. There is no transfer that constitutes a "sale or exchange" for IRC § 1001(c) purposes. The debtor's interest always remained in the abandoned asset; resort to the relation-back doctrine or other fictions is unwarranted. Furthermore, as discussed earlier, Yarbro dealt with property and tax law abandonment, not bankruptcy abandonment. Although it is natural to equate the concepts, it is naturally wrong. The various concepts of abandonment are creatures of their contexts, drawing life from the specific policies at play in their own corners of the legal galaxy. I believe the Task Force shows the weakness of its hand when the only statement directly supporting the application of Yarbro in equating tax law and bankruptcy abandonment is that "the Yarbro analysis is equally applicable to abandonments in bankruptcy." Id. at 449 (citing Lane). Contrary to the manner in which the proposition is stated, it is far from self-evident.
IV. PRIORITIES AND DISCHARGE

A. SCOPE OF DISCHARGE

An individual’s most important bankruptcy objective is a discharge from his or her debts.\(^{90}\) The discharge is at the heart of the fresh start policy promoted by the Bankruptcy Code and the BTA. The chapter 7 discharge is granted virtually automatically unless an objecting party can establish that the debtor has engaged in prohibited conduct, usually constituting some type of fraud or bankruptcy crime.\(^{91}\) The statute providing for discharge is liberally construed in favor of an individual debtor.\(^{92}\) Thus, the objecting party has the burden of establishing a ground for the denial of a discharge.\(^{93}\)

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\(^{91}\) See 11 U.S.C. 727(a)(1) through (a)(10).

\(^{92}\) Accord In re Adeeb, 787 F.2d 1339 (9th Cir. 1986); In re Johnson, 98 BR 359 (Bankr. N.D. 1988); In re Cutignola, 87 BR 702 (Bankr. M.D. Fla. 1988); In re Burke, 83 BR 716 (Bankr. N.D. 1988); In re Drenckhalm, 77 BR 697 (Bankr. D. Minn. 1987); In re Howard, 55 BR 580 (Bankr. E.D.N.C. 1985).

\(^{93}\) If a debtor has been denied a discharge in a bankruptcy case, so that all his or her debts remain outstanding, the debtor may not include the same obligations in a subsequent case to obtain a discharge. The denial of the discharge is res judicata as to the obligations existing at that time, which are forever nondischargeable. Although understood as part of the warp and woof of bankruptcy law, the right to discharge was not a part of the early enactments of bankruptcy acts in the United States. The Supreme Court noted the comparative newness of the discharge and fresh-start policy in bankruptcy in United States v. Kras, 409 U.S. 414, 446-47 (1973). In fact, it was not until the enactment of the Bankruptcy Act of 1898 that the law provided an individual debtor with a right to discharge certain debts pursuant to the bankruptcy process. Moreover, contrary to conventional wisdom, there is no constitutional right to a discharge; discharge is a statutory privilege provided to the honest but unfortunate debtor who has not abused the bankruptcy process. See In re Wheeler, 101 BR 39 (Bankr. N.D. Ohio 1988). A discharge in a bankruptcy case voids any judgment to the extent that it is a determination of the personal liability of the debtor with respect to a prepetition debt. See 11 U.S.C. § 524(a). The discharge also operates as an injunction against the commencement or continuation of an action, the employment of process, or any act, including telephone calls, letters, and personal contacts, to collect, recover, or offset any discharged debt. Id. In effect, the discharge is a total prohibition on debt collection efforts against a debtor. However, a discharge of the debtor does not discharge those liable on the debt along with the debtor, including guarantors, co-makers, or partners. 11 U.S.C.§. 524(e). Furthermore, under BC § 524, any attempt to reaffirm a discharged debt is void unless the provisions of the Bankruptcy Code delineating the requirements of reaffirmation are specifically followed. See 11 U.S.C. § 524(c). To ensure the effectiveness of the discharge, § 525(a) prohibits a governmental unit from denying, suspending, or refusing to renew a license or permit or deny employment solely because the person involved was discharged under the Bankruptcy Code, was insolvent before the bankruptcy case, or has not paid a dischargeable debt. Additionally, under § 525(b), no private employer may terminate the employment of, or discriminate with respect to employment against, an individual who is or has been a debtor under the Code, or an individual associated with a debtor under the Code, solely because the debtor is or has been a debtor under the Code, was insolvent before the commencement
Under chapter 11, § 1141(d) governs the scope and limits of discharge. Pursuant to BC § 1141(d), the confirmation of a plan of reorganization discharges a debtor from any debt that arose before the confirmation of the plan. Unlike § 727(a), a partnership, corporation, or an individual may receive a § 1141(d) discharge. The § 1141(d) discharge is broader than the § 727(a) discharge in that the latter discharges any debts that arose before the order for relief, while the former discharges any debts that arose before the confirmation of the plan.

B. EXCEPTIONS OF DEBT FROM DISCHARGE

Notwithstanding the debtor's discharge under the Code, certain debts are excepted from discharge as a matter of public policy pursuant to § 523(a). These exceptions to discharge are strictly construed. An exception to discharge should be contrasted with an objection to discharge. If successful in an objection to discharge proceeding, the creditor's claim along with every other claim survives the bankruptcy case; that is, the debtor will not receive a discharge at all. It is significantly different with an exception to discharge proceeding under § 523(a). If successful in asserting § 523(a), the creditor's claim will not be discharged and will survive the bankruptcy case; that is, a § 523(a) claim may be enforced and ultimately satisfied even after the bankruptcy case. Thus, although the debtor receives a general discharge, the § 523(a) claims live on.

The burden of proof to assert that the debt is non-dischargeable under § 523(a) falls squarely on the shoulders of the creditor asserting the exception. Among the types of claims that are
nondischargeable are current year taxes and taxes for which the due date falls within three years of
the filing of the bankruptcy petition.\textsuperscript{98} The following tax debts are excepted from discharge under §
523(a) as a matter of law:

- Taxes entitled to priority under §§ 507(a)(2) and (a)(8).
- Taxes connected with fraudulent returns, late returns, or a failure to file.
- Withholding taxes and taxes collected from others, that is, trust fund taxes.
- Debts that are not scheduled in time for the timely filing of the proof of claim.
- Governmental fines and penalties to the extent that they are not compensation for actual
  pecuniary loss. Nonetheless, this category of non-dischargeable debt does not include
tax penalties relating to dischargeable taxes or to any transaction or event that occurred
more than 3 years before the filing of the bankruptcy petition.

Section 523 of the Bankruptcy Code specifies which debts of an individual debtor are not
discharged in a bankruptcy case under § 727 of chapter 7, § 1141 of chapter 11, or § 1328(b) of
chapter 13 (the "hardship discharge").\textsuperscript{99} Included among these debts are certain taxes which are
identified as nondischargeable.\textsuperscript{100}

Section 523(a)(1) of the Bankruptcy Code sets forth the taxes or customs duties that are not
dischargeable by an individual debtor in a chapter 7, 11 or 13 bankruptcy case under §§ 727, 1141
or 1328(b)(chapter 13 "hardship discharge"), respectively. However, the regular chapter 13 super-
discharge does discharge debts identified under § 523(a).\textsuperscript{101}

\textsuperscript{98} 11 U.S.C. §§ 523(a)(1), 507(a).
\textsuperscript{99} However, these taxes may be discharged in a chapter 13 under § 1328(a), i.e., the chapter 13 super-
discharge.
\textsuperscript{100} In In re Olsen, 123 B.R. 312 (Bankr. N.D. Ill. 1991), the bankruptcy court held that a nondischargeable
tax claim survives bankruptcy regardless of whether such claim was filed or allowed in the bankruptcy case.
\textsuperscript{101} See 11 U.S.C. §1328(a).
The first category of nondischargeable tax claims is set forth in § 523(a)(1).102 Under this section, a tax or customs duty specified in § 507(a)(2) as an involuntary gap claim103 or § 507(a)(8)104 is nondischargeable whether or not a claim for such tax was allowed by the court or filed in the case.105 These priority and nondischargeable tax claims include the following:

1. Involuntary gap claims under § 507(a)(2)106
2. Income or gross receipts taxes incurred prepetition and within three years from the filing of the bankruptcy petition107
3. Income or gross receipts taxes assessed within 240 days from the filing of the bankruptcy petition108

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102 11 USC § 523(a)(1), which reads as follows:
A discharge under section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt—

(1) for a tax or a customs duty—

(A) of the kind and for the periods specified in section 507(a)(2) or 507(a)(8) of this title, whether or not a claim for such tax was filed or allowed;

(B) with respect to which a return, if required—

(i) was not filed; or

(ii) was filed after the date on which such return was last due, under applicable law or under any extension, and after two years before the date of the filing of the petition; or

(C) with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax.


104 11 U.S.C. § 523(a)(1)(A); 11 USC § 507(a)(8)(this section relates to the priority of allowed unsecured tax claims of governmental units)


106 The second priority as set forth in § 507(a)(2) of the Bankruptcy Code is “unsecured claims allowed under § 502(f) of this title.” Under § 502(f), an involuntary gap claim is one which arises in the ordinary course of a debtor’s business after the filing of an involuntary petition against the debtor but before either the appointment of a trustee or the entry of an order for relief. An involuntary gap claim is allowed “the same as if such claim had arisen before the date of the filing of the petition.” The involuntary gap claim is the creature of the involuntary bankruptcy case. Recall from chapter 1 that the filing of an involuntary petition against the debtor does not operate as an order for relief under the Bankruptcy Code. This priority speaks directly to the time delay made possible by segregating the order for relief from the filing of the petition.

107 An eighth priority is allowed by § 507(a)(8)(A)(i) of the Bankruptcy Code for unsecured federal tax liens (“unsecured claims of governmental units”) to the extent that such claims are for income or gross receipts taxes incurred before the filing of the bankruptcy petition for which the due date of the tax return (including any extension) occurred within three years before the date the bankruptcy petition was filed or for which the due date of the return (including any extensions) occurred after the filing of the petition. As indicated, the due date of the return, and not the date when the taxes are assessed, determines the priority.
4. Income or gross receipts taxes still assessable under applicable law at the time the bankruptcy petition is filed\textsuperscript{109}

5. Recent property taxes assessed prepetition and last due without penalty within one year of the filing\textsuperscript{110}

6. Trust fund taxes incurred at any time\textsuperscript{111}

7. The employer’s share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition was filed\textsuperscript{112}

8. Excise taxes related to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition\textsuperscript{113}

\textsuperscript{108} Also included are income and gross receipts taxes assessed at any time within 240 days before the date the bankruptcy petition was filed. The 240-day period is extended for the period of time an offer of compromise is considered by the IRS after submission by the taxpayer, plus 30 days after such offer is rejected. Under this rule, the date on which the IRS assesses the tax, rather than the date of the return, determines the priority.

\textsuperscript{109} Section 507(a)(8)(A)(iii) grants priority to income and gross receipts taxes not assessed before the filing of a bankruptcy petition, but which are still permitted to be assessed under applicable tax laws. Accordingly, a prepetition and unsecured federal tax lien will still receive a seventh priority under this section if the statute of limitations still allows an assessment of the tax liability after the bankruptcy petition is filed, even though such assessment was not made within the 240-day period (plus any extension) prior to the bankruptcy filing.

\textsuperscript{110} An unsecured claim of a governmental unit for property taxes assessed before the bankruptcy petition was filed and last payable without penalty within one year before the filing of the petition is given a seventh priority.

\textsuperscript{111} Taxes required to be collected or withheld and for which the debtor is liable in whatever capacity are given a seventh priority under § 507(a)(8)(C) of the Bankruptcy Code.

\textsuperscript{112} The employer’s share of employment taxes on wages earned from the debtor and paid before the filing of a bankruptcy petition receives an eighth priority under § 507(a)(8)(D) of the Bankruptcy Code, to the extent the return for such taxes was last due (including any extensions of time) within three years before the filing of the bankruptcy petition or was due after the bankruptcy petition was filed. Older tax claims of this nature are payable as nonpriority general claims. Likewise, the employee’s share of employment taxes on wages earned from a debtor and paid before the filing of a bankruptcy petition also receives an eighth priority in the same manner as the employer’s share of employment taxes.

\textsuperscript{113} Unsecured claims for excise taxes are given an eighth priority under § 507(a)(8)(E) of the Bankruptcy Code. The excise taxes claimed must relate to transactions for which a return (if required) is last due (plus any extension) within three years before the filing of the bankruptcy petition or due after the filing of the bankruptcy petition. If a return is due, the three year period is extended if the due date for filing the return was extended.
9. Certain customs duty under § 507(a)(8)(F) of the Bankruptcy Code

The second category of nondischargeable tax claims is set forth in BC § 523(a)(1) and includes the following taxes:

1. Tax liabilities relating to a tax return which was not filed;\(^{115}\)

2. Tax liabilities reported by a tax return filed late and filed within two years prior to the filing of the bankruptcy petition or filed after the bankruptcy petition;

3. Tax liabilities reported by a fraudulent return\(^ {116}\) or from an attempt by the debtor to willfully evade or avoid any tax.\(^ {117}\)

114 Unsecured claims for customs duty are given an eighth priority under § 507(a)(8)(F) of the Bankruptcy Code. According to the legislative history, this priority covers duties on imports entered for consumption within one year before the filing of the petition, but which are still unliquidated on the petition date; duties covered by an entry liquidated or unliquidated within one year before the petition date; and any duty on merchandise entered for consumption within four years before the petition but not liquidated as of the petition date, if the Secretary of the Treasury or his or her delegate certifies that duties were not liquidated because of possible assessment of antidumping or countervailing duties or fraud penalties.

115 \(11 \text{ USC} \, \, § 523(a)(1)(B); \) see 124 Cong. Rec. H11,113-14 (daily ed Sept 28, 1978); S 17,430-31 (daily ed Oct 6, 1978); \( \) see also \( \text{In re Graham}, 108 \text{ B.R.} 498 (\text{Bankr. E.D. Pa.} 1989)\), where the bankruptcy court held that a prepetition tax court decision holding the debtor liable to the IRS for the debtor’s underpayment of taxes, but which did not decide that the underpayment was fraudulent, did not preclude the debtor from disputing the government’s claim that such tax liabilities were non-dischargeable for fraud; \( \text{In re Fernandez}, 112 \text{ B.R.} 888 (\text{Bankr. N.D. Ohio} 1990)\), where the bankruptcy court held that the debtor’s conduct concerning tax obligations was shown to be willful and evasive and thus, the tax obligations were deemed non-dischargeable; \( \text{In re Kirk}, 114 \text{ B.R.} 771 (\text{Bankr. N.D. Fla.} 1990)\), where the bankruptcy court held that the debtors’ conduct demonstrated a purposeful attempt to evade income taxes and thus, the claim of the IRS for civil fraud penalties was allowed; \( \text{In re Carapella}, 115 \text{ B.R.} 365 (\text{N.D. Fla.} 1990)\), where the district court held that the tax liability of a chapter 7 debtor for a fraudulent return filed by the debtor was nondischargeable; \( \text{In re Gilder}, 122 \text{ B.R.} 593 (\text{Bankr. M.D. Fla.} 1990)\), where the bankruptcy court held that where the debtor submitted false withholding statements for the express purpose for eliminating the withholding of federal income taxes from wages, such conduct was a “willful attempt to evade or defeat tax” within the meaning of the exception to discharge; \( \text{In re Hopkins}, 133 \text{ B.R.} 102 (\text{Bankr. M.D. Ohio} 1991)\), where the
The third category of nondischargeable taxes is set forth in § 523(a)(7). This section provides that tax penalties which are basically punitive in nature are nondischargeable only if the penalty is computed by reference to a related tax liability which is also nondischargeable. It appears that if the amount of the penalty is not computed by reference to a tax liability, the transaction or event giving rise to the penalty must occur during a three-year period ending on the date of the filing of the bankruptcy petition.

In In re Burns and In re Roberts, the United States Courts of Appeals for the Eleventh and Tenth Circuits held that a tax penalty is discharged if the tax to which it relates is discharged or if the transaction or event giving rise to the penalty occurred more than three years prior to the filing of the bankruptcy petition. Moreover, in In re Henderson, the bankruptcy court held that tax penalties relating to nondischargeable tax liabilities incurred more than three years before the filing of the bankruptcy court held that the wife’s signing of joint returns which she knew were in error constituted the making of a fraudulent return or willfully attempting to evade such tax and, thus, such tax debts were nondischargeable in the wife’s bankruptcy case; In re Peterson, 132 B.R. 68 (Bankr. D. Wyo. 1991), where the bankruptcy court held that the debtor did not “willfully” attempt to evade tax by signing returns which the government admits were not fraudulent and then filing for relief under chapter 7 shortly after such taxes became eligible to be dischargeable; In re Graham, 973 F.2d 1089 (3d Cir. 1992), where the United States Court of Appeals for the Third Circuit held that a United States Tax Court judgment holding the debtors liable for income tax deficiencies resulting from fraudulent tax returns did not have claim preclusion or issue preclusion effect in determining whether the debtors’ liability was nondischargeable; In re Levinson, 969 F.2d 260 (7th Cir. 1992), where the United States Court of Appeals for the Seventh Circuit held that the evidence was sufficient to support a determination that the debtor had filed fraudulent tax returns so as to render the tax debts nondischargeable.

118 11 USC § 523(a)(7), which reads as follows:
   (a) A discharge under Section 727, 1141, or 1328(b) of this title does not discharge an individual debtor from any debt—
   (7) to the extent such debt is for a fine, penalty, or forfeiture payable to and for the benefit of a governmental unit, and is not compensation for actual pecuniary loss, other than a tax penalty—
   (A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or
   (B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

120 887 F.2d 1541 (11th Cir. 1989).
121 906 F.2d 1440 (10th Cir. 1990).
of a bankruptcy petition were dischargeable in a chapter 7 case. Furthermore, in In re Fullmer, the United States Court of Appeals for the Tenth Circuit held that tax penalties imposed pursuant to nondischargeable tax debts are nondischargeable as well. But in In re Byrum, where the district court held that a tax penalty assessed by the Internal Revenue Service more than three years before the debtor filed a chapter 7 petition was dischargeable. Likewise, in In re McKay, the United States Court of Appeals for the Ninth Circuit held that civil fraud penalties imposed on unpaid taxes accruing more than three years before the filing of the debtor’s bankruptcy petition were dischargeable, even though the debt for unpaid taxes was not dischargeable on the ground of fraud.

With respect to individual debtors in reorganization under chapter 11, § 1141(d)(2) of the Bankruptcy Code incorporates by reference the exceptions to discharge set forth in § 523 and discussed above. Section 1141(d)(2) of the Bankruptcy Code provides that the confirmation of a chapter 11 plan does not discharge an individual debtor from any debt excepted from discharge under § 523.

With respect to all debtors (i.e., including corporations and partnerships), the confirmation of a chapter 11 plan does not discharge the debtor from any debts (including taxes) if:

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123 962 F.2d 1463 (10th Cir. 1992).
125 See also In re Henderberg, 108 B.R. 407 (Bankr. N.D.N.Y. 1989), where the bankruptcy court held that a taxing authority’s claim for penalties did not enjoy priority status because such penalties were not for actual pecuniary loss; In re Virtual Network Servs Corp, 902 F.2d 1246 (7th Cir. 1990), where the United States Court of Appeals for the Seventh Circuit held that the bankruptcy court exercise its equitable jurisdiction to subordinate the claim of the IRS for a nonpecuniary tax loss penalty to the claims of other creditors in a chapter 11 liquidation proceeding; In re Mako, Inc, 135 B.R. 902 (E.D. Okla. 1991), where the district court held that the IRS was not entitled to security or priority status for the penalty portion of its claim against the debtor for unpaid taxes; In re Garcia, 955 F.2d 16 (5th Cir. 1992), where the United States Court of Appeals for the Fifth Circuit held that prepetition interest on a tax liability, as a pecuniary loss penalty, was entitled to the same priority in the chapter 13 case as the underlying taxes.
126 957 F.2d 689 (9th Cir. 1992).
128 11 USC §§ 1141(d)(2) and 523.
1. The plan provides for the liquidation of all or substantially all of the property of the estate.

2. The debtor does not engage in business after consummation of the plan.

3. The debtor would be denied a discharge under § 727(a) of the Bankruptcy Code if the case were a chapter 7 liquidation proceeding.\(^{129}\)

Thus, a debtor is not discharged from any debt (including federal taxes) by the confirmation of a plan if the plan is a liquidation plan and if the debtor would be denied a discharge in a chapter 7 liquidation proceeding pursuant to § 727(a) of the Bankruptcy Code.\(^{130}\) Under § 727(a)(1), only an individual, and not a corporation or a partnership, may obtain a discharge.\(^{131}\)

After a debtor has made all payments required by the chapter 13 plan, the bankruptcy court grants to the debtor a discharge of all debts provided for by the plan or disallowed under § 502, except the following debts:

1. Debts with the final payment falling due after the final payment under the plan is due as set forth in § 1322(b)(5), that is, certain long-term debt.\(^{132}\)

2. Debts owed to a spouse, former spouse, or child for alimony, maintenance, or support in connection with a separation agreement, divorce decree, or property settlement agreement as set forth in § 523(a)(5).\(^{133}\)

3. Certain student loans that do not pose an undue hardship to the debtor as set forth in § 523(a)(8);

\(^{129}\) Id. § 1141(d)(3).

\(^{130}\) S Rep No 989, 95th Cong, 2d Sess 129 (1978).


\(^{133}\) Id. § 1328(a)(2).
4. Debts for death or personal injury caused by the debtor’s operation of a motor vehicle while intoxicated as set forth in § 523(a)(9);

5. Debts for restitution included in a sentence on the debtor’s conviction of a crime.\textsuperscript{134}

Thus, § 1328 discharges most of the debts listed in § 523(a) that may not otherwise be discharged in a chapter 7 or chapter 11 case. Included in those debts discharged in a chapter 13 case are the tax claims identified in § 523(a)(1). However, all priority claims under § 507 of the Bankruptcy Code must be paid in full pursuant to the chapter 13 plan. In addition, § 1328(e) of the Bankruptcy Code provides that the bankruptcy court may revoke a discharge if it had been obtained through fraud, provided the request for revocation is made within one year after the discharge is granted.\textsuperscript{135}

The chapter 13 discharge is much broader in scope than either the chapter 7 or chapter 11 discharge. Recall that under chapter 7 or chapter 11 (when the debtor is an individual), a creditor who persuades the court to except its debt under § 523(a) of the Code may disregard any discharge order and enforce its claim even after discharge or plan confirmation. Not so in the chapter 13 case. Under § 1328(a), almost all debts are discharged, even those that are non-dischargeable under § 523(a). The only debts which are not discharged are those for alimony and support payments, certain educational loans, damages related to death or personal injury caused by the debtor’s operation of a motor vehicle while the debtor was intoxicated from the use of alcohol or drugs and criminal restitution. Consequently, chapter 13 may be a more useful tool for the debtor who has a substantial amount of debt that a court may find non-dischargeable under § 523(a), for example, tax debts.

\textsuperscript{134} 11 U.S.C. § 1328(a).
\textsuperscript{135} Id. § 1328(e).
When does the discharge occur? Unlike the limited chapter 11 discharge that arises at the time the plan is confirmed, the chapter 13 discharge arises only after the debtor has completed full performance under the chapter 13 plan.

What happens to the chapter 13 right to discharge if the debtor is unable to complete performance under the plan? Section 1328(b) of the Code answers this question. If the reason the chapter 13 debtor cannot perform under the plan can be traced to reasons beyond the debtor’s control, the debtor may receive a “hardship” discharge so long as the debtor has performed sufficiently to have ensured that the creditors have received more under the chapter 13 plan as partially performed than they would have received under a chapter 7 liquidation. Nonetheless, the Code extracts a price from the chapter 13 debtor who by powers beyond the debtor’s control must resort to the hardship discharge. A discharge granted under this subsection discharges the debtor from all unsecured debts provided for by the plan or disallowed under § 502, except: claims with final payments falling due after the final payment under the plan is due as set forth in § 1322(b)(5); and debts as specified in § 523(a). Thus, those § 523(a) debts that are generally non-dischargeable but would have been discharged under chapter 13 remain non-dischargeable if the debtor is granted the hardship discharge. In other words, the chapter 13 hardship discharge is but the chapter 7 discharge in a different guise.

Since the chapter 13 discharge discharges “all debts provided for by the plan,” the critical issue is frequently the interpretation of the phrase “provided for by the plan,” and, in the tax area,
the ability of the chapter 13 debtor to discharge §§ 507(a)(2) and (a)(8) priority tax claims even though such claims may have been “provided for” in the debtor’s plan, but not actually paid.

Suppose, for example, that the debtor’s chapter 13 plan provides that the debtor will “pay one hundred percent of allowed claims to the IRS?” Suppose further that the IRS receives a timely notice of the debtor’s chapter 13 plan, but that the IRS does not file its proof of claim in a timely manner, and the IRS is legitimately owed a designated amount of prepetition taxes which qualify as a priority unsecured claim under § 507(a)(8). Upon consummation of the debtor’s chapter 13 plan, are the prepetition priority taxes owed to the IRS discharged?

It is clear that § 1322(a)(2) of the Bankruptcy Code provides that a plan must provide for the full payment in deferred cash payments of all § 507(a)(8) priority claims, including tax claims. In the example as stated above, however, there is authority to support the debtor’s position that the debtor will be discharged from the prepetition priority taxes owed to the IRS because the taxes were “provided for” under the debtor’s plan combined (fortunately, for the debtor) with the lack of diligence by the IRS in failing to file its proof of claim in a timely manner. For example, in In re Gregory,139 the court stated that “provided for by the plan” means that plan must deal with the claim at issue or refer to it. The plan need not pay the claim or provide a benefit for the claim.140

Disallowed claims, including those claims for priority taxes under BC § 507(a)(8) are discharged in a chapter 13 case. This most often happens where the IRS has failed to timely file a proof of claim and the claim is disallowed. Bankruptcy Rule 3002 provides that a creditor must file

139 705 F.2d 1118 (9th Cir. 1983).
140 See also In re Ryan, 78 B.R. 175 (Bankr. Tenn. 1987); In re Daniel, 107 B.R. 798 (Bankr. N.D. Ga. 1989), where the bankruptcy court held that the tax claim of the IRS was “provided for” under the debtor’s chapter 13 plan and such claim was therefore discharged upon completion of the plan; In re Leber, 134 B.R. 911 (Bankr. N.D. Ill. 1991), where the bankruptcy court held that a tax claim by the Illinois Department of Revenue which had actual notice of the debtor’s chapter 13 case, but which did not file a proof claim for its prepetition tax claim, was discharged by the chapter 13 plan, despite the contention that the Department was not effectively “provided for” in the plan.
a proof of claim within 90 days from the first date scheduled for the BC § 341 meeting. Any creditors, including the IRS, may seek an extension in which to file the proof of claim.\textsuperscript{141}

Section 1325(a)(3) requires that a debtor’s chapter 13 plan be proposed in good faith, which courts consistently observe is one of the central, perhaps the most important, confirmation finding to be made by the court in any chapter 13 case. Despite such sentiments by the courts, “good faith” is not defined in the Code or in its legislative history. Because of the ability of debtors to discharge tax debts in a chapter 13, including tax debts arising from the failure to file a return or from tax fraud, the issue of the plan’s good faith is often in contention.

A majority of the federal courts have concluded that a debtor’s good faith should be determined on a case by case basis considering the “totality of the circumstances.” These courts have suggested a list of factors that courts should consider in analyzing a debtor’s good faith. These factors include:

1. the amount of the proposed payments and the amount of the debtors’ surplus;
2. the debtors’ employment history, ability to earn and the likelihood of future increases in income;
3. the probable or expected duration of the plan;
4. the accuracy of the plan’s statements of the debts, expenses and percentage repayment of unsecured debt and whether any inaccuracies are an attempt to mislead the court;
5. the extent of preferential treatment between classes of creditors;
6. the extent to which secured claims are modified;

\textsuperscript{141}Bankr. R. 3002(c)(1).
7. the type of debt sought to be discharged and whether any such debt is nondischargeable in chapter 7;

8. the existence of special circumstances such as inordinate medical expenses;

9. the frequency with which the debtor has sought relief under the Bankruptcy Code;

10. the motivation and sincerity of the debtor in seeking chapter 13 relief;

11. the burden which the plan's administration would place upon the trustee; and

12. the percentage of the repayment to unsecured creditors.\(^{142}\)

Although many courts have either added or subtracted from this "laundry list" of factors, they agree that a factor to be considered in the analysis is whether the debt sought to be discharged is dischargeable under chapter 7.\(^{143}\)

Alternatively, some courts believe that the "laundry list" approach is an improper method for courts to utilize in their good faith analysis. These courts would apply the "honesty-of-intention" test in analyzing the good faith standard. In utilizing this test, courts examine whether a debtor intentionally misrepresented his financial status in the proposed plan, unfairly manipulated the Code, or otherwise inequitably proposed the chapter 13 plan. This approach precludes the court from scrutinizing a debtor's plan, and, therefore, a debtor's attempt to discharge a debt nondischargeable under chapter 7 does not enter into a court's good faith determination.

\(^{142}\) In re Estus, 695 F.2d 311, 317 (8th Cir. 1982)(citations omitted).

\(^{143}\) The court in In re Easley, 72 B.R. 948, 950-55 (Bankr. M.D. Tenn. 1987), conducted a survey of over 300 good faith decisions and generated a list of 17 good faith attributes which the court found appropriate: (1) frequency of bankruptcy filing; (2) accuracy of petition statements and schedules; (3) motivation in filing chapter 13; (4) initial filing of chapter 7 rather than chapter 13; (5) existence of debt nondischargeable in a chapter 7 case; (6) circumstances of incurring debt; (7) nature and amount of unsecured debt; (8) probable duration of the plan; (9) degree of effort; (10) likelihood of future increases in income; (11) percentage of repayment of debt; (12) amount of proposed payments; (13) amount of surplus in budget; (14) special circumstances; (15) burden of administration; (16) amount of attorney's fees; and (17) generic tests such as "fundamental fairness," "honesty of intention," and "totality of the circumstances." Id.
V. BANKRUPTCY AMENDMENTS OF 2005\textsuperscript{144}

As I complete these materials, President Bush has signed sweeping legislation that with change significantly the practice of bankruptcy law. On April 20, 2005, the President signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("2005 Act"). Most of the changes in the Bankruptcy Act will take effect on October 17, 2005, (180 days after the enactment date), but do not apply to cases commenced before Oct. 17, 2005. The 2005 Act’s tax provisions, among other things, would: (1) align, for tax purposes, the chapter 13 discharge with that of the chapter 7 discharge, thus, for example, prohibiting the discharge under a chapter 13 bankruptcy filing of any debt for fraudulent tax payments; (2) provide greater protection for holders of \textit{ad valorem} tax liens on real or personal property; (3) simplify the process for filing of claims by states for certain fuel taxes; (4) set a priority for tax claims and simplify the calculation of interest applicable to tax claims and (5) resolve the issue as to the appropriate interest rate on tax claims in bankruptcy cases. Following is an overview of the tax provisions of the 2005 Act:

\textit{Title VII: Bankruptcy Tax Provisions}

- (Sec. 701) Amends the Bankruptcy Code to modify the treatment of certain tax liens.

- (Sec. 702) Provides that a claim for debtor's liability for fuel tax which is filed by the base jurisdiction designated under the International Fuel Tax Agreement shall be allowed as a single claim.

- (Sec. 703) Requires the clerk of each district to maintain a listing under which a governmental entity responsible for the collection of taxes within such district may designate an address for service of requests and describe where further information for filing such requests may be found.

\textsuperscript{144} This list was originally compiled by the New York City Bar Association.
➤ (Sec. 704) Prescribes the rate of interest to be paid on mandatory interest payments on tax claims.

➤ (Sec. 705) Revises the specifications for income tax claims receiving eighth priority (allowed unsecured claims of governmental units). Provides for tolling of the time periods covering such tax claims for stays of proceedings in a prior bankruptcy case, and the pendency or effect of offers in compromise or installment agreements.

➤ (Sec. 707) Prohibits a Chapter 13 discharge of any debt for fraudulent tax payments.

➤ (Sec. 708) States that confirmation of a bankruptcy plan under Chapter 11 does not discharge a corporate debtor from any debt for: (1) money or credit obtained by false representation owed to a domestic governmental unit or to a person as the result of an action filed with respect to certain claims against the Federal or a State government; or (2) a tax or customs duty with respect to which the debtor made a fraudulent return or willfully attempted to evade or defeat such tax.

➤ (Sec. 709) Limits the automatic stay of U.S. Tax Court proceedings to prepetition taxes.

➤ (Sec. 710) Sets as a prerequisite for court confirmation of a Chapter 11 bankruptcy plan that includes tax claims, that the debtor make regular cash installment payments over a period ending not later than five years after the date of entry of the order for relief, and in a manner not less favorable than the most favored nonpriority unsecured claim provided for in the plan.

➤ (Sec. 711) Prohibits the avoidance of statutory tax liens by certain purchasers.

➤ (Sec. 712) Amends the Federal judicial code to require officers and agents conducting any business under court authority to pay all Federal, State, and local taxes when due in the course of the business, unless it is a property tax secured by a lien against estate
property which is abandoned by the bankruptcy trustee, or payment of the tax is excused under a specific bankruptcy law. Cites circumstances in which payment of such taxes may be deferred in a case pending under chapter 7 until final distribution is made. Moreover, entitles to administrative expense priority payment certain secured and postpetition unsecured taxes incurred by the bankruptcy estate, including *ad valorem* property taxes. Furthermore, declares that a governmental unit shall not be required to file a request for the payment of administrative expenses relating to a tax liability or tax penalty. Additionally, allows a trustee to recover from property securing a claim for the payment of all *ad valorem* property taxes relating to such property.

> (Sec. 713) Requires as a condition for payment of tardily filed priority tax claims that they be filed either before the trustee commences distribution, or ten days following the mailing to creditors of the summary of the trustee's final report, whichever is earlier (currently, before the trustee commences distribution of the estate).

> (Sec. 716) Conditions court confirmation of a chapter 13 bankruptcy plan upon filing by the debtor: (1) of all prepetition tax returns; and (2) before the day on which the first meeting of the creditors is convened, of all tax returns for taxable periods ending in the four-year period that ends on the date of the filing of the petition. Directs the court to dismiss a plan or convert it to chapter 7, whichever is in the best interests of the creditors and the estate, if a chapter 13 debtor fails to comply with such time frame. Furthermore, expresses the sense of Congress that the Judicial Conference should propose for adoption amended Federal Rules of Bankruptcy Procedure pertaining to objections to tax returns and to plan confirmation.
➢ (Sec. 717) Redefines "adequate disclosure," for Chapter 11 postpetition disclosure and solicitation purposes, to include full discussion of the potential material Federal and State tax consequences of the plan to the debtor and to a hypothetical investor that is representative of the holders of claims or interests in the case.

➢ (Sec. 718) Denies an automatic stay (unless specified conditions are met) to the setoff of an income tax refund for a taxable period which ended before the order for relief against an income tax liability for a taxable period which also ended before the order for relief.

➢ (Sec. 719) Revises special provisions related to the treatment of State and local taxes, including the creation of a separate taxable estate when such is done for Federal tax purposes.

➢ (Sec. 720) Permits a taxing authority to petition the court to convert or dismiss a case if the debtor fails to timely file a tax return or obtain an extension, whichever is in the best interests of creditors and the estate.

Other provisions that may have an affect on tax issues but are not identified in Title VII of the 2005 Act include the following:

• (Sec. 214) Excepts from an automatic stay specified choses-in-action pertaining to domestic support obligations proceedings, including: (1) child custody or visitation; (2) dissolution of marriage; (3) domestic violence; (4) withholding of income that is property of the bankrupt estate for payment of domestic support obligations; (5) suspension of drivers' licenses and professional licenses; (6) reporting of overdue support owed by a parent to certain consumer reporting agencies; (7) interception of
specified tax refunds; and (8) enforcement of medical obligations under title IV, part D (Child Support and Establishment of Paternity) of the Social Security Act.

- (Sec. 224) Permits an individual debtor to exempt from the property of the bankrupt estate certain tax-exempt retirement funds that have not been obligated in connection with any extension of credit.

- (Sec. 314) Includes as nondischargeable chapter 13 debts those incurred: (1) to pay a tax to a non-Federal governmental unit; (2) for restitution or a criminal fine included in a sentence on the debtor's conviction of a crime; (3) for fraud or defalcation while acting in a fiduciary capacity; or (4) for restitution, or damages, awarded in a civil action against the debtor as a result of willful or malicious injury by the debtor that caused personal injury or death to an individual.

- (Sec. 315) Prescribes notice procedures for Chapter 7 and Chapter 13 creditors. Expands debtor's duties to require filing with the bankruptcy court of: (1) Federal tax returns; (2) evidence of employer payments received; (3) monthly net income projections; and (4) anticipated income or expenditure increases. Permits a Chapter 7 or chapter 13 creditor to request the debtor's petition, tax schedules, and statement of affairs, including the debt adjustment plan filed by the debtor. Requires dismissal of a Chapter 7 or 13 case upon debtor's failure to provide to the bankruptcy trustee within seven days before the initial date for the first meeting of creditors a tax return for the latest taxable period prior to filing. Requires that, at the time of filing with the taxing authority, a Chapter 7 or 13 debtor file with the bankruptcy court specified tax documentation pertaining to the period from case commencement until case termination. Requires a Chapter 13 debtor to file with the court a statement of
income and expenditures in the preceding tax year, and monthly net income, showing how calculated. Makes debtor's mandatory documentation available for inspection and copying to certain bankruptcy officers and any party in interest. Requires debtors to furnish driver's license, passport, or other photograph-containing documentation establishing debtor identification.

- (Sec. 1005) Repeals the requirement that the family farmer and spouse receive over 50 percent of income from farming operations in the year before a bankruptcy petition is filed. Allows such income requirement to be met during either the taxable year preceding the year in which the bankruptcy petition is filed, or the taxable year in the second and third taxable years preceding the bankruptcy petition.

- (Sec. 1225) Denies an automatic stay with respect to creation or perfection of a statutory lien for a special tax or special assessment on real property whether or not ad valorem, if the tax or assessment comes due after the filing of a petition for debtor relief.

- (Sec. 1228) Prohibits a court from granting a discharge in a chapter 7 case, or from confirming a reorganization plan in a chapter 11 or 13 case, unless requested tax documents have been provided to the court.

- (Sec. 1302) Requires additional disclosures for credit extensions secured by a dwelling that exceed such dwelling's fair market value, as well as related credit advertisements, including a statement that the interest on the excess portion of such extension is not tax deductible for Federal income tax purposes.
VI. CONCLUSION

Both business and consumer bankruptcies regularly pose challenging tax issues. Many of these issues are often overlooked, much to the detriment of our bankruptcy clients. Fortunately, more attention is paid to tax issues in the bankruptcy context than even ten years ago. These materials are designed to aid you in the robust representation of your client. Best of luck.
THE INTERSECTION BETWEEN BANKRUPTCY AND
REVISED ARTICLE 9 OF THE U.C.C. - NEW DEVELOPMENTS

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SECTION B
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Introduction

Article 9 of the Uniform Commercial Code is the state law governing secured transactions. In 1990, a Study Committee was formed to consider whether to recommend revision Article 9 of the U.C.C. The revision process culminated in 1998, with the promulgation of Revised Article 9. Today, Revised Article 9 is the law in all 50 states and the District of Columbia. Revised Article 9 represents the first major changes to the statute since 1972.

Significant changes were made with respect to the statute’s scope, substantive rules and procedures. The objective of the revisions was to add greater certainty to financing transactions, which would in turn reduce both transaction costs, and cost of credit. The revisions made to Article 9 can be identified as falling within one of two central frameworks: (i) changes that result in the expansion in scope of personal property and transactions covered by Article 9; and (ii) changes that result in the simplification of the creation, perfection, priority, and enforcement of security interests.

This Article addresses five issues that arise within these frameworks: (i) changes in rules with respect to the requirements surrounding the debtor’s name (ii) the rules concerning consignments under Article 9; (iii) new interpretations of the rules concerning the true sale vs. secured loan issue; (iv) the new Article 9 collateral type, deposit accounts; and (v) the expansion of the concept of proceeds under Revised Article 9.

1. Debtor’s Name – Revised §§ 9-503, 9-506, 9-508

Introduction

The filing system is designed to give prospective creditors notice of the debtor’s encumbered property. A prospective creditor will want to see if there are is public notice of another creditor’s claim to debtor’s assets. If a search of the public records reveals a financing statement, the searching creditor will want to review the description of the collateral to determine what property of the debtor is encumbered. From the filing, the
The creditor should be able to obtain the basic contact information for the party having a security interest listed in the financing statement.

The debtor's name is the center of the Article 9 filing system; filing offices index financing statements according to the debtor's name and searchers search for financing statements under the debtor's name. A financing statement is required to include many items of information, but because the statements are indexed according to the name of the debtor, that is arguably the most crucial item of information to get right.

Under old Article 9, the test for determining whether a financing statement filed under a particular name was effective was whether it was, relative to the "correct name," "seriously misleading." Human judgment was relevant in making such a determination because courts considered whether a "reasonably diligent searcher" could discover the erroneous filing. The abandonment of the "reasonably diligent searcher" rule under Revised Article 9 represents a change. Whereas the old manual search systems, could identify certain variations in names, the computerized search logic now used by many state filing offices, has considerably less tolerance for variations.

The Revised Article 9 rule, which recognizes the development of computerized search systems, is not absolutely inflexible, however. Revised Section 9-506(a) provides, "a financing substantially satisfying the requirements of this [provision] is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement misleading." Generally, a financing statement is "seriously misleading" if it

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1 "The filing office shall index an initial financing statement according to the name of the debtor and index all filed records relating to the initial financing statement in a manner that associates with one another an initial financing statement and all filed record relating to the initial statement." U.C.C. § 9-519(c) (2004).

2 Section 9-502(a) provides, . . . a financing statement is sufficient only if it:

- (1) provides the name of the debtor;
- (2) provides the name of the secured party or a representative of the secured party; and
- (3) indicates the collateral covered by the financing statement.

3 See, e.g., Knudson v. Dakota Bank and Trust Co., 929 F.2d 1280, 1283 (8th Cir. 1991) (under former Article 9, a financing statement is not seriously misleading if it "reasonably likely" that searcher searching under the debtor's correct would find the financing statement).

4 Section 9-506 reads in full:

(a) Minor errors and omissions. A financing statement substantially satisfying the requirements of this part is effective, even if it has minor errors or omissions, unless the errors or omissions make the financing statement seriously misleading.

(b) Financing statement seriously misleading. Except as otherwise provides in subsection (c), a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a) is seriously misleading.

(c) Financing statement not seriously misleading. If a search of the records of the filing office under the debtor's correct name, using the filing office's standard search logic, if any, would disclose a financing statement that fails sufficiently to provide the name of the debtor in accordance with Section 9-503(a), the name provided does not make the financing statement seriously misleading.
fails to sufficiently provide the name of the debtor.⁵ A financing statement indicating something less than the debtor’s correct name is not deemed seriously misleading, if “a search of the records of the filing office under the debtor’s correct name, using the filing office’s standard search logic” would reveal the financing statement.⁶ Essentially, Revised Article 9 “allows a searcher to rely on a single search conducted under the correct name of the debtor and penalizes filers only for errors that result in nondisclosure of the financing statement in a search under the correct name.”⁷ This standard is stricter than that of former Article 9.

Although Revised Article 9 allows a searcher to rely on a single search conducted under the correct name of the debtor, there are instances where it is in the best interest of the searcher conduct a more extensive search to detect seriously misleading filings. In some instances, a financing statement, which is found to be “seriously misleading” under the computer search logic standard is nonetheless deemed to be effective.

To illustrate, under Revised Section 9-705, a financing statement filed prior to July 1, 2001 remains effective until it lapses or June 30, 2006. What this means is that a seriously misleading financing statement filed prior to July 1, 2001 remains effective until the earlier of June 30, 2006 or its lapse date, even though the computer search logic, using the stricter standard did not disclose the financing statement.⁸ For this reason, it remains necessary to continue search for “seriously misleading,” but effective filings until June 30, 2006.

Most states have adopted some form of the Model Administrative Rules (MARS), providing strict search logic standard rules.⁹ The MARS search logic ignores punctuation, accents, capitalization, spaces, and business form abbreviations. It does not, however, recognize minor misspellings, common variations, or typographical errors as being equivalent to the correct name of the debtor. Under the Revised 9-506(c) standard, there is a greater risk of failure to perfect as a result of a misspelling of the debtor’s

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(d) “Debtor’s correct name.” For purposes of Section 9-508(b), the “debtor’s correct name” in section (c) means the correct name of the new debtor.

⁵ See § 9-506(b) (2001).

⁶ See § 9-506(c) (2001)

⁷ In re Kinderknecht, 308 B.R. 71 (B.A.P. 10th Cir. 2004).

⁸ Some courts are not complying with § 9-705 and thereby not applying the former Article 9 standard to filings, which are not yet subject to Revised Article 9. Rather, they are improperly applying the stricter computer search logic standard to filings filed prior to July 1, 2001. See e.g., In re Grabowski, 277 B.R. 388, 391 (Bankr. S.D. Ill. 2002).

⁹ The Model Administrative Rules (MARS) appear at www.iaca.org/sts. Sixteen states, including Idaho, Illinois, Indiana, Iowa, Kansas, Kentucky, Maine, Minnesota, New Mexico, Oregon, Rhode Island, Texas, Virginia, Washington, and Wisconsin, have adopted some form of MARS.
name: an error in the debtor’s name is fatal if a search under the correctly spelled name, using the office’s standard search logic, does not locate the financing statement.\textsuperscript{10}

Revised Article 9 calls for the secured party to file an amendment to its financing statement when certain changed circumstances are present: when there is a change in the name of the debtor or transfer of collateral to a new debtor.\textsuperscript{11} Under Revised Section 9-507(c), if a change in the name of the debtor makes a financing statement seriously misleading, a financing statement amendment must be filed in the new name of the debtor within four months of the name change then in order to perfect a security interest in property acquired more than for months after the name change.\textsuperscript{12} Where there is a transfer of collateral to what is defined by Revised Article 9 as a “New Debtor” (one who becomes bound by law or by contract by original debtor’s security agreement),\textsuperscript{13} if the New Debtor’s name is sufficiently different from the old debtor’s to make the filed financing statement seriously misleading, the financing statement filed under the old debtor’s name will perfect the creditor’s security interest in the collateral the transferee has or acquires within 4 months the transfer.\textsuperscript{14} In other words, if the financing statement is seriously misleading because of the New Debtor’s name, the filed financing statement is NOT effective to perfect the creditor’s interest in collateral the New Debtor acquires more than four months after being bound.\textsuperscript{15} For continuous perfection, the creditor must file an initial financing statement providing the new name of the debtor before the expiration of the four month period.\textsuperscript{16}

A creditor’s failure to correctly name the debtor in the financing statement can be fatal if a bankruptcy petition is later filed by or against the debtor. Because it is the duty of a bankruptcy trustee to preserve cash and assets of the debtor’s estate for the benefit of the debtor’s unsecured creditors, the trustee seeks to avoid unperfected security interests.

\textsuperscript{10} See § 9-506(c) (2001).
\textsuperscript{11} See § 9-507(c) 9-508
\textsuperscript{12} Section 9-507(c) provides:

If a debtor so changes its name that a filed financing statement becomes seriously misleading under Section 9-506:

1) the financing statement is effective to perfect a security interest in collateral acquired by the debtor before, or within four months after, the change; and

2) the financing statement is not effective to perfect a security interest in collateral acquired by the debtor more than four months after the change, unless an amendment to the financing statement which renders the financing statement not seriously misleading is filed within four months after the change.

\textsuperscript{13} See § 9-203(e) (2001).
\textsuperscript{14} See § 9-508 (2001).
\textsuperscript{15} See § 9-508(b)(2) (2001).
\textsuperscript{16} \textit{Id.}
The trustee scrutinizes the sufficiency and validity of any security interest asserted against the debtor—bankruptcy’s collateral, and will challenge the perfection and lien position of such interest whenever possible. Where a financing statement fails to correctly provide the name of the debtor and is not disclosed by the computer search logic, the trustee can successfully challenge the filing as being ineffective. As a result, the creditor’s interest is treated as being unperfected and thereby an unsecured claim.

**Sufficiency of the “debtor’s name”**

When is the name of the debtor, “sufficient”? Revised Section 9-503(a) sets forth the standards for sufficiency some types of debtors. For example, the name of a debtor who is a registered organization is the name “indicated on the public record of the debtor’s jurisdiction of organization which shows the debtor to have been organized.”

The name of a decedent’s estate is sufficient “if the financing statement provides the name of the decedent and indicates that the debtor is an estate.”

“A financing statement sufficiently provides the name of a debtor, who is a trust or trustee, only if the financing statement: (a) provides the name specified for the trust in its organic documents or, if no name is specified, provides the name of the settlor and additional information sufficient to distinguish the debtor from other trusts having one or more of the same settlers; and (b) indicates, in the debtor’s name or otherwise, that the debtor is a trust or is a trustee acting with respect to property held in trust.”

The drafters also included a catchall provision, which provides that a financing statement sufficiently provides the name of the debtor if the debtor has a name, only if the provides the individual or organizational name of the debtor; and if the debtor does not have a name, only if it provides the names of the partners, members, associates, or other persons comprising the debtor.

So how do you determine what is an individual debtor’s name? Do you look at the name on the debtor’s driver’s license? Or her passport? Or her birth certificate? Or the name a person is commonly known as? Imagine a situation where Mary Ellen Smith’s birth certificate reads, “Mary Ellen Jones,” her driver’s license reads, “Mary E. Jones,” her passport is Mary Ellen Smith (following nuptials to Jim (aka) James J. Smith), and she is known in her community as Emmy Smith (M.E. Smith). What is this debtor’s correct name?

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**Recent Case Law**

In *In re Spearing Tool and Manufacturing Co*, 292 B.R. 579 (May 14, 2003), on October 15, 2001 the IRS filed two notices of federal tax liens with the Michigan Secretary of State under the name of “Spearing Tool & MFG Company.” The debtor’s exact registered name was “Spearing Tool and Manufacturing Co.” In making its decision to make funding advances to the debtor between October 15, 2001 and April 6, 2002, plaintiff relied upon the fact that its search under the exact registered name of the debtor did not disclose any liens, including the IRS’s lien.

In an adversary proceeding, plaintiff petitioned for a determination of lien priority, contending that IRS’s liens were not properly filed with the Secretary of State’s office because they did not provide the exact registered name of debtor. Therefore the filings were ineffective. The question considered by the court was whether IRS tax liens, which satisfied the requirements of federal law, but did not satisfy state law requirements regarding the sufficiency of the debtor’s name on a financing statement, were ineffective.

The court observed that federal law, which only requires that the notice of tax lien “identify the taxpayer,” controls the form and content of tax lien notices. In holding that the federal tax liens were effective, the court found that “there was no error in identifying the taxpayer [and] . . . the IRS used the accepted abbreviation for the word Manufacturing.” As further support for its conclusion, the court also pointed out that “the debtor frequently used the Mfg. and MFG abbreviations in identifying itself . . . and plaintiff itself referred to the debtor as Spearing Tool and Mfg. in creditor narratives prepared by one of its employees.”

* * *

The varying degrees of tolerance built into the computerized search logic utilized by the applicable filing offices, in some instances, can yield different results. For example, in the Florida case of *In re Summit Staffing Polk County*, 305 B.R. 347 (October 15, 2003), the trustee sought determination of priority of her interest in the debtor’s account receivable. Associated Receivable Funding of Florida, Inc. had filed a financing statement under the debtor’s old name; it failed, however, to refile or amend the financing statement to reflect the New Debtor resulting from the old debtor’s incorporation.

The facts of the case are as follows. On September 4, 2001, Associated Receivable filed a financing statement with the Florida Secretary of State, naming “Randy A. Vincent as the debtor, and Summit Staffing as an additional debtor.” The addresses of both the debtor and the additional debtor were the same. On March 14, 2002, Summit Staffing Polk County, Inc. was incorporated and conducted the business formerly conducted by Randy A. Vincent d/b/a Summit Staffing. Associated Receivable loaned Summit Staffing Polk County, Inc. operating funds as it did with Randy A. Vincent. The parties did not enter a new security agreement nor was a new financing statement filed.

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21 305 B.R. at 349.
On October 16, 2002, Summit Staffing Polk County, Inc. petitioned for Chapter 7 bankruptcy. The trustee claimed priority to the debtor's only account receivable, which was acquired more than four months after the debtor's name change, upon the ground that when "she conducted a UCC search . . . using the actual corporate name of the Debtor, Summit Staffing of Polk County, Inc.," the search did not result in the disclosure of Randy Vincent's financing statement and no secured interest in any of the Debtor's assets was found." 22 The court, applying the computer search logic standard, held that the Associated Receivables previously filed financing statement was not misleading because a search under the correct name of the new debtor, "Summit Staffing of Polk, Inc., which had an address of 5903 Charloma Drive, Lakeland, Florida, 33813 . . . disclosed the financing statement showing the debtor Summit Staffing" with exactly the same address as the debtor in this case. 23 As further support for its conclusion, the court stated, "whether the erroneous filing was actually found by the searcher or not . . . [is of no consequence, so long as] that filing would be disclosed in the results of a proper search." The court also observed that a searcher using the Florida Secured Transaction Registry is directed "Use the Previous and Next buttons to display additional search results . . . and should certainly do so." 24

In the neighboring jurisdiction of Georgia, the court in Receivables Purchasing Co. Inc., v. R & R Directional Drilling, LLC, 263 Ga.App. 649 (October 16, 2003), found that a financing statement filed against "Network Solutions, Inc." rather than "Network Solutions, Inc.,” the exact corporate name of the debtor, was seriously misleading under Revised Section 9-506(c): a search of the filing office's records using its standard search method did not reveal the financing statement filed against the incorrect name of the debtor.

The rulings of In re Summit Staffing Polk County and Receivables Purchasing Co. Inc. illustrate that whether a financing statement is considered to be seriously misleading under Revised Section 9-506(c) greatly depends on the level of tolerance built into the computer search logic of the applicable filing office. The computer search logic used by the Florida filing office in Summit Staffing Polk County is an example of liberal search logic: it disclosed a financing statement filed under the name of "Randy A. Vincent" and "Summit Staffing" where the name searched was "Summit Staffing of Polk County." In contrast, the computer search logic used by the Georgia filing office in Receivables Purchasing Co. Inc., failed to disclose a financing statement in the name of "Network Solutions Inc." where the name searched was "Network Solutions Inc."

* * *

In a line of cases involving financing statements filed under the nickname of the debtor, the courts addressed the question of whether such financing statements were seriously misleading. For example, in In re Erwin, 50 U.C.C. Rep.Serv.2d 933 (Bankr.

22 Id.

23 305 B.R. at 353.

24 305 B.R. at 354.
D. Kan. 2003), the bankruptcy court ruled that a financing statement filed under the name of “Mike Erwin,” rather than “Michael A. Erwin,” was not seriously misleading, even though the search logic using the exact name of the debtor, “Michael A. Erwin,” did not disclose the financing statement filed under “Mike Erwin.” The court’s rationale for deviating from the clear meaning of Revised Section 9-506(c) was that the drafters “did not give any specific criteria for the sufficiency of an individual’s name” in Revised Section 9-503. 25 The court observed that the “drafters clearly understood how to give specific rules for debtor names, even requiring a debtor corporation’s legal name.” 26 Accordingly, the court held that a financing statement filed against “Mike Erwin,” the name by which the debtor was generally known, fulfilled the notice function of the filing system and would have been disclosed by a searcher, who “exercised some reasonable due diligence” in conducting a search. 27

In In re Kinderknecht v. Deere and Co. 300 B.R. 47 (Bankr. D. Kan. 2003), the Kansas Bankruptcy Court, using the same reasoning as it did in In re Erwin, found that a financing statement filed against “Terry Kinderknecht,” debtor’s nickname, rather than Terrance Kinderknecht, the debtor’s formal legal name, was not seriously misleading. The court not only noted that a reasonably diligent searcher would have found the financing statement by searching “Terry,” but also pointed out that the debtor filed his Chapter petition under the name of “Terry” rather than “Terrance, and the debtor listed the secured debt at issue in his bankruptcy schedules.

The Tenth Circuit reversed the bankruptcy court’s ruling in Kinderknecht and disavowed Erwin. 28 On appeal, the Tenth Circuit in Erwin, 308 B.R. 71 (B.A.P. 10th Cir. 2004), held that Kansas law (Revised 9-506(c)), required that a financing statement against an individual debtor be filed against his or her legal name.

II. Consignments – Revised § 9-102(a)(20)

Introduction

Many manufacturers and suppliers sell their goods through consignment transactions. In a consignment transaction, the manufacturer or supplier (consignor) delivers his goods to a dealer (consignee) to sell to his customer. If the consignee sells the goods, he must remit the proceeds to the consignor. If, however, the consignee does not sell the goods, he must return them to the consignor or be liable for the price of the goods. During the consignment, title to the goods remains in the consignor and passes directly to the purchaser when the goods are sold.

25 50 UCC Rep.Serv.2d 933.

26 Id.

27 Id.

28 See In re Kinderknecht, 308 B.R. 71 (B.A.P. 10th Cir. 2004).
The drafters of Revised Article 9 brought all consignments entirely under the scope of Article 9 and removed non-security consignments from the purview of UCC Article 2. Article 9 does, however, exclude certain consignment transactions from its coverage. Non-Article 9 consignments include transaction in which the consignee is: (1) engaged in the business under the same name of the seller, (2) an auctioneer, (3) generally known by its creditor to be substantially engaged in selling goods of others. Also, if the aggregate value of each of the consignor’s deliveries is less than $1,000 or if the goods were consumer goods in the hands of the consignor, the Article 9 filing rules do not apply. Non-Article 9 consignments are usually bailments and consignors in such transactions must look to the applicable state common law or statutory law to determine its rights. On the other hand, if the transaction is an Article 9 consignment, Article 9 establishes “the rules pertaining to lien creditors, buyers, and attachment, perfection, and priority of competing security interests [concerning Article 9] consigned goods.” But it does not govern “the relationship between the consignor and consignee.” Simply stated, Article 9 provides rules for “determining the rights and interests of third-party creditors of, and purchasers of goods from, the consignee, but not . . . remedies of the consignor [against the consignee.]”

Under Revised Section 9-319, “the consignee is deemed to have rights and title to goods identical to those of the consignor,” and thereby have the power to grant security interests in the goods to its creditors. Consequently, where the consignee has granted a security interest in the goods to his creditors, the goods are subject to liens in bankruptcy, unless the consignor has complied with the laws of Article 9. Prior to the Article 9 revisions, consignors could protect itself against creditors of the consignee or the consignee’s trustee in bankruptcy by displaying a sign on the goods stating the consignor’s interest (e.g., “property of and consigned by LRL Manufacturing Co.”) or segregating the goods in an area designated as containing the consignor’s property. Although it does not harm the consignor to still require the consignee to clearly mark the

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29 Revised Section 9-109(a)(4) provides, “this article applies to a consignment.” Section 2-326(3), which dealt with non-security consignments, has been deleted from Article 2.

30 § 9-109, Comment 6.

31 Id.

32 Id.

33 See § 9-319(a).

34 Section 9-319, Comment 2 provides:

For purposes of determining the rights of certain third parties, the consignee is deemed to acquire all rights and title that the consignor had, if the consignor’s security interest is unperfected. The consignee acquires these rights even though, as between the parties, it purchases a limited interest in the goods (as would be the case in a true consignment, under which the consignee acquires only the interest of a bailee). As a consequence of this section, creditors of the consignee can acquire a judicial liens and security interests in goods.
goods because it is a good business practice, such markings will not protect the goods from the reach of creditors and bankruptcy trustees if the consignor has not complied with Article 9 filing requirements.

For purposes of perfection and priority, Article 9 consignments are treated as purchase money security interests (PMSIs). Revised Section 9-103(d) provides, “the security interest of a consignor in goods that are subject of a consignment is a purchase-money security interest in inventory.” This does not mean that consignments are not recognized under Revised Article 9. Instead, this means that the special perfection and priority rules that have always governed PMSIs in inventory also govern consignments under Revised Article 9. The official comment 6 in § 9-103 explains that the drafters intended to “obviate any need to set forth special priority rules applicable to the interest of a consignor.”

“Purchase money collateral means goods or software that secures a purchase money obligation incurred with respect to that collateral; and a purchase money obligation is an obligation of an obligor incurred as all or part of the price of the collateral or for value given to enable the debtor to acquire rights in or use of the collateral if the value is in fact so used.” Simply stated, a purchase money security interest in inventory is value given to the debtor solely to acquire rights in specifically purchased new inventory. “The concept of purchase money security interest requires a close nexus between the acquisition of collateral and the secured obligation. Thus, a security interest does not qualify as a purchase-money security interest if a debtor acquires property on unsecured credit and subsequently creates the security interest to secure the price.”

In order for a purchase money security interest in inventory to prevail over a previously perfected security interest in inventory, the purchase money lender must: (1) have filed a UCC-1 financing statement prior to the time that the debtor possesses the property; (2) send notice of the intended delivery to existing inventory financiers; (3) within five years before the debtor receives possession of the property; which (4) tells the recipient that the sender intends to acquire a PMSI inventory of the debtor and describes such inventory. To prevail over the claims of consignee creditors or the trustee in

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35 See § 9-103(d).

36 Id.

37 “[Revised Section 9-324(b) and (c)] afford a means by which a purchase money security interest in inventory can achieve priority over an earlier-filed security interest in the same collateral.” § 9-324, Comment 4.

38 § 9-103, Comment 6.

39 § 9-103(a).

40 § 9-103, Comment 3.

41 See § 9-324(b).
bankruptcy, a consignor must also comply with these rules.\(^42\) In other words, a consignor must take two steps before delivering the goods to the consignee. First, the consignor must file a UCC-I financing statement that describes the consigned goods to be delivered. The financing statement must be filed in the jurisdiction where the consignee is organized.\(^43\) Second, the seller must send notice to the creditors of the consignee possessing a conflicting security interest. The notice must describe the consigned goods and indicate that the consignor has a consignment interest in the goods. If the consignor takes these two steps, he will defeat claims of the consignee’s creditors. On the other hand, if the consignor fails to comply with the Article 9 filing requirements, his goods will be subject to the claims of the consignee’s creditors.

**Recent Case Law**

Recent case law involving consignments governed by Article 9 illustrate the adverse effects of a consignor’s failure to comply with the filing requirements of Revised Article 9.

In *In re Valley Media, Inc.*, 279 B.R. 105 (Bankr. D. Del. 2002), consignors objected to the debtor’s motion to sell consignment inventory. Prior to 1996, the debtor, the largest full-line supplier of entertainment, obtained all inventory on a terms basis. In November 2001, when the debtor voluntarily petitioned for bankruptcy, it possessed inventory which it obtained under either terms relationships based on purchase invoices or a consignment relationship based on distribution agreements. Under a terms agreement, the debtor purchased inventory outright and thereby obtained title. Under a consignment agreement, however, the title to the inventory remained with the vendor-consignor and the goods were not paid for until the debtor-consignee sold the products. Although the debtor possessed two types of inventory, i.e., terms and consignment, it did not segregate the inventory. Inventory obtained by terms or consignment was “commingled and essentially indistinguishable as to whether it was held on a terms or a consignment basis.”\(^44\) The debtor did not post signs, “nor were there any markings on the inventory that would indicate to an outside observer that some of the inventory held by [the debtor] had been obtained on a consignment basis.”\(^45\) As of the petition date, the debtor had in its possession approximately $108 million worth of inventory of which consigned goods accounted for less than 15 percent.

In determining whether to grant the consignee’s motion to auction all its inventory, including consigned inventory, the court opined that “the ability of the [consignors] to assert their ownership rights against a creditor of the consignee in the context of the consignment relationship formed by the Distribution Agreements was

\(^{42}\) See § 9-103(d), Comment 6.

\(^{43}\) See §§ 9-301(1) & 9-307.

\(^{44}\) 279 B.R. at 116.

\(^{45}\) Id.
governed either by former [Uniform Commercial Code] (U.C.C.) § 2-32646 (prior to July 1, 2001) or by revised §9-102(a)(20) (from July 1, 2001) [,which] . . . also implicates revised U.C.C. §§ 9-319(a) & 9-103(d).47 The court further opined that it did not need to “decide which code provision applied in this case since the parties agreed that the analysis of the contesting [consignors’] rights to the contested inventory remained the same under either the former or the revised U.C.C. provisions as enacted in California.”48 Therefore, the question considered by the court was whether the consignee could be considered a “merchant” under revised U.C.C. § 9-102(a)(20) or a “person conducting business” under former U.C.C. § 2-326(3)(b).

The court indicated that the purpose of former U.C.C. § 2-326(3) and now revised U.C.C. §§ 9-102(a)(20) & 9-319(a) was “to protect general creditors of the consignee from claims of consignors that have undisclosed consignment that create secret liens on the inventory.”49 The court then found that to prevent application of former U.C.C. § 2-326(3) and revised U.C.C. § 9-102(a)(20), the consignor must either have (1) filed a UCC-1 financing statement as required under U.C.C. Article 9 or 2 or (2) prove that the debtor is generally known by his creditors to be substantially engaged in selling the goods of others. Because the contesting consignors had not filed a UCC-1 financing statement, the court found that they had the burden of proving by a preponderance of the evidence:

46 Former U.C.C. § 2-326 provides:

(1) Unless otherwise agreed, if delivered goods may be returned by the buyer even though they conform to the contract, the transaction is . . . (b) A “sale or return” if the goods are delivered primarily for resale.

(2) Except as provided in subdivision (3), . . . goods held on sale or return are subject to [the claims of the buyer’s creditors] while in the buyer’s possession.

(3) Where goods are delivered to a person for sale and the person maintains a place of business at which he or she deals in goods of the kind involved, under a name other than the name of the person making the delivery, then with respect to claims of creditors of the person conducting the business the goods are deemed to be on sale or return. The provisions of this subdivision are applicable even though an agreement purports to reserve title to the person making delivery until payment or resale or uses such words as “on consignment” or “on memorandum”. However this subdivision is not applicable if the person making the delivery does any of the following:

(a) Establishes that the person conducting the business is generally known by his or her creditors to be substantially engaged in selling the goods of others.

(b) Complies with the filing provisions of the division on secured transactions.

47 279 B.R. at 122.

48 Id.

49 279 B.R. at 125.
that the debtor was substantially engaged in selling the goods of others, and (2) that it was generally known creditors of the debtor that this is the case.

In granting the debtor’s motion to sell the consigned inventory, the court found that the consignors had not met their burden because they did not demonstrate that a majority of the creditors had actual knowledge that the debtor was substantially engaged in selling the goods of others. The court also found that even if the contesting consignors demonstrated that a majority of the creditors of the debtor “knew of the consignment sales, they could not and did not show that [the debtor] was actually substantially engaged in such sales . . . [because] the percentage of consigned inventory for [the debtor] was never more than 17.03 percent, which [was] below the 20 percent threshold.”

In a case factually similar to Valley Media, the Chapter 7 Trustee in In re Corvette Collection of Boston, 294 B.R. 409 (S.D. Fla. 2003), brought an adversary proceeding to determine the priority and extent of alleged liens against motor vehicles that owners had left with the bankrupt used car dealership. The debtor, a used Corvette dealership, owned some of its inventory outright and held the rest on consignment. On the bankruptcy petition date, the debtor had six Corvettes in its possession on consignment of which three were pursuant to written consignment contracts and three were pursuant to alleged oral consignment contracts. Rather than filing a UCC-1 financing statement or a recorded security agreement with the Florida Department of Motor Vehicles, the consignors “withheld their respective Corvettes’ title prior to placing the Corvettes on consignment with the Debtor.”

The court observed that “three main issues must be determined” to assess the validity of the Trustee’s assertion that because the consignors failed to perfect their interests, “[their] interests in the Corvettes [were] unsecured and [could] be avoided pursuant to 11 U.S.C. § 544(a)(1), which vests the Trustee with the authority, as of the date, to avoid any transfer or obligation of the Debtor which is avoidable by a hypothetical creditor on a simple contract with a judicial lien on the property of the Debtor unsatisfied as of the commencement of the case.”

The first issue [was] whether the [consignors] delivered to the Debtor the six Corvettes. The second issue [was] whether the Debtor’s creditors were aware that the Debtor was substantially engaged in selling the goods of others because, if so, the Debtor held the Corvettes on approval, thereby rendering the Corvettes beyond the reach of the Debtor’s creditors. Finally, regarding the orally consigned vehicles, the last issue [was] whether the Statute of Frauds render[ed] the oral consignment agreements unenforceable.

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50 379 B.R. at 132.

51 294 B.R. at 411.

52 Id.

53 294 B.R. at 412.
With respect to these issues the court held the following. First, the court ruled that the physical delivery of the Corvettes to the debtor satisfied the delivery requirement under the Florida U.C.C. and that delivery of the certificate of title was not necessary to effectuate delivery of the goods for the purpose of consignment. Second, the court stated that consigned goods, the goods are subject to the claims of the debtor's creditors because there is a presumption that the goods are held by the debtor "sale or return." The court then, endorsing Valley Media, indicated that "consignor[s could] overcome this presumption by proving (i) he or she has complied with an applicable law providing for a consignor's interest or the like to be evidenced by a sign or (ii) he or she established that the person conducting the business is generally known by his or creditors to substantially engaged in selling the goods of others, or (iii) he or she complied with the filing provisions of the chapter on secured transactions." Because neither consignor filed a UCC-1 financing statement nor marked the Corvettes as consigned goods, they could only overcome the presumption by establishing that the debtor was generally known by his creditors as being engaged in consignment transaction. The court held that the consignors did not meet this burden because their own testimony that "most of the debtor's inventory was held on consignment and that everybody who wanted to sell a Corvette knew that the debtor primarily sold consigned vehicles fell short of [their] burden..." The defendant also failed to demonstrate that the majority of the debtor's creditors actually knew that the debtor was engaged in the business of selling the goods of others because "general knowledge in the industry was insufficient to prove knowledge by a majority of creditors." Lastly, the court ruled that the oral consignment contracts were not barred by the Statute of Frauds. For these reasons, the court ruled that consigned goods were governed by Article 9 and the consignors had failed to perfect their interest. Consequently, the Trustee could avoid their interest under § 544(a) of the Bankruptcy Code.

54 294 B.R. at 413. The court noted that the Florida Statute § 672.326 recognizes two types of consignments: "sale on approval" transaction and "sale or return consignment. In distinguishing the two types of consignments, the court explained:

In a sale on approval transaction, the consignor delivers goods to the consignee primarily for use. Fla. Stat. 672.326(1)(a). Goods held on approval are not subject to the claims of the consignee's creditors until acceptance, and the consignor need not take any action to protect its interest in the goods. On the other hand, in a sale or return consignment, the consignor delivers goods to the consignee primarily for resale. Fla. Stat. 672.326(1)(b). Goods held "sale or return" are subject to the claims of the consignee's creditors. Id.

55 294 B.R. at 414.

56 Id.

57 294 B.R. at 415. The majority of creditors are determined by the number of creditors, not by the amount of their claims. Id.
III. True Sale or Transfer of Collateral?

Introduction

A perennially Article 9 "hot topic" is whether an asset transfer is a “true sale” or a transfer of collateral in connection with a secured loan. This issue arises most frequently in the securitization context. In a typical securitization, a firm, known as the “originator” transfers rights to payment from receivables to a special purpose entity (“SPE.”) The SPE in turn, sells securities backed by the receivables (known as asset-backed securities, or ABS) to investors. The investors are paid from collections on the receivables.

A central issue for participants in securitization transactions is whether, upon a securitization originator’s bankruptcy, the transferred assets will be included in the originator’s bankruptcy estate. What property is included in a debtor’s bankruptcy estate is at the center of the bankruptcy process. Estate property is used to satisfy creditor claims, and it may be used, sold, leased, or borrowed against (subject, in certain cases, to secured parties being provided with adequate protection), and it may be required to be returned to the estate if in the hands of third parties. Estate assets are subject to the automatic stay and court permission is required before any party with a claim can act upon them.

If however, the assets are deemed sold, the debtor no longer has use of or access to them. Both the reorganizing debtor (needing assets to accomplish its reorganization (and especially liquid assets)) as well as debtor’s other creditors (who are entitled to recover what is owed to them from the debtor’s estate assets) are motivated to challenge the purported “true sale” of transferred assets. Accordingly, once bankruptcy is filed, the trustee (under the supervision of the court) will carefully examine all of the originator’s prior transactions.

The Bankruptcy Code has conventionally relied upon non-bankruptcy law to define the property rights of parties to a bankruptcy. When what is at issue is whether a transfer of Article 9 assets are properly included in the transferee’s bankruptcy estate, the question of the nature of the transfer, as well as the steps needed to be taken to establish the transferee’s property rights, have always been non-bankruptcy-law determinations.

Revised Article 9

Revised Article 9 includes a new section that purportedly speaks to the true sale issue. Section 9-318 reads:

No Interest Retained in Right to Payment That is Sold; Rights and Title of Seller of Accounts or Chattel Paper with Respect to Creditors and Purchasers,

58 The debtor’s estate, as defined under section 541(a) is comprised of “interests of the debtor in property.” 11 U.S.C. § 541(a) (1997).
(a) **Seller retains no interest.** A debtor that has sold an account, chattel paper, payment intangible, or promissory note does not retain a legal or equitable interest in the collateral sold.

(b) **Deemed rights of debtor if buyer's security interest unperfected.** For purposes of determining the rights of creditors of, and purchasers for value or an account or chattel paper from, a debtor that has sold an account or chattel paper, while the buyer's security interest is unperfected, the debtor is deemed to have rights and title to the account or chattel paper identical to those the debtor sold. 59

This provision was included in the Revision, largely in response to the holding in *Octagon Gas Systems v. Rimmer (In re Meridian Reserve, Inc.),* 995 F.2d 948 (10th Cir. 1993), 60 in which the United States Court of Appeals for the Tenth Circuit held that property sold by the debtor prior to its bankruptcy was included in debtor's bankruptcy estate. The Tenth Circuit relied upon the Supreme Court's expansive interpretation of "estate" in *United States v. Whiting Pools, Inc.,* 462 U.S. 198, 203-205 (1994), in concluding that, because property of the estate includes property subject to a security interest, and because the sales of accounts are governed by the law governing transfers of security interests, accounts sold remain property of the debtor's bankruptcy estate. 61 Indeed, the *Octagon* decision, 62 coupled with the uncertainty surrounding both the issue of asset classification and the scope of Article 9, led the PEB Drafting Committee to make a series of substantive changes to Article 9 to address the risk to originators and investors engaging in securitization transactions. 63 One such change was the inclusion of Section 9-318.

Revised Section 9-318 makes clear that "true sales" of assets remove such assets from the estate, provided the transfer is perfected. Section 9-318, however, does not determine whether an asset transfer is a true sale. Official Comment 2 notes that, "[n]either this Article nor the definition of "security interest" in section 1-201 provides rules for distinguishing sales transactions from those that create a security interest securing an obligation." 64 Thus, this remains a determination to be made by courts on a case-by-case basis.


60 In *Octagon,* the transferee did not file a financing statement to perfect its interest, leaving it vulnerable to avoidance by the bankruptcy trustee, pursuant to its § 544(a) lien avoidance powers. It is possible, however, that the transferee was automatically perfected under § 9-302(1)(e) (providing for the automatic perfection of certain isolated and small transfers of accounts).

61 *Octagon,* 995 F.2d 948, 955.


Courts and the True Sale v. Collateral Transfer Dilemma

In addressing the collateral transfer v. true sale issue, courts have tried to balance the rights of asset transferees against the interests of the debtor’s general creditors who may not be aware that the debtor no longer owns what appears to be its income stream. Because a “true sale” of a debtor’s accounts can be structured in a way that takes on certain aspects of a secured loan, courts have looked behind the formal structure of a documented “sale” and, if certain factors are present, treat the buyer’s interest as a lien rather than an ownership right. Even in light of parties’ characterization of an asset transfer as a true sale, courts will independently examine the substance of the transaction. See Reaves Brokerage Co., Inc. v. Sunbelt Fruit & Vegetable Co., Inc., 336 F.3d 410 (5th Cir. 2003) (stating that “[c]haracterization of the agreement at issue turns on “the substance of the relationship” . . . “not simply the label attached to the transaction”).

Courts have historically decided whether a particular transfer is an assignment of collateral or a true sale based upon the presence (or absence) of the following factors: (i) residual interests retained by the transferor, (ii) transfer price set at fair market value by independent appraisers, (iii) recourse to the asset transferor, (iv) the acquisition of dominion and control over the assets by the transferee, (v) the transfer of the benefits and burdens of ownership by the transferee, and (vi) the intent of the parties as expressed in their writings. See, e.g., Major’s Furniture Mart, Inc. v. Castle Credit Corp., 602 F.2d 538, 542-44 (3d Cir. 1979) (describing the factors relevant to the determination of the existence of a true sale, and finding that because the agreement between the parties allocated the risk of account non-payment to the seller, the transaction was a loan); In re Cornet Capital Corp., 142 B.R. 78 (Bankr. S.D. N.Y. 1992) (transaction was a secured loan because of transferee’s payment of interest to purchasers of interests, notwithstanding transferor’s default); In re Evergreen Valley Resort, Inc. 23 B.R. 659 (Bankr. D. Maine 1982) (transaction was a secured loan because of transferee’s payment of interest to purchasers of interests, notwithstanding transferor’s default); In re Hurricane Elkhorn Coal Corporation, 19 B.R. 609 (W.D. Ky 1982) (transaction was a secured loan because of debtors retained interest); Federated Dept. Stores, Inc. v. Commissioner, 51 T.C. 500, 511 (1968), aff’d, 426 F.2d 417 (6th Cir. 1970) (because transferor retained some risk, transfer was deemed to be a collateral assignment); Fireman’s Fund Ins. Companies v. Grover (In re Woodson Co.), 813 F.2d 266, 272 (9th Cir. 1987) (transferor retention of risk, coupled with lending interest rate, suggested a loan, rather than a sale); Bear v. Cohen (In re Golden Plan of California, Inc.), 829 F.2d 705, 707, 710 (9th Cir. 1986).

65 Whether or not the transfer is a true sale, if the asset is governed by Article 9, the transferee must give notice of the transfer by filing a financing statement.

66 “So long as people do not mean what they say or do not say what they mean, there will be enough uncertainty to keep everyone busy hiding intent and obfuscating meaning.” In re Winston Mills, Inc., 6 B.R. 587, 596 (Bankr. S.D.N.Y. 1980), cited in In re Best Products Co., Inc., 157 B.R. 222 (S.D.N.Y. 1993) (in which the court analyzed whether a transaction was a lease, or a secured financing).
Many securitization transactions, however, include a mix of factors, some suggesting a true sale and others suggesting a collateral transfer. While parties may intend one characterization, the facts and circumstances of the transfer may suggest another. See Castle Rock Indus. Bank v. S.O.A.W. Enters., Inc. (*In re S.O.A.W. Enters., Inc.*), 32 B.R. 279, 283 (Bankr. W.D. Tex. 1983) (notwithstanding the parties’ characterization as a sale, a participation agreement was determined to be a loan transaction); Boerner v. Colwell Co., 577 P.2d 200, 204-205 (Cal. 1978) (transfer of construction contracts deemed to be a sale and not a loan).

The court in the recent case Reaves Brokerage Brokerage Co., Inc. v. Sunbelt Fruit & Vegetable Co., Inc., 336 F.3d 410 (5th Cir. 2003), relying upon the analysis in *Endico Potatoes v. CIT Group/Factoring, Inc.*, 67 F.3d 1063 (2d. Cir. 1995), identified the “transfer of risk” as the salient determining factor:

The root of all of these factors is the transfer of risk. Where the lender has purchased the accounts receivable, the borrower’s debt is extinguished and the lender’s risk with regard to the performance of the accounts is direct, that is, the lender and not the borrower bears the risk of non-performance by the account debtor. If the lender holds only a security interest, however, the lender’s risk is derivative or secondary, that is, the borrower remains liable for the debt and bears the risk of non-payment by the account debtor, while the lender only bears the risk that the account debtor’s non-payment will leave the borrower unable to satisfy the loan.  

The parties to the asset transfer transactions in Reaves Brokerage characterized their transfers as *sales* of accounts. The transferee was referred to in the so-called factoring agreement as “absolute owners of all accounts.” The agreement further described the transfers using many terms consistent with a “true sale.”

The court did not stop its analysis with the parties’ and the contract’s characterization of the transaction, however. It found that the transferee had full recourse against the transferor in the event of underperformance or non-payment of the transferred accounts. Moreover, the parties’ arrangement included a system of “advances” against the value of the accounts – similar to a revolving line a credit. In addition, the financing statement filed by the account transferee included assets beyond the accounts purported to be “sold.” Recognizing that the “distinction between purchase and lending transactions can be blurred,” and limiting its holding “to the facts and arguments of this admittedly close case,” the court found the account transfer to be a a secured transaction, rather than a “true sale.”

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67 *67 F.3d 1063, 1069.*

68 *The financing statement listed collateral including, “accounts, contract rights, instruments, documents, chattel paper” and other “general intangibles.” Id. at 416.*

69 *Id. at [417]. The court also made clear that it was “guided by the policies behind [Perishable Commodities] PACA, which mandate protection of suppliers of fresh fruit and other perishable commodities. We express no opinion on the proper construction of factoring agreements in non-PACA contexts.”*
Interestingly, in *Carter v Four Seasons Funding Corporation*, 351 Ark. 637 (2003), the court identified the intent of the parties, as evidenced by the "surrounding facts and circumstances," as the determining factor as to whether the transfer at issue was a true sale or a transfer of collateral, even after finding clear evidence of retained risk on the part of the seller. Because the parties expressed a clear intent to engage in a sales transaction and not a secured loan, the court concluded the transaction was a sale. The court explained its conclusion:

The Purchase Agreement at issue was the result of negotiations between two sophisticated business entities. The terms of the agreement expressly contemplated the sale of account receivables at a discount — a common means of raising capital. Looking at the agreement itself and the actions of the parties, we discern no basis for a reversal of the circuit court on grounds that it clearly erred in finding that the parties agreed to a sale of accounts receivable. To us, it is clear that the parties intended a factoring agreement and an analysis of all relevant factors confirms our conclusion. Moreover, we agree with the circuit court that the appellants failed to meet their burden of proof by clear and convincing evidence that the financial arrangement was a subterfuge for usurious loans. To conclude as appellants would have us do under these facts would be to cast legal doubt on the business of factoring accounts receivable as a means of raising capital. This we are not inclined to do.\(^7\)

**State Statutes: It's a True Sale Because I Say It Is**

Some states have attempted to remove discretion from state courts as to whether a particular asset transfers is a true sale or collateral transfer. For example, Delaware’s Asset-Backed Securities Facilitation Act reads in part:

1. Any property, assets or rights purported to be transferred, in whole or in part, in the securitization transaction shall be deemed to no longer be the property, assets or rights of the transferor;
2. A transferor in the securitization transaction, its creditors or, in any insolvency proceeding with respect to the transferor or the transferor’s property, a bankruptcy trustee, receiver, debtor, or debtor in possession or similar person, to the extent the issue is governed by Delaware law, shall have no rights, legal or equitable, whatsoever to reacquire, reclaim, recover, repudiate, disaffirm, redeem or recharacterize as property of the transferor any property, assets or rights purported to be transferred, in whole or in part, by the transferor; and

\(^7\) 351 Ark, at 661.
3. In the event of a bankruptcy, receivership or other insolvency proceeding with respect to the transferor or the transferor's property, to the extent the issue is governed by Delaware law, such property, assets and rights shall not be deemed to be part of the transferor's property, assets, rights or estate.  

Similar provisions have been included as non-uniform amendments to Article 9 in Alabama, Ohio, South Dakota, Texas, and Virginia. These provisions were designed to statutorily define when a transfer is true sale, based solely on the intention of the parties to engage in a securitization. Would a federal court be bound by these statutes?

**Bankruptcy Courts' Equitable Powers**

Recently, a bankruptcy court demonstrated a willingness to rely upon its equitable powers to decide that the assets the debtor transferred and initially characterized as securitized, were property of the debtor's bankruptcy estate. See *In re LTV Steel Co.*, 274 Bankr. 278 (Bankr. N.D. Ohio 2001). The court, after weighing the interests of the affected parties, observed that if debtor was unable to access its liquid receivables, it would have immediately ceased business operations. With respect to the issue of whether the securitized assets were property of the estate, the court said:

... there seems to be an element of sophistry to suggest that the Debtor does not retain at least an equitable interest in the property that is subject to the interim order. Debtor's business requires it to purchase, melt, mold and cast various metal products. To suggest that Debtor lacks some ownership interest in products that it creates with its own labor, as well as the proceeds to be derived from that labor, is difficult to accept. Accordingly, the court concludes that Debtor has at least some equitable interest in the inventory and receivables, and that this interest is property of the Debtor's estate. This equitable interest is sufficient to support the entry of the interim cash collateral order. Finally, it is readily apparent that granting Abbey National

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73 ORC Ann. 1109.75 (2004).
74 S.D. Codified Laws § 54-1-10 (2003).
76 2004 Va. ALS 600.
77 See also N.C. Gen. Stat § 53-426 (2004) (declaring all securitization transfers to be true sales when the originator is a bank); MCLS § 460.10 (2004) (declaring public utility securitization transfers to be true sales); R.I. Gen. Laws § 39-1-59 (2004) (declaring public utility securitization transfers to be true sales).
relief from the interim cash collateral order would be highly inequitable. The Court is satisfied that the entry of the interim order was necessary to enable Debtor to keep its doors open and continue to meet its obligations to its employees, retirees, customers and creditors. Allowing Abbey National to modify the order would allow Abbey National to enforce its state law rights as a secured lender to look to the collateral in satisfaction of this debt. This circumstance would put an end to Debtor’s business, would put thousands of people out of work, would deprive 100,000 retirees of needed medical benefits, and would have more far reaching economic effects on the geographic areas where Debtor does business . . . .

Prior to the court’s ultimate resolution of this issue, the parties reached a settlement. The court’s apparent willingness, in the name of equity, to return transferred assets to the debtor’s bankruptcy estate in order to facilitate debtor’s reorganization sent shock waves through the securitization markets. The final chapter on the extent to which bankruptcy courts will exercise their equitable powers in this context is not yet written.

Bankruptcy Reform Legislation – Withdrawn

The uncertainty surrounding the true sale issue led to the introduction, as part of The Bankruptcy Reform Act of 2001, of an amendment to Section 541 defining “property of the estate.” Section 912 was an attempt to federalize the issue of whether the transfer of receivables is a true sale or collateral transfer. The proposed language makes clear

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78 The debtor’s estate, as defined under section 541(a) is comprised of “interests of the debtor in property.” 11 U.S.C. § 541(a) (1997).


Section 541 of title 11, United States Code, is amended in subsection (b) by inserting after paragraph (7), as added by this Act, the following:

(8) any eligible asset (or proceeds thereof), to the extent that such eligible asset was transferred by the debtor, before the date of commencement of the case, to an eligible entity in connection with an asset-backed securitization, except to the extent such assets (or proceeds or value thereof) may be recovered by the trustee under section 550 by virtue of avoidance under section 548(a); and by adding at the end the following new subsection

(f) For purposes of this section, The term “asset-backed securitization” means a transaction in which eligible assets transferred to an eligible entity are used as the source of payment on securities, including, without limitation, all securities issued by governmental units, at least one class or tranche of which was rated investment grade by one or more nationally recognized securities rating organizations, when the securities were initially issued by an issuer;

The term “eligible asset” means--financial assets (including interests therein and proceeds thereof), either fixed or revolving, whether or not the same are in existence as of the date of the transfer, including residential and commercial mortgage loans, consumer receivables, trade receivables, assets of governmental units, including payment obligations relating to taxes, receipts, fines, tickets, and other sources of revenue, and lease receivables, that, by their terms, convert into cash within a finite period, plus any residual interest in property subject to receivables included in such financing assets plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to
that notwithstanding how the transfer would be characterized by a court under state law, if the parties represent in writing that a sale was intended, the parties formal characterization would control (provided certain defined criteria were met). For example, whether or not the debtor retains some of the risk of ownership or the transferee retains recourse rights against the debtor, the parties’ declaration of the asset transfer as a sale would make it so.  

After much controversy and public discussion, Section 912 was

security holders;
(B) cash; and
(C) securities, including, without limitation, all securities issued by governmental units;
(1) The term “eligible entity” means--
(A) an issuer; or
(B) a trust, corporation, partnership, governmental unit. Limited liability company (including a single member limited liability company), or other entity engaged exclusively in the business of acquiring and transferring eligible assets directly or indirectly to an issuer and taking actions ancillary thereto;
(2) The term “issuer” means a trust, corporation, partnership, or other entity engaged exclusively in the business of acquiring and holding eligible assets, issuing securities backed by eligible assets, and taking actions ancillary thereto; and
(3) The term “transferred” means, the debtor, under a written agreement, represented and warranted that eligible assets were sold, contributed, or otherwise conveyed with the intention of removing them from the estate of the debtor pursuant to subsection (b)(8) (whether or not reference is made to this title or any section hereof), irrespective and without limitation of --
(A) whether the debtor directly or indirectly obtained or held an interest in the issuer or in any securities issued by the issuer;
(B) whether the debtor had an obligation to repurchase or to service or supervise the servicing of all or any portion of such eligible assets; or
(C) the characterization of such sale, contribution, or other conveyance for tax, accounting, regulatory reporting or other purposes.


Subsection (1) of proposed section 912 purported to allow the trustee to recover transferred assets for the estate under section 550 “by virtue of avoidance under section 548(a).” The negative inference in this language seems to be that these excluded “eligible assets” are beyond the reach of the trustee’s other powers to recover assets transferred by the debtor —specifically, those provided for in sections of the law other than section 548. Section 548(a) avoidance is limited to giving the bankruptcy trustee the right to recover for the estate transfers by the debtor that are deemed to be fraudulent made within one-year of bankruptcy filing. The other important avoidance powers include section 544(a)(I) (which provides for the avoidance of unperfected security interests) and section 547 (which provides for the avoidance of transfers that result in a preference for one creditor over all other creditors as a group). In particular, section 544(a)(I) allows the bankruptcy trustee to avoid unperfected transfers of accounts when the creditor has not “perfected” its transfer by a simple notice filing. Even in the case of a true sale of accounts, a judgment lien creditor would have state law priority in transferred account assets when the “buyer” fails to file a financing statement. Under this provision, that same unperfected buyer (assuming a true sale of accounts) would be safe from challenge in bankruptcy. The proposed language that makes these federalized “true sales” immune from section 544(a)(I) avoidance is a significant departure from bankruptcy law’s historic deference to state law.
ultimately withdrawn from the Bankruptcy Reform bill. This provision would have compelled courts to accept the parties' characterization of a transfer as a true sale, even in the face of incontrovertible evidence of a secured lending.

Legal Opinions

Because the definitive determination of the collateral transfer v. true sale issue is so uncertain, lawyers have historically been reluctant (and in some instances, unwilling) to unqualifiedly conclude in legal opinions that a specific asset transfer is a true sale. Indeed, in recent testimony before Congress addressing the "true sale" issue, it was observed:

In order to obtain sales treatment under the relevant accounting standards, participants in mortgage-backed and asset-backed securitization transactions must obtain assurances from counsel that the sale of assets will be final under applicable bankruptcy law. Such legal advice is referred to as a "true sale opinion." Unfortunately, there is a lack of guiding judicial precedent regarding what constitutes such a true sale of assets. The considerations in the analysis are highly subjective and depend upon a qualitative assessment of a wide variety of facts and circumstances. For these and other reasons, any true sale opinion will generally be a reasoned one, with various assumptions as to factual matters and conclusions that introduce an unnecessary degree of legal uncertainty in the asset-backed market. As a result, for some types of transactions, true sale opinions can be extremely difficult, costly, and in a few cases, impossible to render.

IV. Deposit Accounts § 9-102(a)(29)

Introduction

Under Revised Article 9, a creditor can now take an original security interest in a business debtor's deposit accounts. Under former Article 9, deposit accounts were


83 § 9-109, Comment 16 ("except in consumer transactions, deposit accounts may be taken as original collateral under this Article").
expressly excluded from collateral that a creditor could take an original security interest in, but were often captured by the creditor as proceeds of other original collateral. Moreover, a number of states enacted non-uniform amendments to old Article 9, including deposit accounts as potential Article 9-governed collateral. Consequently, secured lenders rarely attempted to take a security interest in deposit accounts, which frequently represent a large portion of an individual’s or organization’s wealth.

Revised Section 9-102(a)(29) defines “deposit accounts” as a “demand, time savings, passbook, or similar account maintained with a bank.” Deposit accounts do not include investment property, such as stocks, or accounts evidenced by an instrument, such as certificated CDs. Revised Article 9 allows creditors to take a security interest in a deposit account held by debtors, except in connection with consumer transactions. A consumer transaction is one in which both the obligation incurred and the collateral acquired are primarily for personal, family, or household use. A lender can, however, take a security interest in a consumer’s deposit account in a business transaction. It is also important to note that a secured party that has not expressly or directly taken a security interest in a deposit account may nevertheless have an interest in such an account as proceeds.

The law of the depositary bank’s jurisdiction governs perfection and priority of security interests in deposit accounts, unless the parties agree upon another jurisdiction. To perfect a security interest in a deposit account held by a non-consumer, commercial debtor, the lender must “control” the account. A security interest in a deposit account cannot be perfected by filing a UCC-1 financing statement: control is the only way to perfect a security interest in a deposit account.

Revised Section 9-104 sets forth the different methods of gaining control of a depositary account. If the secured party is also the depositary bank in which the deposit

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84 See Former Section 9-104(l).
86 § 9-109(a)(29).
87 See Id.
88 See § 9-109(d)(13).
89 See § 9-102(a)(26).
90 § 9-304(a) – (b).
91 § 9-314.
92 See § 9-312(b)(1).
93 See § 9-104.
account is maintained, control is automatic. If, on the other hand, the secured party is not the depositary bank, the secured party may obtain control either by: (1) obtaining an authenticated agreement under which the depositary bank agrees to "comply with instructions originated by the secured party directing disposition of the funds in the deposit account without further consent by the debtor; or [(2)] becoming the [depositary] bank's customer with respect to the deposit account, [in which case the secured party would be entitled to withdraw funds from the account]. By becoming the bank's customer, the secured party acquires the rights of customer under UCC Article 4 rather than solely the rights of a secured party under Article 9. Even if the debtor has the right to withdraw funds from the deposit account, the secured party is still deemed to have control over the account. The method used by the secured party to control the deposit account is critical because methods of control are treated differently for the purpose of determining priority.

As a general rule, the party who has control of the deposit account has priority, and if more than one party has control, the party that first obtained control has priority. The exception to the general rule, however, is that a depositary bank's right of setoff or recoupment will always prevail over a competing security interest, unless the secured party gained control by becoming the bank's customer with respect to the account. Simply stated, a secured party that gains control over a deposit account by placing its name on the account jumps ahead of all other secured lenders and the recoupment and setoff rights of the depositary bank. Where the secured party has perfected by a control agreement, the bank's rights will prevail unless the lender obtained a subordination agreement from the bank. Finally, the interest of a secured party who has an interest in a deposit account as proceeds will always be defeated by secured parties who have perfected by control.

94 § 9-104(a)(2).
95 § 9-104(a)(2)-(3).
96 § 9-104(b).
98 § 9-327, Comment 4 states, "the security interest of the bank with which the deposit account is maintained normally takes priority over all other conflicting security interests in the deposit account . . . A secured party who takes a security interest in the deposit account as original collateral can protect itself against the results of this rule in one of two one ways. It can take control of the deposit account by becoming the bank's customer . . . Alternatively, the secured party can obtain a subordination agreement from the bank."
99 See §9-327, Comment 4.
100 Id.
**Recent Case Law**

In *In re E-Z Serve Convenience Stores*, 299 B.R. 126 (M.D.N.C. 2003), a debtor granted a security interest in its “present and hereafter acquired inventory; present and future accounts; present and future documents of title; present and future general intangibles; present and future subsidiary collateral; and present and future other collateral.” In preparation for its bankruptcy filing, the debtor hired legal counsel and made advance payments totaling $790,000 (“retainer”). After rendering several months of service, the debtor’s legal counsel was informed by the Trustee that their services were no longer needed. At this time, counsel held a retaining balance of $186,546.96. In response to counsel’s motion to withdraw and transfer funds, the debtor’s secured creditor filed a limited objection, contending that it had a secured and perfected security interest in the debtor’s right to the remaining portion of the retainer because the retainer was a general intangible.

In rebuttal, the Trustee argued that the secured creditor did not have a perfected security interest in the remaining portion of the retainer because “the asset is a deposit account” of the debtor that is controlled by legal counsel and the secured creditor did not have a perfected interest in that deposit account on the petition date.

The court began its analysis by recognizing that the UCC definition of deposit account is “a demand, time, savings, passbook, or similar account maintained with a bank.” The court then determined that the debtor’s interest in the retainer was not a deposit account for several reasons. First, the funds were held in a trust account by legal counsel, not a bank. Although the trust account may have been legal counsel’s deposit account, it was not the debtor’s account. Finally, numerous courts have found that a right to a refund is a general intangible. For these reasons, the court concluded that the unearned portion of the retainer held by the debtor’s legal counsel was a general intangible and not a deposit account.

In *Sonic Engineering, Inc v. Konover Constr Co*, 51 UCC Rep.Serv.2d 844 (Conn. Super. Ct 2003), debtor granted a security interest in a deposit account. The question considered by the court was whether a judgment creditor or a secured creditor had priority to the deposit account. In November 2002, Sonic obtained a judgment against Konover Construction and sent a state marshal to carry out a bank execution. The marshal obtained a check in the requested amount but was asked by a bank employee not to do anything with the check for 24 hours, in order to give the bank to ensure that the execution was proper. Several hours later, a bank employee left the marshal a message indicating that the check should be returned because the debtor had signed a control agreement pledging the account as collateral to another creditor. The marshal deposited the check anyway, but was unable to obtain the funds because the bank had placed a stop payment on the check.

On January 28, 2003, Michael Konover signed a loan agreement under which he agreed to loan Konover Construction Company an amount not to exceed two million dollars. Pursuant to the loan agreement, Konover Construction Company signed a revolving loan promissory not, and a control agreement was signed by Michael Konover,
the president of Konover Construction Company, and the depository bank. The court observed that "the control agreement was clearly intended to comply with the provisions of § 9-104 of the Uniform Commercial Code in order to establish a security interest in [Konover Construction Company] bank account in favor of Michael Konver."101 Sonic argued that its interest had priority to the deposit account because it was a holder in due course. The court, however, found that Sonic was not a holder in due course because it never possessed the instrument, and even if "the marshal should be deemed to have been at least in part acting as agent of Sonic, then Sonic had notice of a potential claim. In ruling that the secured creditor had priority to the deposit account, the court concluded that the secured creditor satisfied the § 9-203(b) requirements by advancing $700,000 to the debtor and controlling the deposit account collateral pursuant to §9-104, although the debtor was able to draw funds from the deposit account.

V. Proceeds – Revised § 9-102(a)(64)

Introduction

Revised Section 9-102(a)(64) defines “proceeds” as “whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral,” “whatever is collected on, or distributed on account of, collateral, as well as all "rights arising out of collateral."102 This definition, in eliminating the requirement that an asset can only rise to the level of proceeds as a result of a disposition of the original collateral, reflects an expanded conception of proceeds.103 “Proceeds” now has the potential to include a broad range of property-with-a-connection-to-the-original collateral.104

The broad language used by the drafters must, however, be read in light of the function and purpose of security interests’ extension to proceeds of original collateral. To

101 51 UCC Rep.Serv.2d 844.
102 The Section 9-102(a)(64) definition of proceeds reads in full:

(A) whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral;
(B) whatever is collected on, or distributed on account of collateral;
(C) rights arising out of collateral;
(D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or
(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

103 “Proceeds includes whatever is received upon the sale, exchange, collection or other disposition of collateral or proceeds.” Former U.C.C. § 9-306(1) (1995).

104 Unlike a security interest in original collateral, a security interest in proceeds attaches automatically at the time the proceeds arise. See §§ 9-203(f), 9-315(a)(2)(2001).
understand the reason for a security interest’s extension to proceeds, one must ask the threshold question of why creditors’ security interests extends to proceeds at all? One theory is that a security interest extends to proceeds to reflect the hypothetical *ex ante* bargain of reasonable debtors and creditors. If an item of collateral is sold or otherwise permanently disposed of, a secured party reasonably would expect that its lien would continue in whatever assets the debtor receives in exchange. What is received represents a return on the productive capacity of the sold collateral.

An asset’s economic value can be expended in a variety of ways, however, beyond being permanently and absolutely disposed of. The language of Article 9’s revised definition of proceeds reflects this. For instance, Revised Article 9 deems cash generated from the lease or license of collateral as proceeds, in accordance with the theory that such leasing or licensing exhausts an asset’s finite productive capacity. An attachment of a security interest in the cash received from the lease or license is simply an acknowledgment that the economic value of assets can take different forms.

The contours of the new proceeds definition, however, are as yet undefined. The language with the greatest potential to be liberally construed is found in Section 9-102(a)(64), subsections (b) & (c). These subsections identify proceeds as including “whatever is collected on, or distributed on account of collateral,” as well as “rights arising out of collateral.” Because of the lack of specific definition, the constraints placed upon its interpretation must be found in the fundamental policy underlying Article 9’s coverage of proceeds. Not every asset that can conceivably trace its roots to original collateral ought to be deemed proceeds. What is “collected upon” or what “arises out of” an encumbered asset must be viewed through a coherent policy lens to determine whether or not it rises to the level of an Article 9 “proceed.”

The history of the proceeds definition, while leaving some fundamental questions unanswered, supports limitations on the interpretation of its broad language. For example, while the 1992 Article 9 Permanent Editorial Board (“PEB”) Study Group report saw proceeds-collateral as including property received in exchange or replacement of the original collateral, it also recommended that “those things that are so necessarily and obviously associated with an interest in the original collateral that a security agreement and financing statement ought not be required to mention them explicitly,” should similarly be deemed proceeds.

The PEB Study Report made clear, however, that not every asset that

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105 There is no indication that the “rights arising” language finally adopted in Revised 9-102(a)(64)(c) was designed to go very far beyond the vision of the PEB Study Group. In fact, in the Section 9-101, Official Comment 4(f), “significant revisions,” the Drafters seem to attach little independent significance to the “rights arising” concept. The “significant revisions” section makes reference to “distributions on account of collateral” and “claims arising out of loss ... or damage” as examples of the kind of rights and property that “arise out of” collateral.”U.C.C. 9-101, comment 4(f).

106 Permanent Editorial Board for the Uniform Commercial Code Article 9: Report 110-11 (1992). This “close association” model of proceeds embraces “all forms of distributions on account of securities, partnership interests, and other intangibles ... that do not involve an “exchange”
owes its existence to the original collateral is a proceed. The report observed that, "at some point, the acquisition of assets by the debtor . . . will be too attenuated for those assets to be considered proceeds." When, and under what circumstances one reaches that point remains the, as yet, unanswered question.

Since the competition for proceeds collateral commonly arises following a debtor’s bankruptcy filing, the scope of a creditor’s security interest often turns on how proceeds are defined in bankruptcy. Section 552(b) of the Bankruptcy Code states that security interests created before bankruptcy, extend to debtor’s assets received post-bankruptcy, provided the assets are “proceeds, product, offspring or profits of the pre-bankruptcy collateral. The statute offers the further qualification that the proceeds must be recognized by the parties’ security agreement and by “applicable non-bankruptcy law.”

Bankruptcy courts have adopted one of two approaches to defining the contours of “proceeds” under Section 552(b). The first approach has historically deferred to the interpretation of the term as used pursuant to Article 9; the alternative approach is to use the language of Section 552(b), in light of its legislative history. The legislative history of Section 552(b) states that “the term proceeds . . . covers any property into which property subject to the security interest is converted” and is “not limited to the technical definition of that term in the U.C.C.” Interestingly, in expanding the language of proceeds under Article 9, the revision brings the two approaches to interpreting “proceeds” in a bankruptcy context into alignment. The most common approach to interpreting “proceeds” under the Bankruptcy Code, brings us back to the question we began with: what are the limitations on the broad language found in Revised § 9-102(a)(64)?

To illustrate the contours of their suggested expansion, the Study Group noted that “accounts generated by a construction contractor should not be considered proceeds of the contractor’s construction equipment, even though the equipment depreciates as a result of its use in generating accounts. Nor should inventory fabricated by a debtor’s factory equipment be considered proceeds.” According to the Study Group, there are some assets with a connection to original collateral which are not as clearly defined as proceeds. For example, the report declined to conclude that cash earned from music or video machines should be considered a “proceed” of the machine as original collateral, noting that the answer turned on the question of whether the machine is merely providing a service, or whether the cash generated ought to be deemed to arise from the machine’s short-term rental. It is not clear that such a distinction is supported by either the language or the policy underlying the statutory provision.

107 To illustrate the contours of their suggested expansion, the Study Group noted that “accounts generated by a construction contractor should not be considered proceeds of the contractor’s construction equipment, even though the equipment depreciates as a result of its use in generating accounts. Nor should inventory fabricated by a debtor’s factory equipment be considered proceeds.” According to the Study Group, there are some assets with a connection to original collateral which are not as clearly defined as proceeds. For example, the report declined to conclude that cash earned from music or video machines should be considered a “proceed” of the machine as original collateral, noting that the answer turned on the question of whether the machine is merely providing a service, or whether the cash generated ought to be deemed to arise from the machine’s short-term rental. It is not clear that such a distinction is supported by either the language or the policy underlying the statutory provision.


Recent Case Law

In In re Rebel Rents, Inc. 2004 Bankr. LEXIS 615 (Feb, 20, 2004), (a recent case applying former Article 9) debtor granted a security interest in its “inventory machinery, equipment, attachments, accessories and replacement parts thereof . . . . , plus all proceeds derived there from.” The question considered by the court was whether the creditor’s lien extended to debtor’s lease income. The court recognized that under former Section 9-306, while courts interpreted “proceeds” broadly to include “what was received when collateral or proceeds were sold, exchanged, collection or otherwise disposed of,” none of the cases extended the definition of proceeds to include income generated by a lease of the collateral. The court quoted In re Cleary Bros. Constr. Co, 9 B.R. 40 (Bankr. D.D. Fla. 1980): “The words “otherwise disposed of” related to a permanent or final conversion, not a temporary use . . . . The way to create a security interest in rent under the U.C.C. is to assign the lease or to give a security interest in the lease. The rent would then be the proceeds of the collateral as: “the account arising when a right to payment is earned under a contract right.” In seeking further guidance, the court looked to the Permanent Editorial Board Commentary No. 9, issued in June 29, 1992. This Commentary, in adopting a functional approach to the determination of whether lease payments on encumbered equipment ought to be deemed proceeds of such equipment, stated:

Lease rentals would constitute proceeds of a secured party’s collateral consisting of goods even where the subsequent lease of goods is for a term which is of a short duration in relation to the useful life of the goods. Where the goods have a limited useful life, any transfer of the use and possession of the goods in return for a consideration constitutes a disposition, however small, of the debtor’s interest in the goods. If that consideration consists of chattel paper, that chattel paper and the payments thereon constitute proceeds of the secured party’s collateral.”

The court, in observing that the parties were unable to cite to a single case that relied on the position taken in the Commentary, ultimately concluded that creditor’s lien on debtor’s equipment did not extend to rental income from the debtor’s lease of the equipment. As final support for their conclusion, the court cited Revised Article 9’s expanded definition of proceeds and its explicit language defining proceeds as including “whatever is acquired upon the . . . . lease . . . of collateral.”

* * *

In a line of cases involving payments made in connection with agricultural commodities, the courts addressed the question of whether certain payments constituted “proceeds.” For example, in In re Stallings, 290 B.R. 777 (March 24, 2003), the court declared that government payments designed to compensate debtor for damaged crops were not proceeds of the crops. While the court recognized that Revised Article 9 expanded the proceeds definition, it ultimately concluded that “it is too much of an interpretative stretch to view the . . . payment, which can be seen as a “gift” from the government . . . . as falling within the U.C.C. definition of proceeds.”

112 290 B.R. at 783.
this right? An economic-based functional analysis would ask the question of whether the government payments were a substitute for the destroyed crops. Would the secured party reasonably expect that its lien would continue in the payments, upon the destruction of the crops? If the crops were not destroyed, but instead, grown, harvested and sold, would it be reasonable for the parties to expect that the creditor’s security interest attach to the proceeds of the sale?

In another case involving government agricultural payments, In re Gary Stevens, 307 B.R. 124 (March 3, 2004) the court found that agricultural program payments were not proceeds of the previous year’s crops, but proceeds “arising from or relating to” contract rights having their origin in “the statutory and regulatory fabric of the farm support program,” (citing, Kingsley, 865 F.2d 975, 980 (8th Cir. 1989)). Because, however, the creditor did not properly perfect its interest in the original collateral, the court avoided the creditor’s interest in the proceeds payments.

In In re Wiersma, 283 B.R. 294 (September 20, 2002), the court found that Debtor’s damage claims against an insurer of cows (and milk), arising out of the loss of, and damage the cows, were “proceeds” of the creditor’s secured interest in the cows. Broadly interpreting the language, the court found that “proceeds” includes all components of the damage claim, including punitive damages. Citing Idaho Code § 28-9-02(64), the court concluded, “[t]he UCC definition of “proceeds” includes within its scope whatever is acquired upon disposition of collateral, all rights arising out of collateral, and includes all claims arising out of the loss of, or damage to, collateral” (emphasis added).

* * *

In perhaps the most interesting case examining the contours of proceeds under Revised Article 9, In re Cafeteria Operators, L.P., 299 B.R. 400 (July 1, 2003), the court was presented with the issue of whether the revenues generated by a restaurant were proceeds of the creditor’s original collateral. In this case, a creditor held an original security interest in “all personal and fixture property of every kind and nature, including without limitation all furniture, fixtures, equipment, raw materials, inventory, other goods, accounts... deposit accounts, rights to proceeds of letters of credit and all general intangibles.” Following the debtor’s bankruptcy, what was at issue was creditor’s claim to post-petition revenues generated by the debtor restaurant.

The court began its analysis by recognizing that Bankruptcy Code Section 552(b) expressly provides for creditors’ security interest to continue in proceeds of original collateral. In reliance on the Section 552(b)’s express reference to “non-bankruptcy law,” the court determined that Article 9’s definition of proceeds controls the question of whether the cash and cash equivalent revenue ought to be deemed proceeds, and therefore the encumbered collateral of the secured creditor. The court observed that under state law, the revenues generated by the debtor restaurant could be “conceivably” deemed proceeds from the “sale of food and beverage inventory and arise out of the use of fixtures.

113. 299 B.R. at 406. The court in a footnote observed that the secured creditors “did not argue that the cash allegedly generated as a result of the use of the fixtures falls within another § 552(b)(1) exception, i.e., product, offspring, profits.” Id. at 408.
and equipment” (emphasis added). The court stated that, “on its face, the Massachusetts definition of proceeds does not include revenues generated by a service-oriented business, since services are not tangible collateral” (emphasis added), but then conceded that the post-petition restaurant revenues at issue may be proceeds “since they are acquired, inter alia, upon the sale of food and beverage inventory and arise out of the use of fixtures and equipment, i.e., stoves, ovens, warmers, tables, chairs, plates, forks and knives, all of which are subject to Bank Group’s pre-petition lien.”

Relying on a witness who testified that approximately two-thirds of the revenues received by the restaurant were “derived ... from the time and energy expended by the Debtor’s employees who provide services for which the Debtor’s customer’s pay. ... [and] ... [t]he only asset converted to cash ... is the food and beverage inventory,” the court ultimately concluded that, “the revenue generated from the use of fixtures and equipment in the present case does not constitute proceeds under Massachusetts law.” (emphasis added).

A number of issues are raised by this court’s interpretation of the definition of “proceeds.” First, there is no requirement under Article 9 that proceeds can only spring forth from tangible collateral. For example, inventory can arise from contract rights and when such contract rights are offered as collateral, the inventory is proceeds of such intangible rights. Further, when intellectual property is taken as collateral, payments made pursuant to a license to use such intellectual property are proceeds of the intellectual property.

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114 In comparing restaurant revenues with hotel receipts, the court observed that other bankruptcy courts have found that a secured lender’s lien on all a debtor’s assets “created a lien on all of the debtor hotel’s revenues, including income from the restaurant and bar. ... In ultimately distinguishing restaurant revenues from hotel revenues, the court observed that “the hotel cases involve use of real property without real diminishment to the facility, ... [y]et, the rents generated thereby are typically cash collateral since they are generated primarily from the use of real property.” ... “In a restaurant, the food and beverages that make up the final product of the restaurant undoubtedly are used up in the process. The reasoned approach is to grant a limited interest in post-petition revenues.” Id. at 409.

115 299 B.R. 400 at 406.

116 299 B.R. 400 at 410.

117 299 B.R. 400 at 410. It is interesting to note that in this case, the secured party had an interest in “all general intangibles” of the debtor. Among the general intangibles of a restaurant are the employment contracts with the chef and other “service employees.” Revenues from the service component of a restaurant meal, while not involving a disposition, would surely be considered “collected ... on account” of such service contracts.

118 For example, debtor/retailer contracts with supplier for the manufacturer of an item of furniture. The contract is a “thing in action” and is intangible. If debtor offers the contract as collateral to its financier, once the furniture is completed and identified to the contract, it becomes an item of inventory in debtor’s hands – at the same time being proceeds of the contract to manufacture it.
Moreover, as noted above, the requirement that there has to be a conversion (or disposition) to give rise to proceeds has been lifted. Proceeds includes “whatever is collected on, or distributed on account of, collateral, as well as all “rights arising out of collateral.” 119 One could view revenues from the sale of food cooked and served in a restaurant as “collected . . . on account of” both the inventory and the restaurant fixtures.

Would the revenues be properly considered “arising out of” the original collateral in this case? The risk of such a characterization is that there is potential for that phrase to include every conceivable asset that owes its existence, no matter how tangentially, to original collateral. In the most extreme case, the “arising out of” language allows for the argument that any property that can trace its causal or creative roots to the original collateral rises to the level of “proceeds,” even if it does not represent a direct economic return on the productive capacity of the asset. For example, it has been suggested that the “rights arising” language could capture the “organs grown from stem cells “arising out” of the debtor’s patent on the stem cells or on the growth process.”120 This expansive view of the proceeds right would allow the secured party to extend the security interest into property that goes beyond original collateral’s direct future productive capacity. At a certain point, rights that “arise out of” original collateral become too attenuated to be reasonably expected by the creditor to be proceeds of its original collateral.

Interestingly, the court ultimately rested its compromise holding on the equitable exception to the rule in Section 552(b), limiting a continuing security interest in proceeds received post-petition. The court observed, “[t]he equities of the case” provision is intended to prevent secured creditors from receiving windfalls to allow bankruptcy courts broad discretion in balancing the interests of secure creditors against the general policy of the Bankruptcy Code, which favors giving debtors a “fresh start.”121

119 The Section 9-102(a)(64) definition of proceeds further includes,

(D) to the extent of the value of collateral, claims arising out of the loss, nonconformity, or interference with the use of, defects or infringement of rights in, or damage to, the collateral; or

(E) to the extent of the value of collateral and to the extent payable to the debtor or the secured party, insurance payable by reason of the loss or nonconformity of, defects or infringement of rights in, or damage to, the collateral.

120 See Jonathan Lipson, Remote Control” Revised Article Nine and the Negotiability of Information, 62 OHIO ST. L. J. 1327, 1322-33 (2002) (“The new proceeds definition could extend the secured parties’ proceeds right far beyond the range of the original collateral and create surprise encumbrances on information and related property rights . . . “).

THE APPLICABILITY OF TILL TO CHAPTER 11
CRAM DOWN CASES

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THE APPLICABILITY OF TILL TO CHAPTER 11 CRAM DOWN CASES

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SECTION C
BACKGROUND

Facts:

On October 2, 1998, the Debtors, Lee and Amy Till, purchased a used truck from Instant Auto Finance for $6,395 plus $330.75 in fees in taxes. The Tills financed all but $300 of the purchase price by entering into a retail installment contract that Instant Auto assigned to the Respondent, SCS Credit Corporation. Under the terms of the loan, which carried a 21% finance charge per year over the course of its 136 week term, the agreed to cover the debt by making 68 biweekly payments. Instant Auto, and then SCS, retained a purchase money security interest that allowed for repossession of the truck if the Tills defaulted under the contract.

On October 25, 1999, the Tills filed a joint petition for relief under chapter 13 of the Bankruptcy Code. While the Tills owed SCS $4,894.89, the parties agreed that the truck was worth only $4,000, and, therefore, SCS's secured claim was limited to $4,000.

The Tills debt adjustment plan proposed to pay SCS from a portion of their monthly wages, over a three year period. Interest on SCS's secured claim would accrue at a rate of 9.5%, a rate which was based on the national prime rate of approximately 8% plus a 1.5% risk premium. SCS objected to the proposed rate, contending that it was entitled to interest at the rate of 21% per year, which was the rate SCS could obtain if it could foreclose on the truck and reinvest the proceeds in a loan substantially similar to the original loan made to the Tills.

Procedural History:

The Bankruptcy Court confirmed the Tills' plan over SCS's objection. The District Court reversed, holding that the "coerced loan" (aka "forced loan") approach, described below, was the proper method to determine cram down interest rates, and that the lender should receive at least the amount it could have obtained if it had foreclosed on the loan, sold the collateral, and reinvested the proceeds in loans of equivalent duration and risk (there was evidence that the lender routinely received 21% interest on its loans).

The Seventh Circuit, by a divided panel, agreed with the District Court's result, but held that the Bankruptcy Court should have started with the 21% contract rate as the "presumptive contract rate", and then permitted the debtors and the lender to argue why the rate should be adjusted upward or downward from the contract rate. In re Till, 301 F.3d 583 (7th Cir. 2002). The dissent disagreed, arguing that the proper cram down rate should be based upon the lender's cost of funds - "what it would cost the creditor to obtain the cash equivalent of the collateral from an alternative source."
After granting certiorari, a sharply divided Supreme Court reversed and essentially agreed with the Bankruptcy Court, but without a majority opinion. Till v. SCS Credit Corp., 541 U.S. 465, 124 S.Ct. 1951 (2004).
The Statutes:

In both the chapter 11 and chapter 13 contexts, the Bankruptcy Code permits a court to confirm, or cram down, a plan over the objection of a secured creditor.

As Till was a chapter 13 case, the Debtors invoked the cram down provision of 11 U.S.C. § 1325 in obtaining approval of their plan. In relevant part, § 1325(a)(5)(B) states a plan may be crammed down if the holder of each allowed secured claim retains the lien securing the such claim and:

the value, as of the effective date of the plan, of property to be distributed under the plan on account of [an allowed secured] claim is not less than the allowed amount of such claim." 11 U.S.C. § 1325(a)(5)(B)(ii).

Therefore, the Till plurality held that when a plan provides a secured creditor with deferred payments, as opposed to a lump sum payment, the bankruptcy court must choose an interest rate sufficient to compensate the creditor for the risk of inflation and the risk of nonpayment, and nothing more. It is, therefore, necessary to ensure only that the creditor receive at least the value of its claim. 541 U.S. at 474.

In the chapter 11 context, a similar provision governs how secured claims must be treated in order for a plan of reorganization to be crammed down:

With respect to a class of secured claims, the plan [must] provide[]... that each holder of a claim of such class receive on account of such claim deferred cash payments totaling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property. 11 U.S.C. §1129(b)(2)(A)(i)(II).

Thus, as in the chapter 13 context, a dissenting secured creditor must be compensated if a chapter 11 plan provides that the secured creditor's claim will be paid with deferred payments. However, as discussed herein, the Till plurality only briefly touches on chapter 11 cram downs, and, in so doing, creates uncertainty as to whether its holding with regard to the appropriate methodology for determining the interest rate to be paid to dissenting secured creditors applies to such cram downs.
Alternative Methods of Determining Cram Down Interest Rate:

Formula (a/k/a Prime Plus) Rate

Under the formula, or prime plus, approach a bankruptcy court begins with the national prime rate and then adjusts it upward according to the risk of default.

Not only was this the approach adopted by the Tills and approved by the Bankruptcy Court, but the formula rate was adopted by a plurality of four Justices, led by Justice Stevens. The plurality opinion states that the appropriate size of the upward risk adjustment depends on "such factors as the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." Id. at 479. Accordingly, the bankruptcy court must hold an evidentiary hearing with regard to the appropriate risk adjustment. The plurality declined to address the level of risk premium that should be added to the prime rate, but it did note that courts have generally approved risk premiums of 1%-3%.

Because the formula approach starts from "a concededly low estimate," the evidentiary burden is on the creditors. Id. In the plurality's view, the formula approach "entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary proceedings." Id.

Ultimately, the plurality's adoption of the formula approach is a manifestation of its belief that the burden of rebutting the presumptive rate should be placed on creditors, as relevant information is more readily available to creditors than debtors in the chapter 13 context.

Contract Rate

The contract rate approach uses the contract rate as the presumptive base rate. The contract rate then may be adjusted either upward or downward, depending on changed circumstances or the interest rate environment.

The plurality rejected this approach because, like the coerced loan approach, it "improperly focuses on the creditor's potential use of the proceeds of a foreclosure sale." Id. at 477. Moreover, the plurality emphasized that while the contract rate approach does allow a debtor to present evidence and argue for a downward rate adjustment, too much of a burden is placed on the debtor, who will have to obtain voluminous and complex information about the creditor in order to rebut the presumptive contract rate. Additionally, reasoned the plurality, the contract rate approach entitles inefficient lenders to obtain higher cram down rates that well-managed lenders. Finally, the plurality noted that because the contract rate approach focuses on a creditor's prior dealings with the debtor, "similarly situated creditors may end up with vastly different cram down rates." Id. at 478.
The dissent endorsed the contract rate approach and essentially agreed with the Seventh Circuit that the contract rate should be the starting point, and that the parties had the burden of showing why an adjustment from that rate - up or down - was appropriate.

In critiquing the dissent's endorsement of the contract rate approach, the plurality stated that the dissent relied on two flawed assumptions: "(1) 'subprime lending markets are competitive and therefore largely efficient'; and (2) the risk of default in Chapter 13 is normally no less than the risk of default at the time of the original loan." \textit{Id}, at 481.

Regarding the efficiency of subprime lending markets, the plurality rejected the notion that Congress relied on this assumption when enacting chapter 13. Moreover, the plurality called into question whether subprime lending markets are perfectly competitive, noting that used vehicles are often sold by means of tie-in transactions and that the extensive state and federal regulation of subprime lending markets indicates that unregulated subprime lenders would exploit borrowers' ignorance.

As to the assumption attributed to the dissent that the risk of default in chapter 13 is no less than the risk of default at the time of the original loan, the plurality stated that in enacting chapter 13, "Congress intended to create a program under which plans that qualify for confirmation have a high probability of success." \textit{Id}, at 482. In the plurality's view, there might be merit to the statement that too many risky plans are being confirmed, "but the solution is to confirm fewer such plans, not to set the default cram down rates at absurdly high levels, thereby increasing the risk of default." \textit{Id}, at 483.

\textbf{Coerced Loan (a/k/a Forced Loan) Rate}

The coerced loan, or forced loan, approach estimates the rate the creditor would realize on a loan of like duration and risk. This was the approach adopted by the district court and then, in modified form, by the Seventh Circuit.

The plurality rejected this approach because it would require a bankruptcy court to consider evidence about the market for comparable loans. Additionally, the plurality stated that the coerced loan approach overcompensates creditors because it takes into account factors, such as transaction costs and profits, that are not relevant in the context of cram down loans.

\textbf{Cost of Funds Rate}

The cost of funds approach estimates what it would cost the lender to obtain the cash equivalent of the collateral from another source.

In discussing this approach, the plurality noted that the cost of funds approach "rightly disregards the now-irrelevant terms of the parties' original contract, [but] it mistakenly focuses on the creditworthiness of the creditor rather
than the debtor." *Id.* at 478. Additionally, the plurality emphasized that like the contract rate approach, the cost of funds approach places a significant evidentiary burden on the debtor.
Factors Guiding the Court's Choice in the Chapter 13 Context

Three considerations guided the plurality in the analysis by which it arrived at the conclusion that the formula rate is the appropriate approach to setting cram down interest rates. Id. at 474-77.

First, the plurality cited administrative concerns. Specifically, the plurality stated that the appropriate approach should be one that may be applied to the Bankruptcy Code's other cram down provisions, is familiar to the financial community, and minimizes the need for expensive evidentiary proceedings. Id. at 474.

Second, the plurality noted that in chapter 13 cases involving secured interests in personal property, a bankruptcy court has the authority "to modify the number, timing, or amount of the installment payments from those set forth in the debtor's original contract" with a secured creditor. Id. at 475. In connection with this authority, the plurality further noted that the circumstances dictating how the bankruptcy court modifies the original obligation include the fact that the risk of default is lower because the postbankruptcy obligor is the court-supervised estate.

The bankruptcy court's power to modify the debtor's obligations, including of course the interest rates on contracts, ties directly into the court's obligation to confirm only those plans that are feasible. That is, the cram down and feasibility provisions of chapter 13 together obligate "the court to select a rate high enough to compensate the creditor for its risk but not so high as to doom the plan." Id. at 480.

The third consideration guiding the plurality's analysis is that the chapter 13 cram down provision requires an objective rather than a subjective inquiry. According to the plurality, "the court should aim to treat similarly situated creditors similarly, and to ensure that an objective economic analysis would suggest the debtor's interest payments will adequately compensate all such creditors for the time value of their money and the risk of default." Id. at 477 (emphasis added).

In the plurality's view, the formula rate best addressed these three considerations. The formula approach satisfies the plurality's administrative concerns in that it is a methodology easily grasped by the financial community and the bankruptcy courts. Moreover, as set forth above, the formula approach, at least according to the plurality, provides for "a straightforward, familiar, and objective inquiry" thereby minimizing the need for expensive evidentiary proceedings. Finally, the plurality implied that the formula approach was the

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Section 1325(a)(6) states that a chapter 13 plan may only be confirmed if "the debtor will be able to make all payments under the plan and to comply with the plan."
approach that would most successfully provide bankruptcy courts the means to implement chapter 13 plans that would compensate secured creditors for their risk and the time value of money, while still meeting the Bankruptcy Code's feasibility requirement.
**Chapter 11 in Till:**

Though it only briefly references chapter 11, the plurality opinion creates an air of confusion as to how it's holding that the formula approach is the appropriate method for determining the cram down rate of interest should be applied to chapter 11 cram downs.

In discussing the requirement generally found in the Bankruptcy Code's cram down provisions that a stream of deferred payments must be discounted to its present dollar value to ensure that a creditor receives the value of its claim, the plurality cited to numerous provisions of §1129 and stated: "We think it likely that Congress intended bankruptcy judges and trustees to follow essentially the same approach when choosing an appropriate interest rate under any of these provisions." *Id.* at 474.

Here, the plurality seemed to signal that whichever approach was deemed appropriate in the chapter 13 context would also be applicable in the chapter 11 context.

However, shortly thereafter, the plurality seemed to indicate that a there may be justification for applying different types of cramdown rates in chapter 13 than in chapter 11. Specifically, in footnote 14, the plurality noted that while there is no free market of willing cram down lenders in the chapter 13 context because every cram down loan is imposed by a court over the objection of the secured creditor, "the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession." *Id.* at 477, fn. 14. Accordingly, the plurality suggested that "when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce." *Id.* On the other hand, "[i]n a Chapter 13 context... the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure." *Id.*

It is hard to understand why rates of interest charged for debtor in possession ("DIP") financing have any relevance whatsoever to the rate of interest that should be offered to a secured creditor in a cram down context. A DIP loan is normally granted upon a debtor's entrance into chapter 11, and although it has the added benefits of the jurisdiction of the bankruptcy court on the issue of risk, it is often limited to the pre-petition lender who has the leverage in the negotiations as a result of, among other things, the provisions of Section 364 (c) and (d). Since a cram down loan relates to a loan upon emergence from chapter 11, a more relevant interest rate might be the rates charged in connection with exit financing where the bargaining position of the debtor and the lender are more equal. In any event, cram down is just that, and there is no market for such loans even in chapter 11. It may be that if the formula approach applies in chapter 11, and in order to make some sense out of footnote 14, the rates that the market may be offering for exit financing should be used to set the upward adjustment to the prime rate and may, in many cases, be a floor on what
may be appropriate in a cram down context depending on how the cram down loan and the exit financing compare in terms of collateral, duration, payment terms, and the like.

Given the plurality's analysis, Till should apply to chapter 11 cram downs notwithstanding footnote 14. As noted above, the standard for cramming down a secured creditor in chapter 13 under §1325(a)(5)(B) is virtually identical to the standard for cramming down a secured creditor in chapter 11 under §1129(b)(2)(A)(i). Moreover, with the exception of plurality's observation that the bankruptcy court's continued supervision of the plan payments phase reduces lender risk, all of the factors that led the plurality to choose the formula approach apply equally in chapter 13 and chapter 11. There is no reason to believe that the plurality's administrative and evidentiary concerns would not apply equally in the chapter 11 context. Similarly, nothing in §1129(b)(2)(A) differentiates it from §1325(a)(5)(B) with respect to whether the inquiry, from the point of view of a secured creditor, should be objective. Above all, in both the chapter 13 and chapter 11 contexts, the bankruptcy court has both the power to modify rights of any creditor and the obligation to confirm only those plans that are feasible. See 11 U.S.C. § 1123 (a)(5)(H), 11 U.S.C. § 1129 (a)(11). As such, it appears that all of the factors that led the plurality to adopt the formula approach in the chapter 13 context would also lead it to adopt the formula approach in the chapter 11 context.
Chapter 13 Cases Citing Till:

In re Smith, 310 B.R. 631, 633-34 (D. Kan. 2004) (reversing the bankruptcy court because while the bankruptcy court correctly adopted the formula approach, it did not properly apply the formula method as mandated by Till in that (1) it did not use the prime rate as its base rate; and (2) it did not conduct case-by-case evidentiary hearings to determine the proper risk adjustment for each loan)

In re Bouzek, 311 B.R. 239, 242 (Bankr. E.D. Wis. 2004) (Justice Thomas' concurring opinion in Till cited for its analysis of Rash – specifically explaining the rationale of Rash that a replacement value standard is appropriate in chapter 13 cramdowns because the creditor is receiving neither the property nor the value of the property and, therefore, is exposed to both the risk of default and deterioration of the property's value)

In re Pokrzywinski, 311 B.R. 846 (Bankr. E.D. Wis. 2004) (holding that add-on interest that nearly doubles the amount of interest paid as compared to simple interest based on a declining balance would result in a windfall to the creditor is "untenable" after Till)

In re Berksteiner, 2004 Bankr. LEXIS 1576, *2-*6 (Bankr. S.D. Ga. 2004) (holding that the evidentiary burden placed on creditors by Till applies equally to a creditor seeking an adjustment of the local rule's 12% default rate)

In re Scrogum, 2004 Bankr. LEXIS 1376, *3-*4 (Bankr. C.D. Ill. 2004) (denying confirmation of the debtor's plan because, under Till, the debtor's proposal to pay a creditor at an interest rate of zero, which was the contract rate of the retail installment contract between the debtor and the creditor, violated § 1325; rather, the formula approach should be employed)

In re Harken, 2004 Bankr. LEXIS 2062, *3-*5 (Bankr. N.D. Iowa 2004) (employing the formula approach in setting an interest rate (prime rate of 5% plus a risk adjustment of 3%) to be paid on the creditor's claim during the debtor's chapter 13 plan)

In re Bivens, 317 B.R. 755, 759, 762-70 (Bankr. N.D. Ill. 2004) (analyzing the means by which to arrive at an appropriate risk adjustment and then holding that a 7% rate, which included a risk adjustment of more than 2%, comported with the formula approach of Till and was adequate to protect the creditor's interest)

In re Moore, 319 BR. 504, 515 (Bankr. S.D. Tex. 2005) (passing mention of Till with regard to scrutiny courts should apply to chapter 13 plans)

In re Cachu, 2005 Bankr. LEXIS 236 (Bankr. E.D. Cal. 2005) (in determining the cramdown interest rate applicable to the county's claim for real property taxes in light of Till, court settled on a rate of 4.75% (prime rate of 4.25% plus a risk adjustment of 0.5%).)
In re Nowlin, 2005 Bankr. LEXIS 273, *15-*16 (Bankr. E.D. Pa. 2005) (where a debtor proposed to a creditor 8% (4% prime plus 4% risk adjustment) on its crammed down claim, court found that such rate was adequate to compensate the creditor for any risk it may assume under the plan)

In re Pike, 2005 Bankr. LEXIS 381, *5-*8 (Bankr. D. Kan. 2005) (holding that where a creditor is oversecured and a party in interest objects to payment of the contract rate or higher rate, the court may determine the appropriate rate by applying Till's formula approach)

In re Cook, 2005 Bankr. LEXIS 254 (N.D. Ohio 2005) (stating that Till is not binding authority because five justices did not agree on the rationale and because there is no common denominator among the opinions in Till and, therefore, relying on Sixth Circuit caselaw in holding that that the "coerced loan" approach is appropriate method for determining rate of interest to be paid to unsecured creditors where plan proposes to pay a 100% distribution over time to unsecured creditors)
Chapter 11 Cases Citing Till:

In re LWD, Inc., 2005 Bankr. LEXIS 384, *35-37 (Bankr. W.D. Ky. 2005) (citing to Till in determining the discount rate to be used to calculate the amount the defendant must pay to the debtors' estates for not adequately disclosing an insurance policy and, in turn, causing bidders to undervalue the debtors' assets)

In re AE Hotel Venture, 321 B.R. 209 n.8 (Bankr. E.D. Ill. 2005) (in differentiating between default interest sought under § 506(b) and interest that is charged to compensate for the risk of non-payment, Till cited for the proposition that interest may be charged to compensate for the risk of non-payment)

In re Prussia Associates, 2005 Bankr. LEXIS 557, *31-*52 (Bankr. E.D. Pa. 2005) (holding that in the chapter 11 context that Till is instructive, but not controlling insofar as it mandates use of the formula approach)
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Ronald F. Greenspan and Cynthia Nelson, UnTill We Meet Again: Why Till Might Not Be the Last Word on Cram Down Interest Rates, FTI Consulting, Inc.

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MEDIATION

An Opportunity To Provide For A Just And Fair Compromise Of Bankruptcy Controversies

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SECTION D
MEDIATION

An opportunity to provide for a just and fair compromise of Bankruptcy Controversies

INTRODUCTION

The Alternative Dispute Resolution Act (T 28 U.S.C. Sec. 651, et. seq.) 1 marked a major step forward for the federal judiciary in addressing the growing docket load confronting the district courts and, clearly, the U. S. Bankruptcy Courts as well. Pursuant to Sec. 651(b): “Each United States district court shall authorize, by local rule adopted under Sec. 2071(a), the use of alternative dispute resolution processes in all civil actions, including adversary proceedings in bankruptcy, in accordance with this chapter..., except that the use of arbitration may be authorized only as provided in Sec. 654. Each United States district court shall devise and implement its own alternative dispute resolution program, by local rule adopted under Sec. 2071(a), to encourage and promote the use of alternative dispute resolution in its district.”

Although the specific statutory language refers to “each United States district court...” a sensible and now accepted reading applies to adversary proceedings before the United States Bankruptcy Courts as a “...unit of the district court...” (28 U.S.C. 151). As of the present date, almost all

1 The legislative history of this important legislation, as amended and passed by Congress on October 30, 1998, provides that:

“(1) Alternative dispute resolution, when supported by the Bench and Bar, and utilizing properly trained neutrals in a program adequately administered by the Court, has the potential to provide a variety of benefits, including greater satisfaction of the parties, innovative methods of resolving disputes and greater efficiency in achieving settlements;

(2) Certain forms of alternative dispute resolution, including mediation, early neutral evaluation, mini-trials and voluntary arbitration, may have potential to reduce the large backlog of cases now pending in some federal courts throughout the United States, thereby allowing the Courts to process their remaining cases more efficiently; and

(3) The continued growth of Federal Appellate Court – Annexed Mediation Programs, suggests that this form of alternative dispute resolution can be equally effective in resolving disputes in the federal trial courts;

Therefore, the District Courts should consider including mediation in their local alternative dispute resolution programs.”
bankruptcy courts recognize the importance of alternative dispute resolution and by local rule have provided for some form of implementation of this legislation. The most frequent form of alternative dispute resolution is clearly mediation and its success is readily apparent by the marked and dramatic decrease in civil trials in the federal court system. Alternative dispute resolution can involve more than one form of dispute resolution, and the most common forms are arbitration, early neutral evaluation (including issue resolution), mini-trials and mediation as the most frequently employed form of dispute resolution. Even when one form of alternative dispute resolution has failed, resort to some other form might well be an advisable approach to resolving a complex and heated controversy. For example, where mediation has failed (and in some cases, this is because of a lack of complete discovery by one or both parties at the time of scheduled mediation), the parties may choose to participate in a mini-trial or have the matter rescheduled for binding arbitration.

An excellent example of how mediation procedures have been successfully implemented is the United States Bankruptcy Court for the District of Delaware. Because of the number of mega Chapter 11 cases that have been, and continued to be, filed in this district, and the thousands of adversary proceedings that are generated in such cases, Chief Judge Mary F. Walrath, on April 7, 2004, entered a general order regarding the mandatory utilization of mediation in all preference actions “filed on and after May 1, 2004.” No later than 90 days after the filing of an answer or other responsive pleading, the parties are required to file a stipulation providing for the appointment of a mediator (although there are 31 approved names on the

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2 “In the federal courts, the number of civil cases reaching trial has fallen from 11% in 1962 to 1.8% in 2002.” See “The Vanishing Trial: An Examination of Trials and Related Matters in Federal and State Courts” – Author: Marc Galanter – Professor of Law, University of Wisconsin. A similar decrease has been observed in connection with adversary proceedings that have been successfully settled through the process of mediation.

3 A mini-trial is usually limited to a one day presentation and is usually presided over by a former judge selected by both parties. The ruling, of course, is not binding but is frequently used as a basis for achieving a reasoned settlement based upon the results of a condensed trial.
mediation registry of this Court, the parties are usually free to select a qualified mediator of their choice) and within 60 days after entry of the order assigning the adversary proceeding to mediation, the mediator is required to file a Certificate of Completion. Within 90 days of the order assigning the adversary proceeding to mediation, the proceeding will be set for trial by the Court. See Court Forms that are Employed by the U.S. Bankruptcy Court in the District of Delaware are attached. In many instances, this same procedure will be employed for other types of adversary proceedings, other than preference actions.

Because of the continuing and mounting success of mediation, courts and counsel should realize that this mediation procedures are suitable in a number of other ways. In complex Chapter 11 cases, a mediator can be helpful in assisting the debtor and creditor constituencies in working through the many problems confronting counsel in the formulation of a successful plan of reorganization. One of the most important objectives of a seasoned mediator is to have the parties focus on mutually obtainable results, by separating the parties from the problem and the stated positions taken, and instead have the parties focus on their mutual interests and the alternative avenues available for reaching and satisfying those interests. The skilled mediator (in reality a problem-solver), will usually stress the benefits of a continued relationship and will search for a solution that may have been overlooked by both parties in their initial adversarial confrontation. A respected and disinterested mediator can often promote the basis for a reasoned and fair solution that was either overlooked or ignored in the early stages of the adversarial confrontation. For example, in connection with an objection to an administrative priority claim that would prove to be difficult to pay by the debtor because of its limited resources, the mediator might well suggest some other alternative other than a dollar payment for the claim. Where the plan of reorganization anticipates a continued business operation by the debtor, a new
contract of employment or some other suitable arrangement that meets the satisfaction of both parties, might well be one way of resolving the debtor’s objection to such a claim.

Almost any type of dispute arising in a bankruptcy case (for example, turnover proceedings, avoidance actions, landlord/tenant issues, customer disputes, etc.) can be referred to mediation. Employing mediation for resolution of asbestos claims is yet another example of how a critical element in developing a plan of reorganization can be successfully addressed. Although non-dischargeability proceedings are yet another example, objections to a debtor’s discharge (Sec. 727(a) proceedings) would not, because of the public interest factor in dealing with the fresh start doctrine and the court’s necessary involvement pursuant to Federal Rule of Bankruptcy Procedure 7041.

MEDIATION – STRATEGIC CONSIDERATIONS FOR COUNSEL

One of the primary considerations for employing mediation is the cost of trial preparation and the expenses attendant to the trial itself. In many cases, the cost of employing an expert witness(es) must be factored into the financial equation of reaching a reasoned settlement. Aside from counsel fees and related trial expenses, the time lost by the party representatives must also be factored in. Together with the delay occasioned by the court’s docket and the uncertainty of prevailing at trial, mediation is a worthwhile step to be considered before progressing too far down the path to trial. Even where the core legal issues appear well settled and established, factual nuances and trial presentation can frequently result in a different outcome.

Another important consideration and benefit for mediation is the first opportunity of the client to become actively involved in the legal process. Most mediators will wisely require the presence of both parties to be involved in the mediation conference and the client will feel a sense of achievement by being permitted to present his or her side of the ‘story.’ The mediator,
as part of the introduction to the mediation process, will highlight that all of the statements and negotiations are strictly confidential and enjoy the same privilege as all settlement talks pursuant to FRE 408. Moreover, the mediator will explain that there are no communications between the mediator and the judge concerning the mediation process except for the filing of a status report as usually required by local rule.

For the attorney involved in mediation, there is the opportunity to observe the demeanor and the abilities of opposing counsel and, more importantly, to discern the strength and weaknesses of the opposition’s cases. Most mediators will, prior to the actual mediation session, require the submission of position papers in order for the mediator to become fully acquainted with the factual background and the legal issues involved. This can afford each counsel with an excellent opportunity to present, in a condensed form, the first “trial brief.”

Finally, one of the truly great benefits of mediation is the opportunity for counsel to achieve an objective that could never be achieved in litigation where the judge decides the matter in one way or the other. In other words, there may be other objectives that can be reached consensually where the parties are brought to focus on mutual and shared interests. In one mediation involving a substantial administrative priority claim, the mediator after numerous conferences with both parties suggested that a sale of real estate to the administrative priority claimant, which was of economic benefit to the claimant, but was a burden to the reorganizing debtor, might be a way to settle the claim without payment of cash that was of vital concern to the reorganized debtor in connection with its limited resources. Withdrawal of the claim, and the transfer of the subject property, proved to be a better than contemplated result for both parties and was a result that could not have been achieved by litigation.
PREPARATION FOR MEDIATION

The first consideration is the timing and scheduling of the mediation. Ideally, there should be at least some initial discovery by both parties in order for counsel to be aware of the key items of evidence that will be introduced in order to support the respective legal positions of the parties. In many cases, counsel are reluctant to mediate if there are major 'gaps' in the evidentiary process.

Secondly, and even before the scheduling of a mediation date, the selection of a mediator is a matter of critical importance. Most courts, such as Delaware, have an approved list of mediators but in any case, counsel should carefully ascertain the background and experience of the mediator to be selected. Former judges are often a good choice, particularly where there are open and unsettled legal issues involved. More importantly, counsel will want to be sure that the mediator has done a complete conflicts check in order to be sure that the mediator is truly disinterested.

Next, will be for the parties to arrange a pre-mediation conference call in order to 'iron out' such issues as – the most convenient location for the mediation in order to reduce travel expenses, a convenient date for all of the parties to attend and the fees to be charged by the mediator (many mediators will employ a reduced rate because of the nature and goals of mediation). Although most mediations will involve a sharing of the mediator’s fees and expenses, the ultimate burden may already be a matter of court order. In Delaware, where preference adversary proceedings are commenced, the estate will be solely responsible for the payment of the mediation fees. In some instances, the court may permit the mediator to apportion the fees and expenses as the mediator deems equitable. Also, an estimate of time should be made in order to allow for luncheon and related expense items that may arise. Counsel
will also want to know what the mediator will expect by way of position papers (the length, document inclusion and submission dates).

Finally, because mediation is an integral part of the litigation journey, counsel must be aware of the importance of client preparation. Although the process is confidential and non-binding, you will want to prepare your client and determine in advance the extent to which the client is comfortable in advancing his or her position. It may be advisable to have the client focus on the factual background and his or her personal involvement in connection with the development of the claim in order to make the case presentation more personal and meaningful. It would be advisable to impress upon the client the need for suitable dress. Although mediation is not as formal as the trial, the client should be aware that it is an important stage of the litigation process.

**THE MEDIATION SESSION**

The mediator, after an introduction to the mediation, will outline the order of presentation and the procedures to be employed, usually in connection with separate breakout sessions. The actual mediation process is, in a very real sense, an advanced form of negotiation. You should never be in a position to have to bargain against yourself. Advancing an offer to the next stage is critical to the timing and manner of a parties' presentation. Some of the key points in advancing your clients position may best be summarized as follows:

1. Understand the other sides problems – separate the personalities from the parties problem.
2. Avoid emotional outbursts – recognize and understand the other parties emotions – “put yourself in their shoes!”
3. Focus on the parties interests – not their stated positions.
(4) Ascertain what are the shared or mutual interests or concerns and focus on possible solutions or options in advancing an ultimate objective for your client.

(5) Avoid arguments – these are almost always self-defeating and instead counsel should rely upon and insist on resort to objective criteria in connection with negotiating any stated position.

(6) Use the mediator to advance your strong and best positions in order to move the other party to a possible position of settlement.

Finally, always leave the ‘door open’ to possible meetings or conference calls if there seems to be some positive movement toward a possible settlement.

CONCLUDING MEDIATION

At the mediation session, once an agreement has been reached, it is important to reduce the essential terms and conditions of any settlement to writing and have one party assume responsibility for preparing a final settlement agreement. Be sure and verify and establish any specific requirements for submission and approval, particularly if there are any particular conditions in an existing order of a confirmed plan. Usually, prior to plan confirmation, settlements will require compliance with Bankruptcy Rule 9019. In most instances, unless objections are filed, there will be no need for a court hearing. As a final matter, be sure there is an understanding of who is responsible for the payment of the mediator’s fees and expenses.

CONCLUSION

Mediation may well prove to be the most important tool available to the bench and bar in addressing the mushrooming explosion of litigation in the nation’s bankruptcy courts. Proper implementation of mediation by the bankruptcy courts and resort to the mediation process by
counsel will greatly assist clients in achieving a fair and reasoned settlement of most controversies and will provide these same parties with an effective means of achieving objectives that a court would be unable to achieve by mere entry of an order or judgment.
ORDER ASSIGNING ADVERSARY PROCEEDING TO MEDIATION AND SETTING MEDIATION DEADLINES

Pursuant to this Court's Standing Order dated April 7, 2004, RE: Procedures in Adversary Proceedings, not individually, but solely in his capacity as Trustee for (Plaintiff(s) and Defendant(s) (collectively, the "Parties"), are directed to mediation to attempt to resolve disputes by and between the Parties relative to the above-captioned adversary proceeding. Upon the foregoing, it is hereby

ORDERED, that the above-captioned adversary proceeding is hereby assigned to mediation; and it is further

ORDERED, that the costs of the mediation shall be paid by the bankruptcy estate, or if there is no bankruptcy estate, by the plaintiff in the adversary proceeding; and it is further

ORDERED, that:

(a) If the parties have stipulated to entry of this order, Honorable Roger M. Whelan, who has been selected by the parties is appointed the mediator in this adversary proceeding; or,

(b) If the parties have not stipulated to entry of this order, the court appoints, who is a mediator from the Register of Mediators of the United States Bankruptcy Court for the District of Delaware, as the mediator in this adversary proceeding; and it is further

ORDERED, that the Parties shall furnish the mediator with copies of such documents and such confidential statement of position as the mediator may request; and it is further

ORDERED, that within twenty (20) days of appointment, the mediator shall schedule an initial mediation session; and it is further

ORDERED, that this mediation shall be conducted in accordance with the Local Rules of the United States Bankruptcy Court of the District of Delaware. (Effective February 1, 2002, amended September 1, 2002 ("Local Rule 9019-3 Mediation"); and it is further

ORDERED, that pursuant to Local Rule 9019-3(c)(iii)(A), the Parties and counsel shall attend such mediation sessions as the Mediator shall deem appropriate and necessary at such times and places as the mediator shall determine; and it is further

ORDERED, that no later than 10 days following the conclusion of the mediation or 60 days after the entry of this order, whichever is earlier, the mediator shall file and serve on the parties the mediator's certificate of completion or mediation status report. The information provided by the mediator shall not contain any information concerning the merits of the case or confidential communications made during the mediation process; and it is further

ORDERED, that within one day after the entry of this Order, the attorneys for each of the Parties shall send a copy of this Order to (1) each of the individual Parties that such attorney represents; and/or (2) the principal, officer, director or other person with full settlement authority for each entity that such attorney represents.

Date: 10/12/04

/s/ Paul B. Lindsey
United States Bankruptcy Judge
District of Delaware

(VAN-416)
10 DAYS

RESPONSIVE PLEADINGS FILED

90 DAYS

DISCOVERY

COMPATANT

FILED
IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

ORDER (A) APPROVING MANDATORY MEDIATION
PROCEDURES FOR CERTAIN CLAIMS AND (B) APPOINTING
MEDIATOR TO MEDIATE THE CLAIMS INCLUDED THEREIN

This matter coming before the Court on the Motion for an Order (A) Approving
Mandatory Mediation Procedures and (B) Appointing Mediator to Mediate the Claims included
Therein (the "Motion") filed by the above-captioned debtors and debtors in possession
(collectively, the "Debtors"); the Court (a) having reviewed the Motion and all pleadings relating
thereto, (b) having reviewed the objections and statements filed in response to the Motion
(collectively, the "Objections"), and (c) having heard the statements of counsel regarding the
Motion at a hearing before the Court (the "Hearing"); the Court finding that (a) the Court has
jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334, (b) this is a core proceeding
pursuant to 28 U.S.C. § 157(b)(2), (c) notice of the Motion and the Hearing was sufficient under
the circumstances and (d) implementation of the Mediation Procedures (as such term is defined
in the Motion) and as modified below is in the best interests of the Debtors' estates and creditors;
and the Court having determined that the legal and factual bases set forth in the Motion and at
the Hearing establish just cause for the relief granted herein:
IT IS HEREBY ORDERED THAT:

1. The Motion is GRANTED, and the Objections are OVERRULED to the extent not withdrawn or otherwise addressed herein.

2. Capitalized terms not otherwise defined herein have the meanings given to them in the Motion.

3. The Mediation Procedures set forth in the revised Mediation Procedures Term Sheet, a copy of which is attached hereto as Exhibit 1, are approved in all respects.

4. The Notice of Designation attached to the Motion as Exhibit D is approved.

5. Roger M. Whelan is found to be a disinterested person under 11 U.S.C. § 101(14) and he is hereby appointed as the Mediator. Mr. Whelan’s compensation shall include an hourly rate for mediation services of $350 per hour, subject to future adjustments following notice to the Court, and reimbursement of all out-of-pocket costs and expenses. The Debtors are authorized, without further notice or Court approval, to compensate and reimburse Mr. Whelan for the Debtors' portion of his fees, costs and expenses in connection with the Mediation Procedures.

6. During the period that a Mediation Claim is subject to the Mediation Procedures, the Debtors and the Claimant on which the Notice of Designation has been served shall be enjoined from, among other things, commencing or continuing any action or proceeding in any manner or any place to resolve, reconcile, determine the nature, priority or amount of or collect upon a Mediation Claim other than through the Mediation Procedures. This injunction (the "Mediation Injunction") shall commence: (a) with respect to Claims held by Claimants identified on the Preliminary Mediation Claims List or the Potential Additional Mediation
Claimants List, on the date that the applicable Notice of Designation is filed and served; and
(b) with respect to Non-Included Claims, if no objection to inclusion in the Mediation Procedures is timely filed, upon the expiration of the 20-day objection period described above or, if an objection to inclusion in the Mediation Procedures is filed, upon the entry of an order of the Court overruling the objection. The Mediation Injunction shall expire with respect to a Mediation Claim only when the Mediation Procedures have been completed with respect to that Claim.

7. Mediation Claims shall remain subject to the automatic stay under section 362 of the Bankruptcy Code after expiration of the Mediation Injunction through the date of confirmation of a plan or plans of reorganization in the applicable Debtors' chapter 11 cases, unless the stay is or has been earlier terminated by an order of the Court or by consent of the Debtors.

8. Notwithstanding anything herein to the contrary, the claims asserted by American Commercial Bank, Bayview Services, Inc., U.S. Attorney's Office on behalf of the Small Business Administration, William Eldridge, Tecon Corporation, Trousdale Northwest, Inc., Mary Wilcoxen, Anne P. Nix, Nix Realty, Inc., James P. Nix, and Jim Nix shall not be subject to the Mediation Procedures.

9. The Debtors and the Mediator are authorized to take all steps necessary or appropriate to implement the Mediation Procedures.

Date: May 2001

CHIEF UNITED STATES BANKRUPTCY JUDGE.
IN THE UNITED STATES BANKRUPTCY COURT
FOR THE DISTRICT OF DELAWARE

MEDIATION PROCEDURES TERM SHEET

The following summarizes the mandatory mediation procedures (the "Mediation Procedures") adopted in the chapter 11 cases of the above-captioned debtors and debtors in possession (collectively, the "Debtors"). Each claim that potentially could be included in the Mediation Procedures is referred to herein as a "Claim." Each holder of a Claim is referred to herein as a "Claimant" and the claimants are referred to herein collectively as the "Claimants." A "Mediation Claim" is a Claim included in the Mediation Procedures.

Inclusion of Claims in the Mediation Procedures. A Claim may be included in the Mediation Procedures whether or not a proof of claim has been filed and whether or not the Debtors have filed an objection to the Claim. Claimants may request that the Debtors include their Claims in the Mediation Procedures, but the initial decision to include Claims in the Mediation Procedures shall be in the sole discretion of the Debtors. A Claim will be classified as a Mediation Claim, and therefore be subject to the Mediation Procedures, upon the filing and service of a "Notice of Designation" (as defined below) by the Debtors on counsel for the Claimant or upon a Claimant if appearing pro se. Upon the entry of an order approving the Mediation Procedures (the "Mediation Order"), the Debtors will designate certain Claims for resolution through the Mediation Procedures by serving upon holders of such Claims a Notice of Designation indicating that the applicable Claim has been submitted to the Mediation Procedures (the "Notice of Designation"). After receipt of the Notice of Designation, the Claimant may request that the Debtors include other Claims in the Mediation Procedures. In the event of a dispute concerning inclusion of the other Claims, the Mediator shall have the sole discretion as to whether such other Claims shall be included in the Mediation Procedures. The Debtors will send a copy of the Notice of
Designation to the Mediator, notifying the Mediator of the pending mediation and of the need for the scheduling of a mediation conference (a "Mediation Conference") between the parties. Once the Notice of Designation is served, a Claimant may request that certain Claims be mediated prior to other Claims, and the Mediator shall decide in his sole discretion if circumstances exist that justify in placing a requested Claim prior to the mediation of other Claims.

* No Right to Withdraw Claim from the Mediation Procedures. The Debtors shall not have the right to withdraw from the Mediation Procedures any Claim once a Notice of Designation is served.

* Objection to Inclusion in the Mediation Procedures. Each Claimant who is identified on either the Preliminary Mediation Claims List attached as Exhibit B to the Motion or the Potential Additional Mediation Claimants List attached as Exhibit C to the Motion will be subject to the Mediation Procedures upon service of the Notice of Designation on such Claimant, without further opportunity to object to the Mediation Procedures in this Court, except as provided in the Mediation Order.

* Non-Included Claimants. A Claimant not identified on the Preliminary Mediation Claims List or the Potential Additional Mediation Claimants List (a "Non-Included Claimant") that the Debtors serve with (a) a copy of the Mediation Order, (b) a copy of this Mediation Procedures Term Sheet and (c) a Notice of Designation will have 20 days to file an objection with the Court to the inclusion in the Mediation Procedures of any of its Claim(s) identified in the Notice of Designation ("Non-Included Claim(s)"). If the Non-Included Claimant fails to file with the Court an objection to its inclusion in the Mediation Procedures within this 20-day time period, the Non-Included Claimant shall be subject to the Mediation Procedures without further order of the Court. If the Non-Included Claimant timely files an objection to its inclusion in the Mediation Procedures, the Debtors shall have 20 days from the date of the filing of the objection to file a reply to the objection and a request for a hearing before the Court regarding inclusion of the applicable Claim in the Mediation Procedures.

* Removal from ADR Procedures. If a Claim with respect to which a Notice of Designation is served is subject to the alternative dispute resolution procedures previously approved by the Court in these Chapter 11 cases (the "ADR Procedures"), the Claim will be removed from the ADR Procedures and included in the Mediation Procedures.

* Status Conference. Within 20 days of the service of the Notice of Designation, the Mediator shall conduct by telephone a status conference with the Claimant, Claimant's counsel and counsel to the Debtors, to discuss the preparation for the mediation.

D - 20
The Mediation Conference. The Mediator, in consultation with the parties, shall set the date of the mediation conference (the "Mediation Conference"). The Mediator may schedule one or more Mediation Conferences subsequent to the Mediation Conference if the Mediator believes that doing so would further the likelihood of resolution. Mediation Conferences will be conducted for not longer than one-half day (four hours), unless further extended by agreement of the parties.

- Telephonic Mediation Conferences. While disfavored, the Mediator may, where appropriate, allow the Mediation Conferences to be held telephonically.

- In-Person Mediation Conferences. The Mediation Conferences shall be held in Washington, D.C., unless the Mediator directs otherwise or the parties mutually agree to another location.

Submission Materials. Not less than seven calendar days before the date of the Mediation Conference, each party shall submit directly to the Mediator, and serve on all counsel and pro se Claimants participating in the Mediation Conference, a written statement of no more than five pages, exclusive of exhibits, setting forth the parties' respective positions on the Mediation Claim(s) (the "Submissions"). The Mediator may in his sole discretion permit a party to file a Submission of more than five pages. The Submission may consist of previously filed pleadings, in which case the five-page limit shall not apply. The Mediator may, at any time, request that the parties submit additional materials or designate that materials be submitted only to the Mediator. The Submissions and all other materials provided to the Mediator shall not be filed with the Court and the Court shall not have access to them.

Persons Required to Attend. The following persons must attend the Mediation Conference:

- The applicable Claimant and the Claimant's attorney unless the Claimant's attorney certifies in writing to the Mediator that he has full settlement authority without the need to contact the client, in which case the Claimant may be excused from attending the Mediation. If the Claimant has appeared pro se in the Debtors' chapter 11 cases, only the applicable Claimant;

- A representative of the Debtors (e.g., an attorney for the Debtors) who has full authority to negotiate and settle the matter on behalf of the Debtors. The Mediator may order that a non-attorney representative of the Debtors must appear in addition to one of the Debtors' attorneys.
Failure to Attend. If the Claimant fails to appear at the Mediation without the consent of the Mediator, the Debtors may file a motion to disallow the claim. If the Debtors fail to appear at the Mediation without the consent of the Mediator, the Claimant may file a motion to allow the Claim in full.

Mediation Fees, Costs and Expenses. The Mediator shall direct how his fees and out-of-pocket costs and expenses of the mediation shall be shared between the Debtors and the Claimant. In the event said amounts are not paid within the 30 days, the Mediator may request that the Court reduce the amount owed to a money judgment in favor of the Mediator.

Other Costs and Expenses. The Mediator may request that the Debtors provide him with publicly available information so as to develop background information and establish appropriate and efficient Mediation Procedures. The Debtors shall pay all fees, costs and expenses incurred by the Mediator in reviewing this information and establishing the Mediation Procedures.

Mediation Procedures and the Local Rules. The Mediation Procedures are based in large part on Rule 9019-3 of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware (the "Local Rules"). In the event of any conflict between the Local Rules and the Mediation Procedures, the Mediation Procedures shall govern.

Confidentiality of Mediation Materials and Communications. All memoranda, work product and other materials contained in the case files of the Mediator are confidential. Any communication made in or in connection with the mediation that relates to a controversy being mediated, whether made to the Mediator or to a party, or to any person if made at the Mediation Conference, is confidential; provided, however, Claimants may discuss the merits of their respective positions. Confidential materials and communications are not subject to disclosure in any judicial or administrative proceeding.

Civil Immunity. The Mediator shall be immune from civil liability for or resulting from any act or omission done or made while engaged in efforts to assist or facilitate a mediation unless the act or omission was made or done in bad faith, with malicious intent or in a manner exhibiting a willful, wanton disregard of the rights, safety or property of another.

Protection of Information Disclosed at Mediation. The Mediator and the participants in mediation are prohibited from divulging, outside of the mediation, any oral or written information disclosed by the parties or by witnesses in the course of the mediation. No person may rely on or
introduce as evidence in any arbitral, judicial or other proceeding evidence pertaining to any aspect of the mediation effort, including but not limited to: (a) views expressed or suggestions made by a party with respect to a possible settlement of the dispute; (b) the fact that another party had or had not indicated willingness to accept a proposal for settlement made by the Mediator; (c) proposals made or views expressed by the Mediator; (d) statements or admissions made by a party in the course of mediation; and (e) documents prepared for the purpose of, in the course of or pursuant to the mediation, other than documents that prior to the Mediation Conference have been filed with the Court. In addition, without limiting the foregoing, Rule 408 of the Federal Rules of Evidence, and any applicable federal or state statute, rule, common law or judicial precedent relating to the privileged nature of settlement discussions, mediation or other alternative dispute resolution procedures shall apply. Information otherwise discoverable or admissible in evidence, however, does not become exempt from discovery, or inadmissible in evidence, merely by being used by a party in the mediation.

Discovery from Mediator. The Mediator shall not be compelled to disclose to the Court or to any person outside the Mediation Conference any of the records, reports, summaries, notes, communications or other documents received or made by the Mediator while serving in such capacity. The Mediator shall not testify or be compelled to testify in regard to the mediation in connection with any arbitral, judicial, or other proceeding. The Mediator shall not be a necessary party in any proceedings relating to the mediation.

Preservation of Privileges. The disclosure by a party of privileged information to the Mediator does not waive or otherwise adversely affect the privileged nature of the information.

Recommendations by Mediator. The Mediator is not required to prepare written comments or recommendations to the parties. The Mediator may present a written settlement recommendation memorandum to attorneys or pro se Claimants, but not to the Court. The Mediator may, in his sole discretion and without disclosing the information protected from disclosure as described above, submit reports to the Court that would categorize unresolved Claims and make recommendations to the Court with respect to the manner in which the legal issues raised by the Claims should be resolved.

Preparation of Orders. The Debtors shall have the authority to compromise and settle Mediation Claims without further Court order in accordance with the parameters set forth in the Court's Order Granting Debtors and Debtors in Possession Ongoing Authority to Settle and Pay Certain Categories of Claims and Controversies dated December 28, 1999.
Beginning on July 31, 2001, the Debtors will file on a monthly basis a motion under Bankruptcy Rule 9019 listing all Claims settled, the original amount of each Claim settled, the amount of each settlement and the name of each Claimant’s counsel whose Claims were settled during that month.

Final Disposition of Claims. Claims not resolved through the Mediation Procedures shall be resolved by the Court or another appropriate court or forum.

Injunction. During the period that a Mediation Claim is subject to the Mediation Procedures, the Debtors and the Claimant on which the Notice of Designation has been served will be enjoined from, among other things, commencing or continuing any action or proceeding in any manner or any place to resolve, reconcile, determine the nature, priority or amount of or collect upon a Mediation Claim other than through the Mediation Procedures described herein. This injunction (the "Mediation Injunction") will commence: (a) with respect to Claims held by Claimants identified on the Preliminary Mediation Claims List or the Potential Additional Mediation Claimants List, on the date that the applicable Notice of Designation is filed and served; and (b) with respect to Non-Included Claims, if no objection to inclusion in the Mediation Procedures is timely filed, upon the expiration of the 20-day objection period described above or, if an objection to inclusion in the Mediation Procedures is filed, upon the entry of an order of the Court overruling the objection. The Mediation Injunction will expire with respect to a Mediation Claim only when the Mediation Procedures have been completed with respect to that Claim. Nothing contained herein shall restrict the Claimant from seeking relief from the Mediation Injunction from the Court in accordance with the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure and the Local Rules. In addition, Mediation Claims will remain subject to the automatic stay under section 362 of the Bankruptcy Code after expiration of the Mediation Injunction through the date of confirmation of a plan or plans of reorganization in the applicable Debtors’ chapter 11 cases, unless the stay is or has been earlier terminated by an order of the Court or by consent of the Debtors.
MOTION OF DEBTORS AND DEBTORS IN POSSESSION FOR AN ORDER (A) APPROVING MANDATORY MEDIATION PROCEDURES FOR CERTAIN CLAIMS AND (B) APPOINTING MEDIATOR TO MEDIATE THE CLAIMS INCLUDED THEREIN

The above-captioned debtors and debtors in possession (collectively, the "Debtors") hereby move the Court for the entry of an order (i) approving the mediation procedures proposed herein (the "Mediation Procedures") to assist in the resolution of certain unresolved claims against the Debtors' estates and (ii) appointing a single mediator to mediate the claims included in the Mediation Procedures. In support of this Motion, the Debtors respectfully represents as follows:

Background

A. General

1. On June 1, 1999 (the "Petition Date"), 831 of the Debtors commenced their respective reorganization cases by filing voluntary petitions for relief under chapter 11 of the Bankruptcy Code, 11 U.S.C. §§ 101-1330 (the "Bankruptcy Code"). On December 30, 1999, Debtor Neweol (Delaware), L.L.C. commenced its voluntary chapter 11 case. The Debtors'
chapter 11 cases have been consolidated for procedural purposes only and are being administered jointly.

2. The Debtors are continuing in possession of their respective properties and are operating and managing their businesses, as debtors in possession, pursuant to sections 1107 and 1108 of the Bankruptcy Code.

3. On June 11, 1999, the United States trustee for the District of Delaware (the “United States Trustee”) appointed a statutory committee of unsecured creditors in these chapter 11 cases (the “Creditors’ Committee”), pursuant to section 1102 of the Bankruptcy Code.

4. The Court has jurisdiction over this matter pursuant to 28 U.S.C. §§ 157 and 1334. This is a core proceeding pursuant to 28 U.S.C. § 157(b)(2).

5. Debtor Loewen Group International, Inc., a Delaware corporation (“LGI”), is a wholly-owned subsidiary of Debtor The Loewen Group Inc., a British Columbia corporation (“TLGI”). The other Debtors are either direct or indirect subsidiaries or affiliates of LGII. On June 1, 1999, TLGI and certain of the Debtors’ Canadian affiliates commenced insolvency proceedings under the Canadian Companies’ Creditors Arrangement Act in the Ontario Superior Court of Justice in Toronto, Ontario.

B. Claims to Be Submitted to the Mediation Procedures

6. Prior to the Petition Date, the Debtors entered into thousands of agreements in connection with their acquisition of hundreds of funeral home and cemetery businesses and their ongoing business operations. The types of agreements into which the Debtors most commonly entered in connection with these acquisitions include:

- purchase agreements;
- noncompetition agreements;
consulting, management, employment and other similar agreements;

 leases; and

right of first refusal agreements.

In addition, the Debtors frequently issued promissory notes in connection with their acquisitions.

7. Some of the nondebtor parties to these transactions and agreements already have filed proofs of claim in these cases. Others either have objected to the Debtors’ requests to reject agreements and/or may file proofs of claim for rejection damages in the future. Each such nondebtor party is referred to herein as a “Claimant,” and the nondebtor parties are referred to herein collectively as the “Claimants.” Certain of the proofs of claim that have been filed have been included on claims objections filed by the Debtors, and others have not yet been included on any claims objection.

8. On March 15, 2001, the Court held a hearing (the “March 15 Hearing”) on motions filed by the Debtors to disallow proofs of claim asserted in respect of the rejection or termination of noncompetition agreements.¹ At the hearing, the Court recommended that the Debtors file a motion seeking approval of a mandatory mediation program to assist in resolving claims arising from noncompetition and consulting agreements. In this regard, the Court stated in part as follows:

[I]t does seem to me that this is an area where one . . . mediator with expertise in bankruptcy should be able to, I think, settle a lot of these matters. And so I would encourage the debtor to file such a motion and, in that regard, perhaps put on hold the existing ADR

¹ See Verified Motion for an Order Disallowing Certain Claims Asserted on Account of Terminated Noncompetition Agreements (D.I. 5971) (the “Terminated Noncompetition Agreements Motion”); Verified Motion for an Order Disallowing Certain Claims Asserted on Account of Rejected Noncompetition Agreements (D.I. 5973) (the “Rejected Noncompetition Agreements Motion”).
procedure with respect to claims arising out of non-compete and consulting agreements.

(Transcript of Proceedings dated March 15, 2001 at 81:10-81:16 (the “March 15 Transcript”).)²

9. In light of the Court's comments during the March 15 Hearing, the Debtors are proposing the Mediation Procedures. These procedures are proposed in addition to the alternative dispute resolution procedures (the “ADR Procedures”) previously approved by the Court in these chapter 11 cases.³

10. The Debtors believe that the mediation approach recommended by the Court will be beneficial in resolving not only claims arising from noncompetition and consulting agreements, but also other types of claims arising from the prepetition acquisition transactions described above. Accordingly, the Debtors request authority, in their sole discretion, to submit to the Mediation Procedures unresolved claims arising from noncompetition and consulting agreements or from prepetition acquisition transactions (collectively, the “Claims”). As discussed above, the Debtors anticipate that the Claims, without limitation, include claims asserted in proofs of claim, requests for payment of administrative expense and rejection damages claims that may not have yet been asserted.⁴ In some but not all instances, Claims referred to the Mediation Procedures will be the subject of pending claims objections filed by the Debtors. In general, the Debtors intend to submit all related Claims held by a Claimant or group of Claimants to mediation at the same time, so that the Claims may be mediated together.

² A copy of the relevant portion of the March 15 Transcript is attached hereto as Exhibit A.

³ The Court approved the ADR Procedures pursuant to its Order Approving Alternative Dispute Resolution Procedures, dated February 28, 2000 (D.I. 3345).

⁴ For example, the Debtors wish to refer to the mediation procedures the rejection damages claims associated with certain pending motions to reject noncompetition and consulting agreements.
11. Based on filings by the Claimants and communications with the Claimants or their counsel to date, the Debtors believe that the following issues will frequently arise in connection with the mediation of the Claims:

- Whether the agreements at issue are executory contracts subject to assumption or rejection or instead constitute deferred purchase price obligations of the Debtors.

- Whether the agreements at issue are stand-alone agreements that may be independently assumed or rejected or whether the agreements are integrated with other agreements entered into in connection with the same acquisition transaction.

- Whether the damages in respect of the termination or rejection of noncompetition agreements are the unpaid balances under the agreements or some other amount.

- Whether the damages under an agreement denominated as a “consulting agreement” are subject to the damages cap imposed by section 502(b)(7) of the Bankruptcy Code.

- Whether the parties have claims or counterclaims under any related purchase agreement (e.g., in respect of post-closing adjustments and contingent purchase price obligations).

Request for Approval of the Mediation Procedures and Authority Therefor

12. By this Motion, the Debtors seek approval of the Mediation Procedures to assist in the resolution of the Claims. Claims submitted to the Mediation Procedures are referred to herein as “Mediation Claims.” A Claim would be classified as a Mediation Claim, and therefore be subject to the Mediation Procedures, upon the filing and service of a Notice of Designation (as defined below) on a Claimant by the Debtors. A preliminary list of the initial Claims that the Debtors anticipate will be subject to the Mediation Procedures (the “Preliminary Mediation Claims List”) is attached hereto as Exhibit B. The Preliminary Mediation Claims List includes: (a) the Claims to which the Debtors objected by means of the Terminated
Noncompetition Agreements Motion and the Rejected Noncompetition Agreements Motion that have not been the subject of a default order entered by the Court; (b) the Claims held by nondebtor parties to certain consulting and noncompetition agreements that are the subject of pending contract rejection motions; and (c) any other Claims held by the holders of these Claims that have not been disallowed or otherwise resolved (whether or not specifically identified on the Preliminary Mediation Claims List). The Preliminary Mediation Claims List includes approximately 37 Claimants and 68 Claims. To provide holders of Claims notice of the proposed Mediation Procedures, the Debtors are serving copies of this Motion on holders of the Claims included on the Preliminary Mediation Claims List and, in addition, on the holders of the other currently-filed Claims that the Debtors have identified for possible submission to the Mediation Procedures, as set forth on the list (the “Potential Additional Mediation Claimants List”) attached hereto as Exhibit C. The Debtors, however, reserve their rights to include Claims held by Claimants not identified on either the Preliminary Mediation Claims List or the Potential Additional Mediation Claimants List in the Mediation Procedures.

A. The Proposed Mediation Procedures

13. The Debtors propose to implement the Mediation Procedures on the following terms:

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5 The Court has entered defaults order granting the relief requested in the Terminated Noncompetition Agreements Motion and the Rejected Noncompetition Agreements Motion with respect to claimants that did not oppose the motions. See Order Disallowing Certain Claims Asserted On Account of Terminated Noncompetition Agreements (D.I. 6379); Order Disallowing Certain Claims Asserted On Account of Rejected Noncompetition Agreements (D.I. 6380).

6 The approval of the Mediation Procedures will be without prejudice to the Debtors’ rights to object to a Claim on any and all grounds prior to its inclusion in the Mediation Procedures.
• Inclusion of Claims in the Mediation Procedures. A Claim may be included in the Mediation Procedures whether or not a proof of claim has been filed and whether or not the Debtors have filed an objection to the Claim. Claimants may request that the Debtors include their Claims in the Mediation Procedures, but the decision to include Claims in the Mediation Procedures shall be in the sole discretion of the Debtors. A Claim will be classified as a Mediation Claim, and therefore be subject to the Mediation Procedures, upon the filing and service of a “Notice of Designation” (as defined below) on a Claimant by the Debtors. Upon the entry of an order approving the Mediation Procedures (the “Mediation Order”), the Debtors will designate certain Claims for resolution through the Mediation Procedures by serving upon holders of such Claims a Notice of Designation indicating that the applicable Claim has been submitted to the Mediation Procedures (the “Notice of Designation”). The Debtors will send a copy of the Notice of Designation to the mediator appointed by the Court (the “Mediator”), notifying the Mediator of the pending mediation and of the need for the scheduling of a mediation conference (a “Mediation Conference”) between the parties.

• Reservation of Right to Withdraw Claim from the Mediation Procedures. The Debtors shall have the right, in their sole discretion, to withdraw from the Mediation Procedures any Claim that has been submitted thereto.

• Objection to Inclusion in the Mediation Procedures. Upon the entry of the Mediation Order, each Claimant who is identified on either the Preliminary Mediation Claims List or the Potential Additional Mediation Claimants List who fails to file an objection to the Motion or whose objection is overruled by the Court will be subject to the Mediation Procedures upon service of the Notice of Designation on such Claimant, without further opportunity to object to the Mediation Procedures in this Court.

• Non-Included Claimants. A Claimant not identified on the Preliminary Mediation Claims List or the Potential Additional Mediation Claimants List (a “Non-Included Claimant”) that the Debtors serve with (a) a copy of the Mediation Order, (b) a copy of the Mediation Procedures term sheet attached to the Mediation Order and (c) a Notice of Designation will have 20 days to file an objection with the Court to the inclusion in the Mediation Procedures of any of its Claim(s) identified in the Notice of

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7 The Notice of Designation will be substantially in the form attached hereto as Exhibit D.

8 The Debtors anticipate that most of the Non-Included Claimants will be Claimants who file claims subsequent to the date of this Motion in respect of damages on account of the Debtors’ rejection of executory contracts.
Designation ("Non-Included Claims"). If the Non-Included Claimant fails to file with the Court an objection to its inclusion in the Mediation Procedures within this 20-day time period, the Non-Included Claimant shall be subject to the Mediation Procedures without further order of the Court. If the Non-Included Claimant timely files an objection to its inclusion in the Mediation Procedures, the Debtors shall have 20 days from the date of the filing of the objection to file a response to the objection and a request for a hearing before the Court regarding inclusion of the applicable Claim in the Mediation Procedures.

- **Removal from ADR Procedures.** If a Claim with respect to which a Notice of Designation is served is subject to the ADR Procedures, the Claim will be removed from the ADR Procedures and included in the Mediation Procedures.

- **The Mediation Conference.** The Mediator, in consultation with the parties, shall set the date of the mediation conference (the "Mediation Conference"). The Mediator may schedule one or more Mediation Conferences subsequent to the Mediation Conference if the Mediator believes that doing so would further the likelihood of resolution. Mediation Conferences will be conducted for not longer than one-half day (four hours), unless further extended by agreement of the parties.

  - **Telephonic Mediation Conferences.** The Mediation Conferences may be held telephonically when appropriate.

  - **In-Person Mediation Conferences.** In-person Mediation Conferences will be held in Wilmington, Delaware, unless the Mediator directs otherwise or the parties mutually agree to another location.

  - **Submission Materials.** Not less than seven calendar days before the date of the Mediation Conference, each party shall submit directly to the Mediator, and serve on all counsel and pro se parties, a written statement of no more than five pages, exclusive of exhibits, setting forth the parties’ respective positions on the Mediation Claim(s) (the "Submissions"). The Mediator may, at any time, request that the parties submit additional materials or designate that materials be submitted only to the Mediator. The Submissions and all other materials provided to the Mediator shall not be filed with the Court and the Court shall not have access to them.

  - **Persons Required to Attend.** The following persons must attend the Mediation Conference:

    - The applicable Claimant and the Claimant’s attorney; and
A representative of the Debtors (e.g., an attorney for the Debtors) who has full authority to negotiate and settle the matter on behalf of the Debtors.

Failure to Attend. Willful failure to attend any Mediation Conference in accordance with the Mediation Procedures will result in the disallowance of the Claimant’s Mediation Claim(s). A person required to attend the Mediation Conference is excused from appearing if all parties and the Mediator agree in advance of the Mediation Conference that the person need not attend.

Mediation Fees, Costs and Expenses. The fees and administrative costs of the mediation shall be shared equally by the Debtors and the Claimant, unless otherwise ordered by the Mediator.

Mediation Procedures and the Local Rules. The Mediation Procedures are based in large part on Rule 9019-3 of the Local Rules of Bankruptcy Practice and Procedure of the United States Bankruptcy Court for the District of Delaware (the “Local Rules”). Notwithstanding the Local Rules, however, except as otherwise set forth in the Mediation Order and the Mediation Procedures, the Mediator shall determine the methods, procedures and timing of the mediation, in consultation with the Court, if necessary. In the event of any conflict between the Local Rules and the Mediation Procedures, the Mediation Procedures shall govern.

Confidentiality of Mediation Materials and Communications. All memoranda, work product and other materials contained in the case files of the Mediator are confidential. Any communication made in or in connection with the mediation that relates to a controversy being mediated, whether made to the Mediator or to a party, or to any person if made at the Mediation Conference, is confidential. Confidential materials and communications are not subject to disclosure in any judicial or administrative proceeding.

Civil Immunity. The Mediator shall be immune from civil liability for or resulting from any act or omission done or made while engaged in efforts to assist or facilitate a mediation unless the act or omission was made or done in bad faith, with malicious intent or in a manner exhibiting a willful, wanton disregard of the rights, safety or property of another.

Protection of Information Disclosed at Mediation. The Mediator and the participants in mediation are prohibited from divulging, outside of the mediation, any oral or written information disclosed by the parties or by witnesses in the course of the mediation. No person may rely on or introduce as evidence in any arbitral, judicial or other proceeding evidence pertaining to any aspect of the mediation effort, including but not limited...
to: (a) views expressed or suggestions made by a party with respect to a possible settlement of the dispute; (b) the fact that another party had or had not indicated willingness to accept a proposal for settlement made by the Mediator; (c) proposals made or views expressed by the Mediator; (d) statements or admissions made by a party in the course of mediation; and (e) documents prepared for the purpose of, in the course of or pursuant to the mediation. In addition, without limiting the foregoing, Rule 408 of the Federal Rules of Evidence, and any applicable federal or state statute, rule, common law or judicial precedent relating to the privileged nature of settlement discussions, mediation or other alternative dispute resolution procedures shall apply. Information otherwise discoverable or admissible in evidence, however, does not become exempt from discovery, or inadmissible in evidence, merely by being used by a party in the mediation.

• **Discovery from Mediator.** The Mediator shall not be compelled to disclose to the Court or to any person outside the Mediation Conference any of the records, reports, summaries, notes, communications or other documents received or made by the Mediator while serving in such capacity. The Mediator shall not testify or be compelled to testify in regard to the mediation in connection with any arbitral, judicial, or other proceeding. The Mediator shall not be a necessary party in any proceedings relating to the mediation.

• **Preservation of Privileges.** The disclosure by a party of privileged information to the Mediator does not waive or otherwise adversely affect the privileged nature of the information.

• **Recommendations by Mediator.** The Mediator is not required to prepare written comments or recommendations to the parties. The Mediator may present a written settlement recommendation memorandum to attorneys or *pro se* litigants, but not to the Court. The Mediator may, in his sole discretion and without disclosing the information protected from disclosure as described above, submit reports to the Court that would categorize unresolved Claims and make recommendations to the Court with respect to the manner in which the legal issues raised by the Claims should be resolved.

• **Preparation of Orders.** The Debtors shall have the authority to compromise and settle Mediation Claims without further Court order in accordance with the parameters set forth in the Court's Order Granting Debtors and Debtors in Possession Ongoing Authority to Settle and Pay Certain Categories of Claims and Controversies, dated December 28, 1999 (D.I. 3066) (the "Settlement Order"). Beginning at the end of the third calendar quarter of the year 2001, for all settlements falling outside the parameters of the Settlement Order, the Debtors shall submit on a
quarterly basis fully executed stipulations and orders to the Court with respect to all settlements reached under the Mediation Procedures during the calendar quarter, together with a motion for approval of the settlements.

- **Final Disposition of Claims.** Claims not resolved through the Mediation Procedures shall be resolved by the Court or another appropriate court or forum.

- **Injunction.** During the period that a Mediation Claim is subject to the Mediation Procedures, the Debtors and the Claimant on which the notice has been served will be enjoined from, among other things, commencing or continuing any action or proceeding in any manner or any place to resolve, reconcile, determine the nature, priority or amount of or collect upon a Mediation Claim other than through the Mediation Procedures described herein. This injunction (the "Mediation Injunction") will commence: (a) with respect to Claims held by Claimants identified on the Preliminary Mediation Claims List or the Potential Additional Mediation Claimants List, on the date that the applicable Notice of Designation is filed and served; and (b) with respect to Non-Included Claims, if no objection to inclusion in the Mediation Procedures is timely filed, upon the expiration of the 20-day objection period described above or, if an objection to inclusion in the Mediation Procedures is filed, upon the entry of an order of the Court overruling the objection. The Mediation Injunction will expire with respect to a Mediation Claim only when the Mediation Procedures have been completed with respect to that Claim. In addition, Mediation Claims will remain subject to the automatic stay under section 362 of the Bankruptcy Code after expiration of the Mediation Injunction through the date of confirmation of a plan or plans of reorganization in the applicable Debtors’ chapter 11 cases, unless the stay is or has been earlier terminated by an order of the Court.

**B. Relevant Authorities**

14. This Court is authorized to approve the Mediation Procedures pursuant to section 105(a) of the Bankruptcy Code, which provides that “the Court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title.” 11 U.S.C. § 105(a). Given the nature of the Claims and the common issues relating to many of the Claims, the Debtors believe that the Mediation Procedures will assist in resolving the Claims
in an expeditious, cost-effective and fair manner. Accordingly, the Debtors believe that approval of the Mediation Procedures will benefit all parties.


Request to Appoint the Mediator and Authority Therefor

16. The Debtors are hereby nominating Roger M. Whelan, outside counsel to Shaw Pittman and former United States Bankruptcy Judge for the District of Columbia, to serve as the Mediator. A brief biography of Mr. Whelan is attached hereto as Exhibit E. The Debtors are aware of no relationship between them and Mr. Whelan.

17. As noted above, unless otherwise ordered by the Mediator, costs of the mediation will be shared equally by the Debtors and the nondebtor parties to the mediation. In accordance with precedent in this District, the Debtors request authority to compensate and

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9 Copies of the unreported orders cited herein are available upon request from counsel to the Debtors.

10 Mr. Whelan has indicated that he does not represent any party in these cases and has not been retained by or heard any matters involving the Debtors, their creditors, their equity security holders or any other parties in interest, or their respective attorneys and accountants, the United States Trustee or any person employed in the Office of the United States Trustee, in any matter related to the Debtors or their estates.
reimburse the Mediator for the Debtors’ portion of his services and expenses in connection with the Mediation Procedures without further notice or Court approval. See In re Venture Stores, Inc., No. 98-101 (RRM) (D. Del. Oct. 16, 1998) (authorizing the payment of the mediator’s fees without further notice or court approval).

**Notice**

18. No trustee or examiner has been appointed in these chapter 11 cases. Notice of this Motion has been given to: (a) the United States Trustee; (b) counsel to the Creditors’ Committee; (c) counsel to the Debtors’ postpetition lenders; (d) each of the Claimants identified on the Preliminary Mediations Claims List or the Potential Additional Claimants List and/or their counsel, if known; and (e) the other parties on the general service list being maintained in these cases. In light of the nature of the relief requested in this Motion, the Debtors submit that no other or further notice is required.

**No Prior Request**

19. No prior request for the relief sought in this Motion has been made to this or any other court.
WHEREFORE, the Debtors respectfully request that the Court enter an Order, substantially in the form attached hereto as Exhibit F: (i) approving the Mediation Procedures on the terms described herein; (ii) appointing Mr. Whelan to serve as the Mediator and authorizing the Debtors to compensate and reimburse the Mediator for the Debtors’ portion of his services and expenses in connection with the Mediation Procedures without further notice or Court approval; (iii) authorizing the Debtors to take all steps that the Debtors determine, in their sole discretion, are necessary or appropriate to implement the Mediation Procedures; and (iv) granting such other and further relief as the Court may deem proper.

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RECENT AMENDMENTS TO THE BANKRUPTCY CODE AND RULES

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SECTION E
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SECTION E
Since 1997, a bankruptcy bill seemed to raise its head out of the ground every year like Punxatawny Phil, the erstwhile groundhog, only to return below ground each year for any number of reasons. The bill grew over the years from an initial version of just a couple of hundred pages to S.256, a 500 plus page bill that finally made its way through the Senate and then the House of Representatives. President Bush signed the bill on April 20, 2005. It is Public Law 109-06. Any bill that is over 500 pages is bound to have something for everyone, and this bill is no different. It is impossible in these materials to cover each and every aspect of the bill, and I will not attempt to do so. I will try to highlight for you some of the high spots (or low spots depending on your view of the bill) both as it applies to consumer debtors and business debtors as well as creditors in those cases. I assume that some of these issues will be addressed in more detail in other sessions of the seminar, so my effort will be to make you aware generally of the changes, and I expect there will be additional seminars in which you will have more substantial time to consider the issues in greater detail. Before addressing the amendments to the Code, however, I will first address recent amendments to the Bankruptcy Rules and Official Forms and amendments to the Rules and Forms that are on the horizon.

**AMENDED RULES AND FORMS EFFECTIVE ON DECEMBER 1, 2004**

The Rules Enabling Act process begins with a proposal from the Advisory Committee on Bankruptcy Rules to the Standing Committee on Rules of Practice and Procedure that amendments to the rules and forms be published for comment. If the Standing Committee agrees, the amendments usually are published in August with the comment period concluding the following February. The Advisory Committee then reconsiders the proposal along with the comments submitted to the Committee either in writing or at a public hearing, and the Committee will then, if appropriate, recommend to the Standing Committee that the amendments be approved and presented to the Judicial Conference of the United States. If the Standing Committee accepts that recommendation, the Judicial Conference of the United States reviews the proposals. If the Judicial Conference finds the proposals acceptable, it will forward the amendments to the Supreme Court for its consideration. The Supreme Court will then issue an order by May 1 of each year promulgating the rule changes and additions. These rules, however, only become effective if Congress takes no action to the contrary prior to the following December 1. Thus, the rules adoption process takes approximately three years from the time the rule is first proposed until it becomes effective in bankruptcy cases.

Three rules amendments became effective on December 1, 2004. They amended Bankruptcy Rules 1011(a), 2002(j), and 9014(c). A description of the amendments follows.

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1 The Judicial Conference will forward only the proposed rules and rules amendments to the Supreme Court. As to the Official Forms, the Judicial Conference has the final say on these amendments. Consequently, approval of Forms changes can be accomplished in one year less than approval of a rule amendment or addition.
The amendments to Rules 1011(a) and 2002(j) were both technical and minor. In Rule 1011(a), a cross reference to Rule 1004(b) was changed by deleting "(b)" which had previously been deleted by an amendment to that rule. The Rule 2002(j) amendment changed the mailing address of notices to the Internal Revenue Service from the "District Director" (a position no longer in existence in the IRS) to "the address set out in the register maintained under Rule 5003(e).

The amendments to Rule 9014 were more significant. Those amendments essentially provide that contested matters are not governed by the mandatory disclosure provisions of Rule 26 of the Federal Rules of Civil Procedure. The rationale for excepting contested matters from these requirements was that most contested matters would be concluded before the mandatory discovery periods would have expired. Subjecting the many motions for relief from the stay and other contested matters to this process seems counterproductive, so the amendment provides that they do not apply, unless the court directs otherwise. In a particular matter, the court could find that these procedures would be helpful and could order the parties to follow those provisions.

**AMENDED RULES AND FORMS TO BE EFFECTIVE ON DECEMBER 1, 2005**

There are several amendments to the Bankruptcy Rules that will become effective, absent Congressional action to the contrary, on December 1, 2005. These rules amended are:

- Rule 1007 is amended to require the debtor in a voluntary case to submit with the petition a list of entities to which notices will be sent in the case. The listed parties are identified as the entities listed or to be listed on Schedules D through H of the Official Forms.

- Rule 2002 is amended to add a subdivision (g)(4) to the rule. This subdivision authorizes an entity and a notice provider to agree on the form and method of notices to the given to the entity by the notice provider. It will especially enable creditors with involvement in a substantial number of cases throughout the country to tailor their noticing needs.

- Rule 3004 is amended to conform the rule to § 501(c) of the Bankruptcy Code. The amendment clarifies that the debtor or trustee may not file a proof of claim until after the time for filing a proof by a particular creditor has expired.

- Rule 3005 is amended to delete any reference to a creditor filing a proof of claim that supersedes a claim filed on behalf of the creditor by a codebtor. The amendment thus conforms the rule to § 501(b) of the Bankruptcy Code.

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*These amendments will become effective only if Congress does not take any action to the contrary prior to December 1, 2005.*
• Rule 5005 is amended to add the clerk of the bankruptcy appellate panel and the
district judge among the persons who can transmit papers to the proper person or
entity when those papers were erroneously delivered to them initially.

• Rule 7004 is amended to authorize the clerk specifically to sign, seal, and issue a
summons electronically. The amendment does not address the service
requirements for a summons which are set out in other provisions of Rule 7004.

• Rule 9001(9) inserts the definition of notice provider into this rule, and other
definitions are renumbered to reflect this insertion.

• Rule 9006 is amended to clarify that the three day period is added to the end of
the time period for taking action when service is accomplished through certain
specified means. This amendment intended to conform as closely as possible
to the amendment being proposed by the Advisory Committee on Civil Rules.

• Rule 9036 is amended to delete the requirement that the sender of an electronic
notice have received confirmation of receipt of that notice to make the notice
complete.

**BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT
OF 2005**

Every bill has a name, and this one is no different. Its name ostensibly tells you
what the bill covers, but also as with all bills, names can be deceiving. For example,
Subtitle B of Title IV of the bill is called “Small Business Provisions.” The bill actually
includes a new definition of a “Small Business”, but if you thought that Subtitle B of
Title IV contained only provisions that apply to small businesses, you would be wrong.
As for the “abuse prevention” and “consumer protection” in the bill, the jury is still out
on those. In this portion of the materials, I will address some of the more significant
parts of the bill.

The general effective date of the Act is October 17, 2005, which is 180 days after
the date of the enactment, April 20, 2005. Several provisions became effective upon the
date of enactment. Sections 522(o), (p), and (q) along with §§ 727(a)(12) and
1141(d)(5)(C) are already effective. They place limits on homestead exemptions and
delay the entry of an order of discharge if § 522(q) is applicable in a particular case.
CONSUMER PROVISIONS

Means Testing

The provision of the bill that has probably received the most attention in the press is the amendment to § 707(b) that inserts a means test into the Bankruptcy Code. Section 707(b) already contained a provision authorizing the court to dismiss a chapter 7 case if it was a substantial abuse of that chapter. The case law generally had devolved to a sort of totality of the circumstances test, and the courts often focused upon the debtor’s ability to make significant payments under a chapter 13 plan in considering whether to dismiss a particular chapter 7 case. Congress clearly found this level of judicial oversight of improper filings insufficient, and the new § 707(b) is now several pages longer and provides that a debtor who cannot pass the means test is a presumptive abuser of chapter 7.

Note the structure of § 707(b). In subparagraph (1), the court is directed to dismiss any case that presents an abuse of chapter 7, and conversion of the case is possible if the debtor so requests. Subparagraph (2) then sets out the lengthy provisions of the means test that generate a presumption of abuse when a specific amount of “money” is left from the debtor’s “current monthly income” when a variety of expenses (some actual and some set out by Internal Revenue National and Local Living Standards) are deducted from that income. The amount is a sliding scale between $100 and $166.67 per month of excess “money.” The scale slides in the following manner. First, if your remaining monthly income exceeds $166.67, you are presumed to be in abuse of chapter 7, regardless of the amount or nature of your debts. If the remaining monthly income is less than $100, you have “passed” the means test, and you are free to pursue chapter 7 nirvana. If the remaining monthly income is between $100 and $166.67, then you must take the debtor’s nonpriority unsecured claims, and to the extent that they exceed $24,000, then the monthly income must be equal to or greater than 25% of that debt for the presumption of abuse to arise. For example, if the nonpriority unsecured debt is $32,000, then the presumption of abuse arises if the debtor can pay 1/60th of $8,000 each month.

Debtor Education: Credit Counseling and Financial Management Courses

The legislation includes plenty of provisions for debtor education. Debtors must meet these obligations both at the beginning and at the end of the case. Section 109(h) adds another prerequisite for eligibility for any form of bankruptcy relief for an individual debtor. They must have had an individual or group briefing describing credit counseling opportunities and the counselor must have assisted the individual in performing a budget analysis. This briefing can be by telephone or over the internet, so I can envision debtors’ attorneys providing a dedicated computer terminal in their office for this purpose. The credit counselor also must be an approved agency (the United States trustee is tasked with certifying the agencies, see §111). This counseling must be done during the 180 days prior to the filing of a petition by the debtor. Since this must be done prior to the filing “by a debtor,” it does not appear that the failure of a debtor to
obtain credit counseling will be a bar to involuntary cases against individuals. You should note, however, that this obligation applies to all individual debtors, not just those whose debts are primarily consumer debts. The obligation to obtain credit counseling does not apply if

- there are no approved agencies available in the district (but, remember that telephone and internet methods are available) (§109(h)(2)(A)),
- the debtor certifies in a manner satisfactory to the court that exigent circumstances warrant a waiver of the obligation and states that he or she could not obtain credit counseling during a 5 day period after which the debtor requested the counseling, (§ 109(h)(3)
- by reason of mental illness or incapacity the debtor could not reasonably participate in the briefing, (§ 109(h)(4) or
- the debtor is “active military serving in a military combat zone.” (§ 109(h)(4))

At the end of the case under chapter 7 (§ 727(a)(11) and chapter 13 (§ 1328(g)), the debtor must have “completed an instructional course concerning personal financial management.” The United States trustee also must approve these courses, and the exceptions in § 109(h)(4) apply to this requirement. We certainly don’t want our military in combat zones being distracted by personal financial management courses, and Congress took care of that.

**Discharge and Dischargeability**

The time between chapter 7 discharges under the revised Code will be 8 years instead of 6. Congress also has introduced a time limit on discharge in chapter 13 cases. Up to now, the effective limit on multiple discharges in chapter 13 was the plan confirmation process. Congress now is much more explicit on the matter through the enactment of § 1328(f). Under that section, the debtor is not eligible for a chapter 13 discharge if the debtor received a discharge in a case under chapter 7, 11, or 12 during the 4 year period prior to the commencement of the chapter 13 case, or if the debtor received a prior chapter 13 discharge in a case that was commenced within 2 years of the current chapter 13 case.

As for the dischargeability of debts, there are several amendments to § 523, and Congress has essentially wiped out the super discharge in chapter 13. For example,

- presumed nondischargeability under § 523(a)(2)(C) is expanded to purchases of luxury goods and services within 90 days of the order for relief (used to be 60 days), with the threshold debt being reduced from $1,225 to $750. Similarly, the cash advance period is extended from 60 to 70 days, and the $1,225 is again reduced to $750,
- nondischargeable student loans no longer are limited to those provided by governmental units or nonprofit institutions,
- debts incurred to pay taxes owed to any governmental units, not just taxes owed to the federal government as was previously the case,
• all domestic support obligations and other debts owed to a spouse, former spouse or child of the debtor without regard to any balancing of the parties’ needs (note also that debts governed by § 523(a)(15) no longer will need to be challenged in the bankruptcy court under the new § 523(c)(1), and
• debts owed to a pension, profit-sharing, stock bonus, or other plan under specified provisions of the Internal Revenue Code.

Debtor Filing Obligations and Consequences

In addition to completing the schedules and statements as currently required, debtors under the Revised Code will have additional responsibilities. They must show evidence of their identity, and they must file with the court copies of pay stubs and the like for the 60 days prior to the filing of the petition, as well as both current and past tax returns (or transcripts). The debtor also must file a statement of “monthly net income”, a term that is not defined in the Code, but which probably refers to the means test. (See above).

If the debtor fails to file all of the materials required under § 521(a)(1) within 45 days of the filing of the petition, the case is automatically dismissed effective on the 46th day. Any party in interest can ask the court for an order of dismissal which shall be entered within 5 days. The debtor can, however, ask for an extension of the 45 day filing period on the grounds that the debtor made a good faith attempt to compile and file the materials, and that “the best interests of creditors would be served by the administration of the case.” § 521(i). The taxing authorities have their own authority to seek dismissal or conversion of the case if the debtor fails to file a timely tax return. § 521(j).

Debtor’s Attorney’s Certification

Under Revised Code § 707(b)(4)(D), the debtor’s attorney’s signature certifies that the attorney “has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect.” A similar consequence flows from the attorney’s signature on the petition, pleadings and written motions. If the court finds that the attorney’s conduct failed to meet Rule 9011 standards, it can impose civil penalties against the attorney payable either to the court or the trustee or United States trustee.

Attorneys also are “debt relief agencies” under the Revised Code, and new §§ 526 through 528 contain a long list of restrictions on these agencies. Specific notices must be given to debtors, including a notice that reminds debtors that they can represent themselves. Section 342(b) of the Revised Code also includes information that must be given to debtors, including several reminders that the documents and information supplied must be truthful and that criminal sanctions are available against those who may be untruthful.
Serial Filing and the Automatic Stay

Congress amended § 362(c)(3) and (4) to add additional limitations on the operation of the automatic stay. In response to cases in which the debtor filed a series of separate cases, or a series of filers filed separate cases involving the same property, the new law provides that the stay is either greatly restricted in its application, or does not arise at all upon the filing of the petition. In a chapter 7, 11, or 13 case, the stay automatically terminates 30 days after a petition is filed if there was a case dismissed within one year prior to the filing of the new case. The stay can be extended if a party in interest requests the extension and the court finds that the new case was filed in good faith. There is a presumption that the new case was not filed in good faith if there was more than 1 prior case in the year immediately preceding the filing of the most recent case, or if the prior case was dismissed for failure to amend the petition or schedules in the absence of a substantial excuse (and inadvertence or negligence by an attorney is not a sufficient excuse). The stay also expires in 30 days if there has been no substantial change in the debtor’s financial or personal affairs since the conclusion of the previous case.

The stay also terminates in 30 days with respect to any creditor who had a pending motion for relief from the stay in the original case at the time the case was dismissed, or whose motion for relief was granted in the previous case.

These 30 day stays provide the debtor with a short breathing spell while giving creditors who have been through it all before with the debtor some confidence that the stay will not go on forever in a series of cases. There is no stay, however, if the debtor had two or more prior cases pending within one year of the commencement of the latest case. Instead, the court may impose the stay on the request of a party in interest. Once again, the party in interest must overcome the same presumption that the new filing is not in good faith.

The automatic stay also expires as to property subject to security interests if the debtor does not either reaffirm, redeem, or surrender the property as contemplated by § 521(a)(2). The debtor must act within 45 days “after the first meeting of creditors” or the stay expires. That section does allow the trustee to move the court during the 45 day period to protect any property that is of consequential value to the estate.

Valuation of Collateral

For purposes both of redemption under § 722 and cramdown under § 1325(a)(5), valuation is based on the cost of replacement of the property without any reduction for the costs of sales or marketing of the property. This amendment to § 506(a)(2) sets the replacement cost as the retail price for similar property. Thus, the standard is more along the lines of a consignment or used goods store rather than a “garage sale” standard for the valuation of the property.
Exemptions

The Revised Code makes a number of changes to the exemption provisions. Kentucky has recently opted back in to the federal exemptions, so Kentucky debtors now have a choice to make at the start of the case. That assumes, of course, that Kentucky law applies. Revised Code § 522(b)(3)(A) provides that the law where the debtor has been domiciled for the past 730 days governs the debtor’s exemptions. If the debtor has not resided in Kentucky for the 730 days prior to the commencement of the case, then the law of the jurisdiction where the debtor resided for the greater part of the 180 days before the 730 day period governs. That subsection concludes by stating that if the choice of law rule results in the debtor “being ineligible for any exemption, the debtor may elect to exempt property” under the federal exemptions.

A variety of retirement funds also are exempt without regard to whether the debtor selects state or federal exemptions. The exemption for IRAs may not exceed $1,000,000 unless “the interests of justice” require that the cap be ignored. Bankruptcy Code § 522(n).

As for homestead exemptions, there are several new provisions. First, the homestead exemption under state law is capped at $125,000 until a debtor has lived in the state for 1215 days. (This is approximately 40 months.) If the debtor has resided in the state for longer than that period, then there is no cap on the amount of that homestead under § 522(p). Furthermore, if the value of the homestead includes the value of otherwise nonexempt property disposed of by the debtor in the past 10 years with intent to hinder, delay, or defraud creditors, then the $125,000 cap also applies to the homestead. Bankruptcy Code § 522(o).

The $125,000 cap also applies if the debtor commits a felony which demonstrates that the case is an abuse of title 11, or if the debtor owes a debt attributable to a violation of the securities laws and several other listed categories of fraudulently or criminally created debts. This limit, however, will not apply if the full exemption is necessary for the support of the debtor or any dependent of the debtor. Bankruptcy Code § 522(q).

The amendments that added subsections (o), (p), and (q) became effective on the date of passage of the legislation, April 20, 2005.

The Revised Code also now includes a more complete definition of household goods for purposes of the avoidance of liens that impair an exemption. New § 522(f)(4) tells us what is in the definition of household goods, as well as what is not. A VCR is in (how old is this legislation?), but works of art (unless done by the debtor or a relative of the debtor) are out.

Notices to Creditors

Revised § 342 contains several provisions governing notices to creditors. For example, under § 342(c)(2), any notice that the debtor sends to creditors must be sent to
the address supplied to the debtor by the creditor in at least 2 communications to the debtor in the 90 days prior to the commencement of a voluntary case. Note that this applies only to notices given by the debtor.

Under § 342(e), a creditor can file with the court and serve on the debtor a notice of address to be used in the case. The creditor also may file with any bankruptcy court a notice of address to be used in all chapter 7 or 13 cases where that creditor holds a claim. If a notice is sent to another address notwithstanding the creditor’s effort to have the notice sent to a specific address, the notice is ineffective until the notice is “brought to the attention of such creditor.” Moreover, monetary penalties cannot be imposed on a creditor for violation of the stay unless the wrongful conduct occurs after the creditor receives notice in accordance with this provision.

Reaffirmation

The reaffirmation provisions are supplemented by a new subsection (k) in § 524 of the Revised Code. This subsection contains a lengthy disclosure obligation for reaffirmation agreements to be enforceable. The information is several pages long and is intended to ensure that the debtor fully understands the scope and effect of the reaffirmation agreement. For example, the debtor must complete a statement that sets out the debtor’s actual monthly income and expenses to show that he or she can afford to enter into the reaffirmation agreement. Subsection (m) provides that the agreement is presumed to be an undue hardship if the debtor’s statement shows that the debtor’s income is less than the total of the debtor’s expenses and the reaffirmation payment. The debtor then must demonstrate to the satisfaction of the court that other income is available to cover the payment of the reaffirmation obligation.

Ride Through

Revised Code § 521(a)(6) provides that an individual debtor may not retain personal property that is subject to a purchase money security interest unless the debtor reaffirms or redeems the property within “45 days after the first meeting of creditors under section 341(a).” The statute does not say if this is 45 days “from the first date set for the § 341(a) meeting of creditors” (a phrase used elsewhere in the Code), or 45 days from the conclusion of the meeting of creditors. Section 521(a)(6) goes on to provide that if the debtor does not act in that time frame, the stay is terminated and the property is no longer property of the estate (subject to the trustee’s right to mover the court prior to the expiration of the period for an order directing delivery of the property to the trustee). Section 362(h)(1), however, provides that the stay terminates and property is no longer property of the estate if the debtor fails to act within 30 days of the first date set for the meeting of creditors. This section is not limited to purchase money security interests, though they are not excluded from the section. This is a conflict that the courts will have to resolve unless it is addressed in a technical corrections bill.


CHAPTER 13 CHANGES

Commencement of Payments

Under Revised Code § 1326(a)(1), absent a court order to the contrary, the debtor must begin making payments to the trustee to the extent the proposed plan so provides, and to lessors and secured creditors according to the terms of the lease or as adequate protection to the secured creditor, respectively. This seems to assume that the court is not involved in determining the amount of the payment necessary to provide adequate protection of the creditor’s claim. Some personal property may not be depreciating as rapidly as others, and it is unclear how the payments would be made, and in what amount, in the absence of a court determination.

Stripdown of Secured Claims

Historically, the court would value the collateral and the debtor would pay the present value of that collateral through periodic payments. Section 1325(a), as revised, now provides that the valuation process does not apply when valuing purchase money security interests in motor vehicles created within 910 days of the commencement of the case, and purchase money security interests in any other collateral if those interests were created within one year of the commencement of the case. This raises the question of the impact of the surrender of the collateral under § 1325(a)(5)(C). If the property is deemed to be worth the amount of the outstanding indebtedness, then the entire debt would seem to be satisfied by the surrender of the property, and the creditor could not share in any distribution to unsecured creditors.

The Revised Code also provides in § 1325(a)(5)(B)(i) that the holder of the lien being crammed down in the plan retain the lien on the property until the earlier of the payment of the full debt (both secured and unsecured) or discharge at the end of the case. The lien is also retained by the creditor if the case is dismissed or converted. As to conversion, this operates to apply the payments made in the chapter 13 case first to the unsecured portion of the claim and thereafter to the secured portion of the debt.

Payments of Support Obligations

The Revised Code provides that the court cannot confirm a plan unless the debtor is current on all domestic support obligations. Moreover, if the debtor misses any such payments as they come due during the life of the plan, the court can dismiss or convert the case on motion of a party in interest under § 1307(c)(11).

The Chapter 13 Means/Disposable Income Test

Disposable income under § 1325(b) is now defined as the debtor’s “current monthly income” less expenses for the maintenance and support of the debtor and the debtor’s dependents. “Current monthly income” is a defined term as more completely described in the general means test discussion above. This artificial income number is
imported into the chapter 13 disposable income calculation. Moreover, if the debtor’s current monthly income times twelve exceeds the state’s median income for a household of that size, the expenses deducted from that number are the living expenses allowed under the means test by reference to the IRS guidelines. For debtor’s below the median income level, actual expenses are deducted from the income to determine the debtor’s disposable income.

If the debtor’s income is above the state median income level, the payment plan must be at least 5 years.

**Discharge and Dischargeability**

The super discharge is no longer. Most of the nondischargeable categories of § 523(a) are imported into the chapter 13 full payment discharge. One exception is for a debt for damage to property as a result of a willful or malicious injury caused by the debtor. (Note also that this is willful or malicious, as compared to willful and malicious as set out in § 523(a)(6).)

**Repayment of Pension Loans**

Revised Code § 1322(f) in connection with new § 362(b)(19) creates an obligation for chapter 13 debtors to repay loans made by a pension, profit-sharing, stock bonus, or other plan established under specific provisions of the Internal Revenue Code. This provision also protects the continuing withholding of funds from a debtor’s wages to make these payments. In short, it permits the debtor to repay himself or herself from their current wages. The amounts so withheld are specifically excluded from the definition of disposable income in chapter 13.

**THE INDIVIDUAL DEBTOR IN CHAPTER 11**

Individual debtors in chapter 11 are in for a whole new ballgame. First, new § 1115 provides that property of the estate includes the debtor’s postpetition earnings from personal service. This is a change from the prior law, and it brings chapter 11 into line with the treatment of these earnings in chapter 13. New § 1129(a)(15) provides that the debtor must either pay objecting claimants in full, or pay all projected disposable income into the plan for at least 5 years. The creditors could accept less favorable treatment, but there would not seem to be much incentive for a creditor to accept anything less than at least five years of the debtor’s disposable income. Also as in chapter 13 cases, an individual debtor in chapter 11 does not receive a discharge until the completion of all of the payments under the plan. See § 1141(d)(5). A partial payment discharge is available for the debtor if modification of the plan is not practicable and the present value of the payments already made is not less than the amount that creditors would have received in a chapter 7 case.
BUSINESS PROVISIONS

The primary focus on the reform legislation has been on its consumer bankruptcy provisions in general, and the means test, in particular. But, with over 500 pages of reform, there are plenty of changes in store for business bankruptcy cases. These changes include an entirely new chapter of the Code, Chapter 15, addressing cross-border insolvency cases, and complicated rules governing the netting of certain financial contracts. Title IV of the Bill includes general and small business bankruptcy provisions, and this paper highlights a number of those amendments.

Title IV of the Bill is titled General and Small Business Bankruptcy Provisions. Subtitle A of the title of the bill is titled “General Business Bankruptcy Provisions,” and Subtitle B is “Small Business Bankruptcy Provisions.” Notwithstanding this apparent split in the two subtitles, several of the provisions in Subtitle B (Small Business) actually apply to all cases. Therefore, this analysis includes first the generally applicable provisions, then the provisions applicable to small business debtors, and finally the provisions in the small business debtor subtitle that nonetheless apply to all cases.

Amendments that apply generally:

- **Section 402** of the bill would amend § 341 of the Code by adding a new subsection (e) that permits the court, after notice and a hearing, to dispense with a meeting of creditors if the debtor has filed a plan and solicited acceptances of the plan prior to the commencement of the case.

- **Section 404** of the bill amends current § 365(d)(4) to provide that the unexpired leases of nonresidential real estate in which the debtor is the lessee are deemed rejected and must be immediately surrendered to the lessor by the earlier of 120 days after the commencement of the case, or the date of the confirmation of a plan. The court, for cause, may extend the 120 day period for an additional 90 days, but any extension subsequent to the additional 90 days is available only with the consent of the lessor.

- **Section 405** of the bill recognizes the authority of the court to order the U.S. trustee to adjust the number of members and the makeup of committees under § 1102. The provision also suggests (“the court may order the United State trustee . . .”) that small business concerns, as defined in § 3(a)(1) of the Small Business Act, be added to the appropriate creditors’ committee if the claim is the small business concern holds, in comparison with its annual gross revenue, is disproportionately large. So, a small business that has a “large” claim against the debtor can be added to the creditors’ committee and thereby play an active role in the case while holding down their costs.

- **Section 406** of the bill includes added protections for a warehouseman’s lien. They would be protected from actions under Code § 545 to avoid statutory liens.
• **Section 408** of the bill amends § 1125 of the Code to authorize the solicitation of acceptances or rejections of a plan if the entity “was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law.” Thus, if a creditor received a solicitation to vote in favor of a plan in a prepackaged chapter 11, other lawful solicitations can be made while the case is pending.

• **Section 409** of the bill amends § 547(c)(2) of the Code by restructuring the provision (former subparagraphs (B) and (C) become (A) and (B), while former subparagraph (A) is subsumed into the opening language of the exception). More importantly, however, the “and” between former subparagraphs (B) and (C) becomes an “or” under the amended section. This effectively expands the exception to preference recoveries, especially in those jurisdictions that required proof of each of the conjunctively linked elements under § 547(c)(2).

• **Section 410** of the bill continues the focus on preferences although this is an amendment to the venue provision governing actions to collect money or property. Under the amendment, these actions must be brought in the defendant’s home district for any action to collect a consumer debt of less than $15,000, or any other debt in excess of $10,000. The $10,000 business debt limit applies only if the defendant is a noninsider. If the defendant is an insider, the $1,000 venue limit continues.

• **Section 411** of the bill imposes a new deadline for the exclusivity period for filing a plan under § 1121 of the Code. Under the amendment, the exclusivity period cannot exceed 180 days from the date of the order for relief. The existing law permits the court to extend this deadline on a showing of good cause. There is no specific limit on the court’s discretion under the current law (other than cause) in setting the final deadline for the exclusivity period. To the extent that the expiration of the exclusivity period results in a shifting of the balance of power in a chapter 11 case, this amendment will make this shift more certain in the future in cases where the debtor has a need for additional time in which to craft a plan.

• **Section 414** of the bill amends § 101(14) of the Code by deleting the provisions of that section that automatically render investment bankers for a security of the debtor (without regard to the timing of the issuance of the securities) and their attorneys not disinterested. Under the amendment, the only provision that would render investment banks not disinterested is the general provision that they may not have an interest materially adverse to the estate or any class of creditors or equity security holders.

• **Section 415** of the bill adds a new subparagraph (E) to § 330(a)(3) of the Code directing the court to consider whether a professional person is board certified or has otherwise demonstrated skill and experience in the bankruptcy field. The
amendment makes board certification a specific factor in the award of compensation to professionals.

- **Section 417** of the bill amends § 366 of the Code by adding a fairly detailed definition of “assurance of payment” for purposes of that section. There are several mechanisms offered as appropriate “assurances of payment”, such as prepayment or surety bonds. Interestingly, the amendment specifically provides that the timely payment of utility charges in the past is not evidence of assurance of payment in the future. Not surprisingly, the availability of an administrative expense priority is not an assurance sufficient under the provision.

- **Section 419** of the bill directs the Judicial Conference of the United States to prescribe forms for all chapter 11 debtors to disclose the “value, operations, and profitability” of entities in which the debtor holds a controlling or substantial interest. Not addressed by the provision is what happens if the entity, which is not in bankruptcy and which may not be controlled by the debtor (but rather is an entity in which the debtor’s interest is “substantial”) does not submit such a report. The entity is not itself a debtor, and the debtor may not be in a position to force the entity to complete the form.

- **Section 331** is an amendment that was added during the Senate markup of the bill. It includes strict limitations on the payment or allowance of claims for retention bonuses or severance pay to key personnel of the debtor. Specifically, the amendment provides that payments to induce persons who are insiders to remain in the debtor’s employ are not allowed unless the payment is essential to retain the person who has “a bona fide job offer from another business at the same or a greater rate of compensation”, and the amount of the payment does not exceed ten times the amount of a similar transfer to a non-management employee during the calendar year of the proposed transfer, or if no such transfer has been made to a non-management person during the calendar year of the case, then it may not exceed 25 times the amount of any similar transfer to an insider in the calendar year preceding the case. Severance pay is similarly limited to an amount not to exceed 10 times the amount of the mean severance pay given to non-management employees, unless the severance pay is a part of a program generally applicable to all employees. The amendment also prohibits the payment or allowance of any other obligations outside of the ordinary course of business as priority administrative expenses unless they are “justified by the facts and circumstances of the case.” Tying the maximum amounts to payments made to other employees during the calendar year of the case presumably includes both pre and post bankruptcy payments.
Amendments that apply in “small business” bankruptcy cases:

- Section 431 of the bill adopts a more flexible process for the confirmation of plans in small business cases. Under this amendment, the court may determine that the plan contains sufficient information such that no disclosure statement is required. Additionally, disclosure statements can be submitted on standard forms and can be conditionally approved, with final approval to be given at the confirmation hearing. The hearing on approval of the disclosure statement may also be combined with the confirmation hearing itself. This should allow the case to proceed to confirmation with fewer hearings and less cost to the participants.

- Section 432 of the bill sets out the definition of a small business. It is a person engaged in commercial or business activities, other than owning or operating real estate, and it must have no more than $2 million in debt (excluding debt to insiders or affiliates). Furthermore, for the debtor to be a “small business debtor”, either the U.S. trustee has not appointed a creditors’ committee in the case, or if a creditors’ committee was appointed, it “is not sufficiently active and representative to provide effective oversight of the debtor.” Since the U.S. trustee cannot appoint a committee until the case is filed and the debtor has identified some creditors, it would seem that a debtor that otherwise meets the definition at the moment of the filing of a voluntary petition would be a small business debtor, and would seem to lose that status when a committee is appointed. If the committee thereafter becomes “insufficiently active and representative”, the debtor might revert back to being a small business debtor. The definition has several loose ends.

- Section 434 of the bill adds a new § 308 to the Code. That section establishes new reporting requirements for small business debtors. They must file periodic reports setting out their “profitability” (i.e. “the amount of money that the debtor has earned or lost during current and recent fiscal periods”), reasonable approximations of their projected cash receipts and disbursements, comparisons of their actual receipts and disbursements to their earlier projections, and stating their compliance with the Bankruptcy Rules and tax and other governmental filing obligations including the payment of taxes. This reporting obligation does not become effective until 60 days after rules are prescribed to establish the forms for use in reporting the data. Section 435 of the bill directs the Judicial Conference to prescribe the forms.

- Section 436 of the bill inserts a new § 1116 into the Code. That section sets out a list of 7 duties for the trustee or debtor in possession in small business cases. (Remember, it may be difficult in some cases to determine whether the debtor is a small business debtor. See the discussion of Section 432, supra.) Among the duties are filing financial statements and tax returns within 7 days of the date of the order for relief, meet with the U.S. trustee prior to the § 341 meeting, timely
file other documents and tax returns during the case, and permit the U.S. trustee to inspect the debtor's premises and books and records.

- **Sections 437 and 438** of the bill set new deadlines for plan exclusivity and the filing and confirmation of a plan in a small business case. Section 437 sets the exclusive period for the debtor to file a plan at 180 days after the order for relief, and the plan and disclosure statement, in any event, must be filed within 300 days after the order for relief. Section 438 then provides that the court shall confirm a plan in a small business case not later than 45 days after the plan is filed, as long as it complies with the applicable provisions of the Bankruptcy Code. The deadlines for the exclusivity period, the time for filing plans, and the time for confirmation of a filed plan can only be extended for a reasonable time at the end of which confirmation of a plan will result. The order extending the time also must be signed before the existing deadline has expired. Thus, requests for extensions must be made in sufficient time to allow the court to hear and determine whether an extension is warranted. The passage of the deadline means that the debtor would not have a confirmable plan, and that would be grounds for conversion or dismissal of the case.

- **Section 439** of the bill creates a new obligation for the United States trustee to conduct initial interviews with small business debtors prior to the § 341 meeting of creditors. The interview is to evaluate the debtor's financial viability and business plan and to set up an agreed scheduling order. It is also intended to provide an opportunity for the United States trustee to advise the debtor of various reporting and filing obligations. The amendment also requires the United States trustee to promptly move for conversion or dismissal whenever there are grounds for such a motion.

**Amendments from the Small Business Subtitle that apply to all cases:**

- **Section 440** of the bill amends § 105(d) of the Code to require (rather than simply to allow) the court to hold "such status conferences as are necessary to further the expeditious and economical resolution of the case."

- **Section 441** of the bill places new limits on the availability of the automatic stay if a small business debtor has filed a previous bankruptcy case. Under the amendment, the automatic stay would not apply in a small business case if the debtor has another case pending simultaneously (presumably the stay in that case would be in effect), and the stay would not operate if the debtor was in a small business case that was dismissed within 2 years of the order for relief in the second case, or if the debtor had a plan confirmed in a small business case within 2 years of the new case. The provision also applies if an entity acquired all or substantially all of the assets in a small business of the kinds described above. The debtor can overcome this denial of the automatic stay by showing by a preponderance of the evidence that the second bankruptcy filing resulted from
circumstances beyond the debtor's control, and that it is more likely than not that the court will confirm a plan, other than a liquidating plan, in a reasonable time.

- **Section 442** of the bill is another provision that is included among the small business case changes, but the amendment applies in fact to all chapter 11 cases. It amends § 1112 of the Code by restating examples of cause for conversion or dismissal of chapter 11 cases. This section also amends § 1104(a) of the Code by adding a new subparagraph (3) which permits the court to appoint a trustee or examiner in lieu of converting or dismissing the case. The court also may deny an otherwise well-taken motion if the debtor or another party in interest establishes that there is a reasonable likelihood that a plan will be timely confirmed and that as to the grounds for granting the motion to dismiss or convert, there is a reasonable justification for the act or omission, and the failure will be cured within a reasonable time. If the "cause" for dismissal or conversion is substantial or continuing loss or diminution of the estate and an absence of a reasonable likelihood of rehabilitation, however, the court cannot deny dismissal or conversion even if the debtor shows a reasonable likelihood of timely confirmation of a plan. An interesting aspect of the amendment is that it substantially copies existing § 1112(b), and it adds a number of additional examples of grounds for dismissal or conversion. In the opening language of the proposed § 1112(b)(1), however, the bill would seem to change the category of persons eligible to move for conversion or dismissal. Under the current provision, the issue is raised "on request of a party in interest or the United States trustee or bankruptcy administrator." The bill, however, says that the issue can be raised "on request of a party in interest." There is no mention of the United States trustee or bankruptcy administrator as parties that can raise this issue. Given the Supreme Court's decision in *Lamie v. United States Trustee*, 540 U.S. 526 (2004), in which the Court held that the removal of the debtor's attorney from the list of persons entitled to payment out of the estate prevented the payment of fees to the debtor's attorney, the deletion of the United States trustee and the bankruptcy administrator from existing § 1112(b) could be construed as a Congressional determination that those parties cannot raise the issue of conversion or dismissal of chapter 11 cases. On the other hand, § 307 of the Code provides that the United States trustee may appear and be heard on any issue, and this separate statutory authority may be enough to grant standing to the U.S. trustee in these matters. It would also be unusual for Congress to create an entirely new set of duties for the United States trustee relative to the oversight of small business debtors, and then preclude the trustee from moving to dismiss or convert those cases in appropriate circumstances.

- **Section 444** of the bill amends § 362(d)(3) in a couple of aspects. The section sets out a requirement that as to single asset real estate, the debtor either must have filed a confirmable plan or have commenced making monthly payments to the secured creditor to keep the automatic stay in effect. This requirement arises under the existing law "90 days after the entry of the order for relief." However, it may be difficult to know whether a particular case is a single asset real estate
case, so the amendment provides that the important date is the later of the 90 day period, or 30 days after the court determines that the debtor has “single asset real estate.” The amendment also clarifies that the debtor may make payments to the creditor from the rents or other income generated by the property. Finally, the amendment changes the amount of the payment necessary to continue the stay in effect. Under the existing provision, the debtor must pay an amount “equal to interest at a current fair market rate on the value of the creditor’s interest in the real estate.” Under the amendment, the payment must be in the amount of the “nondefault contract rate of interest on the value of the creditor’s interest in the real estate.”

- **Section 445** of the bill adds a subparagraph (7) to § 503(b) of the Code. This provision caps the amount of an administrative expense claim resulting from the rejection of an unexpired lease of nonresidential real estate to the monetary obligations for a period of 2 years from the later of the rejection of the lease or the turnover of the premises. This amount is further limited to the extent that the claimant either recovers or has a right to receive payment from another source. Of course, any amount of the claim in excess of the cap would constitute a general unsecured claim allowable to whatever extent § 502(b)(6) permits.

**HEALTH CARE BUSINESSES**

The Revised Code introduces several new definitions including health care business, patient, and patient records. A health care business is an entity that offers to the general public facilities and services for a variety of medical care. A patient is an individual who receives services from a health care business, and patient records are written records of the patient’s health care.

In a chapter 7, 9, or 11 case of a health care business, the court is directed in § 333 of the Revised Code to order the appointment of a patient care ombudsman in the first 30 days of the case, unless determines that the appointment is unnecessary. Absent such a ruling, the United States trustee appoints the ombudsman who is then directed to monitor the quality of the health care and represent the interests of the patients. The ombudsman is required to submit periodic reports on the quality of patient care at least every 60 days. If the quality of health care is diminishing substantially or otherwise compromising the well being of the patients, the ombudsman is to make an immediate report to the court with notice to all parties in interest.

Revised Code § 704(a)(12) directs the trustee (or debtor in possession in a chapter 11 case) to use all reasonable and best efforts to transfer patients to another acceptable health care facility if the debtor health care business is closing. The trustee is to identify another facility that is located reasonably near the debtor’s business and offers substantially similar services and maintains a reasonable quality of care.
If the health care business is closed, the costs of closing are administrative expenses. New § 351 then directs the disposal of patient records. It provides for both publication and personal notice of the disposal of the records, and the section ultimately even provides for the shredding of records that are unclaimed. Section 704 is also amended to add these obligations.

**CROSS BORDER CASES**

Section 304 of the Code governed cases ancillary to foreign proceedings, but the reform legislation repealed the provision. In its place is an entire chapter of the Code. Chapter 15 of the Code incorporates the Model Law on Cross-Border Insolvency and provides the mechanism for a foreign representative to commence a case under title 11. The chapter includes a number of provisions to govern these cases, and it is beyond the scope of this outline to address all of those issues. There is one provision in chapter 15, however, that applies in all bankruptcy cases, not just those commenced under chapter 15. Section 1514 governs notices to be given to creditors with foreign addresses. It provides that notices to these creditors be given individually absent specific court authority to the contract. Additionally, § 1514(d) requires that the rules and any court order directing notice must provide additional time to those creditors "as is reasonable under the circumstances."
PRACTICING BANKRUPTCY MATTERS
IN KENTUCKY’S COURTS

CONSTITUTIONAL ISSUES POSED BY
THE BANKRUPTCY ABUSE PREVENTION AND
CONSUMER PROTECTION ACT OF 2005

Hon. Joe Lee
Hon. Joseph M. Scott, Jr.
Hon. William S. Howard
Hon. David T. Stosberg
Hon. Thomas H. Fulton

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CONSTITUTIONAL ISSUES POSED BY THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

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APPENDIX

SECTION F
CONSTITUTIONAL ISSUESPOSED BY

THE BANKRUPTCY ABUSE PREVENTION
AND CONSUMER PROTECTION ACT OF 2005

I. Constitutionality of Provisions Regulating the Practice of Law

A. Does the power of Congress to enact uniform laws on the subject of bankruptcies empower Congress to regulate the practice of law in bankruptcy proceedings?

There are at least three provisions of the new law that raise this issue.

(1) Section 110 imposes strict guidelines for bankruptcy petition preparers. They must advise the debtor they are not attorneys, cannot practice law, or give legal advice. The Judicial Conference of the U.S. must prescribe the form of this notice, and can fix the maximum fees to be charged by petition preparers. Subsection 110(k) provides:

(k) Nothing in this section shall be construed to permit activities that are otherwise prohibited by law, including rules and laws that prohibit the unauthorized practice of law.

(2) Section 341 contains this provision with respect to representation of creditors at meetings of creditors.

(c) The court may not preside at, and may not attend, any meeting under this section including any final meeting of creditors. Notwithstanding any local court rule, provision of a State constitution, any otherwise applicable nonbankruptcy law, or any other requirement that representation at the meeting of creditors under subsection (a) be by an attorney, a creditor holding a consumer debt or any representative of the creditor (which may include an entity or an employee of an entity and may be a representative for more than 1 creditor) shall be permitted to appear at and participate in the meeting of creditors in a case under chapter 7 or 13, either alone or in conjunction with an attorney for the creditor. Nothing in this subsection shall be construed to require any creditor to be represented by an attorney at any meeting of creditors.

(3) Sections 526, 527, and 528 of the new law, by regulating the activities of a "debt relief agency," in effect regulate the interview between an attorney and a debtor client, by specifying the documents the attorney must provide to the debtor, the advice the attorney must give is set out in the statute, including that the debtor can represent himself or herself, or get help from
a petition preparer, and the attorney is precluded from advising the debtor to pay an attorney (apparently including the attorney giving the advice) a fee for services performed as part of preparing for or representing a debtor in a case under title 11. § 526(a)(4).

B. Do the provisions of the new law regulating advertising by lawyers violate the First Amendment?

Section 528 mandates that attorneys who represent debtors (assisted persons) in filing for relief under title 11 include in their commercial advertising the statement:

We are a debt relief agency. We help people file for relief under the Bankruptcy Code or a substantially similar statement.

This is somewhat comparable to the labeling that must appear on a pack of cigarettes or on prescription drugs. The attorney must label himself or herself as harmful to the interests of debtor clients.

The Supreme Court has found many attempts to regulate commercial advertising by attorneys, pharmacists, and other entities to be violative of the First Amendment.

The Supreme Court has never held that commercial speech may be suppressed in order to further a state’s interest in discouraging purchases of the underlying product that is advertised. *Central Hudson Gas v. Public Service Com’n of New York*, 447 U.S. 557, 100 S. Ct. 2343 (1980); *Virginia State Bd. Of Pharmacy v. Virginia Citizens Consumer Council, Inc.*, 963 S. Ct. 1817, 425 U.S. 748 (1976) (State may not suppress dissemination of concededly truthful information about entirely lawful activity on basis of fear of that information’s effect upon its disseminators and its recipients.


II. Constitutional Issues Concerning IRS Standards Used in Means Testing

The IRS National Standards permit debtors with higher incomes to spend more for food and other services than debtors with lower incomes.

For example, for a debtor with a four-person family whose income is less than $833, the total allowance for food, apparel, personal care and miscellaneous expenses is $881; for a debtor with a family of the same size whose income is $5,834 or greater the allowance for these items is $1,564, an additional $683.

Does this violate equal protection? Does it violate the requirement that bankruptcy laws be uniform?

According to Black's Law Dictionary uniform means:

Uniform. Conforming to one rule, mode, pattern, or unvarying standard; not different at different times or places; applicable to all places or divisions of a country. Equable; applying alike to all within a class; sameness.

A statute is general and uniform in its operation when it operates equally upon all persons who are brought within the relations and circumstances provided for; when all persons under the same conditions and in the same circumstances are treated alike, and classification is reasonable and naturally inherent in the subject-matter. The words “general” and “uniform” as applied to laws have a meaning antithetical to special or discriminatory laws.

III. Valuation of Property

Is it constitutional to mandate a standard for valuing personal property of individual debtors who file for relief under chapter 7 or 13 different from the standard for valuing personal property of individual debtors who file for relief under chapters 11 and 12? § 506(a)(2).

Section 506(a) of the Code, as amended by subparagraph (2) provides:

(2) If the debtor is an individual in a case under chapter 7 or 13, such value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would
charge for property of that kind considering the age and condition of the property at the time value is determined.

Apparently, the old (present) valuation standards continue to apply in chapter 11 and chapter 12 cases.

Does this mean a self-employed electrician who files for relief under chapter 11 or a family farmer who files for relief under chapter 12 may continue to strip down a debt secured by a truck to the value of the vehicle, while a debtor in chapter 7 or 13 is denied that privilege?

NOTE: Congress did not change § 522(a) which defines value to mean fair market value.

Is personal property securing an allowed claim to be listed at a greater value (replacement value) in one schedule and at a lesser value (market value) in the exemption schedules?

IV. Does Compulsory Chapter 13 Violate the Thirteenth Amendment Prohibition Against Involuntary Servitude?

The Thirteenth Amendment to the U.S. Constitution was ratified on December 6, 1865. The Amendment abolished not only slavery but also “involuntary servitude,” except as punishment for crime. The U.S. Supreme Court has recognized that the Thirteenth Amendment is self-executing and that the words “involuntary servitude” have a larger meaning than slavery. The plain intention was to make labor free, by prohibiting control by which “the personal service of one man is disposed of or coerced for another’s benefit, which is the essence of involuntary servitude. Bailey v. State of Alabama, 219 U.S. 219, 241 (1911). Underscoring supplied.

The U.S. Supreme Court held in Bailey v. State of Alabama, 219 U.S. 219, 31 S. Ct. 145 (1911) that the Thirteenth Amendment prohibition against involuntary servitude cannot be transgressed indirectly by the creation of a statutory presumption any more than it can be violated by direct enactment. “The power to create presumptions is not a means of escape from constitutional restrictions.” 219 U.S. at pg. 239; 31 S. Ct. at pg. 151.

In a subsequent case, Taylor v. State of Georgia, 315 U.S. 25, 62 S. Ct. 415 (1942), the U.S. Supreme Court held the fact the debtor is afforded an opportunity to rebut the presumption of guilt of the crime of fraud arising from non-payment of debt does not make a statutory presumption on which a conviction of fraud rests any less repugnant to the Thirteenth Amendment, 315 U.S. at pg. 30; 62 S. Ct. at pg. 418 (1942).
Comment: The means-test provisions are grounded on the presumption that a debtor who can pay at least 25 percent of his or her non-priority unsecured debt over a period of 60 months is deemed to be abusing the provisions of chapter 7 by filing for relief thereunder. The presumption is based on a rigid mathematical formula and the further presumption that the employment, health, income and size of the debtor's family and health of family members will remain static during a five-year payment period. The bill requires the court to notify creditors that the debtor has been determined to be an abuser of chapter 7 before any hearing by the court on that issue.

Three Presidential commissions that have studied the issue have rejected compulsory chapter 13, as has Congress on several occasions commencing as far back as 1932.

The Brookings Institution in its study of bankruptcy published in 1971 considered the question of compulsory chapter 13. The authors of the study concluded it was impossible to tell whether the positive effect on the economy of forcing debtors to repay old debt would outweigh the effect of reduced spending and consumption by such debtors during the period of repayment. They concluded the net result either way would surely be small.

Brookings also considered the question of whether bankruptcies increase interest rates for all borrowers as claimed by proponents of the present legislation. The authors of the study concluded that bankruptcies probably increase interest rates only for poor, low income workers who are poor credit risks and do not increase interest rates for the public in general.

V. Practice Issues

A. Kentucky's Opt-Out

As most practitioners know by now, Kentucky, which in early 1980 opted out of the exemptions provided by section 522(d) of the Bankruptcy Code, has now amended KRS 427.170 to opt back in, to make available to debtors the option of claiming exemptions under state law or under section 522(d).

Two other states, Arkansas and New Hampshire, apparently are recent opt-in states.

This change in the law increases the homestead exemption from $5,000 per person to $18,450 per person, or $36,900 in a joint husband and wife case. Other exemptions are increased as well. The new law takes effect June 20, 2005.

The question naturally arises whether a debtor whose case is now pending may on and after June 20, 2005 amend Schedule C to claim exemptions under Code
§ 522(d).

The law seems pretty well established that exemptions are determined as of the date of the filing of the petition. *White v. Stump*, 266 U.S. 310, 313, 45 S. Ct. 103 (1924). There are quite a number of cases to this effect in instances where a state has modified its exemption laws. See *Bankruptcy Service, Lawyers Edition*, Vol. 2E, § 26:190. This would seem to end the discussion.

However, in this instance the § 522(d) exemptions have been in effect since the Code took effect October 1, 1989. They were in effect a few months until Kentucky opted out, at which time a debtor was denied access to the § 522(d) exemptions. Now the debtor's access to those exemptions has been restored. While Kentucky's out-out was in effect Congress increased the § 522(d) exemptions. These exemptions were also adjusted upward pursuant to § 104 of the Code.

**B. Strip Down**

Only one provision of S. 256 appears to be retroactive, an amendment to § 523(a)(19) relating to the exception to discharge for violation of the Federal securities laws. Otherwise, provisions of the law take effect October 18, 2005 or thereafter.

In *U.S. v. Security Industrial Bank*, 459 U.S. 70, 103 S. Ct. 407, the Supreme Court held that § 522(f) could not be utilized to avoid a nonpossessionary, nonpurchase-money lien that was created before enactment of the Code. The court concluded Congress had inadequately expressed an intent to make this lien avoidance provisions of the Code retroactive. The majority opinion of six justices noted there was a substantial question respecting the constitutionality of retroactive application. The remaining three justices concurred in the result based on *Holt v. Henley*, 232 U.S. 637, 43 S. Ct. 459 (1914) cited by the majority as standing for the proposition that “[no] bankruptcy law shall be construed to eliminate property rights which existed before the law was enacted in the absence of an explicit command from Congress.”

The Supreme Court has held that the provisions of the bankruptcy law are part of every contract as if fully set out in the contract.

Does this mean the right of a debtor to strip the allowed amount of a secured claim to the value of the collateral may still exist with respect to collateral securing any debt contracted prior to the effective date of the new law?

The Supreme Court in the *Security Industrial Bank* case instructed that no bankruptcy law shall be construed to eliminate property rights which existed before the law was enacted, in the absence of an explicit command from
Congress.

C. Miscellaneous

Kentucky's new law regulating the activities of debt adjusters; KRS 380.010.

Doesn't regulation in effect legitimize such activities?
AN ACT relating to debtor-creditor relations.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 427.170 is amended to read as follows:

An individual debtor domiciled in this state is[-not] authorized to exempt from property of said debtor's estate the property specified under 11 U.S.C. 522(d)[subsection-(d) of section 522 of The Bankruptcy Code of 1978, 92 Stat. 2549 (1978), Public Law 95-598].
AN ACT relating to the business of debt adjusting.

Be it enacted by the General Assembly of the Commonwealth of Kentucky:

Section 1. KRS 380.010 is amended to read as follows:

As used in this chapter, the following terms mean:

(1) "Debt adjuster," a person who acts or offers to act for a consideration as an intermediary between a debtor and his creditors for the purpose of settling, compounding, or in anywise altering the terms of payment of any debts of the debtor; and to that end, receives money or other property from the debtor, or on behalf of the debtor, for payment to, or distribution among, the creditors of the debtor.

(2) "Debtor," an individual or individuals jointly and severally, or jointly or severally indebted.

"Person" includes, but is not limited to, individuals, partnerships, associations, corporations, limited liability companies, trusts, and other legal entities.

(2) "Debt adjusting" means doing business in debt adjusting, budget counseling, debt management, or debt pooling service, or holding oneself out, by words of similar import, as providing services to debtors in the management of their debts, to do any of the following:

(a) Effect the adjustment, compromise, or discharge of any account, note or other indebtedness of the debtor;

(b) Receive from the debtor and disburse to the debtor's creditors any money or other thing of value; or

(c) Solicit business and advertise as a debt adjuster; and

(3) "Reside" means to live in a particular place on a temporary or permanent basis.

SECTION 2. A NEW SECTION OF KRS CHAPTER 380 IS CREATED TO READ AS FOLLOWS:

(1) Subject to subsection (3) of this section, a person, whether or not located in this
state, engaged in debt adjusting shall do both of the following:

(a) Unless specifically instructed otherwise by a debtor, disburse to the appropriate creditors all funds received from the debtor, less any contributions or fees not prohibited by subsection (2) of this section, within thirty (30) days of receipt of the funds from the debtor; and

(b) Maintain a separate trust account for the receipt of any funds from debtors and the disbursement of the funds to creditors on behalf of the debtors.

(2) If contributions or fees for engaging in debt adjusting are accepted, directly or indirectly, a person engaged in debt adjusting shall not do any of the following:

(a) Accept a contribution or fee exceeding seventy-five dollars ($75) from a debtor residing in this state for an initial set up;

(b) Accept a consultation contribution or fee exceeding fifty dollars ($50) per calendar year from a debtor residing in this state; or

(c) Accept a periodic contribution or fee from a debtor who resides in this state that exceeds the greater of eight and one-half percent (8.5%) of the amount paid by the debtor each month for distribution to the debtor's creditors or thirty dollars ($30).

(3) Subsections (1) and (2) of this section shall not prohibit a person engaged in debt adjusting for a debtor who resides in this state from charging the debtor a bad check charge of twenty dollars ($20) or the amount passed on from the debt adjuster's bank, whichever is greater, in addition to contributions or fees not prohibited by subsection (2) of this section.

(4) Fees or contributions permitted in subsections (1), (2), and (3) of this section may be adjusted on an annual basis by the amount equivalent to any increase in the consumer price index, published by the United States Department of Labor, Bureau of Labor Statistics.

(5) Any person that engages in debt adjusting shall file an initial registration form.
accompanied by an initial registration fee of two hundred fifty dollars ($250), and
the registration shall be renewed each year thereafter for a fee of two hundred
fifty dollars ($250) to cover the actual cost of filing the registration, in
accordance with administrative regulations promulgated by the Attorney General.

(6) Any person that engages in debt adjusting shall arrange for and undergo an
annual audit of the person's business, including any trust funds deposited and
distributed to creditors on behalf of debtors, which shall be conducted by an
independent, third-party certified public accountant. Both of the following shall
apply to an audit performed under this subsection:

(a) The person shall file the results of the audit and the auditor's opinion with
the Consumer Protection Division of the Office of the Attorney General
within thirty (30) days of the anniversary date of filing the initial
registration; and

(b) The Attorney General shall make available a summary of the results of the
audit and the auditor's opinion upon written request of any person and
payment of a fee not to exceed the cost of copying the summary and
opinion.

(7) A person engaged in debt adjusting shall obtain and at all times maintain
insurance coverage for errors and omissions, employee dishonesty, depositor's
forgery, and computer fraud in the amount of ten percent (10%) of the monthly
average for the immediately preceding six (6) months of the aggregate amount of
all deposits made with the person by all debtors. The insurance coverage shall
comply with all of the following:

(a) The minimum limit of the insurance coverage shall not be less than one
hundred thousand dollars ($100,000), and the maximum limit of the
insurance coverage shall not be more than two hundred fifty thousand
dollars ($250,000):
(b) The insurance coverage shall not include a deductible in excess of ten percent (10%) of the face amount of the policy coverage;

(c) The insurance coverage shall be issued by an insurer and rated at least A-, or its equivalent, by a nationally recognized rating organization; and

(d) The insurance coverage shall provide that the Consumer Protection Division of the Office of the Attorney General shall be named as an additional interested party.

(8) Any person engaged in debt adjusting shall comply with the provisions of this section.

SECTION 3. A NEW SECTION OF KRS CHAPTER 380 IS CREATED TO READ AS FOLLOWS:

The Attorney General shall promulgate administrative regulations in accordance with KRS Chapter 13A to ensure the proper administration and enforcement of this chapter.

Section 4. KRS 380.030 is amended to read as follows:

The following persons shall not be considered debt adjusters for the purposes of this chapter:

(1) Any attorney-at-law of this state;

(2) Any person who is a regular, full-time employee of a debtor, and who acts as an adjuster of his employer's debts;

(3) Any person acting pursuant to any order or judgment of court, or pursuant to authority conferred by any law of this state or of the United States;

(4) Any person who is a creditor of the debtor, or an agent of one (1) or more creditors of the debtor, and whose services in adjusting the debtor's debts are rendered without cost to the debtor;

(5) Any person who, at the request of a debtor, arranges for or makes a loan to the debtor, and who, at the authorization of the debtor, acts as an adjuster of the debtor's debts in the disbursement of the proceeds of the loan, without compensation for the
services rendered in adjusting the debts; and

(6) Any charitable, religious or educational organization, determined to be exempt from taxation under Section 501(c)(3) of the Internal Revenue Code that is not in the business of debt adjusting, as defined in Section 1 of this Act.

Section 5. KRS 380.990 is amended to read as follows:

Any person who violates the provisions of Section 2 of this Act, sets or offers to act as a debt-adjuster in the state is guilty of a misdemeanor and, upon conviction, shall be punished by a fine of five hundred dollars ($500) or imprisonment not to exceed sixty (60) days, or both such fine and imprisonment.

Section 6. The following KRS section is repealed:

380.020 Injunction against debt adjuster -- Appointment of receiver.
DISPOSABLE INCOME, CRAM-DOWN, AND DISCHARGE: SIGNIFICANT CHANGES IN CHAPTER 13 PRACTICE AS A RESULT OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005

Beverly M. Burden
Chapter 13 Trustee, Eastern District of Kentucky
Lexington, Kentucky

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AS A RESULT OF
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CONSUMER PROTECTION ACT OF 2005
by
Beverly M. Burden
Chapter 13 Trustee, Eastern District of Kentucky

Prepared for the
12th Biennial Judge Joe Lee Bankruptcy Institute
University of Kentucky College of Law
May 21, 2005

WARNING:
DO NOT RELY ON THIS OUTLINE!!

YOU MUST READ THE AMENDED BANKRUPTCY CODE
AND FORMULATE YOUR OWN CONCLUSIONS.

I HAVE ATTEMPTED TO SET FORTH A SUMMARY OF ONLY A
FEW OF THE LEGISLATIVE CHANGES THAT AFFECT DISPOSABLE
INCOME, TREATMENT OF SECURED CLAIMS, AND DISCHARGE
ISSUES IN CHAPTER 13 CASES. THIS IS NOT A COMPREHENSIVE
ANALYSIS OF THE BAPCPA OR OF ANY SINGLE ISSUE.

BECAUSE THE BAPCPA CONTAINS ERRORS, INCONSISTENCIES,
AND AMBIGUITIES AND DOES NOT LEND ITSELF TO EASY
INTERPRETATION, I DO NOT WARRANT THE ACCURACY OF
EVEN THE MEAGER INFORMATION CONTAINED HEREIN.

FURTHERMORE, THE BAPCPA IS SUBJECT TO CHANGE THROUGH
TECHNICAL AMENDMENTS, WHICH COULD RESULT IN
SUBSTANTIVE CHANGES TO PROVISIONS OF THE BAPCPA EVEN
BEFORE THE EFFECTIVE DATE OF THE NEW LAW.

Beverly M. Burden
DISPOSABLE INCOME, CRAM-DOWN, AND DISCHARGE:
SIGNIFICANT CHANGES IN CHAPTER 13 PRACTICE AS A RESULT
OF THE BANKRUPTCY ABUSE PREVENTION AND
CONSUMER PROTECTION ACT OF 2005

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SECTION G
A) Disposable Income

1) § 1325(b)(1)(B): If the trustee or a creditor holding an unsecured claim objects to confirmation, the Plan must provide that: “all of the debtor’s projected disposable income to be received in the applicable commitment period will be applied to make payments to the unsecured creditors under the plan.”

2) § 1325(b)(2): “Disposable Income”:

   a) Start with “current monthly income” defined in § 101(10A) as:

      (i) “the average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor’s spouse receive)” for the preceding 6 months;

      (ii) include “any amount paid by any entity other than the debtor (or in a joint case the debtor and the debtor’s spouse) on a regular basis for the household expenses of the debtor or the debtor’s dependents”;

      (iii) exclude per § 101(10A):

            (01) Social Security benefits,

            (02) payments to victims of war crimes,

            (03) payments to victims of terrorism;

   b) then exclude per § 1325(b)(2):

      (i) child support payments  

      (ii) foster care payments  for dependent child;

      (iii) or disability payments  

   c) then per § 1325(b)(2)(A) deduct amounts “reasonably necessary to be expended” (see below) for:
(i) maintenance or support of debtor and dependents (including postpetition child support payments), and

(ii) charitable contributions (up to 15% of debtor’s gross income);

d) then per § 1325(b)(2)(B), if the debtor is engaged in business, deduct necessary business expenses;

e) then per § 1322(f) deduct amounts required to repay 401K or other pension loans (§ 1322(f) incorporates by reference new § 362(b)(19), which excepts pension loans from the automatic stay).

3) § 1325(b)(3): “Amounts reasonably necessary to be expended under [§ 1325(b)(2)] shall be determined in accordance with subparagraphs (A) and (B) of section 707(b)(2) if the debtor has current monthly income, when multiplied by 12, greater than” the median family income of the applicable State for the appropriate family size.

a) § 101(39A): “Median Family Income” is the median family income calculated and reported by the Bureau of the Census, adjusted to reflect changes in the Consumer Price Index.

b) If the debtor’s current monthly income multiplied by 12 is more than the median family income, refer to the “means test” in § 707(b)(2) to determine allowable expenses.

c) If debtor’s income is less than median family income, presumably the amount of reasonably necessary expenses is determined in the same manner as under present law.
d) Kentucky Median Family Income in 1999 (last report of Census Bureau)

<table>
<thead>
<tr>
<th>Overall</th>
<th>2 persons</th>
<th>3 persons</th>
<th>4 persons</th>
<th>5 persons</th>
<th>6 persons</th>
<th>7 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>40,939</td>
<td>35,846</td>
<td>42,361</td>
<td>48,815</td>
<td>47,720</td>
<td>45,139</td>
<td>42,859</td>
</tr>
</tbody>
</table>

adjusted for 13.385% increase in CPI between 1999 and 2004:

<table>
<thead>
<tr>
<th>Overall</th>
<th>2 persons</th>
<th>3 persons</th>
<th>4 persons</th>
<th>5 persons</th>
<th>6 persons</th>
<th>7 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>46,418</td>
<td>40,643</td>
<td>48,031</td>
<td>55,348</td>
<td>54,107</td>
<td>51,180</td>
<td>48,595</td>
</tr>
</tbody>
</table>

BUT – per § 1325(b)(3), “in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $525 per month for each individual in excess of 4”:

<table>
<thead>
<tr>
<th>Overall</th>
<th>2 persons</th>
<th>3 persons</th>
<th>4 persons</th>
<th>5 persons</th>
<th>6 persons</th>
<th>7 or more</th>
</tr>
</thead>
<tbody>
<tr>
<td>46,418</td>
<td>40,643</td>
<td>48,031</td>
<td>55,348</td>
<td>55,873</td>
<td>56,398</td>
<td>56,923</td>
</tr>
</tbody>
</table>
4) § 707(b)(2) allowable monthly expenses (expenses used in the "Means Test"):

a) “average monthly payments on account of secured debts”, which is:

(i) “the total of all amounts scheduled as contractually due to secured creditors in each month of the 60 months following the petition” and

(ii) “any additional payments to secured creditors necessary for the debtor ... to maintain possession of the debtor’s primary residence, motor vehicle, or other property necessary for the support of the debtor and the debtor’s dependents, that serves as collateral for secured debts” [arrearages]

(iii) divided by 60 (months);

b) total priority debts divided by 60 (months);

c) an allowance for housing and utilities as determined by IRS Collection Financial Standards (Local);

d) an allowance for transportation expenses as determined by IRS Collection Financial Standards (Regional);

e) an allowance for food and household expenses as determined by IRS Collection Financial Standards (National) (copy of relevant Financial Standards included with outline);

f) “Other Necessary Expenses” as defined by the IRS, if debtor can substantiate actual expenditures for expenses such as:

(i) child care

(ii) insurance – health, life, and disability

(iii) health care

(iv) payroll withholding taxes

(v) other – see Internal Revenue Manual 5.15.1.10 (copy included with outline);
g) expenses to maintain safety from family violence;

h) expenses to care for elderly, chronically ill, or disabled household members;

i) school expenses up to $1,500 per year [$125 per month] for each child under age 18, "if the debtor provides documentation of such expenses and a detailed explanation of why such expenses are reasonable and necessary, and why such expenses are not already accounted for" in the IRS Standards.

j) if the debtor demonstrates it is reasonable and necessary, an additional allowance for food and clothing of up to 5% of the IRS food and clothing allowance;

k) an additional amount based on actual expenses for home energy costs "if the debtor provides documentation of such expenses and demonstrates that such actual expenses are reasonable and necessary"; and

l) actual administrative expense of administering a chapter 13 plan, up to 10% of projected plan payments.

5) Plan duration:

a) § 1325(b)(4)(A): "Applicable Commitment Period" (the period during which all of the debtor’s projected disposable income to be received will be applied to make payments to unsecured creditors under the plan) is:

(i) 3 years, or

(ii) not less than 5 years "if the current monthly income of the debtor and the debtor’s spouse combined, when multiplied by 12, is not less than . . ." the median family income.

b) Compare § 1322(d), the maximum duration of the plan:

(i) "If the current monthly income of the debtor and the debtor’s spouse combined, when multiplied by 12, is not less than” the median family income, “the plan may not provide for payments over a period that is longer than 5 years.”

(ii) "If the current monthly income of the debtor and the debtor’s spouse combined, when multiplied by 12, is less than” the median family income, “the plan may not provide for payments over a period that is longer than 3 years,” unless the court approves a period that is not longer than 5 years.
6) Verification of Income:

a) § 521(a)(1)(B): Debtor must file:
   
   (i) copies of all “payment advices or evidence of payment received within 60 days before the date of the filing of the petition, by the debtor from any employer of the debtor;”

   (ii) “a statement of the amount of monthly net income, itemized to show how the amount is calculated”; and

   (iii) “a statement disclosing any reasonably anticipated increase in income or expenditures over the 12-month period following the date of the filing of the petition.”

b) § 521(e)(2)(A): Debtor must provide to the trustee and any requesting creditor a copy of the debtor’s most recent Federal tax return, or at the debtor’s option a transcript of the return.
   
   (i) The tax return/transcript must be provided to the trustee at least 7 days before the date first set for the meeting of creditors.

   (ii) If the debtor fails to comply, “the court shall dismiss the case” unless the debtor demonstrates that noncompliance was due to circumstances beyond the control of the debtor.

c) § 521(f)(1)-(f)(3): At the request of the court, the U.S. Trustee, or party in interest, an individual debtor in chapter 7, 11, or 13 must file with the court:
   
   (i) tax returns/transcripts for “each tax year of the debtor ending while the case is pending”;

   (ii) tax returns/transcripts for the preceding 3 years if the returns had not been filed with the IRS as of the date of the petition but were subsequently filed;

   (iii) amendments to those tax returns.

d) § 521(f)(4): At the request of the court, the U.S. trustee, or a party in interest, in a chapter 13 case, the debtor must file annually a statement of income and expenses for the preceding year, and a statement of monthly income, “that shows how income, expenditures, and monthly income are calculated.”
(i) deadlines for filing the 521(f)(4) statement:

(01) if the plan has not been confirmed, 90 days after the end of the tax year or one year after the petition date, whichever is later;

(02) after confirmation, annually, “not later than the date that is 45 days before the anniversary of the confirmation of the plan.”

(ii) § 521(g): The statement must disclose:

(01) “the amount and sources of income of the debtor”;

(02) “the identity of any person responsible with the debtor for the support of any dependent of the debtor”; and

(03) “the identity of any person who contributed, and the amount contributed, to the household in which the debtor resides.”

e) § 1308: If the debtor has not filed tax returns for any of the 4 years preceding the petition date, the debtor must file those returns no later than the day before the date of the first meeting of creditors, with certain extensions as described in the section.
**IRS Collection Financial Standards**

www.irs.gov; search site for “collection financial standards”

**General**

Collection Financial Standards are used to help determine a taxpayer's ability to pay a delinquent tax liability.

Allowances for food, clothing and other items, known as the National Standards, apply nationwide except for Alaska and Hawaii, which have their own tables. Taxpayers are allowed the total National Standards amount for their family size and income level, without questioning amounts actually spent.

Maximum allowances for housing and utilities and transportation, known as the Local Standards, vary by location. Unlike the National Standards, the taxpayer is allowed the amount actually spent or the standard, whichever is less.

**Food, Clothing and Other Items**

*National Standards* for reasonable amounts have been established for five necessary expenses: food, housekeeping supplies, apparel and services, personal care products and services, and miscellaneous.

All standards except miscellaneous are derived from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey (CES). The miscellaneous standard has been established by the IRS.

**Alaska and Hawaii**

Due to their unique geographic circumstances and higher cost of living, separate standards for food, clothing and other items have been established for Alaska and Hawaii.

**Housing and Utilities**

The *housing and utilities standards* are derived from Census and BLS data, and are provided by state down to the county level.

**Transportation**

The *transportation standards* consist of nationwide figures for monthly loan or lease payments referred to as ownership costs, and additional amounts for monthly operating costs broken down by Census Region and Metropolitan Statistical Area (MSA). Public
transportation is included under operating costs. A conversion chart has been provided with the standards which shows which IRS districts fall under each Census Region, as well as the counties included in each MSA. The ownership cost portion of the transportation standard, although it applies nationwide, is still considered part of the Local Standards.

The ownership costs provide maximum allowances for the lease or purchase of up to two automobiles if allowed as a necessary expense. The operating costs are derived from BLS data.

If a taxpayer has a car payment, the allowable ownership cost added to the allowable operating cost equals the allowable transportation expense. If a taxpayer has no car payment, or no car, only the operating costs portion of the transportation standard is used to come up with the allowable transportation expense.

Recent Revisions

The Local Standards for housing and utilities and transportation were revised on 01/01/04 to:

- add family size to the housing and utilities allowances (two or less, three, and four or more);
- base automobile ownership/leasing costs on the five-year average of new and used car financing data compiled by the Federal Reserve Board of Governors; and,
- reflect updated information from the Bureau of Labor Statistics.

The revised Local Standards for housing and utilities and transportation are effective for financial analysis conducted on or after January 1, 2004.
National Standards for Allowable Living Expenses

Collection Financial Standards for Food, Clothing and Other Items. Due to their unique geographic circumstances and higher cost of living, separate standards have been established for Alaska and Hawaii.

One Person National Standards
Based on Gross Monthly Income

<table>
<thead>
<tr>
<th>Item</th>
<th>less than $833</th>
<th>$833 to $1,249</th>
<th>$1,250 to $1,666</th>
<th>$1,667 to $2,499</th>
<th>$2,500 to $3,333</th>
<th>$3,334 to $4,166</th>
<th>$4,167 to $5,833</th>
<th>$5,834 and over</th>
</tr>
</thead>
<tbody>
<tr>
<td>Food</td>
<td>197</td>
<td>215</td>
<td>231</td>
<td>258</td>
<td>300</td>
<td>339</td>
<td>369</td>
<td>543</td>
</tr>
<tr>
<td>Housekeeping supplies</td>
<td>19</td>
<td>20</td>
<td>25</td>
<td>26</td>
<td>29</td>
<td>36</td>
<td>37</td>
<td>51</td>
</tr>
<tr>
<td>Apparel &amp; services</td>
<td>60</td>
<td>61</td>
<td>70</td>
<td>75</td>
<td>100</td>
<td>124</td>
<td>134</td>
<td>207</td>
</tr>
<tr>
<td>Personal care products &amp; services</td>
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Two Persons National Standards
Based on Gross Monthly Income

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**Four Persons National Standards Based on Gross Monthly Income**

**More than Four Persons National Standards Based on Gross Monthly Income**

- For each additional person, add to four person total allowance: $134, $145, $155, $166, $177, $188, $199, $209

*effective January 1, 2005*
Kentucky - Housing and Utilities Allowable Living Expenses

Collection Financial Standards
Financial Analysis - Local Standards: Housing and Utilities (effective 1/1/2005)

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<td>1,189</td>
<td>1,367</td>
</tr>
<tr>
<td>Taylor County</td>
<td>745</td>
<td>876</td>
<td>1,008</td>
</tr>
<tr>
<td>Todd County</td>
<td>655</td>
<td>770</td>
<td>886</td>
</tr>
<tr>
<td>Trigg County</td>
<td>737</td>
<td>867</td>
<td>997</td>
</tr>
<tr>
<td>Trimble County</td>
<td>794</td>
<td>934</td>
<td>1,075</td>
</tr>
<tr>
<td>Union County</td>
<td>719</td>
<td>846</td>
<td>973</td>
</tr>
<tr>
<td>Warren County</td>
<td>907</td>
<td>1,067</td>
<td>1,227</td>
</tr>
<tr>
<td>Washington County</td>
<td>686</td>
<td>807</td>
<td>927</td>
</tr>
<tr>
<td>Wayne County</td>
<td>619</td>
<td>728</td>
<td>837</td>
</tr>
<tr>
<td>Webster County</td>
<td>688</td>
<td>810</td>
<td>931</td>
</tr>
<tr>
<td>Whitley County</td>
<td>712</td>
<td>838</td>
<td>964</td>
</tr>
<tr>
<td>Wolfe County</td>
<td>552</td>
<td>649</td>
<td>746</td>
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<tr>
<td>Woodford County</td>
<td>975</td>
<td>1,148</td>
<td>1,320</td>
</tr>
</tbody>
</table>
### Allowable Living Expenses for Transportation

Collection Financial Standards  
Financial Analysis - Local Standards: Transportation *

#### Ownership Costs

<table>
<thead>
<tr>
<th>National</th>
<th>First Car</th>
<th>Second Car</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$475</td>
<td>$338</td>
</tr>
</tbody>
</table>

#### Operating Costs & Public Transportation Costs

<table>
<thead>
<tr>
<th>Region</th>
<th>No Car</th>
<th>One Car</th>
<th>Two Cars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Northeast Region</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>New York</td>
<td>$230</td>
<td>$298</td>
<td>$393</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>$236</td>
<td>$298</td>
<td>$392</td>
</tr>
<tr>
<td>Boston</td>
<td>$259</td>
<td>$284</td>
<td>$380</td>
</tr>
<tr>
<td>Pittsburgh</td>
<td>$161</td>
<td>$286</td>
<td>$380</td>
</tr>
<tr>
<td>Midwest Region</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Chicago</td>
<td>$257</td>
<td>$329</td>
<td>$422</td>
</tr>
<tr>
<td>Detroit</td>
<td>$312</td>
<td>$376</td>
<td>$469</td>
</tr>
<tr>
<td>Milwaukee</td>
<td>$212</td>
<td>$247</td>
<td>$341</td>
</tr>
<tr>
<td>Minneapolis-St. Paul</td>
<td>$276</td>
<td>$303</td>
<td>$397</td>
</tr>
<tr>
<td>Cleveland</td>
<td>$198</td>
<td>$293</td>
<td>$387</td>
</tr>
<tr>
<td>Cincinnati</td>
<td>$222</td>
<td>$272</td>
<td>$365</td>
</tr>
<tr>
<td>St. Louis</td>
<td>$203</td>
<td>$287</td>
<td>$383</td>
</tr>
<tr>
<td>Kansas City</td>
<td>$246</td>
<td>$291</td>
<td>$384</td>
</tr>
<tr>
<td>South Region</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Washington, D.C.</td>
<td>$289</td>
<td>$313</td>
<td>$407</td>
</tr>
<tr>
<td>Baltimore</td>
<td>$225</td>
<td>$240</td>
<td>$334</td>
</tr>
<tr>
<td>Atlanta</td>
<td>$283</td>
<td>$258</td>
<td>$351</td>
</tr>
<tr>
<td>Miami</td>
<td>$284</td>
<td>$344</td>
<td>$439</td>
</tr>
<tr>
<td>Tampa</td>
<td>$255</td>
<td>$265</td>
<td>$359</td>
</tr>
<tr>
<td>Dallas-Ft. Worth</td>
<td>$309</td>
<td>$332</td>
<td>$425</td>
</tr>
<tr>
<td>Houston</td>
<td>$281</td>
<td>$367</td>
<td>$462</td>
</tr>
<tr>
<td>West Region</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Los Angeles</td>
<td>$275</td>
<td>$353</td>
<td>$448</td>
</tr>
<tr>
<td>San Francisco</td>
<td>$317</td>
<td>$373</td>
<td>$466</td>
</tr>
<tr>
<td>San Diego</td>
<td>$311</td>
<td>$318</td>
<td>$415</td>
</tr>
</tbody>
</table>
Portland $189 $246 $339
Seattle $258 $335 $427
Honolulu $295 $314 $409
Anchorage $312 $336 $431
Phoenix $273 $326 $420
Denver $302 $351 $442

* Does not include personal property taxes. (effective January 1, 2005)

For Use with Allowable Transportation Expenses Table

The Operating Costs and Public Transportation Costs sections of the Transportation Standards are provided by Census Region and Metropolitan Statistical Area (MSA). The following table lists the states that comprise each Census Region. Once the taxpayer's Census Region has been ascertained, to determine if an MSA standard is applicable, use the definitions below to see if the taxpayer lives within an MSA (MSAs are defined by county and city, where applicable). If the taxpayer does not reside in an MSA, use the regional standard.

Northeast Census Region

<table>
<thead>
<tr>
<th>MSA</th>
<th>COUNTIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>New York</td>
<td>Bronx, Dutchess, Kings, Nassau, New York, Orange, Putnam, Queens, Richmond, Rockland, Suffolk, Westchester</td>
</tr>
<tr>
<td></td>
<td>Bergen, Essex, Hudson, Hunterdon, Mercer, Middlesex, Monmouth, Morris, Ocean, Passaic, Somerset, Sussex, Union, Warren</td>
</tr>
<tr>
<td></td>
<td>Fairfield, Litchfield, Middlesex, New Haven</td>
</tr>
<tr>
<td></td>
<td>Pike</td>
</tr>
<tr>
<td>Philadelphia</td>
<td>Bucks, Chester, Delaware, Montgomery, Philadelphia</td>
</tr>
<tr>
<td></td>
<td>Atlantic, Burlington, Camden, Cape May, Cumberland, Gloucester, Salem</td>
</tr>
<tr>
<td></td>
<td>New Castle</td>
</tr>
<tr>
<td></td>
<td>Cecil</td>
</tr>
<tr>
<td>Boston</td>
<td>Bristol, Essex, Hampden, Middlesex, Norfolk, Plymouth, Suffolk, Worcester</td>
</tr>
<tr>
<td></td>
<td>Hillsborough, Merrimack, Rockingham, Strafford</td>
</tr>
</tbody>
</table>

G - 18
<table>
<thead>
<tr>
<th>MSA</th>
<th>COUNTIES (unless otherwise specified)</th>
</tr>
</thead>
</table>
| Chicago | **IL:** Cook, DeKalb, DuPage, Grundy, Kane, Kankakee, Kendall, Lake, McHenry, Will  
|       | **IN:** Lake, Porter  
|       | **WI:** Kenosha |
| Milwaukee | **WI:** Milwaukee, Ozaukee, Racine, Washington, Waukesha |
| Minneapolis-St. Paul | **MN:** Anoka, Carver, Chisago, Dakota, Hennepin, Isanti, Ramsey, Scott, Sherburne, Washington, Wright  
|       | **WI:** Pierce, St. Croix |
| Cleveland | **OH:** Ashtabula, Cuyahoga, Geauga, Lake, Lorain, Medina, Portage, Summit |
| Cincinnati | **OH:** Brown, Butler, Clermont, Hamilton, Warren  
|       | **KY:** Boone, Campbell, Gallatin, Grant, Kenton, Pendleton  
|       | **IN:** Dearborn, Ohio |
| St. Louis | **MO:** Crawford, Franklin, Jefferson, Lincoln, St. Charles, St. Louis, Warren, St. Louis city  
|       | **IL:** Clinton, Jersey, Madison, Monroe, St. Clair |
| Kansas City | **MO:** Cass, Clay, Clinton, Jackson, Lafayette, Platte, Ray  
|       | **KS:** Johnson, Leavenworth, Miami, Wyandotte |

**Midwest Census Region**

North Dakota, South Dakota, Nebraska, Kansas, Missouri, Illinois, Indiana, Ohio, Michigan, Wisconsin, Minnesota, Iowa

**South Census Region**

CT: Windham

ME: York

PA: Allegheny, Beaver, Butler, Fayette, Washington, Westmoreland
Texas, Oklahoma, Arkansas, Louisiana, Mississippi, Tennessee, Kentucky, West Virginia, Virginia, Maryland, District of Columbia, Delaware, North Carolina, South Carolina, Georgia, Florida, Alabama

<table>
<thead>
<tr>
<th>MSA</th>
<th>COUNTIES (unless otherwise specified)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Washington, D.C.</td>
<td>in DC: District of Columbia</td>
</tr>
<tr>
<td></td>
<td>in MD: Calvert, Charles, Frederick, Montgomery, Prince George's, Washington</td>
</tr>
<tr>
<td></td>
<td>in VA: Arlington, Clarke, Culpepper, Fairfax, Fauquier, King George, Loudoun, Prince William, Spotsylvania, Stafford, Warren, Alexandria city, Fairfax city, Falls Church city, Fredericksburg city, Manassas city, Manassas Park city</td>
</tr>
<tr>
<td></td>
<td>in WV: Berkeley, Jefferson</td>
</tr>
<tr>
<td>Baltimore</td>
<td>in MD: Anne Arundel, Baltimore, Carroll, Harford, Howard, Queen Anne's, Baltimore city</td>
</tr>
<tr>
<td>Atlanta</td>
<td>in GA: Barrow, Bartow, Carroll, Cherokee, Clayton, Cobb, Coweta, DeKalb, Douglas, Fayette, Forsyth, Fulton, Gwinnett, Henry, Newton, Paulding, Pickens, Rockdale, Spalding, Walton</td>
</tr>
<tr>
<td>Miami</td>
<td>in FL: Broward, Miami-Dade</td>
</tr>
<tr>
<td>Tampa</td>
<td>in FL: Hernando, Hillsborough, Pasco, Pinellas</td>
</tr>
<tr>
<td>Dallas-Ft. Worth</td>
<td>in TX: Collin, Dallas, Denton, Ellis, Henderson, Hood, Hunt, Johnson, Kaufman, Parker, Rockwall, Tarrant</td>
</tr>
<tr>
<td>Houston</td>
<td>in TX: Brazoria, Chambers, Fort Bend, Galveston, Harris, Liberty, Montgomery, Waller</td>
</tr>
</tbody>
</table>

**West Census Region:**


<table>
<thead>
<tr>
<th>MSA</th>
<th>COUNTIES (unless otherwise specified)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Los Angeles</td>
<td>in CA: Los Angeles, Orange, Riverside, San Bernadino, Ventura</td>
</tr>
<tr>
<td>San Francisco</td>
<td>in CA: Alameda, Contra Costa, Marin, Napa, San Francisco, San Mateo, Santa Clara, Santa Cruz, Solano, Sonoma</td>
</tr>
<tr>
<td>San Diego</td>
<td>in CA: San Diego</td>
</tr>
<tr>
<td>Portland</td>
<td>in OR: Clackamas, Columbia, Marion, Multnomah, Polk, Washington, Yamhill</td>
</tr>
<tr>
<td></td>
<td>in WA: Clark</td>
</tr>
<tr>
<td>Seattle</td>
<td>in WA: Island, King, Kitsap, Pierce, Snohomish, Thurston</td>
</tr>
<tr>
<td>Location</td>
<td>State</td>
</tr>
<tr>
<td>--------------</td>
<td>--------</td>
</tr>
<tr>
<td>Honolulu</td>
<td>HI</td>
</tr>
<tr>
<td>Anchorage</td>
<td>AK</td>
</tr>
<tr>
<td>Phoenix</td>
<td>AZ</td>
</tr>
</tbody>
</table>
Allowable Expense

Overview

1. Allowable expenses include those expenses that meet the necessary expense test. The necessary expense test is defined as expenses that are necessary to provide for a taxpayer's and his or her family's health and welfare and/or production of income. The expenses must be reasonable. The total necessary expenses establish the minimum a taxpayer and family needs to live.

2. There are three types of necessary expenses:
   - National Standards
   - Local Standards
   - Other Expenses

3. National Standards: These establish standards for reasonable amounts for five necessary expenses. Four of them come from the Bureau of Labor Statistics (BLS) Consumer Expenditure Survey: food, housekeeping supplies, apparel and services, and personal care products and services. The fifth category, miscellaneous, is a discretionary amount established by the Service. It is $100 for one person and $25 for each additional person in the taxpayer's household.

Note:

All five standards are included in one total national standard expense.

4. Local Standards: These establish standards for two necessary expenses: housing and transportation. Taxpayers will be allowed the local standard or the amount actually paid, whichever is less.
   - Housing - Standards are established for each county within a state. When deciding if a deviation is appropriate, consider the cost of moving to a new residence; the increased cost of transportation to work and school that will result from moving to lower-cost housing and the tax consequences. The tax consequence is the difference between the benefit the taxpayer currently derives from the interest and property tax deductions on Schedule A to the benefit the taxpayer would derive without the same or adjusted expense.
   - Transportation - The transportation standards consist of nationwide figures for loan or lease payments referred to as ownership cost, and additional amounts for operating costs broken down by Census Region and Metropolitan Statistical Area. Operating costs were derived from BLS data. If a taxpayer has a car payment, the allowable ownership cost added to the allowable operating cost equals the allowable transportation expense. If a taxpayer has no car payment only the operating cost portion of the transportation standard is used to figure the allowable transportation expense. Under ownership costs, separate caps are provided for the first car and second car. If the taxpayer does not own a car a standard public transportation amount is allowed.

5. Other - Other expenses may be allowed if they meet the necessary expense test. The amount allowed must be reasonable considering the taxpayer's individual facts and circumstances.

6. Conditional expenses. These expenses do not meet the necessary expenses test. However, they are allowable if the tax liability, including projected accruals, can be fully paid within five years.

7. National local expense standards are guidelines. If it is determined a standard amount is inadequate to provide for a specific taxpayer's basic living expenses, allow a deviation. Require the taxpayer to provide reasonable substantiation and document the case file.

8. Generally, the total number of persons allowed for national standard expenses should be the same as those allowed as dependents on the taxpayer's current year income tax return. Verify
exemptions claimed on taxpayer's income tax return meet the dependency requirements of the IRC. There may be reasonable exceptions. Fully document the reasons for any exceptions. For example, foster children or children for whom adoption is pending.

9. A deviation from the local standard is not allowed merely because it is inconvenient for the taxpayer to dispose of valued assets.

10. Revenue officers should consider the length of the payments. Although it may be appropriate to allow for payments made on the secured debts that meet the necessary expense test, if the debt will be fully repaid in one year only allow those payments for one year.

5.15.1.8 (05-01-2004)
National Standards

1. National standards include the following expenses:
   A. Apparel and services. Includes shoes and clothing, laundry and dry cleaning, and shoe repair.
   B. Food. Includes all meals, home and away.
   C. Housekeeping supplies. Includes laundry and cleaning supplies; other household products such as cleaning and toilet tissue, paper towels and napkins; lawn and garden supplies; postage and stationary; and other miscellaneous household supplies.
   D. Personal care products and services. Includes hair care products, haircuts and beautician services, oral hygiene products and articles, shaving needs, cosmetics, perfume, bath preparations, deodorants, feminine hygiene products, electric personal care appliances, personal care services, and repair of personal care appliances.
   E. Miscellaneous. A discretionary allowance of $100 for one person and $25 for each additional person in a taxpayer's family.

2. Allow taxpayers the total national standard amount for their income level.

   Example: The taxpayer's expenses are: housekeeping supplies - $150, clothing - $150, food - $600, miscellaneous - $400 (Total Expenses - $1,300). The taxpayer is allowed the national standard of $1,100.

3. A taxpayer that claims more than the total allowed by the national standards must substantiate and justify each separate expense of the total national standard amounts.

   Example: A taxpayer may claim a higher food expense than allowed. Justification would be based on prescribed or required dietary needs.

5.15.1.9 (05-01-2004)
Local Standards

1. Local standards include the following expenses:
   A. Housing and Utilities. The utilities include gas, electricity, water, fuel, oil, bottled gas, trash and garbage collection, wood and other fuels, septic cleaning, and telephone. Housing expenses include: mortgage or rent, property taxes, interest, parking, necessary maintenance and repair, homeowner's or renter's insurance, homeowner dues and condominium fees. Usually, this is considered necessary only for the place of residence. Any other housing expenses should be allowed only if, based on a taxpayer's individual facts and circumstances, disallowance will cause the taxpayer economic hardship.
   B. Transportation. Vehicle insurance, vehicle payment (lease or purchase), maintenance, fuel, state and local registration, required inspection, parking fees, tolls, driver's license, public transportation. Transportation costs not required to produce income or ensure the health and welfare of the family are not considered necessary. Consider availability of public transportation if car payments (purchase or lease) will prevent the tax liability
from being paid in part or full. Public transportation costs could be an option if it does not significantly increase commuting time and inconvenience the taxpayer.

Note:

If the taxpayer has no car payment, or no car, question how the taxpayer travels to and from work, grocer, medical care, etc. The taxpayer is only allowed the operating cost or the cost of transportation.

5.15.1.10 (05-01-2004)
Other Expenses

1. Other expenses may be considered if they meet the necessary expense test - they must provide for the health and welfare of the taxpayer and/or his or her family or they must be for the production of income. This is determined based on the facts and circumstances of each case.

2. If other expenses are determined to be necessary and, therefore allowable, document the reasons for the decision in your history.

3. The amount allowed for necessary or conditional expenses depends on the taxpayer’s ability to full pay the liability within five years and on the taxpayer’s individual facts and circumstances. If the liability can be paid within 5 years, it may be appropriate to allow the taxpayer the excessive necessary and conditional expenses. If the taxpayer cannot pay within 5 years, it may be appropriate to allow the taxpayer the excessive necessary and conditional expenses for up to one year in order to modify or eliminate the expense. (See IRM 5.14, Installment Agreements)

<table>
<thead>
<tr>
<th>Expense Item</th>
<th>Expense is Necessary if:</th>
<th>Notes/Tips</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounting and legal fees.</td>
<td>Representation before the Service is needed or meets the necessary expense tests. Amount must be reasonable.</td>
<td>Disallow any other accounting or legal fees. Disallow costs not related to solving current liability.</td>
</tr>
<tr>
<td>Charitable contributions (Donations to tax exempt organizations)</td>
<td>If it is a condition of employment or meets the necessary expense tests. Example: A minister is required to tithe according to his employment contract.</td>
<td>Disallow any other charitable contributions that are not considered necessary. Example: Review the employment contract.</td>
</tr>
<tr>
<td>Child Care (Baby-sitting, day care, nursery and preschool)</td>
<td>It meets the necessary expense test. Only reasonable amounts are allowed.</td>
<td>Cost of child care can vary greatly. Do not allow unusually large child care expense if more reasonable alternatives are available. Consider the age of the child and if both parents work.</td>
</tr>
<tr>
<td>Court-Ordered Payments (Alimony, child support, including orders made by the state, and other court ordered payments)</td>
<td>If court ordered and being paid, they are allowable. If payments are not being made, do not allow the expense. Child support payments for natural children or legally</td>
<td>Review the court order.</td>
</tr>
<tr>
<td>Category</td>
<td>Description</td>
<td>Example</td>
</tr>
<tr>
<td>--------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Dependent Care (For the care of the elderly, invalid, or handicapped)</td>
<td>Adopted dependents may be allowed.</td>
<td>Example: An attorney must take so many education credits each year or they will not be accredited and could eventually lose their license to practice before the State Bar. A teacher could lose their position or in some States their pay is commensurate with their education credits.</td>
</tr>
<tr>
<td>Education</td>
<td>It is required for a physically or mentally challenged child and no public education providing similar services is available. Also allowed only for the taxpayer and only if required as condition of employment.</td>
<td>To determine monthly expenses, the total out of pocket expenses would be divided by 12. The Schedule A may also be used to determine the yearly expense. Ensure that the amount used is out of pocket after excessive insurance claims are paid. Substantiate that payments are being made.</td>
</tr>
<tr>
<td>Health Care</td>
<td>Required for the health and welfare of the family. Elective surgery would not be allowed such as plastic surgery or elective dental work. The taxpayer must provide proof of excessive out of pocket medical expenses.</td>
<td></td>
</tr>
<tr>
<td>Involuntary Deductions</td>
<td>If it is a requirement of the job; i.e. union dues, uniforms, work shoes.</td>
<td>To determine monthly expenses, the total out of pocket expenses would be divided by 12.</td>
</tr>
<tr>
<td>Life Insurance</td>
<td>If it is a term policy on the life of the taxpayer only.</td>
<td>If there are whole life policies, these should be reviewed as an asset for borrowing against or liquidating. Life insurance used as an investment is not a necessary expense.</td>
</tr>
<tr>
<td>Secured or legally perfected debts</td>
<td>If it meets the necessary expense test.</td>
<td>Taxpayer must substantiate that the payments are being made.</td>
</tr>
<tr>
<td>Unsecured Debts</td>
<td>If the taxpayer substantiates and justifies the expense, the minimum payment may be allowed.</td>
<td>Examples of unsecured debts which may be necessary expenses include:</td>
</tr>
<tr>
<td></td>
<td>The necessary expense test of health and welfare and/or production of income must be met. Except for payments required for the production of income, payments on unsecured debts will not be allowed if the tax liability, including projected accruals, can be paid in full within 90 days.</td>
<td>Payments required for the production of income such as payments to suppliers and payments on lines of credit needed for business and payment of debts incurred in order to pay a federal tax liability.</td>
</tr>
<tr>
<td>--------------------------------------</td>
<td>------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
<td>----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td><strong>Taxes</strong></td>
<td>It is for current federal, FICA, Medicare, state and local taxes.</td>
<td>Current taxes are allowed regardless of whether the taxpayer made them in the past or not. Delinquent state and local taxes are allowable depending on the priority of the FTL and/or Service agreement with the state and local taxing agencies.</td>
</tr>
<tr>
<td>Optional Telephones and Telephone Services (<em>Cell phone, pager, Call waiting, caller identification or long distance</em>)</td>
<td>It must meet the necessary expense test.</td>
<td></td>
</tr>
<tr>
<td><strong>Student Loans</strong></td>
<td>If it is secured by the federal government and only for the taxpayer's education.</td>
<td>Taxpayer must substantiate that the payments are being made.</td>
</tr>
<tr>
<td>Internet Provider/E-mail</td>
<td>If it meets the necessary expense test - generally for production of income.</td>
<td></td>
</tr>
<tr>
<td>Repayment of loans made for payment of Federal Taxes</td>
<td>If the loan is secured by the taxpayer's assets when those assets are of reasonable value and are necessary to provide for the health and welfare of the family.</td>
<td></td>
</tr>
</tbody>
</table>
B) Treatment of Secured Claims

1) § 1325(a)(5) – The plan can be confirmed if, with respect to each allowed secured claim provided for by the plan –

   a) the creditor has accepted the plan [no change]; or

   b) if the debtor keeps the property, the plan provides that:

      (i) the creditor retains the lien until the earlier of:

         (01) “the payment of the underlying debt determined under nonbankruptcy law” or

         (02) the discharge under § 1328;

         (03) and

      (ii) “the value, as of the effective date of the plan, of property to distributed under the plan on account of such claim is not less than the allowed amount of such claim” [no change]; and

      (iii) if “property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly installments”; and

      (iv) if “the holder of the claim is secured by personal property, the amount of such payments shall not be less than an amount sufficient to provide to the holder of such claim adequate protection during the period of the plan”;

      (v) or

   c) the debtor surrenders the collateral.

2) Valuation of collateral:

   a) § 1325(a) unnumbered paragraph following § 1325(a)(9): “For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph” [i.e., no cramdown] if . . .”
(i) the creditor has a purchase money security interest,

(ii) in a motor vehicle (as defined in title 49 U.S.C.),

(iii) purchased for personal use,

(iv) within 910 days (2-1/2 years) before bankruptcy;

(v) “or if collateral for that debt consists of any other thing of value, if the
debt was incurred during the 1-year period preceding that filing.”

b) In the event a cramdown is permitted, the method of valuation is now codified
as “replacement value.”

(i) § 506(a), which provides for the bifurcation of a claim into a secured
claim to the extent of the value of the collateral and an unsecured claim as
to the balance, now consists of 2 paragraphs.

(ii) § 506(a)(2) provides: “If the debtor is an individual in a case under
chapter 7 or 13, such value with respect to personal property securing an
allowed claim shall be determined based on the replacement value of such
property as of the date of the filing of the petition without deduction for
costs of sale or marketing. With respect to property acquired for personal,
family, or household purposes, replacement value shall mean the price a
retail merchant would charge for property of that kind considering the age
and condition of the property at the time value is determined.”

c) § 348(f)(1)(B): valuations in chapter 13 do not apply in a case converted to
chapter 7.

3) Payments on secured debts:

a) § 1325(a)(5)(B)(iii)(I): Payments must be in equal monthly installments (i.e.,
the trustee can no longer distribute to the class of secured claims on a pro-rata
basis), and

b) § 1325(a)(5)(B)(iii)(II): If the claim is secured by personal property,
payments must be sufficient to provide “adequate protection” “during the
period of the plan.”

(i) What constitutes “adequate protection” is described in § 361.
(ii) § 361 comes into play "when adequate protection is required under section 362, 363, or 364." [no change].

(iii) § 1303 gives the debtor, exclusive of the trustee, the rights and powers of a trustee under section 363(e) (among other subsections) [no change].

(iv) Per § 363(e), if collateral is to be used by the debtor, upon request of the secured creditor the court "shall prohibit or condition the use . . . as is necessary to provide adequate protection" of the creditor's interest in the collateral.

(v) Therefore, it looks like the concept of adequate protection set forth in § 361 would apply under § 1325(a)(5)(B)(iii)(II).

(vi) Per § 361 [no change], adequate protection may be provided by –

(01) making periodic payments to the extent that the use of the collateral under § 363(e) results in a decrease in the value of the creditor's interest in the collateral;

(02) providing an additional or replacement lien to the extent of the decrease in the value of the creditor's interest in the collateral;

(03) granting other relief "as will result in the realization by such entity of the indubitable equivalent of" the creditor's interest in the collateral.

c) What is the interrelationship between the no-cram-down rule, adequate protection payments, and "average monthly payments on secured debts" under the disposable income test? Does § 502(b)(2) (which provides that a claim for unmatured interest is disallowed) affect the analysis?

d) § 1326(a)(1): Unless the court orders otherwise, the debtor must commence making payments 30 days after the filing of the petition.

e) § 1326(a)(1): Unless the court orders otherwise, the debtor pays:

(i) the proposed plan amount to the trustee (less postpetition/pre-confirmation adequate protection payments made directly to the creditor);

(ii) postpetition/pre-confirmation adequate protection payments directly to a creditor holding a purchase-money security interest in personal property, reducing the plan payment by the amount of the adequate protection payment and providing the trustee with evidence of the payment.
f) § 1326(c): Unless otherwise provided in the plan or the order confirming the
plan, the trustee makes payments to creditors under the plan. [no change].

4) § 1326(a)(4): Within 60 days after filing the petition, the debtor must provide to
a creditor holding a purchase money security interest in personal property
evidence of insurance.

5) § 524(i) The willful failure of a creditor to credit payments made to the creditor
pursuant to the plan in accordance with the plan constitutes a violation of the
discharge injunction if the failure to properly credit the payments caused a
material injury to the debtor.
C) Discharge

1) § 1328: There are additional conditions that must be satisfied before the discharge can be entered:

a) § 1328(a): If the debtor owed or owes a debt under a “domestic support obligation” (child support, for example), the debtor must certify that all amounts required to be paid have been paid.

b) § 1328(g): The debtor must complete a course in personal financial management.

c) § 1328(h): The court must determine, after notice and hearing no more than 10 days before entering the discharge:

(i) that there is no reasonable cause to believe that § 522(q)(1) applies to the debtor; that is, that the debtor has claimed under state law certain exemptions totaling more than $125,000, and

(01) per § 522(q)(1)(A) has been convicted of a felony which shows an abuse of the bankruptcy laws; or

(02) per § 522(q)(1)(B) the debtor owes a debt for securities fraud; or

(03) per § 522(q)(1)(B)(iv) the debtor owes a debt arising from “any criminal act, intentional tort, or willful or reckless misconduct that caused serious physical injury or death to another individual in the preceding 5 years.”

(ii) and that there is no reasonable cause to believe that there is a pending proceeding that might give rise to a § 522(q)(1) situation.

2) The “super-discharge” is greatly diminished. Debts that are nondischargeable in a chapter 13 case have been expanded and now include:

a) § 1322(b)(5) long-term debts [no change];

b) § 507(a)(8)(C) priority tax debts;

c) the following obligations that are nondischargeable under § 523(a):
(i) § 523(a)(1)(B) – debts arising from unfiled or late-filed tax returns;

(ii) § 523(a)(1)(C) debts arising from fraudulent tax returns;

(iii) § 523(a)(2) debts obtained by fraud, false financial statements; debts for luxury goods or cash advances obtained shortly before bankruptcy;

(iv) § 523(a)(3) unscheduled debts;

(v) § 523(a)(4) debts for defalcation or embezzlement;

(vi) § 523(a)(5) debts for “domestic support obligations” (defined in § 101(14A));

(vii) § 523(a)(8) student loan debts;

(viii) § 523(a)(9) DUI debts;

d) § 1328(a)(3) restitution and criminal fines [no change];

e) § 1328(a)(4) restitution or damages awarded as a result of a willful or malicious injury.

3) § 1328(f): A debtor may not receive a discharge in a chapter 13 if the debtor received a discharge:

a) per § 1328(f)(1), in a chapter 7, 11 or 12 case filed within 4 years of the filing of the chapter 13; or

b) per § 1328(f)(2), in a chapter 13 case filed within 2 years prior to the current chapter 13 case.
APPENDIX

SELECTED "RED-LINED" SECTIONS OF THE BAPCPA

PREPARED BY DAVIS, POLK, & WARDWELL

§ 101(10A)
§ 101(39A)
§ 506
§ 521
§ 707
§§ 1301 - 1330
BANKRUPTCY CODE AND SELECTED OTHER
PROVISIONS OF THE UNITED STATES CODE

Marked Version Highlighting Amendments by the
Bankruptcy Abuse Prevention and
Consumer Protection Act of 2005, S. 256,
As Passed by the U.S. Senate on March 10, 2005 and
the U.S. House of Representatives on April 14, 2005

The following is the proposed Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, S. 256, as passed by the U.S. Senate on March 10, 2005 and the U.S. House of Representatives on April 14, 2005, marked to show changes against the entire current Bankruptcy Code and selected other statutes. It is intended to show how these statutes will read if and when the legislation is passed by the House and signed by the President. Insertions made by S.256 are underlined. Text in current law that would be deleted by S.256 is identified with text struck through (e.g., these words have been deleted).

This comparison is not comprehensive. It does not compare all of the statutes affected by the proposed Act nor does it address certain other provisions of S.256 such as those directing that certain studies be performed and reports delivered. Davis Polk & Wardwell has compiled these charts as part of our internal analysis of the proposed Act. We are making these materials available in PDF format to visitors to our website (http://www.dpw.com/insolvency) with this understanding and as a courtesy and public service. While we have used reasonable efforts to be as accurate as reasonably possible in compiling this comparison, we do not warrant that the contents are accurate in every respect. Therefore, we urge all readers to consult the applicable provisions of the proposed legislation and not to rely on this document for any specific purpose or transaction.

Please also note that this comparison is a preliminary draft and will be periodically revised. Please forward any corrections to kurt.hoffman@dpw.com or brian.resnick@dpw.com.

Effective Dates. Generally, the amendments shall take effect for cases commenced 180 days after the date of enactment, and will not apply with respect to cases commenced before the effective date. However there are numerous exceptions. Selected exceptions are set forth in the following table.
§ 101. Definitions

In this title— the following definitions shall apply:

(1) The term "accountant" means accountant authorized under applicable law to practice public accounting, and includes professional accounting association, corporation, or partnership, if so authorized.

(2) The term "affiliate" means—
(A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
(B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities—
(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or
(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;
(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or
(D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.

(3) The term "assistant person" means any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than $150,000.

(4) The term "attorney" means attorney, professional law association, corporation, or partnership, authorized under applicable law to practice law.

(A) The term "bankruptcy assistance" means any goods or services sold or otherwise provided to an assisted person with the express or implied purpose of providing information, advice, counsel, document preparation, or filing, or attendance at a creditors' meeting or appearing in a case or proceeding on behalf of another or providing legal representation with respect to a case or proceeding under this title.

(5) The term "claim" means—
(A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
(B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

(6) The term "commodity broker" means futures commission merchant, foreign futures commission merchant, clearing organization, leveraged transaction merchant, or commodity options dealer, as defined in section 761 of this title, with respect to which there is a customer, as defined in section 761 of this title.

(7) The term "community claim" means claim that arose before the commencement of the case concerning the debtor for which property of the kind specified in section 541(a)(2) of this title is liable, whether or not there is any such property at the time of the commencement of the case.

(7A) The term "commercial fishing operation" means—
(A) the catching or harvesting of fish, shrimp, lobsters, urchins, seaweed, shellfish, or other aquatic species or products of such species; or
(B) for purposes of section 109 and chapter 12, aquaculture activities consisting of raising for market any species or product described in subparagraph (A).

(7B) The term "commercial fishing vessel" means a vessel used by a family fisherman to carry out a commercial fishing operation.

(8) The term "consumer debt" means debt incurred by an individual primarily for a personal, family, or household purpose.
(9) The term “corporation”—
(A) includes—
   (i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses;
   (ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;
   (iii) joint-stock company;
   (iv) unincorporated company or association; or
   (v) business trust; but
(B) does not include limited partnership.

(10) The term “creditor” means—
(A) entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor;
(B) entity that has a claim against the estate of a kind specified in section 348(d), 502(f), 502(g), 502(h) or 502(i) of this title; or
(C) entity that has a community claim.

(10A) The term “current monthly income”—
   (A) means the average monthly income from all sources that the debtor receives (or in a joint case the debtor and the debtor’s spouse receive) without regard to whether such income is taxable income, derived during the 6-month period ending on—
      (i) the last day of the calendar month immediately preceding the date of the commencement of the case if the debtor files the schedule of current income required by section 521(a)(1)(D)(i); or
      (ii) the date on which current income is determined by the court for purposes of this title if the debtor does not file the schedule of current income required by section 521(a)(1)(D)(i); and
   (B) includes any amount paid by any entity other than the debtor (or in a joint case the debtor and the debtor’s spouse), on a regular basis for the household expenses of the debtor or the debtor’s dependents (and in a joint case the debtor’s spouse if not otherwise a dependent), but excludes benefits received under the Social Security Act, payments to victims of war crimes or crimes against humanity on account of their status as victims of such crimes, and payments to victims of international terrorism (as defined in section 2331 of title 18) or domestic terrorism (as defined in section 2331 of title 18) on account of their status as victims of such terrorism.

(11) The term “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 the 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.

(12A) The term “debt relief agency” means any person who provides any bankruptcy assistance to an assisted person in return for the payment of money or other valuable consideration, or who is a bankruptcy petition preparer under section 110, but does not include—
   (A) any person who is an officer, director, employee, or agent of a person who provides such assistance or of the bankruptcy petition preparer;
   (B) a nonprofit organization that is exempt from taxation under section 501(c)(3) of the Internal Revenue Code of 1986;
   (C) a creditor of such assisted person, to the extent that the creditor is assisting such assisted person to restructure any debt owed by such assisted person to the creditor;
   (D) a depository institution (as defined in section 3 of the Federal Deposit Insurance Act) or any Federal credit union or State credit union (as those terms are defined in section 101 of the Federal Credit Union Act), or any affiliate or subsidiary of such depository institution or credit union; or
   (E) an author, publisher, distributor, or seller of works subject to copyright protection under title 17, when acting in such capacity.

(12B) “Debt for child support” means a debt of a kind specified in section 523(e)(5) of this title for maintenance or support of a child of the debtor.

The term “debtor” means person or municipality concerning which a case under this title has been commenced.
(38) The term "margin payment" means, for purposes of the forward contract provisions of this title, payment or deposit of cash, a security or other property, that is commonly known in the forward contract trade as original margin, initial margin, maintenance margin, or variation margin, including mark-to-market payments, or variation payments.

(38A) The term "master netting agreement" means:

(A) an agreement providing for the exercise of rights, including rights of netting, setoff, liquidation, termination, acceleration, or close out, under or in connection with one or more contracts that are described in any one or more of paragraphs (1) through (5) of section 561(a); or any security agreement or arrangement or other credit enhancement related to one or more of the foregoing, including any guarantee or reimbursement obligation related to 1 or more of the foregoing; and

(B) if the agreement contains provisions relating to agreements or transactions that are not contracts described in paragraphs (1) through (5) of section 561(a), shall be deemed to be a master netting agreement only with respect to those agreements or transactions that are described in any one or more of paragraphs (1) through (5) of section 561(a).

(38B) The term "master netting agreement participant" means an entity that, at any time before the date of the filing of the petition, is a party to an outstanding master netting agreement with the debtor.

(39) The term "mark-up" has the meaning given it in section 901(a)(2) of title 17.

(39A) The term "median family income" means for any year:

(A) the median family income, both calculated and reported by the Bureau of the Census in the then most recent year; and

(B) if not so calculated and reported in the then current year, adjusted annually after such most recent year until the next year in which median family income is both calculated and reported by the Bureau of the Census, to reflect the percentage change in the Consumer Price Index for All Urban Consumers during the period of years occurring after such most recent year and before such current year.

(40) The term "municipality" means political subdivision or public agency or instrumentality of a State.

(40A) The term "patient" means any individual who obtains or receives services from a health care business.

(40B) The term "patient record" means any written document relating to a patient or a record recorded in a magnetic, optical, or other form of electronic medium.

(41) The term "person" includes individual, partnership, and corporation, but does not include governmental unit, except that a governmental unit that--

(A) acquires an asset from a person--

(i) as a result of the operation of a loan guarantee agreement; or

(ii) as receiver or liquidating agent of a person;

(B) is a guarantor of a pension benefit payable by or on behalf of the debtor or an affiliate of the debtor; or

(C) is the legal or beneficial owner of an asset of--

(i) an employee pension benefit plan that is a governmental plan, as defined in section 414(d) of the Internal Revenue Code of 1986; or

(ii) an eligible deferred compensation plan, as defined in section 457(b) of the Internal Revenue Code of 1986; shall be considered, for purposes of section 1102 of this title, to be a person with respect to such asset or such benefit.

(41A) The term "personally identifiable information" means--

(A) if provided by an individual to the debtor in connection with obtaining a product or a service from the debtor primarily for personal, family, or household purposes--

(i) the first name (or initial) and last name of such individual, whether given at birth or time of adoption, or resulting from a lawful change of name;

(ii) the geographical address of a physical place of residence of such individual;

(iii) an electronic address (including an e-mail address) of such individual;

(iv) a telephone number dedicated to contacting such individual at such physical place of residence;

(v) a social security account number issued to such individual; or

(vi) the account number of a credit card issued to such individual; or

(B) if identified in connection with 1 or more of the items of information specified in subparagraph (A)--

(i) a birth date, the number of a certificate of birth or adoption, or a place of birth; or

(ii) any other information concerning an identified individual that, if disclosed, will result in contacting or identifying such individual physically or electronically.

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(B) if such governmental unit does not designate an address and provide such address to the clerk under subparagraph (A), any request made under this subsection may be served at the address for the filing of a tax return or protest with the appropriate taxing authority of such governmental unit.

(2) A trustee may request a determination of any unpaid liability of the estate for any tax incurred during the administration of the case by submitting a tax return for such tax and a request for such a determination to the governmental unit charged with responsibility for collection or determination of such tax at the address and in the manner designated in paragraph (1). Unless such return is fraudulent, or contains a material misrepresentation, the estate, the trustee, the debtor, and any successor to the debtor are discharged from any liability for such tax—(1) upon payment of the tax shown on such return, if—

(A) upon payment of the tax shown on such return, if—

(i) such governmental unit does not notify the trustee, within 60 days after such request, that such return has been selected for examination; or

(ii) such governmental unit does not complete such an examination and notify the trustee of any tax due, within 180 days after such request or within such additional time as the court, for cause, permits;

(B) upon payment of the tax determined by the court, after notice and a hearing, after completion by such governmental unit of such examination; or

(C) upon payment of the tax determined by such governmental unit to be due.

(c) Notwithstanding section 362 of this title, after determination by the court of a tax under this section, the governmental unit charged with responsibility for collection of such tax may assess such tax against the estate, the debtor, or a successor to the debtor, as the case may be, subject to any otherwise applicable law.

§ 506. Determination of secured status

(a) (1) An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor’s interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor’s interest.

(2) If the debtor is an individual in a case under chapter 7 or 13, such value with respect to personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family, or household purposes, replacement value shall mean the price a retail merchant would charge for property of that kind considering the age and condition of the property at the time value is determined.

(b) To the extent that an allowed secured claim is secured by property the value of which, after any recovery under subsection (c) of this section, is greater than the amount of such claim, there shall be allowed to the holder of such claim, interest on such claim, and any reasonable fees, costs, or charges provided for under the agreement or State statute under which such claim arose.

(c) The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property.

(d) To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—

(1) such claim was disallowed only under section 502(b)(5) or 502(e) of this title; or

(2) such claim is not an allowed secured claim due only to the failure of any entity to file a proof of such claim under section 501 of this title.

§ 507. Priorities

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(b) For the purpose of distribution under this title, a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement of contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock.

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may—
1. under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or
2. order that any lien securing such a subordinated claim be transferred to the estate.

§ 511. Rate of interest on tax claims

(a) If any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law.

(b) In the case of taxes paid under a confirmed plan under this title, the rate of interest shall be determined as of the calendar month in which the plan is confirmed.

SUBCHAPTER II — DEBTOR'S DUTIES AND BENEFITS

§ 521. Debtor's duties

(a) The debtor shall—
1. file—
   (A) a list of creditors; and
   (B) unless the court orders otherwise, a schedule of assets and liabilities;
   (ii) a schedule of current income and current expenditures, and;
   (iii) a statement of the debtor's financial affairs; and, if section 342(b) applies, a certificate—
   (I) of an attorney whose name is indicated on the petition as the attorney for the debtor, or a bankruptcy petition preparer signing the petition under section 110(b)(2), indicating that such attorney or the bankruptcy petition preparer delivered to the debtor the notice required by section 342(b); or,
   (II) if no attorney is so indicated, and no bankruptcy petition preparer signed the petition, of the debtor that such notice was received and read by the debtor:
   (iv) copies of all payment advices or other evidence of payment received within 60 days before the date of the filing of the petition, by the debtor from any employer of the debtor;
   (v) a statement of the amount of monthly net income, itemized to show how the amount is calculated; and
   (vi) a statement disclosing any reasonably anticipated increase in income or expenditures over the 12-month period following the date of the filing of the petition;
2. if an individual debtor's schedule of assets and liabilities includes consumer debts which are secured by property of the estate—
   (A) within thirty days after the date of the filing of a petition under chapter 7 of this title or on or before the date of the meeting of creditors, whichever is earlier, or within such additional time as the court, for cause, within such period fixes, the debtor shall file with the clerk a statement of his intention with respect to the retention or surrender of such property and, if applicable, specifying that such property is claimed as exempt, that the debtor intends to redeem such property, or that the debtor intends to reaffirm debts secured by such property;
   (B) within forty-five to 90 days after the filing of a notice of intent under the first date set for the meeting of creditors under section 341(a) or within such additional time as the court, for cause, within such forty-five 90 day period fixes, the debtor shall perform his intention with respect to such property, as specified by subparagraph (A) of this paragraph; and
(C) nothing in subparagraphs (A) and (B) of this paragraph shall alter the debtor’s or the trustee’s rights with regard to such property under this title, except as provided in section 362(h): 

(3) if a trustee is serving in the case, or an auditor serving under section 586(f) of title 28, cooperate with the trustee as necessary to enable the trustee to perform the trustee’s duties under this title; 

(4) if a trustee is serving in the case, or an auditor serving under section 586(f) of title 28, surrender to the trustee all property of the estate and any recorded information, including books, documents, records, and papers, relating to property of the estate, whether or not immunity is granted under section 344 of this title; and

(5) appear at the hearing required under section 524(d) of this title;

(6) in a case under chapter 7 of this title in which the debtor is an individual, not retain possession of personal property as to which a creditor has an allowed claim for the purchase price secured in whole or in part by an interest in such personal property unless the debtor, not later than 45 days after the first meeting of creditors under section 341(a), either—

(A) enters into an agreement with the creditor pursuant to section 524(c) with respect to the claim secured by such property; or

(B) redeems such property from the security interest pursuant to section 722.

If the debtor fails to so act within the 45-day period referred to in paragraph (6), the stay under section 362(a) is terminated with respect to the personal property of the estate or of the debtor which is affected, such property shall no longer be property of the estate, and the creditor may take whatever action as to such property as is permitted by applicable nonbankruptcy law, unless the court determines on the motion of the creditor filed before the expiration of such 45-day period, and after notice and a hearing, that such property is of consequential value or benefit to the estate, orders appropriate adequate protection of the creditor’s interest, and orders the debtor to deliver any collateral in the debtor’s possession to the trustee; and

(7) unless a trustee is serving in the case, continue to perform the obligations required of the administrator (as defined in section 3 of the Employee Retirement Income Security Act of 1974) of an employee benefit plan if at the time of the commencement of the case the debtor (or any entity designated by the debtor) served as such administrator.

(b) In addition to the requirements under subsection (a), a debtor who is an individual shall file with the court—

(1) a certificate from the approved nonprofit budget and credit counseling agency that provided the debtor services under section 109(h) describing the services provided to the debtor; and

(2) a copy of the debt repayment plan, if any, developed under section 109(h) through the approved nonprofit budget and credit counseling agency referred to in paragraph (1).

(c) In addition to meeting the requirements under subsection (a), a debtor shall file with the court a record of any interest that a debtor has in an education individual retirement account (as defined in section 530(b)(1) of the Internal Revenue Code of 1986) or under a qualified State tuition program (as defined in section 529(b)(1) of such Code).

(d) If the debtor fails timely to take the action specified in subsection (a)(6) of this section, or in paragraphs (1) and (2) of section 362(h), with respect to property which a lessor or bailor owns and has leased, rented, or bailed to the debtor or as to which a creditor holds a security interest not otherwise voidable under section 522(d), 544, 545, 547, 548, or 549, nothing in this title shall prevent or limit the operation of a provision in the underlying lease or agreement that has the effect of placing the debtor in default under such lease or agreement by reason of the occurrence, pendency, or existence of a proceeding under this title or the insolvency of the debtor. Nothing in this subsection shall be deemed to justify limiting such a provision in any other circumstance.

(c)(1) If the debtor in a case under chapter 7 or 13 is an individual and if a creditor files with the court at any time a request to receive a copy of the petition, schedules, and statement of financial affairs filed by the debtor, then the court shall make such petition, such schedules, and such statement available to such creditor.

(2)(A) The debtor shall provide—

(i) not later than 7 days before the date first set for the first meeting of creditors, to the trustee a copy of the Federal income tax return required under applicable law (or at the election of the debtor, a transcript of such return) for the most recent tax year ending immediately before the commencement of the case and for which a Federal income tax return was filed; and

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(ii) at the same time the debtor complies with clause (i), a copy of such return (or if elected under clause (i), such transcript) to any creditor that timely requests such copy.

(B) If the debtor fails to comply with clause (i) or (ii) of subparagraph (A), the court shall dismiss the case unless the debtor demonstrates that the failure to so comply is due to circumstances beyond the control of the debtor.

(C) If a creditor requests a copy of such tax return or such transcript and if the debtor fails to provide a copy of such tax return or such transcript to such creditor at the time the debtor provides such tax return or such transcript to the trustee, then the court shall dismiss the case unless the debtor demonstrates that the failure to provide a copy of such tax return or such transcript is due to circumstances beyond the control of the debtor.

(3) If a creditor in a case under chapter 13 files with the court at any time a request to receive a copy of the plan filed by the debtor, then the court shall make available to such creditor a copy of the plan--

(A) at a reasonable cost; and

(B) not later than 5 days after such request is filed.

(f) At the request of the court, the United States trustee, or any party in interest in a case under chapter 7, 11, or 13, a debtor who is an individual shall file with the court--

(1) at the same time filed with the taxing authority, a copy of each Federal income tax return required under applicable law (or at the election of the debtor, a transcript of such tax return) with respect to each tax year of the debtor ending while the case is pending under such chapter;

(2) at the same time filed with the taxing authority, each Federal income tax return required under applicable law (or at the election of the debtor, a transcript of such tax return) that had not been filed with such authority as of the date of the commencement of the case and that was subsequently filed for any tax year of the debtor ending in the 3-year period ending on the date of the commencement of the case;

(3) a copy of each amendment to any Federal income tax return or transcript filed with the court under paragraph (1) or (2); and

(4) in a case under chapter 13--

(A) on the date that is either 90 days after the end of such tax year or 1 year after the date of the commencement of the case, whichever is later, if a plan is not confirmed before such later date; and

(B) annually after the plan is confirmed and until the case is closed, not later than 45 days before the anniversary of the confirmation of the plan;

a statement, under penalty of perjury, of the income and expenses of the debtor during the tax year of the debtor most recently concluded before such statement is filed under this paragraph, and of the monthly income of the debtor, that shows how income, expenditures, and monthly income are calculated.

(g)(1) A statement referred to in subsection (f)(4) shall disclose--

(A) the amount and sources of the income of the debtor;

(B) the identity of any person responsible with the debtor for the support of any dependent of the debtor; and

(C) the identity of any person who contributed, and the amount contributed, to the household in which the debtor resides.

(2) The tax returns, amendments, and statement of income and expenditures described in subsections (a)(2)(A) and (f) shall be available to the United States trustee (or the bankruptcy administrator, if any), the trustee, and any party in interest for inspection and copying, subject to the requirements of section 315(c) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

(h) If requested by the United States trustee or by the trustee, the debtor shall provide--

(1) a document that establishes the identity of the debtor, including a driver's license, passport, or other document that contains a photograph of the debtor; or

(2) such other personal identifying information relating to the debtor that establishes the identity of the debtor.

(i)(1) Subject to paragraphs (2) and (4) and notwithstanding section 707(a), if an individual debtor in a voluntary case under chapter 7 or 13 fails to file all of the information required under subsection (a)(1) within 45 days after the date of the filing of the petition, the case shall be automatically dismissed effective on the 46th day after the date of the filing of the petition.
Subject to paragraph (4) and with respect to a case described in paragraph (1), any party in interest may request the court to enter an order dismissing the case. If requested, the court shall enter an order of dismissal not later than 5 days after such request.

Subject to paragraph (4) and upon request of the debtor made within 45 days after the date of the filing of the petition described in paragraph (1), the court may allow the debtor an additional period of not to exceed 45 days to file the information required under subsection (a)(1) if the court finds justification for extending the period for the filing.

Notwithstanding any other provision of this subsection, on the motion of the trustee filed before the expiration of the applicable period of time specified in paragraph (1), (2), or (3), and after notice and a hearing, the court may decline to dismiss the case if the court finds that the debtor attempted in good faith to file all the information required by subsection (a)(1)(B)(iv) and that the best interests of creditors would be served by administration of the case.

Notwithstanding any other provision of this title, if the debtor fails to file a tax return that becomes due after the commencement of the case or to properly obtain an extension of the due date for filing such return, the taxing authority may request that the court enter an order converting or dismissing the case.

If the debtor does not file the required return or obtain the extension referred to in paragraph (1) within 90 days after a request is filed by the taxing authority under that paragraph, the court shall convert or dismiss the case, whichever is in the best interests of creditors and the estate.

§ 522. Exemptions

(a) In this section—

(1) "dependent" includes spouse, whether or not actually dependent; and

(2) "value" means fair market value as of the date of the filing of the petition or, with respect to property that becomes property of the estate after such date, as of the date such property becomes property of the estate.

(b)(1) Notwithstanding section 541 of this title, an individual debtor may exempt from property of the estate the property listed in either paragraph (42) or, in the alternative, paragraph (43) of this subsection. In joint cases filed under section 302 of this title and individual cases filed under section 301 or 303 of this title by or against debtors who are husband and wife, and whose estates are ordered to be jointly administered under Rule 1015(b) of the Federal Rules of Bankruptcy Procedure, one debtor may not elect to exempt property listed in paragraph (42) and the other debtor elect to exempt property listed in paragraph (43) of this subsection. If the parties cannot agree on the alternative to be elected, they shall be deemed to elect paragraph (42) where such election is permitted under the law of the jurisdiction where the case is filed. Such property is—

(42) Property listed in this paragraph is property that is specified under subsection (d) of this section, unless the State law that is applicable to the debtor under paragraph (42)(A) of this subsection specifically does not so authorize; or, in the alternative,

(2) (A) any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition at the place in which the debtor’s domicile has been located for the 180 days immediately preceding the date of the filing of the petition or for a longer period of such 180-day period than in any other place; and

(3) Property listed in this paragraph is—

(A) subject to subsections (a) and (p) any property that is exempt under Federal law, other than subsection (d) of this section, or State or local law that is applicable on the date of the filing of the petition at the place in which the debtor’s domicile has been located for the 730 days immediately preceding the date of the filing of the petition or if the debtor’s domicile has not been located at a single State for such 730-day period, the place in which the debtor’s domicile was located for 180 days immediately preceding the 730-day period or for a longer period of such 180-day period than in any other place;

(B) any interest in property in which the debtor had, immediately before the commencement of the case, an interest as a tenant by the entirety or joint tenant to the extent that such interest as a tenant by the entirety or joint tenant is exempt from process under applicable nonbankruptcy law; and

(C) retirement funds to the extent that those funds are in a fund or account that is exempt from taxation under section 401, 403, 408, 408A, 414, 457, or 501(a) of the Internal Revenue Code of 1986.
§ 707. Dismissal of a case or conversion to a case under chapter 11 or 13

(a) The court may dismiss a case under this chapter only after notice and a hearing and only for cause, including—

(1) unreasonable delay by the debtor that is prejudicial to creditors;

(2) nonpayment of any fees or charges required under chapter 123 of title 28; and

(3) failure of the debtor in a voluntary case to file, within fifteen days or such additional time as the court may allow after the filing of the petition commencing such case, the information required by paragraph (1) of section 521, but only on a motion by the United States trustee.

(b) (1) After notice and a hearing, the court, on its own motion or on a motion by the United States trustee, but not at the request or suggestion of trustees (or bankruptcy administrator, if any), or any party in interest, may dismiss a case filed by an individual debtor under this chapter whose debts are primarily consumer debts, or with the debtor’s consent, convert such a case to a case under chapter 11 or 13 of this title, if it finds that the granting of relief would be a substantial abuse of the provisions of this chapter. There shall be a presumption in favor of granting the relief requested by the debtor. In making a determination whether to dismiss a case under this section, the court may take into consideration whether a debtor has made, or continues to make, charitable contributions (that meet the definition of “charitable contribution” under section 548(d)(3)) to any qualified religious or charitable entity or organization (as that term is defined in section 548(d)(4)).

(2) (A) (i) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter, the court shall presume abuse exists if the debtor’s current monthly income reduced by the amounts determined under clauses (ii), (iii), and (iv), and multiplied by 60 is not less than the lesser of—

(I) 25 percent of the debtor’s nonpriority unsecured claims in the case, or $6,000, whichever is greater; or

(II) $10,000.

(ii) (I) The debtor’s monthly expenses shall be the debtor’s applicable monthly expense amounts specified under the National Standards and Local Standards, and the debtor’s actual monthly expenses for the categories specified as Other Necessary Expenses issued by the Internal Revenue Service for the area in which the debtor resides, as in effect on the date of the order for relief, for the debtor, the dependents of the debtor, and the spouse of the debtor in a joint case, if the spouse is not otherwise a dependent. Such expenses shall include reasonably necessary health insurance, disability insurance, and health savings account expenses for the debtor, the spouse of the debtor, or the dependents of the debtor. Notwithstanding any other provision of this clause, the monthly expenses of the debtor shall not include any payments for debts. In addition, the debtor’s monthly expenses shall include the debtor’s reasonably necessary expenses incurred to maintain the safety of the debtor and the family of the debtor from family violence as identified under section 309 of the Family Violence Prevention and Services Act, or other applicable Federal law. The expenses included in the debtor’s monthly expenses described in the preceding sentence shall be kept confidential by the court. In addition, if it is demonstrated that it is reasonable and necessary, the debtor’s monthly expenses may also include an additional allowance for food and clothing of up to 5 percent of the food and clothing categories as specified by the National Standards issued by the Internal Revenue Service.

(II) In addition, the debtor’s monthly expenses may include, if applicable, the continuation of actual expenses paid by the debtor that are reasonable and necessary for care and support of an elderly, chronically ill, or disabled household member or member of the debtor’s immediate family (including parents, grandparents, siblings, children, and grandchildren of the debtor, the dependents of the debtor, and the spouse of the debtor in a joint case, who is not a dependent) and who is unable to pay for such reasonable and necessary expenses.

(III) In addition, for a debtor eligible for chapter 13, the debtor’s monthly expenses may include the actual administrative expenses of administering a chapter 13 plan for the district in which the debtor resides, up to an amount of 10 percent of the projected plan payments, as determined under schedules issued by the Executive Office for United States Trustees.

(IV) In addition, the debtor’s monthly expenses may include the actual expenses for each dependent child less than 18 years of age, not to exceed $1,500 per year per child, to attend a private or public elementary or secondary school. If the debtor provides documentation of such expenses and a detailed explanation of why such expenses are reasonable and necessary, and why such expenses are not already accounted for in the National Standards, Local Standards, or Other Necessary Expenses referred to in subclause (I).
(V) In addition, the debtor's monthly expenses may include an allowance for housing and utilities, in excess of the allowance specified by the Local Standards for housing and utilities issued by the Internal Revenue Service, based on the actual expenses for home energy costs if the debtor provides documentation of such actual expenses and demonstrates that such actual expenses are reasonable and necessary.

(iii) The debtor's average monthly payments on account of secured debts shall be calculated as the sum of—

(1) the total of all amounts scheduled as contractually due to secured creditors in each month of the 60 months following the date of the petition and

(2) any additional payments to secured creditors necessary for the debtor, in filing a plan under chapter 13 of this title, to maintain possession of the debtor's primary residence, motor vehicle, or other property necessary for the support of the debtor and the debtor's dependents, that serves as collateral for secured debts, divided by 60.

(iv) The debtor's expenses for payment of all priority claims (including priority child support and alimony claims) shall be calculated as the total amount of debts entitled to priority divided by 60.

(B) In any proceeding brought under this subsection, the presumption of abuse may only be rebutted by demonstrating special circumstances, such as a serious medical condition or a call or order to active duty in the Armed Forces, to the extent such special circumstances that justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative.

(ii) In order to establish special circumstances, the debtor shall be required to itemize each additional expense or adjustment of income and to provide—

(1) documentation for such expense or adjustment to income; and

(2) a detailed explanation of the special circumstances that make such expenses or adjustment to income necessary and reasonable.

(iii) The debtor shall attest under oath to the accuracy of any information provided to demonstrate that additional expenses or adjustments to income are required.

(iv) The presumption of abuse may only be rebutted if the additional expenses or adjustments to income referred to in clause (i) cause the product of the debtor's current monthly income reduced by the amounts determined under clauses (ii), (iii), and (iv) of subparagraph (A) when multiplied by 60 to be less than the lesser of—

(1) 25 percent of the debtor's nonpriority unsecured claims, or $6,000, whichever is greater; or

(2) $10,000.

(C) As part of the schedule of current income and expenditures required under section 521, the debtor shall include a statement of the debtor's current monthly income, and the calculations that determine whether a presumption arises under subparagraph (A)(i), that show how each such amount is calculated.

(D) Subparagraphs (A) through (C) shall not apply, and the court may not dismiss or convert a case based on any form of means testing, if the debtor is a disabled veteran (as defined in section 3741(1) of title 38), and the indebtedness occurred primarily during a period during which he or she was—

(i) on active duty (as defined in section 101(10) of title 10); or

(ii) performing a homeland defense activity (as defined in section 901(1) of title 32).

(3) In considering under paragraph (1) whether the granting of relief would be an abuse of the provisions of this chapter in a case in which the presumption in subparagraph (A)(i) of such paragraph does not arise or is rebutted, the court shall consider—

(A) whether the debtor filed the petition in bad faith; or

(B) the totality of the circumstances (including whether the debtor seeks to reject a personal services contract and the financial need for such rejection as sought by the debtor) of the debtor's financial situation demonstrates abuse.

(4) (A) The court, on its own initiative or on the motion of a party in interest, in accordance with the procedures described in rule 9011 of the Federal Rules of Bankruptcy Procedure, may order the attorney for the debtor to reimburse the trustee for all reasonable costs in prosecuting a motion filed under section 707(b), including reasonable attorneys' fees, if—

(i) a trustee files a motion for dismissal or conversion under this subsection; and

(ii) the court—

(I) grants such motion; and

(ii) finds that the action of the attorney for the debtor in filing a case under this chapter violated rule 9011 of the Federal Rules of Bankruptcy Procedure.
(B) If the court finds that the attorney for the debtor violated rule 9011 of the Federal Rules of Bankruptcy Procedure, the court, on its own initiative or on the motion of a party in interest, in accordance with such procedures, may order—

(i) the assessment of an appropriate civil penalty against the attorney for the debtor; and

(ii) the payment of such civil penalty to the trustee, the United States trustee (or the bankruptcy administrator, if any).

(C) The signature of an attorney on a petition, pleading, or written motion shall constitute a certification that the attorney has—

(i) performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion; and

(ii) determined that the petition, pleading, or written motion—

(1) is well grounded in fact; and

(2) is warranted by existing law or a good faith argument for the extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1).

(D) The signature of an attorney on the petition shall constitute a certification that the attorney has no knowledge after an inquiry that the information in the schedules filed with such petition is incorrect.

(E) Except as provided in subparagraph (B) and subject to paragraph (6), the court, on its own initiative or on the motion of a party in interest, in accordance with the procedures described in rule 9011 of the Federal Rules of Bankruptcy Procedure, may award a debtor all reasonable costs (including reasonable attorneys' fees) in contesting a motion filed by a party in interest (other than a trustee or United States trustee (or bankruptcy administrator, if any)) under this subsection if—

(i) the court does not grant the motion; and

(ii) the court finds that—

(1) the position of the party that filed the motion violated rule 9011 of the Federal Rules of Bankruptcy Procedure; or

(2) the attorney (if any) who filed the motion did not comply with the requirements of clauses (i) and (ii) of paragraph (4)(C), and the motion was made solely for the purpose of coercing a debtor into waiving a right guaranteed to the debtor under this title.

(F) A small business that has a claim or an aggregate amount less than $1,000 shall not be subject to subparagraph (A)(ii)(I).

(G) For purposes of this paragraph—

(i) the term "small business" means an unincorporated business, partnership, corporation, association, or organization that—

(1) has fewer than 25 full-time employees as determined on the date on which the motion is filed; and

(2) is engaged in commercial or business activity; and

(ii) the number of employees of a wholly owned subsidiary of a corporation includes the employees of—

(A) a parent corporation; and

(B) any other subsidiary corporation of the parent corporation.

(H) Only the judge or United States trustee (or bankruptcy administrator, if any) may file a motion under section 707(b), if the current monthly income of the debtor, or in a joint case, the debtor and the debtor's spouse, as of the date of the order for relief, when multiplied by 12, is equal to or less than—

(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner.

(B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $225 per month for each individual in excess of 4.

(I) No judge, United States trustee (or bankruptcy administrator, if any), trustee, or other party in interest may file a motion under paragraph (2) if the current monthly income of the debtor, including a veteran (as that term is defined in section 101 of title 38), and the debtor's spouse combined, as of the date of the order for relief when multiplied by 12, is equal to or less than—

(1) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner.
(ii) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(iii) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $525 per month for each individual in excess of 4.

(B) In a case that is not a joint case, current monthly income of the debtor's spouse shall not be considered for purposes of subparagraph (A) if—

(i) the debtor and the debtor's spouse are separated under applicable nonbankruptcy law; or

(ii) the debtor and the debtor's spouse are living separate and apart, other than for the purpose of evading subparagraph (A); and

(iii) the debtor files a statement under penalty of perjury—

(1) specifying that the debtor meets the requirement of subclause (I) or (II) of clause (i); and

(2) disclosing the aggregate, or best estimate of the aggregate, amount of any cash or money payments received from the debtor's spouse attributed to the debtor's current monthly income.

(c) (1) In this subsection—

(A) the term "crime of violence" has the meaning given such term in section 16 of title 18; and

(B) the term "drug trafficking crime" has the meaning given such term in section 924(9)(2) of title 18.

(2) Except as provided in paragraph (2), after notice and a hearing, the court, on a motion by the victim of a crime of violence or a drug trafficking crime, may when it is in the best interest of the victim dismiss a voluntary case filed under this chapter by a debtor who is an individual if such individual was convicted of such crime.

(3) The court may not dismiss a case under paragraph (2) if the debtor establishes by a preponderance of the evidence that the filing of a case under this chapter is necessary to satisfy a claim for a domestic support obligation.

SUBCHAPTER II -- COLLECTION, LIQUIDATION, AND DISTRIBUTION OF THE ESTATE

§ 721. Authorization to operate business

The court may authorize the trustee to operate the business of the debtor for a limited period if such operation is in the best interest of the estate and consistent with the orderly liquidation of the estate.

§ 722. Redemption

An individual debtor may, whether or not the debtor has waived the right to redeem under this section, redeem tangible personal property intended primarily for personal, family, or household use, from a lien securing a dischargeable consumer debt, if such property is exempted under section 522 of this title or has been abandoned under section 554 of this title, by paying the holder of such lien the amount of the allowed secured claim of such holder that is secured by such lien in full at the time of redemption.

§ 723. Rights of partnership trustee against general partners

(a) If there is a deficiency of property of the estate to pay in full all claims which are allowed in a case under this chapter concerning a partnership and with respect to which a general partner of the partnership is personally liable, the trustee shall have a claim against such general partner to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency.

(b) To the extent practicable, the trustee shall first seek recovery of such deficiency from any general partner in such partnership that is not a debtor in a case under this title. Pending determination of such deficiency, the court may order any such partner to provide the estate with indemnity for, or assurance of payment of, any deficiency recoverable from such partner, or not to dispose of property.

(c) Notwithstanding section 728(c) of this title, the trustee has a claim against the estate of each general partner in such partnership that is a debtor in a case under this title for the full amount of all claims of creditors allowed in the case concerning such partnership. Notwithstanding section 502 of this title, there shall not be allowed in such partner's case a claim against such partner on which both such partner and such partnership are liable, except to any
(b) (1) Sections 1222(a), 1222(b), and 1223(c) of this title and the requirements of section 1225(a) of this title apply to any modification under subsection (a) of this section.

(2) The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved.

(c) A plan modified under this section may not provide for payments over a period that expires after three years after the time that the first payment under the original confirmed plan was due, unless the court, for cause, approves a longer period, but the court may not approve a period that expires after five years after such time.

(d) A plan may not be modified under this section—

(1) to increase the amount of any payment due before the plan as modified becomes the plan;

(2) by anyone except the debtor, based on an increase in the debtor's disposable income, to increase the amount of payments to unsecured creditors required for a particular month so that the aggregate of such payments exceeds the debtor's disposable income for such month; or

(3) in the last year of the plan by anyone except the debtor, to require payments that would leave the debtor with insufficient funds to carry on the farming operation after the plan is completed.

§ 1230. Revocation of an order of confirmation. [Caution: For provision that 11 USC § § 1201 et seq. are reenacted for a period ending on July 1, 2005, see § 149 of Division C of Act Oct. 21, 1998, P.L. 105-277, which appears as 11 USC § 1201 note.]

(a) On request of a party in interest at any time within 180 days after the date of the entry of an order of confirmation under section 1225 of this title, and after notice and a hearing, the court may revoke such order if such order was procured by fraud.

(b) If the court revokes an order of confirmation under subsection (a) of this section, the court shall dispose of the case under section 1207 of this title, unless, within the time fixed by the court, the debtor proposes and the court confirms a modification of the plan under section 1229 of this title.

§ 1231. Special tax provisions [Caution: For provision that 11 USC § § 1201 et seq. are reenacted for a period ending on July 1, 2005, see § 149 of Division C of Act Oct. 21, 1998, P.L. 105-277, which appears as 11 USC § 1201 note.]

(a) For the purpose of any State or local law imposing a tax on or measured by income, the taxable period of a debtor that is an individual shall terminate on the date of the order for relief under this chapter, unless the case was converted under section 706 of this title.

(b) The trustee shall make a State or local tax return of income for the estate of an individual debtor in a case under this chapter for each taxable period after the order for relief under this chapter during which the case is pending.

(e) The issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan confirmed under section 1225 of this title, may not be taxed under any law imposing a stamp tax or similar tax.

(d) The court may authorize the proponent of a plan to request a determination, limited to questions of law, by a State or local governmental unit charged with responsibility for collection or determination of a tax on or measured by income, of the tax effects, under section 346 of this title and under the law imposing such tax, of the plan. In the event of an actual controversy, the court may declare such effects after the earlier of—

(1) the date on which such governmental unit responds to the request under this subsection; or

(2) 270 days after such request.

CHAPTER 13 – ADJUSTMENT OF DEBTS OF AN INDIVIDUAL WITH REGULAR INCOME

SUBCHAPTER I – OFFICERS, ADMINISTRATION, AND THE ESTATE

§ 1301. Stay of action against codebtor
(a) Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless—

1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or

2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.

(b) A creditor may present a negotiable instrument, and may give notice of dishonor of such an instrument.

(c) On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided by subsection (a) of this section to a creditor, to the extent that—

1) as between the debtor and the individual protected under subsection (a) of this section, such individual received the consideration for the claim held by such creditor;

2) the plan filed by the debtor proposes not to pay such claim; or

3) such creditor's interest would be irreparably harmed by continuation of such stay.

(d) Twenty days after the filing of a request under subsection (c)(2) of this section for relief from the stay provided by subsection (a) of this section, such stay is terminated with respect to the party in interest making such request, unless the debtor or any individual that is liable on such debt with the debtor files and serves upon such party in interest a written objection to the taking of the proposed action.

§ 1302. Trustee

(a) If the United States trustee appoints an individual under section 586(b) of title 28 to serve as standing trustee in cases under this chapter and if such individual qualifies under section 322 of this title, then such individual shall serve as trustee in the case. Otherwise, the United States trustee shall appoint one disinterested person to serve as trustee in the case or the United States trustee may serve as a trustee in the case.

(b) The trustee shall—

1) perform the duties specified in sections 704(2), 704(3), 704(4), 704(5), 704(6), 704(7), and 704(9) of this title;

2) appear and be heard at any hearing that concerns—

   a) the value of property subject to a lien;

   b) confirmation of a plan; or

   c) modification of the plan after confirmation;

3) dispose of, under regulations issued by the Director of the Administrative Office of the United States Courts, moneys received or to be received in a case under chapter XIII of the Bankruptcy Act;

4) advise, other than on legal matters, and assist the debtor in performance under the plan; and

5) ensure that the debtor commences making timely payments under section 1326 of this title;

(b) If with respect to the debtor there is a claim for a domestic support obligation, provide the applicable notice specified in subsection (d).

(c) If the debtor is engaged in business, then in addition to the duties specified in subsection (b) of this section, the trustee shall perform the duties specified in sections 1106(a)(3) and 1106(a)(4) of this title.

(d) In a case described in subsection (b)(6) to which subsection (b)(6) applies, the trustee shall—

(A) provide written notice to the holder of the claim described in subsection (b)(6) of such claim and of the right of such holder to use the services of the State child support enforcement agency established under sections 464 and 466 of the Social Security Act for the State in which such holder resides, for assistance in collecting child support during and after the case under this title; and

(B) include in the notice provided under clause (i) the address and telephone number of such State child support enforcement agency.

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(C) at such time as the debtor is granted a discharge under section 1328, provide written notice to such holder and to such State child support enforcement agency of—

(i) the granting of the discharge;
(ii) the last recent known address of the debtor;
(iii) the last recent known name and address of the debtor's employer; and
(iv) the name of each creditor that holds a claim that—

(I) is not discharged under paragraph (2) or (4) of section 523(a); or
(II) was reaffirmed by the debtor under section 524(c).

(2) (A) The holder of a claim described in subsection (b)(6) or the State child support enforcement agency of the State in which such holder resides may request from a creditor described in paragraph (1)(C)(iv) the last known address of the debtor.

(B) Notwithstanding any other provision of law, a creditor that makes a disclosure or a last known address of a debtor in connection with a request made under subparagraph (A) shall not be liable by reason of making that disclosure.

§ 1303. Rights and powers of debtor

Subject to any limitations on a trustee under this chapter, the debtor shall have, exclusive of the trustee, the rights and powers of a trustee under sections 363(b), 363(d), 363(e), 363(f), and 363(l), of this title.

§ 1304. Debtor engaged in business

(a) A debtor that is self-employed and incurs trade credit in the production of income from such employment is engaged in business.

(b) Unless the court orders otherwise, a debtor engaged in business may operate the business of the debtor and, subject to any limitations on a trustee under sections 363(c) and 364 of this title and to such limitations or conditions as the court prescribes, shall have, exclusive of the trustee, the rights and powers of the trustee under such sections.

(c) A debtor engaged in business shall perform the duties of the trustee specified in section 704(8) of this title.

§ 1305. Filing and allowance of postpetition claims

(a) A proof of claim may be filed by any entity that holds a claim against the debtor—

(1) for taxes that become payable to a governmental unit while the case is pending; or
(2) that is a consumer debt, that arises after the date of the order for relief under this chapter, and that is for property or services necessary for the debtor’s performance under the plan.

(b) Except as provided in subsection (c) of this section, a claim filed under subsection (a) of this section shall be allowed or disallowed under section 502 of this title, but shall be determined as of the date such claim arises, and shall be allowed under section 502(a), 502(b), or 502(c) of this title, or disallowed under section 502(d) or 502(e) of this title, the same as if such claim had arisen before the date of the filing of the petition.

(c) A claim filed under subsection (a)(2) of this section shall be disallowed if the holder of such claim knew or should have known that prior approval by the trustee of the debtor’s incurring the obligation was practicable and was not obtained.

§ 1306. Property of the estate

(a) Property of the estate includes, in addition to the property specified in section 541 of this title—

(1) all property of the kind specified in such section that the debtor acquires after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, er-11, or 12 of this title, whichever occurs first; and
(2) Earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted to a case under chapter 7, 11, or 12 of this title, whichever occurs first.

(b) Except as provided in a confirmed plan or order confirming a plan, the debtor shall remain in possession of all property of the estate.

§ 1307. Conversion or dismissal

(a) The debtor may convert a case under this chapter to a case under chapter 7 of this title at any time. Any waiver of the right to convert under this subsection is unenforceable.

(b) On request of the debtor at any time, if the case has not been converted under section 706, 1112, or 1208 of this title, the court shall dismiss a case under this chapter. Any waiver of the right to dismiss under this subsection is unenforceable.

(c) Except as provided in subsection (e) of this section, on request of a party in interest or the United States trustee and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 7 of this title, or may dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause, including—

(1) unreasonable delay by the debtor that is prejudicial to creditors;
(2) nonpayment of any fees and charges required under chapter 123 of title 28;
(3) failure to file a plan timely under section 1321 of this title;
(4) failure to commence making timely payments under section 1326 of this title;
(5) denial of confirmation of a plan under section 1325 of this title and denial of a request made for additional time for filing another plan or a modification of a plan;
(6) material default by the debtor with respect to a term of a confirmed plan;
(7) revocation of the order of confirmation under section 1330 of this title, and denial of confirmation of a modified plan under section 1329 of this title;
(8) termination of a confirmed plan by reason of the occurrence of a condition specified in the plan other than completion of payments under the plan;
(9) only on request of the United States trustee, failure of the debtor to file, within fifteen days, or such additional time as the court may allow, after the filing of the petition commencing such case, the information required by paragraph (1) of section 521; or
(10) only on request of the United States trustee, failure to timely file the information required by paragraph (2) of section 521; or
(11) failure of the debtor to pay any domestic support obligation that first becomes payable after the date of the filing of the petition.

(d) Except as provided in subsection (e) of this section, at any time before the confirmation of a plan under section 1325 of this title, on request of a party in interest or the United States trustee and after notice and a hearing, the court may convert a case under this chapter to a case under chapter 11 or 12 of this title.

(e) Upon the failure of the debtor to file a tax return under section 1308, on request of a party in interest or the United States trustee and after notice and a hearing, the court shall dismiss a case or convert a case under this chapter to a case under chapter 7 of this title, whichever is in the best interest of the creditors and the estate.

(f) The court may not convert a case under this chapter to a case under chapter 7, 11, or 12 of this title if the debtor is a farmer, unless the debtor requests such conversion.

(g) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

§ 1308. Filing of prepetition tax returns
(a) Not later than the day before the date on which the meeting of the creditors is first scheduled to be held under section 341(a), if the debtor was required to file a tax return under applicable nonbankruptcy law, the debtor shall file with appropriate tax authorities all tax returns for all taxable periods ending during the 4-year period ending on the date of the filing of the petition.

(b) (1) Subject to paragraph (2), if the tax returns required by subsection (a) have not been filed by the date on which the meeting of creditors is first scheduled to be held under section 341(a), the trustee may hold open that meeting for a reasonable period of time to allow the debtor an additional period of time to file any unfilled returns, but such additional period of time shall not extend beyond—

   (A) for any return that is past due as of the date of the filing of the petition, the date that is 120 days after the date of that meeting; or

   (B) for any return that is not past due as of the date of the filing of the petition, the later of—

   (i) the date that is 120 days after the date of that meeting; or

   (ii) the date on which the return is due under the last automatic extension of time for filing that return to which the debtor is entitled, and for which request is timely made, in accordance with applicable nonbankruptcy law.

   (2) After notice and a hearing, and order entered before the filing of any applicable filing period determined under this subsection, if the debtor demonstrates by a preponderance of the evidence that the failure to file a return, as required under this subsection is attributable to circumstances beyond the control of the debtor, the court may extend the filing period established by the trustee under this subsection for—

   (A) a period of not more than 30 days for returns described in paragraph (1); and

   (B) a period not to extend after the applicable extended due date for a return described in paragraph (2).

(c) For purposes of this section, the term "return" includes a return prepared pursuant to subsection (a) or (b) of section 6020 of the Internal Revenue Code of 1986, or a similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal.

SUBCHAPTER II - THE PLAN

§ 1321. Filing of plan
The debtor shall file a plan.

§ 1322. Contents of plan
(a) The plan shall—

   (1) provide for the submission of all or such portion of future earnings or other future income of the debtor to the supervision and control of the trustee as is necessary for the execution of the plan;

   (2) provide for the full payment, in deferred cash payments, of all claims entitled to priority under section 507 of this title, unless the holder of a particular claim agrees to a different treatment of such claim; and

   (3) if the plan classifies claims, provide the same treatment for each claim within a particular class; and

   (4) notwithstanding any other provision of this section, a plan may provide for less than full payment of all amounts owed for a claim entitled to priority under section 507(a)(1)(B) only if the plan provides that all of the debtor's projected disposable income for a 5-year period beginning on the date that the first payment is due under the plan will be applied to make payments under the plan.

(b) Subject to subsections (a) and (c) of this section, the plan may—

   (1) designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated; however, such plan may treat claims for consumer debt of the debtor if an individual is liable on such consumer debt with the debtor differently than other unsecured claims;

   (2) modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims;

   (3) provide for the curing or waiving of any default;

   (4) provide for the discharge of any debt or claims held by the debtor for the payment of which any property other than a security interest in real property that is the debtor's principal residence is held by a secured creditor; and

   (5) provide for the discharge of all or any portion of the debtor's legal obligations that is not in a lien or charge on property of the debtor that is claimed or subject to a security interest in real property that is the debtor's principal residence.
(4) provide for payments on any unsecured claim to be made concurrently with payments on any secured claim or any other unsecured claim;
(5) notwithstanding paragraph (2) of this subsection, provide for the curing of any default within a reasonable time and maintenance of payments while the case is pending on any unsecured claim or secured claim on which the last payment is due after the date on which the final payment under the plan is due;
(6) provide for the payment of all or any part of any claim allowed under section 1305 of this title;
(7) subject to section 365 of this title, provide for the assumption, rejection, or assignment of any executory contract or unexpired lease of the debtor not previously rejected under such section;
(8) provide for the payment of all or part of a claim against the debtor from property of the estate or property of the debtor;
(9) provide for the vesting of property of the estate, on confirmation of the plan or at a later time, in the debtor or in any other entity; and
(10) provide for the payment of interest accruing after the date of the filing of the petition on unsecured claims that are nondischargeable under section 1328(a), except that such interest may be paid only to the extent that the debtor has disposable income available to pay such interest after making provision for full payment of all allowed claims; and
(11) include any other appropriate provision not inconsistent with this title.

(c) Notwithstanding subsection (b)(2) and applicable nonbankruptcy law--
(1) a default with respect to, or that gave rise to, a lien on the debtor's principal residence may be cured under paragraph (3) or (5) of subsection (b) until such residence is sold at a foreclosure sale that is conducted in accordance with applicable nonbankruptcy law; and
(2) in a case in which the last payment on the original payment schedule for a claim secured or unsecured by a security interest in real property that is the debtor's principal residence is due before the date on which the final payment under the plan is due, the plan may provide for the payment of the claim as modified pursuant to section 1325(a)(5) of this title.

(d) The (1) if the current monthly income of the debtor and the debtor's spouse combined, when multiplied by 12, is not less than--
   (A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;
   (B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or
   (C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $925 per month for each individual in excess of 4, the plan may not provide for payments over a period that is longer than three years, unless the court, for cause, approves a longer period; and
   (2) if the current monthly income of the debtor and the debtor's spouse combined, when multiplied by 12, is less than--
   (A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;
   (B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or
   (C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $925 per month for each individual in excess of 4, the plan may not provide for payments over a period that is longer than three years, unless the court, for cause, approves a longer period, but the court may not approve a period that is longer than five years.

(e) Notwithstanding subsection (b)(2) of this section and sections 506(b) and 1325(a)(5) of this title, if it is proposed in a plan to cure a default, the amount necessary to cure the default, shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law.

(f) A plan may not materially alter the terms of a loan described in section 362(b)(19) and any amounts required to repay such loan shall not constitute "disposable income" under section 1325.

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Preliminary Draft – Subject to Revision
§ 1323. Modification of plan before confirmation

(a) The debtor may modify the plan at any time before confirmation, but may not modify the plan so that the plan as modified fails to meet the requirements of section 1322 of this title.

(b) After the debtor files a modification under this section, the plan as modified becomes the plan.

(c) Any holder of a secured claim that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder's previous acceptance or rejection.

§ 1324. Confirmation hearing

After(a) Except as provided in subsection (b) and after notice, the court shall hold a hearing on confirmation of the plan. A party in interest may object to confirmation of the plan.

(b) The hearing on confirmation of the plan may be held not earlier than 20 days and not later than 45 days after the date of the meeting of creditors under section 341(a), unless the court determines that it would be in the best interests of the creditors and the estate to hold such hearing at an earlier date and there is no objection to such earlier date.

§ 1325. Confirmation of plan

(a) Except as provided in subsection (b), the court shall confirm a plan if--

(1) the plan complies with the provisions of this chapter and with the other applicable provisions of this title;

(2) any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;

(3) the plan has been proposed in good faith and not by any means forbidden by law;

(4) the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;

(5) with respect to each allowed secured claim provided for by the plan--

(A) the holder of such claim has accepted the plan;

(B) (i) the plan provides that--

(1) the holder of such claim retain the lien securing such claim until the earlier of--

(aa) the payment of the underlying debt determined under nonbankruptcy law; or

(bb) discharge under section 1328; and

(II) if the case under this chapter is dismissed or converted without completion of the plan, such lien shall also be retained by such holder to the extent recognized by applicable nonbankruptcy law; and

(ii) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; and

(iii) if--

(1) property to be distributed pursuant to this subsection is in the form of periodic payments, such payments shall be in equal monthly amounts; and

(II) the holder of the claim is secured by personal property, the amount of such payments shall not be less than an amount sufficient to provide to the holder of such claim adequate protection during the period of the plan; or

(C) the debtor surrenders the property securing such claim to such holder; and

(6) the debtor will be able to make all payments under the plan and to comply with the plan;

(7) the action of the debtor in filing the petition was in good faith;

(b) A party in interest may object to confirmation of the plan.

(c) After the debtor files a modification under this section, the plan as modified becomes the plan.

(d) Any holder of a secured claim that has accepted or rejected the plan is deemed to have accepted or rejected, as the case may be, the plan as modified, unless the modification provides for a change in the rights of such holder from what such rights were under the plan before modification, and such holder changes such holder's previous acceptance or rejection.
(9) the debtor has filed all applicable Federal, State, and local tax returns as required by section 1308.

For purposes of paragraph (5), section 506 shall not apply to a claim described in that paragraph if the creditor has a purchase money security interest securing the debt that is the subject of the claim, the debt was incurred within the 910-day period preceding the date of the filing of the petition, and the collateral for that debt consists of a motor vehicle (as defined in section 30102 of title 49) acquired for the personal use of the debtor, or if collateral for that debt consists of any other thing of value, if the debt was incurred during the 1-year period preceding that filing.

(b) (1) If the trustee or the holder of an allowed unsecured claim objects to the confirmation of the plan, then the court may not approve the plan unless, as of the effective date of the plan—

(A) the value of the property to be distributed under the plan on account of such claim is not less than the amount of such claim; or

(B) the plan provides that all of the debtor's projected disposable income to be received in the three-year applicable commitment period beginning on the date that the first payment is due under the plan will be applied to make payments to unsecured creditors under the plan.

(2) For purposes of this subsection, the term "disposable income" means current monthly income which is received by the debtor and which is not received by the debtor (other than child support payments, foster care payments, or disability payments for a dependent child made in accordance with applicable nonbankruptcy law to the extent reasonably necessary to be expended for such child) less amounts reasonably necessary to be expended—

(A)(i) for the maintenance or support of the debtor or a dependent of the debtor, including for a domestic support obligation, that first becomes payable after the date the petition is filed; and

(ii) for charitable contributions (that meet the definition of "charitable contribution" under section 548(d)(3)) to a qualified religious or charitable entity or organization (as that term is defined in section 548(d)(4)) in an amount not to exceed 15 percent of the gross income of the debtor for the year in which the contributions are made; and

(B) if the debtor is engaged in business, for the payment of expenditures necessary for the continuation, preservation, and operation of such business.

(3) Amounts reasonably necessary to be expended under paragraph (2) shall be determined in accordance with subparagraphs (A) and (B) of section 707(b)(2), if the debtor has current monthly income, when multiplied by 12, greater than—

(A) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(B) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(C) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $525 per month for each individual in excess of 4.

(4) For purposes of this subsection, the "applicable commitment period"—

(A) subject to subparagraph (B), shall be—

(i) 3 years; or

(ii) not less than 5 years, if the current monthly income of the debtor and the debtor's spouse combined, when multiplied by 12, is not less than—

(I) in the case of a debtor in a household of 1 person, the median family income of the applicable State for 1 earner;

(II) in the case of a debtor in a household of 2, 3, or 4 individuals, the highest median family income of the applicable State for a family of the same number or fewer individuals; or

(III) in the case of a debtor in a household exceeding 4 individuals, the highest median family income of the applicable State for a family of 4 or fewer individuals, plus $525 per month for each individual in excess of 4; and

(B) may be less than 3 or 5 years, whichever is applicable under subparagraph (A), but only if the plan provides for payment in full of all allowed unsecured claims over a shorter period.

(c) After confirmation of a plan, the court may order any entity from whom the debtor receives income to pay all or any part of such income to the trustee.

§ 1326. Payments
(a) (1) Unless the court orders otherwise, the debtor shall commence making the payments proposed by a plan within 30 days after the plan is filed or not later than 30 days after the date of the filing of the plan or the order for relief, whichever is earlier, in the amount--
   (A) proposed by the plan to the trustee;
   (B) scheduled in a lease of personal property directly to the lessor for that portion of the obligation that becomes due after the order for relief reduced by the amounts under subparagraph (A) by the amount so paid and providing the lessor with evidence of such payment, including the amount and date of payment; and
   (C) that provides adequate protection directly to a creditor holding an allowed claim secured by personal property to the extent the claim is attributable to the purchase of such property by the debtor for that portion of the obligation that becomes due after the order for relief reduced by the amounts under subparagraph (A) by the amount so paid and providing the creditor with evidence of such payment, including the amount and date of payment.

(2) A payment made under this subsection paragraph (1)(A) shall be retained by the trustee until confirmation or denial of confirmation of a plan. If a plan is confirmed, the trustee shall distribute any such payment in accordance with the plan as soon as is practicable. If a plan is not confirmed, the trustee shall return any such payment not previously paid and not yet due and owing to creditors pursuant to paragraph (3) to the debtor, after deducting any unpaid claim allowed under section 503(b) of this title.

(3) Subject to section 363, the court may, upon notice and a hearing, modify, increase or reduce the payments required under this subsection pending confirmation of a plan.

(4) Not later than 60 days after the date of filing of a case under this chapter, a debtor retaining possession of personal property subject to a lease or securing a claim attributable in whole or in part to the purchase price of such property shall provide the lessor or secured creditor reasonable evidence of the maintenance of any required insurance coverage with respect to the use or ownership of such property and continue to do so for so long as the debtor retains possession of such property.

(b) Before or at the time of each payment to creditors under the plan, there shall be paid--
   (1) any unpaid claim of the kind specified in section 507(a)(6) of this title; and
   (2) if a standing trustee appointed under section 586(b) of title 28 is serving in the case, the percentage fee fixed for such standing trustee under section 586(e)(1)(B) of title 28; and

   (3) if a chapter 7 trustee has been allowed compensation due to the conversion or dismissal of the debtor's prior case pursuant to section 707(b), and some portion of that compensation remains unpaid in a case converted to this chapter or in the case dismissed under section 707(b) and refiled under this chapter, the amount of any such unpaid compensation, which shall be paid monthly--
      (A) by prorating such amount over the remaining duration of the plan; and
      (B) by monthly payments not to exceed the greater of--
         (i) $25; or
         (ii) the amount payable to unsecured nonpriority creditors, as provided by the plan, multiplied by 5 percent, and the result divided by the number of months in the plan.

(c) Except as otherwise provided in the plan or in the order confirming the plan, the trustee shall make payments to creditors under the plan.

(d) Notwithstanding any other provision of this title--
   (1) compensation referred to in subsection (b)(3) is payable and may be collected by the trustee under that paragraph, even if such amount has been discharged in a prior case under this title; and
   (2) such compensation is payable in a case under this chapter only to the extent permitted by subsection (b)(2).

§ 1327. Effect of confirmation

(a) The provisions of a confirmed plan bind the debtor and each creditor, whether or not the claim of such creditor is provided for by the plan, and whether or not such creditor has objected to, has accepted, or has rejected the plan.

(b) Except as otherwise provided in the plan or in the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor.
(c) Except as otherwise provided in the plan or in the order confirming the plan, the property vesting in the debtor under subsection (b) of this section is free and clear of any claim or interest of any creditor provided for by the plan.

§ 1328. Discharge

(a) As Subject to subsection (d), as soon as practicable after completion by the debtor of all payments under the plan, and in the case of a debtor who is required by a judicial or administrative order, or by statute, to pay a domestic support obligation, after such debtor certifies that all amounts payable under such order or such statute that are due on or before the date of the certification (including amounts due before the petition was filed, but only to the extent provided for by the plan) have been paid unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt--

1. provided for under section 1322(b)(5) of this title;
2. of the kind specified in section 507(a)(4)(D) or in paragraph (1)(B), (1)(C), (2), (3), (4), (5), (8), or (9) of section 523(a), or 523(a)(9) of this title, or
3. for restitution, or a criminal fine, included in a sentence on the debtor's conviction of a crime; or
4. for restitution, or damages, awarded in a civil action against the debtor as a result of willful or malicious injury by the debtor that caused personal injury to an individual or the death of an individual.

(b) As Subject to subsection (d), at any time after the confirmation of the plan and after notice and a hearing, the court may grant a discharge to a debtor that has not completed payments under the plan only if--

1. the debtor's failure to complete such payments is due to circumstances for which the debtor should not justly be held accountable;
2. the value, as of the effective date of the plan, of property actually distributed under the plan on account of each allowed unsecured claim is not less than the amount that would have been paid on such claim if the estate of the debtor had been liquidated under chapter 7 of this title on such date; and
3. modification of the plan under section 1329 of this title is not practicable.

(c) A discharge granted under subsection (b) of this section discharges the debtor from all unsecured debts provided for by the plan or disallowed under section 502 of this title, except any debt--

1. provided for under section 1322(b)(5) of this title; or
2. of a kind specified in section 523(a) of this title.

(d) Notwithstanding any other provision of this section, a discharge granted under this section does not discharge the debtor from any debt based on an allowed claim filed under section 1305(a)(2) of this title if prior approval by the trustee of the debtor's incurring such debt was practicable and was not obtained.

(e) On request of a party in interest before one year after a discharge under this section is granted, and after notice and a hearing, the court may revoke such discharge only if--

1. such discharge was obtained by the debtor through fraud; and
2. the requesting party did not know of such fraud until after such discharge was granted.

(f) Notwithstanding subsections (a) and (b), the court shall not grant a discharge of all debts provided for in the plan or disallowed under section 502, if the debtor has received a discharge--

1. in a case filed under chapter 7, 11, or 12 of this title during the 4-year period preceding the date of the order for relief under this chapter, or
2. in a case filed under chapter 13 of this title during the 2-year period preceding the date of such order.

(g) (1) The court shall not grant a discharge under this section to a debtor unless after filing a petition the debtor has completed an instructional course concerning personal financial management described in section 111.

(2) Paragraph (1) shall not apply with respect to a debtor who is a person described in section 109(h)(4) or who resides in a district for which the United States trustee (or the bankruptcy administrator, if any) determines that the United States trustee (if any) determines that the
approved instructional courses are not adequate to service the additional individuals who would otherwise be required to complete such instructional course by reason of the requirements of paragraph (1).

(3) The United States trustee (or the bankruptcy administrator, if any) who makes a determination described in paragraph (2) shall review such determination not later than 1 year after the date of such determination, and not less frequently than annually thereafter.

(b) The court may not grant a discharge under this chapter unless the court after notice and a hearing held not more than 10 days before the date of the entry of the order granting the discharge finds that there is no reasonable cause to believe that—

(1) section 522(q)(1) may be applicable to the debtor; and
(2) there is pending any proceeding in which the debtor may be found guilty of a felony of the kind described in section 522(q)(1)(A) or liable for a debt of the kind described in section 522(q)(1)(B).

§ 1329. Modification of plan after confirmation

(a) At any time after confirmation of the plan but before the completion of payments under such plan, the plan may be modified, upon request of the debtor, the trustee, or the holder of an allowed unsecured claim, to—

(1) increase or reduce the amount of payments on claims of a particular class provided for by the plan;
(2) extend or reduce the time for such payments; or
(3) alter the amount of the distribution to a creditor whose claim is provided for by the plan to the extent necessary to take account of any payment of such claim other than under the plan; or
(4) reduce amounts to be paid under the plan by the actual amount expended by the debtor to purchase health insurance for the debtor (and for any dependent of the debtor if such dependent does not otherwise have health insurance coverage) if the debtor documents the cost of such insurance and demonstrates that—

A such expenses are reasonable and necessary:

B (i) if the debtor previously paid for health insurance, the amount is not materially larger than the cost the debtor previously paid or the cost necessary to maintain the lapsed policy; or
(ii) if the debtor did not have health insurance, the amount is not materially larger than the reasonable cost that would be incurred by a debtor who purchases health insurance, who has similar income, expenses, age, and health status, and who lives in the same geographical location with the same number of dependents who do not otherwise have health insurance coverage; and
C the amount is not otherwise allowed for purposes of determining disposable income under section 1325(b) of this title;

and upon request of any party in interest, files proof that a health insurance policy was purchased.

(b) (1) Sections 1322(a), 1322(b), and 1323(c) of this title and the requirements of section 1325(a) of this title apply to any modification under subsection (a) of this section.

(2) The plan as modified becomes the plan unless, after notice and a hearing, such modification is disapproved.

(c) A plan modified under this section may not provide for payments over a period that expires after three years of the applicable commitment period under section 1325(b)(1)(B) after the time that the first payment under the original confirmed plan was due, unless the court, for cause, approves a longer period, but the court may not approve a period that expires after five years after such time.

§ 1330. Revocation of an order of confirmation

(a) On request of a party in interest at any time within 180 days after the date of the entry of an order of confirmation under section 1325 of this title, and after notice and a hearing, the court may revoke such order if such order was procured by fraud.

(b) If the court revokes an order of confirmation under subsection (a) of this section, the court shall dispose of the case under section 1307 of this title, unless, within the time fixed by the court, the debtor proposes and the court confirms a modification of the plan under section 1329 of this title.
The Five "Means Test" Questions
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I. Is CMI x 12 ≤ Median?
   Yes
   No

II. Is NMI < $100.00?
   Yes
   No
   Special Circumstances?

III. Is NMI ≥ $166.67?
   Yes
   No

IV. Is NMI x 60 ≥ 25% GUC's?
   Yes
   No

No Presumption

Abuse Presumed
Is the debt a PMSI?

Yes

Is the collateral a "motor vehicle" per 49 USC 30102(a)(6)?

No

Is the collateral "any other thing of value"?

No

Was the motor vehicle acquired for the personal use of the debtor?

Yes

Was the debt incurred within 910 days preceding the petition date?

Yes

Section 506 does not apply to determine amount of secured claim.

No

Was the debt incurred within 1 year preceding the petition date?

Yes

"Cram-down" (as to valuation of collateral) under section 506 is allowed.

No

"CRAM-DOWN" FLOWCHART:
DOES SECTION 506 APPLY?
BY:
Beverly M. Burden
Chapter 13 Trustee, EDKY

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NEW DEFINITION OF WHO MAY BE A DEBTOR:

New §109 (attached)

- §109(a) – no changes
- §109(b) – minor changes – foreign banks and certain foreign insurance companies can be debtors
- §109(c) – (e) – no changes
- §109(f) – family fishermen can now file chapter 12 bankruptcy
- §109(g) – no changes
- §109(h) – entirely new section
  - §109(h)(1) – individual cannot be a debtor unless they have received a briefing from an approved nonprofit credit counseling agency within 180 days prior to filing bankruptcy. This counseling:
    - must outline available credit counseling
    - must assist the individual in analyzing their budget
    - can be in a group setting
    - can be by telephone
    - can be over the internet
  - §109(h)(2)(A) – there is an exception if the US Trustee or BA declare that no agency in the district is able to provide adequate counseling
  - §109(h)(2)(B) – The US Trustee or BA approves the agencies and must review their approvals annually, but may disapprove an agency at any time.
  - §109(h)(3)(A) – Short term exception if debtor files a certification:
    - showing exigent circumstances exist that merit waiver, or
    - showing that debtor requested but was not able to obtain counseling for 5 days after the request was made, and
    - that is satisfactory to the court
• §109(h)(3)(B) – If debtor uses the above short term exception, they still must comply and get the counseling within 30 days (or 45 with a court ordered extension) after filing for bankruptcy.

• §109(h)(4) – The only real exception is if, after notice and a hearing, the court determines that the debtor is:
  - so incapacitated that they cannot make rational decisions regarding finances, or
  - so disabled they are unable to receive the counseling in person, by phone or over the internet, or
  - in active duty in a military combat zone

NEW NOTICING PROVISIONS:

New §342 (attached)

• §342(a) – No change -- notice of entry of order for relief

• §342(b) - Before case is filed, clerk has to give notice of chapters – including:
  - the purpose, benefits and costs of proceeding under each chapter
  - the types of services that are available from credit counseling agencies
  - warning that false statements or concealing assets is grounds for a fine or imprisonment or both
  - warning that all information “supplied by a debtor” in a case may be examined by the Attorney General

• §342(c)(1) - If notice is required to be given “by the debtor” to a creditor, the notice must contain the debtor name, address and last 4 digits of the SSN

• §342(c)(2) – If creditor sends 2 notices during 90 days prior to bankruptcy with account number and with address which creditor requests to receive correspondence, then any notice required to be sent “by the debtor” must be sent to this address and must include the account number
• §342(c)(2) – if creditor can't send 2 notices during 90 days prior to bankruptcy due to nonbankruptcy law, then last 2 notices before the 90 days must be reviewed to see if they have an account number and an address which creditor requests to receive correspondence at, then any notice required to be sent “by the debtor” must be sent to this address and must include the account number.

• §342(c)(2) – if the notice is due to an amendment adding a creditor, “the debtor” must include the full SSN in the notice sent to the creditor, but must include only the last 4 digits of the SSN in the copy filed with the court.

• §342(d) – If the debtor “flunks” the “means test”, then, not later than 10 days after the Ch. 7 petition is filed, the clerk’s office must send notice to all creditors that it is presumed that the debtor is abusing the bk laws by filing chapter 7.

• §342(e) – In a 7 or 13, a creditor may at any time file a notice with the court and debtor of an address to be used for the creditor in that case.
  
  - Six days later, the court and debtor/debtor's attorney must be using the new address for mailings.

• §342(f) - Creditor can give any court a preferred address(es) to use for noticing including a specific subdivision and/or a specific person's attention
  
  - Address can be national for all notices and all bk courts
  
  - Address can be regional for notices in that area
  
  - Address can be by district/court for cases filed in that area
    
    - 31 days later, notices must go to correct address(es)
    
    - Specific case addresses trump a national/regional/etc. address
    
    - Version 2.7 is changing CM/ECF so that when a party pulls up a creditor list, the system will check with the BNC to see if there is a preferred address on file and a pdf document will be returned momentarily with address labels with the correct addresses substituted (except for case specific ones). The BNC's computer will do a comparison, and, if in doubt, the notice goes to both the address provided by the debtor and the preferred address.
➢ When a preferred address request is made to our court, we will either direct the creditor to the BNC website or phone number or we will forward the request to the BNC.

➢ The creditor will be able to sign up directly on-line at the BNC website.

➢ Once the BNC is aware of the request, they will contact the creditor regarding electronic noticing alternatives (EBN).

➢ Available EBN alternatives include EDt (the BNC computer talks to the creditor computer). Also, e-mail or fax noticing are available.

- §342(f) – The creditor can withdraw the preferred address

- §342(g) – If debtor or the court sends a notice and it doesn’t comply with creditor request, then it is ineffective until brought to creditor’s attention.

➢ Until the specific person or subdivision designated receives the notice, it will not have been brought to the creditor’s attention.

➢ What are the consequences if the notice is ineffective?

  ▪ If it is a notice that an order for relief has been entered, the creditor can violate the automatic stay without fear of any monetary penalties.

  ▪ For other notices, §342 is silent as to the consequences.

New FRBP 2002(g) is effective 12/1/05 (attached)

- FRBP 2002(g)(1):

  ➢ 2002 notices must be addressed as last requested in the case by the entity

  ➢ A proof of claim is a request unless it is filed in a no-asset case

  ➢ A proof of interest filed by an equity security holder is a request

  ➢ Other than those two listed items, it is unclear in both the code and the amended FRBP what exactly constitutes a request

- FRBP 2002(g)(2) – If no request is made, then notice will be sent to creditor as listed on the creditor matrix or debtor’s schedules (whichever is filed later) or as listed on the list of equity security holders.
• FRBP 2002(g)(3) – notice will be sent to both the legal representative of an infant or incompetent as listed in schedules and to the requested address unless the legal representative is the one who made the address change request.

• §342(g)(4) – The entity and an AO approved notice provider (BNC) can agree as to where and how notice will be supplied and that will be the proper means to provide notice.
  ➢ Even if the BNC then doesn’t use the agreed upon procedure (such as a form of EBN), the notice is not invalidated.

NOTE: The Advisory Committee on Bankruptcy Rules has determined that the Act and the rule changes are different and can co-exist (5/10-11/05 Bankruptcy Noticing Working Group minutes)

NEW DEBTOR (DEBTOR ATTORNEY) DUTIES:

New §521 (attached)

• §521(a)(1) – Debtor must file the following:
  ➢ a list of creditors,
  ➢ a schedule of assets and liabilities,
  ➢ a schedule of current income and expenses,
  ➢ a statement of financial affairs, and
  ➢ if debtor is an individual with primarily consumer debts, a certificate showing:
    ▪ that the attorney/petition preparer delivered the §342(b) Clerk’s Notice (re: available chapters, etc.) to the debtor,
    or
    ▪ if pro se, that the debtor received the §342(b) Clerk’s Notice and read it
  ➢ copies of all payment “advices” or other evidence of payment by all employers of debtor for 60 days prior to filing date
  ➢ an itemized statement showing calculations of monthly net income
➢ a statement disclosing any expected increase in income or increase in expenses during 12 months after bankruptcy is filed

• §521(a)(2)(A) – if an individual’s schedules show debts of any kind (used to be just consumer), which are secured by property of the estate, the debtor must file a statement of his intention with regard to the property by the 341 meeting or within 30 days after filing (whichever is earlier)

• §521(a)(2)(B) – by 30 days after the “date first set” for the meeting of creditors (or longer if request is made and granted prior to 30 days expiring), debtor must perform his stated intentions

• §521(a)(2)(C) – Debtors and trustees still retain their rights with regard to the property, but automatic stay is terminated if debtor fails to perform the above 2 steps unless:
  ➢ the trustee proves the property has consequential value to the estate and adequate protection is provided to the creditor, or
  ➢ the debtor tries to reaffirm and the creditor refuses

• §521(a)(3) – debtor must cooperate with trustee or auditor (if appointed) to enable them to perform their duties

• §521(a)(4) – debtor must turnover all records, documents and papers relating to the estate to a trustee or auditor (if appointed) regardless of whether immunity has been granted

• §521(a)(5) – debtor must appear at a discharge hearing (if held) and at a hearing regarding entering into a Reaffirmation Agreement (if debtor is pro se)

• §521(a)(6) – debtor must turnover any personal property secured by a PMSI within 45 days after the meeting of creditors (code doesn’t indicate if it is the date first set or the conclusion) unless they have entered into a reaffirmation agreement or redeemed the property. If debtor fails to act within the 45 days, then the stay is terminated unless the trustee proves the property has consequential value to the estate and adequate protection is provided to the creditor.

• §521(a)(7) – unless a trustee has been appointed, the debtor must continue to perform the obligations required of an ERISA administrator for any employee benefit plan if they or their designee were serving as the administrator at the time the case was filed.

• §521(b) – an individual debtor must file with the court:
a certificate from the approved credit counseling agency that
describes the services provided to the debtor, and
a copy of any debt repayment plan developed during the
counseling

• §521(c) – debtor must file a record of any interest the debtor has in:
  an education IRA, or
  a qualified state tuition program

• §521(d) –if the debtor fails to timely take any of the actions previously
  mentioned, or to assume the lease as referred to in §362(h), then, if the
  original lease or agreement entered into by the debtor contains a clause
  that states that filing bankruptcy is a default under the lease/agreement,
  then nothing in this subsection limits the enforcement of such a provision.

• §521(e)(1) – states that creditor can get copies of petition, schedules, etc.

• §521(e)(2)(A) – at least 7 days prior to the "date first set" for the meeting
  of creditors, a debtor must give:

  the trustee a copy of the most recent income tax return that the
  debtor filed prior to filing bankruptcy or a transcript of the return, and

  at the same time, must give a copy of the return/transcript to any
  creditor who has requested one

• §521(e)(2)(B) – case will be dismissed if debtor doesn’t provide tax
  return/transcript to trustee unless it is due to circumstances beyond the
  debtor’s control

• §521(e)(2)(C) – case will be dismissed if debtor doesn’t provide tax
  return/transcript to requesting creditor at same time it is provided to
  trustee unless it is due to circumstances beyond the debtor’s control

• §521(e)(3) – within 5 days of a request by a creditor, court must provide a
  copy of the Ch. 13 plan for a reasonable cost

• §521(f)(1) – (3) – in all cases (except Ch. 12), at the request (not
  automatically) of the court, the US Trustee, or any party in interest, the
  debtor must file with the court:

  each federal income tax return/transcript required by applicable
  law and filed with the taxing authority for each tax year that ends
  while a case is pending.
➢ each federal income tax return/transcript **required** by applicable law for each tax year that ended 3 years prior to bankruptcy which had not been filed before the bankruptcy but is filed with the taxing authority during the bankruptcy.

➢ any amendments to the above tax returns

• §521(f)(4) – a Ch. 13 debtor must file a statement under penalty of perjury of the income and expenses from the tax year just ended, and a statement of monthly income showing how month income and expenses were calculated within:

➢ 90 days after the first tax year ends (or up to 1 year after the case is filed if there has been no plan confirmed yet), and

➢ annually, after the plan is confirmed, until the case is closed

  ▪ The annual statements must be filed 45 days before the anniversary of the confirmation date.

• §521(g)(1) – the statements referred to above must disclose:

  ➢ the amount and sources of income

  ➢ the identity of persons who are also responsible for the support of any dependent of the debtor

  ➢ the identity of any person who contributed to the household in which the debtor resides and the amount they contributed

• §521(g)(2) – the tax returns/transcripts, amended returns/transcripts, and statements referred to above can be inspected and copied by the US Trustee or BA, the trustee, and any party in interest subject to privacy limitations

• §521(h) – if requested by US Trustee or trustee, a debtor must provide documentation establishing their identity

• §521(i)(1) – if the debtor does not file the documentation required by §521(a)(1) within 45 days, on the 46th day, the case will be automatically dismissed without following the normal §707(a) procedure of having notice and a hearing first

• §521(i)(2) – even though the case was automatically dismissed, any party in interest may request that an Order of Dismissal be entered and the court must do so within 5 days of the request
• §521(i)(3) – if the debtor requests an extension before the 45 days have expired, the court may grant the debtor up to an additional 45 days to file the required documents if it is justified

• §521(i)(4) – if a trustee files a motion requesting that the case not be dismissed before the 45 days have expired, the court, after notice and a hearing, may decline to dismiss the case if:

  ➢ the court finds the debtor made a good faith attempt to provide the documents, and

  ➢ it is in the best interest of the creditors to administer the case

• §521(j)(1) – if the debtor doesn’t stay current on filing tax returns/extensions that become due after the bankruptcy is filed, the taxing authority can request that the case be converted or dismissed

• §521(j)(2) – if the debtor still isn’t current on filing tax returns/extensions within 90 days after the taxing authority requests dismissal or conversion, the court will determine what is in the best interest of the creditors and then convert or dismiss the case

**NEW US TRUSTEE AND CASE TRUSTEE DUTIES:**

New §704 (attached)

• §704(a)(1) – (9) – Unchanged

• §704(a)(10) – if someone has a claim against the debtor for domestic support obligations, the trustee must provide a detailed notice. (The requirements for this notice are described further down in the materials under §704(c))

• §704(a)(11) – the trustee must perform the obligations required of an ERISA administrator for any employee benefit plan if the debtor or a designee of the debtor was serving as the administrator at the time the case was filed.

• §704(a)(12) – if the debtor is a health care business that is closing, the trustee must use their best efforts to transfer patients to an alternate health care facility that:

  ➢ is in the vicinity of the one closing, and

  ➢ provides substantially similar services, and
Can these expenditures be deducted in determining the debtor's disposable income if the debtor's "Current Monthly Income" is less than Median Family Income? (applying present case law of the 6th Circuit and local bankruptcy court rulings, which presumably will continue to be controlling the absence of statutory amendments) | if the debtor's "Current Monthly Income" is more than Median Family Income? (applying § 707(b)(2) "means test" expenses as required under amended § 1325(b)(3))

<table>
<thead>
<tr>
<th>Expenditure</th>
<th>Less than Median Family Income</th>
<th>More than Median Family Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Charitable contributions</td>
<td>Yes (with limits)</td>
<td>Unclear, but arguably no</td>
</tr>
<tr>
<td>401K loan repayment</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Payment on debt secured by &quot;luxury&quot; collateral (ATV, boat, Mercedes, etc.)</td>
<td>No</td>
<td>Unclear, but arguably yes</td>
</tr>
<tr>
<td>College tuition for a child over 18</td>
<td>Possibly (depending on circumstances)</td>
<td>No</td>
</tr>
<tr>
<td>Private school for child under 18</td>
<td>Possibly (depending on circumstances)</td>
<td>No more than $1,500 per year</td>
</tr>
</tbody>
</table>
"CRAM-DOWN" FLOWCHART: DOES SECTION 506 APPLY?
BY: Beverly M. Burden (copyright 2005)
(13A) The term “debtor’s principal residence” means:

(A) means a residential structure, including incidental property, without regard to whether that structure is attached to real property; and

(B) includes an individual condominium or cooperative unit, a mobile or manufactured home, or trailer.

(13B) “Debtor” means person or municipality concerning which a case under this title has been commenced.

(14) The term “disinterested person” means a person that:

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not an investment banker for any outstanding security, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) has not been, within three years before the date of the filing of the petition, an investment banker for a security of the debtor, or an attorney for such an investment banker in connection with the offer, sale, or issuance of a security of the debtor;

(D) is not and was not, within two years before the date of the filing of the petition, a director, officer, or employee of the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, and

(E) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor or an investment banker specified in subparagraph (B) or (C) of this paragraph, or for any other reason, or for any other reason.

(14A) The term “domestic support obligation” means a debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provided under applicable nonbankruptcy law notwithstanding any other provision of this title, that is:

(A) owed to or recoverable by:

(i) a spouse, former spouse, or child of the debtor or such child’s parent, legal guardian, or responsible relative; or

(ii) a governmental unit;

(B) in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child’s parent, without regard to whether such debt is expressly so designated;

(C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of:

(i) a separation agreement, divorce decree, or property settlement agreement;

(ii) an order of a court of record; or

(iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and

(D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child’s parent, legal guardian, or responsible relative for the purpose of collecting the debt.

(15) The term “entity” includes person, estate, trust, governmental unit, and United States trustee.

(16) The term “equity security” means:

(A) share in a corporation, whether or not transferable or denominated “stock” or similar security;

(B) interest of a limited partner in a limited partnership; or

(C) warrant or right other than a right to convert, to purchase, sell, or subscribe to a share, security, or interest of a kind specified in subparagraph (A) or (B) of this paragraph;

(17) The term “equity security holder” means holder of an equity security of the debtor.

(18) The term “family farmer” means:

(A) individual or individual and spouse engaged in a farming operation whose aggregate debts do not exceed $1,500,000, but not less than $950,000, of whose aggregate noncontingent, liquidated debts (excluding a debt for the principal residence of such individual or such individual and spouse unless such debt arises out of a farming operation), on the date the case is filed, arise out of a farming operation owned or operated by such individual or such individual and spouse, and such individual or such individual and spouse receive from such farming operation more than 50 percent of such individual’s or such individual and spouse’s gross income for:

(i) the taxable year preceding; or

(ii) each of the 2d and 3d taxable years preceding; the taxable year in which the case concerning such individual or such individual and spouse was filed; or
§ 30102

(a) General definitions.--In this chapter--

(2) "defect" means any defect in performance, construction, a component, or material of a motor vehicle or motor vehicle equipment.

(3) "distributor" means a person primarily selling and distributing motor vehicles or motor vehicle equipment for resale.

(4) "interstate commerce" means commerce between a place in one State and a place in another State or between places in the same State through another State.

(5) "manufacturer" means a person--

(A) manufacturing or assembling motor vehicles or motor vehicle equipment; or

(B) importing motor vehicles or motor vehicle equipment for resale.

(6) "motor vehicle" means a vehicle driven or drawn by mechanical power and manufactured primarily for use on public streets, roads, and highways, but does not include a vehicle operated only on a rail line.

(7) "motor vehicle equipment" means--

(A) any system, part, or component of a motor vehicle as originally manufactured;

(B) any similar part or component manufactured or sold for replacement or improvement of a system, part, or component, or as an accessory or addition to a motor vehicle; or

(C) any device or an article or apparel (except medicine or eyeglasses prescribed by a licensed practitioner) that is not a system, part, or component of a motor vehicle and is manufactured, sold, delivered, offered, or intended to be used only to safeguard motor vehicles and highway users against risk of accident, injury, or death.

PROFESSIONALISM:
DEALING WITH UNPROFESSIONAL CONDUCT
IN BANKRUPTCY

Hon. David S. Kennedy
Chief United States Bankruptcy Judge
Western District of Tennessee
Memphis, Tennessee

SECTION H
PROFESSIONALISM:
DEALING WITH UNPROFESSIONAL CONDUCT IN BANKRUPTCY

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*David S. Kennedy is the Chief Judge of the United States Bankruptcy Court for the Western District of Tennessee; he extends a special thanks to Ms. Alissa York, Bankruptcy Extern from the University of Memphis School of Law, and Vanessa A. Lantin, Esquire, and Steve Barlow, Esquire, his Law Clerks, for their valuable assistance provided during the research and writing of this article.
I. Introduction

There is no nobler profession than that of the law.\(^1\)

Law ... I admire as a science; it becomes tedious and embarrassing only when it degenerates into a trade.\(^2\)

In addition to having to attract and service clients and thereafter generate and collect sufficient fees in order to simultaneously pay law office overhead expenses and establish an acceptable personal level of income, attorneys also have extraordinary and oftentimes very far-reaching ethical and professional duties and responsibilities. Failure to adequately and appropriately perform these ethical and professional duties and responsibilities may result in serious adverse consequences. Attorneys have specific professional duties and responsibilities to provide competent and zealous legal representation and counseling to their clients. Concomitantly they serve as respectful and vigilant officers of the court. Without proper balance and good habits in their professional and personal lives, unwary, oblivious, or uncaring attorneys face serious potential pitfalls and traps (including possible disciplinary action).\(^3\)

Attorneys who practice in the United States bankruptcy courts ("Bankruptcy Attorneys") are required to abide by all generally applicable non-bankruptcy model rules and standards of professionalism and ethical behavior. Bankruptcy attorneys also must adhere to the requirements and limitations existing under and imposed by the Bankruptcy Code (the "Code"), the Federal Rules of Bankruptcy Procedure, and applicable local rules and procedures. Although bad manners, alone, ordinarily will not trigger professional disciplinary action, it is axiomatic that certain acts indeed rise to the level of unacceptable professional conduct. For example, a bankruptcy attorney who exhibits unduly contentious, bellicose, and in your face\(^*\) advocacy in the practice of bankruptcy law, including bad faith or unprofessional conduct during the course of litigation, discovery, arbitration, and mediation, crosses the boundary line of acceptable standards of conduct. Bankruptcy courts will not condone or tolerate unprofessional or bad faith conduct or unethical behavior of attorneys arising out of a case or proceeding under the Code - whether inside or outside of the bankruptcy

\(^1\)See Alexis De Tocqueville's Democracy in America.


courtroom. Bankruptcy courts must vigorously discourage and successfully deter such inappropriate conduct and behavior.

All attorneys should engage in acceptable ethical and professional behavior at all times and places and also should demonstrate appropriate competence, stability, and demeanor. Failure to meet these high ethical and professional standards may result not only in attorney disciplinary proceedings, but also may result in irreversible damage to an attorney's professional and personal reputation. Attorney disciplinary actions include possible disbarment, suspension, censure, reprimand, removal as attorney of record from a particular case or proceeding, and disgorgement or reduction of fees and/or expenses.

It has been the experience of this writer that the hearts and minds of the vast majority of bankruptcy attorneys (99+% ) are in the right place. These attorneys earnestly seek to properly serve the legal profession, their clients, the court, and the public. Despite clear ethical rules and standards, there seemingly are always a few attorneys who, for whatever reason(s), do not sufficiently adhere to these professional rules and standards. This article will address different types of unprofessional or unethical conduct and also will suggest and discuss various responsive approaches to such conduct in bankruptcy cases or proceedings. More specifically, this article addresses the following selected topics:

- overview of professionalism in bankruptcy practice and the attorney disciplinary process;
- personal attacks and inappropriate statements made by counsel during oral arguments or negotiations;

4Overly abusive, aggressive, and combative attorneys who engage in unprofessional or unethical conduct should be distinguished from impaired attorneys who have addiction problems that also may result in professionalism and competency problems. The appropriate response or reaction to unprofessional conduct should be dictated by the circumstances and the people involved. Although the practice of law is a high stress activity and "burn-out" and addictions of various kinds can be serious concerns, nonetheless adherence to the model rules and standards of professional conduct is required of everyone, including the judges. The public must be protected from both the unprofessional and the impaired attorney (or judge). A referral to a local bar association that has a "lawyers-helping-lawyers" program may be a way of saving an impaired attorney-colleague's law license before it is too late.
• attorney conduct arising out of discovery disputes and how and when to bring such disputes to the attention of the bankruptcy court;
• unsupported “lawyer testimony” during oral arguments;
• cloaking improper conduct or communications from view of the bankruptcy court under the guise of “settlement negotiation;” and
• utilization by counsel of self-serving written correspondence and e-mails as exhibits to pleadings.

II. Professionalism in the Practice of Bankruptcy Law and the Attorney Disciplinary Process: Addressing Unacceptably Aggressive or Abusive Behavior by Attorneys in Bankruptcy Cases and Proceedings

Attorneys should guardedly and zealously protect their professional and personal reputations and at the same time foster, promote, and protect the integrity of the justice system as a whole, while also looking out for the best interests of their clients. An inappropriate moral lapse or professional misstep can result in devastatingly adverse consequences to an attorney (or judge) that could be difficult or near impossible to unravel or overcome. In some instances, such an inappropriate lapse or misstep may become the defining moment of an attorney’s future personal and professional reputation and legal career. One split-second misjudgment of a particular kind may produce a lasting personal and/or career tragedy.

It is said that “the law is a jealous mistress.” The rigorous demands of a law practice can be difficult and quite exacting at times. Incivility and unprofessional attorney conduct are nonetheless not acceptable responses or reactions to such demands. Attorneys, as public citizens, also have a responsibility to promote the public good while appropriately representing the legal profession. Additionally, “[a]s an advocate, a lawyer zealously asserts the client’s position under the rules of the adversary system.”

An attorney must be careful not to cross the boundary line from permissible zealousness and enter into the dark underside world of unprofessional or unethical conduct. An attorney who crosses that line may be subject to not only professional disciplinary action from specialized and independent state boards, but also subject to sanctions from the court itself, including possible suspension from practice or disbarment. As will be subsequently discussed, most lower courts hold that the bankruptcy courts have the authority and duty to impose sanctions or suspend an attorney under appropriate circumstances.

5 MODEL RULES OF PROF'L CONDUCT, Preamble ¶ 2 (2003).
6 See infra n. 39 and accompanying text.
These courts find disciplinary authority, for example, in 11 U.S.C. § 105(a), 28 U.S.C. § 1927, Rule 9011 of the Federal Rules of Bankruptcy Procedure, and the inherent powers doctrine.\(^7\) As will be seen, sanctions imposed by the courts must be chosen to employ the least possible power necessary to deter the inappropriate behavior.

A. Professional Rules and Standards of Conduct

The Preamble to the Model Rules of Professional Conduct ("Preamble") states:

A lawyer's conduct should conform to the requirements of the law, both in professional service to clients and in the lawyer's business and personal affairs. A lawyer should use the law's procedures only for legitimate purposes and not to harass or intimidate others. A lawyer should demonstrate respect for the legal system and for those who serve it, including judges, other lawyers and public officials.\(^8\)

The underlying principle of the model rules "include[s] the lawyer's obligation zealously to protect and pursue a client's legitimate interests, within the bounds of the law, while maintaining a professional, courteous and civil attitude toward all persons involved in the legal system."\(^9\)

For example, the following model rules are illustrative. Rule 3.5(d) provides: "A lawyer shall not engage in conduct intended to disrupt a tribunal."\(^10\) The accompanying comments to Rule 3.5 give further guidance: "Refraining from abusive or obstreperous conduct is a corollary of the advocate's right to speak on behalf of litigants . . . An advocate can present the cause, protect the record for subsequent review and preserve professional integrity by patient firmness no less effectively than by belligerence or theatrics . . . The duty to refrain from disruptive conduct applies to any proceeding of a tribunal, including a deposition."\(^11\)

Rule 1.3 provides: "A lawyer shall act with reasonable diligence and promptness in representing a client."\(^12\) Comment 1 to Rule 1.3 states: "The lawyer’s duty to act with reasonable diligence does not

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\(^7\) See, e.g, In re Rimset, Ltd., 212 F.3d 1039, 1043 (7th Cir. 2000); Chambers v. Nasco, Inc., 501 U.S. 32 (1991) (holding that a federal court has inherent power to sanction for bad faith conduct during the course of litigation, and that the purpose of these sanctions is to deter such conduct); In re Computer Dynamics, Inc., 253 B.R. 693 (E.D. Va. 2000) (holding that bankruptcy courts, pursuant to their civil contempt power, can suspend an attorney from practice pending compliance with a court order).

\(^8\) MODEL RULES OF PROF'L CONDUCT, Preamble ¶ 5.

\(^9\) Id. at ¶ 9.

\(^10\) MODEL RULES OF PROF'L CONDUCT R. 3.5.

\(^11\) Id. R. 3.5 Cmt. 4, 5.

\(^12\) Id. R. 1.3.
require the use of offensive tactics or preclude the treating of all persons involved in the legal process with courtesy and respect.13

Not surprisingly, many judicial districts have adopted their own supplemental rules and standards of professional conduct. The supplemental rules and standards of professional conduct of the following judicial districts will be reviewed or cited here: the Northern District of Alabama, Southern District of Georgia, Northern District of Georgia, Western District of North Carolina, Northern District of Florida, and the Eastern District of Kentucky.

The United States Bankruptcy Court for the Northern District of Alabama provides for attorney discipline in the form of “disbarment, suspension, censure, reprimand, removal from a particular case, ineligibility for appointment as court appointed counsel, ineligibility to appear under subsection (b) and (c), monetary sanctions, or any other sanction the court may deem appropriate.”14 The Northern District of Alabama also has established a grievance committee to “conduct, upon referral by the court or a judge thereof, inquiries and investigations with respect to alleged misconduct or commission of a serious crime by an attorney or with respect to reinstatement of an attorney; to conduct and preside over disciplinary hearings; to consider, upon referral by the court or a judge thereof, matters relating to possible incompetency, incapacity, or impairment of an attorney; and to submit written findings and recommendations to the court or referring judge for appropriate action.”15 Pursuant to its Local Rule 2090-2 (h)(1), the “court or a judge thereof may refer to the Grievance Committee any accusation or evidence of misconduct by a member of the bar of this court for such investigation, hearing and report as may be appropriate.”16

13/ R. 1.3 Cmt. 1.
14Bankr. N.D. Ala. R. 2090-2 (t). These disciplinary measures may be taken after an attorney violates the Alabama Rules of Professional Conduct as adopted by the Alabama Supreme Court or the American Bar Association Model Rules of Professional Conduct (except ABA Rule 3.8(f)). In addition, “[a]cts and omissions by any such attorney which violates such standards, individually or in concert with any other person, shall constitute misconduct, whether or not occurring in the course of an attorney-client relationship, and shall be grounds for discipline, as shall the commission by an attorney of any serious crime.” Attorneys must also notify the clerk of the court if they are “(i) disbarred, suspended or publicly disciplined by another court or disciplinary authority, (ii) resigning from another bar while an investigation into allegations of misconduct is pending, or (iii) being convicted by any court of any serious crime.” See also Bankr. N.D. Ala. R. 2090-2(h)(2) B (4). The Middle District of Alabama incorporated Local Rule 83.1 of the U.S. District Court for the Middle District of Alabama, which contains similar grievance provisions and authorizes the court to act sua sponte to address disciplinary issues to the extent of the court's statutory authority.
15Bankr. N.D. Ala. R. 2090-2 (g)(1). (The grievance committee also has the power to “compel the attendance of witnesses, to take or cause to be taken the deposition of any witnesses, and to order the production of books, records, or other documentary evidence.”)
The Southern District of Georgia addresses attorney discipline in its Local Rule 83.5, which states that: “Any attorney who appears in a case or proceeding, or who represents a party in interest in a case or proceeding, may for good cause shown, and after notice and hearing, be disbarred, suspended from practice for a definite time, reprimanded, or subjected to such other discipline as the Court may deem proper.” Local Rule 83.5 further provides that an attorney who has “been disbarred or suspended from the practice of law” in Georgia or any other state, or “has been convicted of a felony or any crime involving moral turpitude . . . may be provisionally suspended forthwith from practice before this Court; and, unless good cause to the contrary is shown within thirty (30) days from the date of such suspension or conviction, an order of disbarment shall be entered.”

The Northern District of Georgia also adopted the Local Rules of Professional Conduct in Rule 2091-1 to “govern all actions and proceedings in the Bankruptcy Court.” The Middle District of Georgia addresses attorney conduct in its Local Rules 9011-1, which states that an attorney will not be granted a leave of absence by the court, but reasonable accommodations will be attempted for those times when the attorney will be absent, provided proper notice is given by the attorney, that the attorney’s bar number should be indicated on “all documents filed with the court,” that motions filed with the clerk shall include a proposed order, that “[a]ll motions should indicate applicable code sections or FRBP which affect the granting or denial of the relief which is sought,” and that motions filed should also include a notice that complies with LBR 9004-1(b).

In the Southern District of Georgia the applicable rules further provide that a violation of the American Bar Association’s Model Rules of Professional Conduct or the Georgia Rules of Professional Conduct “may subject the attorney to appropriate disciplinary action.” However, disciplinary proceedings

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17S.D. Ga. R. 83.5 (expressly incorporated into the Local Rules of the Bankruptcy Court for the Southern District of Georgia).
18Id. R. 83.5(a).
19Id. R. 83.5 (b).
22Id. R. 9011-1(b).
23Id. R. 9013-1(a)-(c). Rule 9013-3 states that all motions filed shall include a certificate of service.
will be closed unless the court finds that justice or the subject of the action requires the proceeding to be open. The Southern District of Georgia has specific rules for matters that come before a non-Article III judge. The United States Attorney for this District will prosecute "any disbarment or disciplinary action brought against any member of the bar of this Court."

Further, the Local Rules of the Southern District of Georgia also provide specific instructions to attorneys as to the examination of witnesses and argument, objections to questions, decorum, the witness, court hours and promptness, exhibits, advance notice of difficult questions, the filing and use of depositions at trial, the use of answers to interrogatories and requests for admissions, and even opening statements. These Local Rules are very specific, even including instructions on where the attorney is to stand during the proceeding; violation of any one of these rules could theoretically be considered a violation of the rules leading to disciplinary action.

25 Id. R. 83.5 (f).
26 Id. R. 83.5 (g).
27 Id. R. 83.10.
28 Id. R. 83.13 - 22.
29 The relevant rules of the Southern District of Georgia are as follows:

LR 83.12 Examination of Witnesses and Argument:
(a) Counsel should conduct examination of witnesses from the lectern or the counsel table.
(b) Do not approach a witness without asking permission of the Court. When permission is granted for the purpose of working with an exhibit, resume the examination from the table or lectern when finished with the exhibit.
(c) Rise when addressing the Court or jury and when making objections.
(d) During opening statement and argument, counsel should stand at the lectern or table unless the Court grants permission to approach another area for a proper purpose.

LR 83.13 Objections to Questions:
(a) When objecting, state only that you are objecting and specify the ground or grounds of objection. Do not use objections for the purpose of making a speech, recapitulating testimony, or attempting to guide the witness.
(b) Argument upon the objection will not be heard until permission is given or argument is requested by the Court.

LR 83.14 Decorum:
(a) Colloquy or argument between attorneys is not permitted. Address all remarks to the Court.
(b) In a jury case, if there is an offer of stipulation, first confer with opposing counsel about it.
(c) Do not ask the reporter to mark testimony. All requests for re-reading of questions or answers shall be addressed to the Court.
(d) Counsel during trial shall not exhibit familiarity with witnesses, jurors, or opposing counsel. The use of first names is to be avoided. During arguments, no juror should be addressed individually or by name.
(e) During the argument of opposing counsel, remain seated at the counsel table and be respectful. Never divert the attention of the Court or the jury.

LR 83.15 The Witness:
(a) Witnesses shall be treated with fairness and consideration; they shall not be shouted at, ridiculed, or otherwise abused.
(b) No person shall ever by facial expression or other conduct exhibit any opinion concerning any testimony which is being given by a witness. Counsel should admonish their clients and witnesses about this common occurrence.

LR 83.16 Court Hours and Promptness:
(a) The Court makes every effort to commence proceedings at the time set. Promptness is expected from counsel and witnesses.
(b) If a witness was on the stand at a recess or adjournment, have the witness on the stand ready to proceed when Court is resumed.
(c) Arrange the schedule of your case so that you will not run out of witnesses and cause unnecessary delay.

LR 83.19 Difficult Questions B Advance Notice:
If you have reason to anticipate that any question of law or evidence is difficult or will provoke an argument, give the Court advance notice.
The Bankruptcy Court for the Western District of North Carolina imposes a specific duty upon attorneys who represent debtors.\textsuperscript{30} Local Rule 2091-1(a) states that "[a]ny attorney who files a bankruptcy petition for or on behalf of a debtor shall remain the responsible attorney of record for all purposes, including the representation of the debtor in all matters that arise in the case and conversion to another Chapter."\textsuperscript{31} Further, "[a]n attorney is automatically deemed relieved of the duty to represent the debtor when the debtor's case is closed. Alternatively, an attorney may be relieved of the duty to represent the debtor only upon motion, and after notice and a hearing, and on the order of this Court."\textsuperscript{32}

The Bankruptcy Court for the Northern District of Florida adopted very specific Rules of Conduct and Decorum applicable in the United States District Court for the Northern District of Florida and attached them as an addendum to the Local Bankruptcy Rules.\textsuperscript{33}

\textsuperscript{30}Bankr. W.D. N.C. L.R. 2091-1(a).

\textsuperscript{31}Id.

\textsuperscript{32}Id. R. 2091-1(b).

\textsuperscript{33}Bankr. N.D. Fl. Addendum A to Local Bankruptcy Rules. This addendum provides as follows:

\textit{Customary and Traditional Conduct and Decorum in the United States District Court:}

\begin{itemize}
  \item[A.] The purpose of the addendum is to state for the guidance of those heretofore unfamiliar with the traditions of this United States District Court certain basic principles concerning courtroom conduct and decorum. These standards are minimal and not all-inclusive. They are intended to emphasize and supplement, not supplant or limit, the ethical obligations of counsel under the Code of Professional Responsibility or the time honored customs of experienced trial counsel.
  \item[B.] When appearing in the United States District Court, all counsel and all persons at counsel table should conduct themselves in the following customary and traditional manner:
    \begin{itemize}
      \item[(1)] Stand as court is opened, recessed or adjourned.
      \item[(2)] Stand when the jury enters or retires from the courtroom.
      \item[(3)] Stand when addressing, or being addressed by, the Court.
      \item[(4)] Address all remarks to the Court, not to opposing counsel.
      \item[(5)] Avoid disparaging personal remarks or acrimony toward opposing counsel and remain wholly detached from any ill feeling between the litigants or witnesses.
      \item[(6)] Refer to all persons, including witnesses, other counsel and the parties, by their surnames and not by their first or given names.
      \item[(7)] Counsel should request permission before approaching the bench; and any document counsel wishes to have the Court examine should be handed to the clerk.
      \item[(8)] Unless opposing counsel has previously been shown exhibits, any exhibit offered in evidence should, at the time of such offer, be handed to opposing counsel.
      \item[(9)] In making objections, counsel should state only the legal grounds for the objection and should withhold all further comment or argument unless elaboration is requested by the Court.
      \item[(10)] In examining a witness, counsel shall not repeat or echo the answer given by the witness.
      \item[(11)] Offers of, or requests for, a stipulation should be made privately, not within the hearing of the jury.
      \item[(12)] In opening statements and in arguments to the jury, counsel shall not express personal knowledge or opinion concerning any matter in issue, shall not read or purport to read from deposition or trial manuscripts, and shall not suggest to the jury directly or indirectly that it may or should request transcripts or the reading of any testimony by the reporter.
      \item[(13)] Counsel shall admonish and discourage all persons at counsel table from making gestures, facial expressions, audible comments, or the like, as manifestations of approval or disapproval during the testimony of witnesses, or at any other time.
      \item[(14)] Smoking, eating, food and drink are prohibited in the courtroom at any time.
    \end{itemize}
\end{itemize}
Finally, the Eastern District of Kentucky has not promulgated a special local rule regarding attorney discipline in the bankruptcy court; however, included here are the rules from the United States District Court regarding attorney discipline to be used as a guide when considering such matters.

Local rule of the District Court for the Eastern District of Kentucky

LR 83.3 Attorney Discipline

(a) Discipline Generally. Any attorney practicing before the Court is subject to discipline by the Court upon a showing that:

(1) The attorney has been subjected to public discipline in any other court of record; or

(2) The attorney is guilty of unprofessional conduct.

(b) Discipline in Another Court; Procedure.

(1) Attorney's Duty to Notify. An attorney practicing before the Court who is subjected to public discipline in any other court of record must promptly inform the Clerk of that action.

(2) Notice to the Attorney. Upon filing a certified copy of a judgment or order demonstrating that another court has disciplined an attorney, the Court will immediately issue a notice to the attorney containing the following:

(A) a copy of the judgment or order from the other court; and

(B) an order to show cause -- within thirty (30) days after service of that order -- why the Court's imposition of the identical discipline would be unwarranted. The challenge to the Court's imposition of the identical sanction must be based on one of the grounds contained in (3). The attorney may respond to the show cause order personally or by mail.

(3) Discipline Imposed; Grounds for Challenge. Thirty (30) days after service of the notice provided in (b)(2), the Court will impose the identical discipline as that imposed by the other court unless the Court concludes that the entry of some other order is appropriate. To conclude that the entry of some other order is appropriate, the Court must find that the record underlying the other court's discipline clearly indicates that:

(A) the procedure was so lacking in notice or opportunity to be heard as to constitute a deprivation of due process;

(B) the proof establishing the misconduct was so infirm that the Court could not -- consistent with its duty -- accept the other court's conclusion as final;

(C) the Court's imposition of the same discipline would result in grave injustice; or

(D) the Court concludes that the misconduct warrants substantially different discipline.

(4) Finality of the Other Court's Action. Unless the Court determines that one of the grounds contained in (3) exists, another court's final adjudication of attorney misconduct conclusively establishes the misconduct for purposes of this Court's discipline. If the discipline in the other court is stayed or is not a final decision, this Court's reciprocal discipline is deferred until the stay expires or the decision becomes final.
(c) Discipline for Unprofessional and Improper Conduct. If it appears to the Court that an attorney practicing before the Court has violated the rules of the Kentucky Supreme Court governing professional conduct or is guilty of other conduct unbecoming an officer of the Court, any judge may order an attorney to show cause -- within a specified time -- why the Court should not discipline the attorney. Upon the expiration of the period specified or upon the attorney's response to the show cause order, the Court will enter an appropriate order. If requested by the responding attorney, the Court will conduct a hearing prior to determining the appropriate order.

(d) Discipline for Contempt. Disbarment from the Court may be utilized as a sanction for contempt of court under the procedures contained in Federal Rule of Criminal Procedure 42. Nothing in this rule shall limit the Court's power to punish contempt.

It is abundantly clear that there are no uniform rules and procedures in the federal system governing attorney discipline matters in the nation's bankruptcy (or district) courts. Accordingly, individual judicial districts are free to establish rules and procedures to be followed and grounds for punishment. (Know your district.) Legitimate confusion may exist regarding whether the bankruptcy court even has the threshold authority to address and ultimately redress violations of ethical standards or unprofessional conduct arising within a particular bankruptcy case or proceeding. It is certain, however, that the attorney disciplinary process allows for the administration of justice and the protection of the public from unprofessional, unqualified, unfit, or unethical attorneys. Attorneys and judges collectively must maintain the integrity of the legal profession, efficiently manage the entire bankruptcy process, and zealously guard the propriety and impartiality of the bankruptcy process.

The attorney disciplinary process should, *inter alia*, balance the regulation of the practice of law with the attorney's need for maintaining a livelihood and professional reputation. If a court proposes to sanction or discipline an attorney, it should, *ipso facto*, give that attorney specific and full notice of the conduct and charges alleged to be sanctionable, and also the standards by which that conduct will be assessed. The court thereafter should allow the attorney a full opportunity to be heard on the matter and to meaningfully defend against specific disciplinary charges. Additionally, the accused attorney must be fully warned of the authority and actual charges under which the court is considering sanctions.

Courts have consistently asserted and maintained that the attorney disciplinary process must balance numerous issues. For example, the disciplinary process must afford attorneys accused of

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34 E.g., 60 East 80th Street Equities, Inc. v. Jeffrey Sapir (In re 60 East 80th Street Equities, Inc.), 218 F.3d 109, 117 (2d Cir. 2000).

35 Id.

36 Id.
unethical conduct with both procedural and substantive due process in all disciplinary proceedings. Of course, disciplinary procedures must be fair and thorough; and they also must be perceived as such by attorneys and the public. It is said that justice should not only be done, but also should be seen to be done. Unquestionably, attorneys should have appropriate notice of applicable professional standards and also proper advance notice of the charges brought against them with a fair and reasonable opportunity to defend themselves.

B. What Authority Do Bankruptcy Courts Have to Discipline Attorneys?

Important threshold questions exist. For example, do the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure, the various local rules, and other statutory or common law support the bankruptcy courts’ exercise of original attorney disciplinary power? Should a bankruptcy judge who has, *sua sponte*, initiated the charge of ethical misconduct and thereby threatened discipline against an attorney recuse him or herself from the disciplinary proceedings because the judge’s impartiality might be reasonably questioned due to an asserted personal bias or prejudice concerning the attorney or party?37 Although the bankruptcy court may have both the express and the inherent authority to discipline attorneys (e.g., suspension) appearing before it, are such disciplinary proceedings ordinarily best reserved to independent bodies that have been specifically created to investigate charges of unprofessional conduct and to prosecute disciplinary proceedings?

There are a number of related substantive and procedural issues that also may be considered by the courts. For example, what is the relationship between a judicially generated disciplinary proceeding in the bankruptcy court (or district court) and one conducted by the state or federal court licensing authorities? As noted earlier, should the bankruptcy court initially defer such disciplinary matters to the district court or specialized and independent state licensing authorities or state boards of professional responsibility? Or, is it preferable under certain facts and circumstances for bankruptcy courts to initially conduct disciplinary proceedings? If disciplinary proceedings are conducted in the bankruptcy court, is there a danger of the appearance of prejudice against the attorney? Should the bankruptcy judge be the accuser, investigator, prosecutor, impartial judge, and “executioner” in the same action? Is a full

evidentiary hearing required in every disciplinary proceeding involving an attorney before a bankruptcy judge? In resolving these and related disciplinary issues, courts have relied upon many different sources of law and procedure to ultimately reach their decisions, including consideration of applicable federal statutes, common law, local district court and bankruptcy court rules and procedures, state ethical and disciplinary rules, and ABA standards. A bankruptcy court that exercises original attorney disciplinary authority should take great care to act within predictable and consistent parameters, within the scope and limitations of bankruptcy jurisdiction, and in full accordance with substantive and procedural due process.

C. Core/Non-Core Proceeding Dichotomy Involving Attorney Disciplinary Actions

It is asserted here that an attorney disciplinary action brought in the bankruptcy court ordinarily is a core proceeding under 28 U.S.C. § 157(b)(1)-(2). As such, the presiding bankruptcy judge has jurisdiction both to hear the matter and also to enter a final order, subject, of course, to traditional appellate review under 28 U.S.C. § 158 utilizing the abuse of discretion standard. By virtue of 28 U.S.C. § 151, each United States judicial district has a bankruptcy court that exists as a statutory unit of the district court. Bankruptcy judges, who are appointed to 14-year terms by the court of appeals for the respective circuit, serve as judicial officers of the district court. Pursuant to Federal Rule of Bankruptcy Procedure 9002(4), "district judge" means "bankruptcy judge" if the proceeding is pending before a bankruptcy judge.

In accordance with 28 U.S.C. § 157(a), a district court may refer all bankruptcy cases and proceedings to the bankruptcy court within its judicial district. Each of the 94 judicial districts has entered broad orders of reference. When a bankruptcy proceeding is referred by the district court to the bankruptcy court, the role and authority of the bankruptcy judge depend on whether the particular matter is a "core proceeding" or a "non-core proceeding." If the particular matter is a core proceeding, the bankruptcy judge may hear and determine all issues and enter a final order, subject to traditional appellate review. The statutory provisions of 28 U.S.C. § 157(b)(2)(A)-(O) set forth a non-exclusive laundry list of

38 In re Sheridan, 362 F.3d 96 (1st Cir. 2004); see In re Johnson, 921 F.2d 585, 587 (5th Cir. 1991); see also 28 U.S.C. § 455(a),(b)(1); Code of Judicial Conduct Canon 3(C)(1); cf. In re Beard, 811 F.2d 818, 827 (4th Cir. 1987).

39 28 U.S.C. §§ 151 and 152(a); Rules 9001(4) and 9002(4) of the Federal Rules of Bankruptcy Procedure.

core matters that may arise in bankruptcy cases. If the matter is a non-core proceeding, absent consent of all the parties to the proceeding under 28 U.S.C. § 157(c)(2), the bankruptcy court by virtue of 28 U.S.C. § 157(c)(1) nonetheless may hear the proceeding and thereafter submit proposed findings of fact and conclusions of law to the district court, and any final order or judgment shall be entered by the district judge after considering the bankruptcy judge’s proposed findings and conclusions and after reviewing de novo those matters to which any party has filed and specifically objected pursuant to FED. R. BANKR. P. 9033. If it is unclear whether a particular proceeding is core or non-core, the bankruptcy judge determines the appropriate classification.

Generally speaking, a particular proceeding that “arises under” the Code as contemplated under 28 U.S.C. §§ 1334(b) and 157(b)(1) is considered core. Whether an attorney disciplinary proceeding that arises within, for example, a single bankruptcy case is a “core proceeding” under 28 U.S.C. § 157(b)(1) or a “non-core proceeding” under 28 U.S.C. § 157(c)(1) is a matter of statutory construction. The term “core proceeding” is not self-defining. Although no explicit statutory reference is made under 28 U.S.C. § 157(b)(2)(A)-(O) to attorney discipline matters (e.g., sanctions, contempt, suspension from practice or disbarment), it is emphasized here that 28 U.S.C. § 157(b)(2) contains only a non-exhaustive laundry list of illustrated core proceedings. The discipline of attorneys who practice in the bankruptcy court is a vital and essential function to the proper administration of the case or proceeding; it also is an essential function “concerning the administration of the [§ 541(a)] estate” as contemplated under 28 U.S.C. § 157(b)(2)(A). Indeed, an attorney disciplinary action is central or core to the administration of the case. A legitimate functional need exists for bankruptcy courts to have “core” jurisdiction over attorney misconduct arising within core proceedings. Congress in the 1984 jurisdictional amendments intended that “core proceedings” would be broadly interpreted in light of the open-ended statutory text contained in


43See, e.g., In re Dragoo, 219 B.R. 460, 465-68 (Bankr. N.D. Tex. 1998), aff’d, 86 F.3d 614 (5th Cir. 1999) (Fifth Circuit affirmed a four-year suspension imposed by a bankruptcy court in a proceeding that involved evidence of attorney misconduct in three separate bankruptcy cases and did not take issue with the bankruptcy court’s express entry of a final order under FED. R. BANKR. P. 7052); see also In re Melendez, 235 B.R. 173, 181-82 and 201-04 (Bankr. D. Mass. 1999) (imposing sanctions in an omnibus disciplinary hearing initiated sua sponte by the bankruptcy court against several debtors’ attorneys for inadequate representation of their respective clients, and expressly entering its findings under FED. R. BANKR. P. 7052); In re Nesom, 76 B.R. 101, 102, n.1 (Bankr. N.D. Tex. 1987) (suspending an attorney for misconduct in two bankruptcy cases after a sua sponte disciplinary hearing by the court, and expressly finding the proceeding was core); In re Ludwick, 185 B.R. 238, 242-47 (Bankr. W.D. Mich. 1995) (en banc) (suspending a bankruptcy attorney from practice for two years and determining that the hearing was a core proceeding). Cf. In re Sheridan, 362 F.3d 96 (1st Cir. 2004).
28 U.S.C. § 157(b). The absence of relevant constitutional and statutory constraints is obvious. It is said that "core comes from core."

Prior to Northern Pipeline Construction Co. v. Marathon Pipe Line Co.\textsuperscript{44} and the enactment of the 1984 bankruptcy jurisdictional amendments, the Supreme Court recognized that a court's power to regulate the conduct of the bar, including the power to suspend and disbar attorneys, is absolutely essential to the administration of justice and the protection of the public.\textsuperscript{45} In In re Sheridan, Circuit Judge Lynch in a dissenting opinion stated:\textsuperscript{46}

> In fact, there is every reason to believe that Congress wanted and expected bankruptcy judges to enforce the professional responsibilities of bankruptcy attorneys through final and binding orders where the misconduct in question occurred in a core bankruptcy proceeding or proceedings. In 1984, when Congress amended the Bankruptcy Code to create the core/non-core distinction, the case law available to Congress provided no reason to think that bankruptcy courts' status as Article I tribunals would bar them from entering final disciplinary orders. In 1926, the Supreme Court itself held in Goldsmith v. U.S. Bd. of Tax Appeals, 270 U.S. 117, 46 S.Ct. 215, 70 L.Ed. 494 (1926), that the U.S. Board of Tax Appeals, an Article I tribunal, possessed the authority not only to promulgate ethical rules of admitting attorneys to practice, but also to disbar attorneys who failed to meet those standards. See id. at 121-22, 46 S.Ct. 215 (emphasizing, in holding that the Board possessed this power, "the character of the work to be done by the board, the quasi judicial nature of its duties, [and] the magnitude of the interests to be affected by its decisions"). The Court explicitly rejected the contention that such a tribunal cannot disbar or discipline lawyers absent express statutory authority, observing that the power of the Board to do so is "so necessary ... and so usual" that the statute creating it would be interpreted to include that power. Id. at 122, 46 S.Ct. 215.

Furthermore, Congress knew that federal courts before 1984 had upheld the power of other Article I tribunals to issue binding disciplinary orders against counsel appearing before them. See, e.g., Kivitz v. SEC, 475 F.2d 956, 962 (D.C. Cir.1973)(power of SEC to disbar attorney for ethical misconduct); Herman v. Dulles, 205 F.2d 715, 715-16 (D.C. Cir. 1953)(similar, International Claims Commission); Francis v. Virgin Islands, 11 F.2d 860, 864 (3d Cir. 1926)(upholding the contempt powers of the U.S. District Court for the Virgin Islands); Fleming v. United States, 279 F. 613, 616 (9th Cir. 1992) (similar, United States Court for China). Consistent with this line of cases, some courts had by 1984 already upheld the authority of bankruptcy courts to discipline attorneys for unethical conduct in bankruptcy cases. As early as 1979, for example, the Second Circuit described as "nothing novel" the proposition that a debtor's counsel could be sanctioned for breaching his ethical responsibilities to

\textsuperscript{44}58 U.S. 50 (1982).

\textsuperscript{45}See, e.g., Roadway Express, Inc. v. Piper, 447 U.S. 752, 764-67 (1980); In re Snyder, 472 U.S. 634, 743-45 (1985) ("Courts have long recognized an inherent authority to suspend or disbar lawyers.").

\textsuperscript{46}362 F.3d 96, 122-23 (1st Cir. 2004).
the bankruptcy court. See In re Arlan's Dept. Stores, Inc., 615 F.2d 925, 943-44 (2d Cir. 1979).

Congress enacted the 1984 bankruptcy amendments against this background. Nothing in the 1984 Act or its legislative history suggests that Congress intended to deny bankruptcy judges the authority to regulate the bankruptcy bar. On the contrary, this court has held that Congress's purpose in the 1984 amendments was to press the jurisdiction of the bankruptcy courts "to its constitutional bounds" in the wake of Northern Pipeline. See In re Arnold Print Works, Inc., 815 F.2d 165, 168 (1st Cir. 1987) (Breyer, J.). The congressional sponsors of the 1984 amendments described non-core proceedings as "Marathon-type" cases, referring to the Northern Pipeline decision, and they understood that category to be "very limited." Id. Accordingly, this court concluded that "Congress intended that 'core proceedings' would be interpreted broadly, close to or congruent with constitutional limits." Id.

Congress had no reason to think that Article III is offended when a bankruptcy court enters a binding order against a bankruptcy attorney for professional misconduct in a core bankruptcy proceeding. Even the principal opinion does not so contend. Indeed, less than a year after its decision in Northern Pipeline, the Supreme Court emphasized the limits of its holding: "The Court's holding in that case establishes only that Congress may not vest in a non-Article III court the power to adjudicate, render final judgment, and issue binding orders in a traditional contract action raising under state law, without consent of the litigants, and subject only to ordinary appellate review." Thomas v. Union Carbide Agric. Prods. Co., 473 U.S. 568, 584, 105 S.Ct. 3325, 87 L.Ed.2d 409 (1985) (emphasis added). (footnotes omitted).

Circuit Judge Lynch's reasoning is persuasive regarding the core/non-core distinction addressed here.

In summary, it is fundamental that federal courts have the inherent power to discipline attorneys who appear before it.47 This inherent power is necessary for federal courts to manage their affairs and to achieve orderly and expeditious disposition of cases and proceedings.48 Pursuant to its inherent power to manage its affairs, a federal court is vested with the power to require those who appear before it to submit to and follow its rules and mandates.49 The bankruptcy court, as a unit of the United States district court and as a federal court, has the responsibility, subject to ordinary and traditional review on appeal, to take appropriate action in order to uphold and protect the integrity of the court, its bar, and the public from unprofessional misconduct or unethical behavior.50

48Id.
49Id.
D. Addressing Unacceptably Aggressive and Abusive Attorneys

As noted earlier, there are no clear uniform standards, rules, or procedures governing attorney discipline in the 94 federal district courts and the 90 bankruptcy courts. As also discussed supra, most courts have held that a bankruptcy court has, in appropriate situations, the statutory and inherent authority to discipline attorneys.\(^{51}\) Attorneys who appear in the bankruptcy courts may not be fully aware of the applicable procedures available to redress asserted violations of ethical and professional standards arising in a bankruptcy case or proceeding. Of course, local rules of the bankruptcy court, local rules of the corresponding district court, and local practice should be taken into consideration.

According to most courts, a bankruptcy court not only has the authority, but also has the duty to unequivocally uphold the integrity of the court and its bar, and to actually protect the public from attorney professional misconduct. Many courts opine that they should regulate and “police” attorneys appearing before them by, for example, sanctioning those who impermissibly violate professional and ethical rules.\(^{52}\) The bankruptcy court, as described by the Fifth Circuit in \textit{In re Johnson},\(^{53}\) suspended an attorney/trustee from practicing before the court for one year. The bankruptcy court in the \textit{Johnson} case ordered the obstreperous attorney to take and successfully pass the multi-state professional ethics examination as a precondition of his reinstatement to the practice of law.\(^{54}\) On appeal, the Fifth Circuit ruled that § 105(a) of the Code was “a basis for holding that bankruptcy courts have both statutory and inherent authority to deny attorneys and others the privilege of practicing before the court.”\(^{55}\) However, the Fifth Circuit reversed the bankruptcy court’s order, holding that the bankruptcy judge under the circumstances should have recused himself from the disciplinary action against the attorney.\(^{56}\)

In an effort to additionally address particular abuses, courts and parties in interest, such as the United States trustee or the bankruptcy administrator, also may refer certain questionable and egregious

\(^{52}\)E.g., \textit{In re Sheridan}, 282 B.R. 79 (B.A.P. 1st Cir. 2003), rev’d on jurisdictional grounds, 362 F.3d 96 (1st Cir. 2004).
\(^{53}\)921 F.2d 585 (5th Cir. 1991).
\(^{54}\)\textit{id.} at 586.
\(^{55}\)\textit{id.}
\(^{56}\)\textit{id.} at 587.
matters to the United States Attorneys Office for possible criminal investigation.\textsuperscript{57} This can result in criminal indictment, prosecution, and conviction in the United States district court under title 18 of the United States Code.

One example of an appellate court upholding a bankruptcy court's authority to discipline attorneys is illustrated in \textit{In re Crayton}.\textsuperscript{58} \textit{Crayton} involved an attorney who was directed by the bankruptcy judge to appear and show cause why he should not be (1) barred from practicing in the bankruptcy court, (2) reported to the State bar, and (3) ordered to disgorge fees. In \textit{Crayton}, the Ninth Circuit Bankruptcy Appellate Panel ("BAP") went into great detail regarding the authority of bankruptcy courts to discipline attorneys, and outlined relevant law and procedure as follows:

- Terms of an attorney disciplinary order are reviewed on appeal for an abuse of discretion.

- "Abuse of discretion" is found if the reviewing court has a definite and firm conviction that the court below committed clear error of judgment in the conclusion it reached upon weighing of relevant factors.

- On review of disciplinary orders, findings of fact are not overturned unless they are clearly erroneous.

- Court may disbar or suspend an attorney only upon presentation of clear and convincing evidence.

- Trial court's interpretation and application of local rules is reviewed for abuse of discretion.

- Bankruptcy court has both express and inherent authority to regulate attorneys who practice before it -- even to disbar attorneys appearing before it. 11 U.S.C. § 105(a).

- Bankruptcy court had the express authority to discipline an attorney who appeared before it in connection with chapter 11 case by barring him from chapter 11 practice in court's district and from all debtor representation under local rules, which provided that attorneys who appear for any purpose before bankruptcy court are subject to its discipline and granted bankruptcy court discretion to determine appropriate penalties, and under the bankruptcy court's power to approve attorney's employment in bankruptcy case. 11 U.S.C. § 327(a); U.S. Bankr. Ct. Rules C.D. Cal., Rules 102(5), 106(1).

\textsuperscript{57}\textit{See} 18 U.S.C. § 3057.

\textsuperscript{58}192 B.R. 970 (9th Cir. B.A.P. 1996).
Under its inherent disciplinary powers, the bankruptcy court had the authority to discipline attorney it found incompetent, and who accepted fees from pro se chapter 11 debtor, refused to return fees upon debtor's demand, and failed to seek employment by bankruptcy court as required, even though it did not expressly find that attorney acted in bad faith; bad faith finding was not required, inasmuch as bankruptcy court was exercising disciplinary powers to protect the public against unqualified practitioners, and, even if it were, finding was implicit in bankruptcy court's determination that the attorney accepted fees from the debtor without obtaining employment from the bankruptcy court and refused to return fees despite the debtor's demand, and in the attorney's admission that he represented chapter 11 debtor although incompetent to do so. 11 U.S.C.A. §§ 105(a), 327(a).

As a unit of the district court, the bankruptcy court is a federal court. 28 U.S.C.A. § 151. And a federal court has power to control admission to its bar and to discipline attorneys who appear before it.

There is no uniform procedure for attorney disciplinary proceedings in the federal system; instead, individual judicial districts are free to define rules to be followed and grounds for punishment. 28 U.S.C.A. § 1654.

Although the bankruptcy court has both express and inherent authority to suspend attorneys appearing before it, disciplinary proceedings are best reserved to independent bodies that have been specifically created to investigate charges of unprofessional conduct and to prosecute disciplinary proceedings, and thus it is recommended that matters involving attorney discipline be referred to standing committee.

In attorney disciplinary proceedings, the question before the court is whether an attorney may continue to practice a profession imbued with public interest and trust.

Court in attorney disciplinary proceeding must consider both fitness of one of its officers and need to protect public from an unqualified practitioner.

Criteria for reviewing attorney disciplinary proceedings are whether the disciplinary proceeding was fair, whether evidence supports findings below, and whether the penalty imposed was reasonable.

Attorney who is subject to discipline is entitled to notice and opportunity to be heard. U.S. Const. Amend. 5.

Attorney subject to disciplinary proceeding must receive prior notice as to reach of grievance procedure and precise nature of charges leveled against him. U.S. Const. Amend. 5.

Evidentiary hearing in attorney disciplinary proceedings is not required by due process. U.S. Const. Amend. 5.

Attorney's admission that he was incompetent to practice chapter 11 bankruptcy law rendered harmless any due process error stemming from bankruptcy court's failure to give attorney notice, in order to show cause issued to attorney, that his competency in such area was at issue. U.S. Const. Amend. 5. The admission
was also clear and convincing evidence that supported the finding of incompetence.

- Bankruptcy court violated attorney's due process rights when it made additional charges against the attorney regarding his competence to represent chapter 7 and 13 debtors, without giving the attorney notice or opportunity to defend himself, following hearing on order to show cause detailing charges against the attorney. U.S. Const. Amend. 5; 11 U.S.C.A. § 327(a).

- Attorney's due process right to notice of charges against him in disciplinary proceeding was satisfied with regard to charges specifically stated in order to show cause that attorney failed to seek employment by bankruptcy court, accepted fees from the Chapter 11 debtor, and failed to refund money upon debtor's demand. U.S. Const. Amend. 5; 11 U.S.C.A. § 327(a).

- Finding in attorney disciplinary order that the attorney admitted he was not qualified to practice bankruptcy law was not supported by the evidence, inasmuch as attorney admitted only that he was incompetent to practice chapter 11 bankruptcy law, no evidence was taken at the hearing with regard to the attorney's competency to practice chapters 7 and 13, and the bankruptcy court, following hearing, relied on past chapter 13 case to assess attorney's current fitness to represent debtors in chapters 7 and 13.

- Remand was necessary when the bankruptcy court did not consider American Bar Association Standards in determining reasonableness of its sanctions in permanently barring the attorney on district-wide basis from practicing chapter 11 bankruptcy law and from representing debtors in Chapters 7 and 13, and when its grounds for order barring the attorney from chapter 11 practice were unclear. This also constituted abuse of discretion.

- Ninth Circuit Bankruptcy Appellate Panel would adopt American Bar Association Standards, using State Bar Standards and relevant case law as supplemental points of reference, as appropriate factors to be used in determining reasonable attorney disciplinary sanction.

Ordinarily, a client's right to choose counsel is considered of the highest importance. However, the duty of the judicial tribunal to protect the public from unqualified, unethical, and unprofessional attorneys may at times require an exception to that special rule. Amazingly, at least one court, in an unpublished opinion, has entered an order that appears to trump the client's ordinarily highly respected right to counsel of choice. In *Klein-Becker v. Stanley*, the United States district court ordered the attorneys in the civil action to immediately change their "manner of practice and start conducting themselves as competent to practice in the federal court," and if they do not change "the Court will contemplate and may enter an order requiring the parties to obtain new counsel." Pursuant to *Klein-Becker*, if counsel crosses the line too far

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60 *Id.* at 930.
and too many times, thereby making a mockery of the court system, the court can trump the client's right to counsel of choice and bar the offending attorney from practicing in that court.

In another recent case which demonstrates the developing law of attorney disciplinary actions, in the Bankruptcy Court for the District of Maryland, the Attorney Grievance Commission of Maryland filed an adversary proceeding in the bankruptcy case of a disbarred attorney, seeking to have a judgment of $6,903.76 against him declared nondischargeable under 11 U.S.C. § 523(a)(7), claiming that the judgment rendered against him in connection with attorney disciplinary proceedings for voluntarily misappropriating funds and violating the Maryland Rules, the Maryland Code, and the Maryland Rules of Professional Conduct related to trust accounts was excepted from the Chapter 7 discharge sought by the attorney.\(^{61}\) The court outlined the three-pronged test under § 523(a)(7), stating that the following three elements must be in place for a debt to be nondischargeable under that provision: "(1) the debt must be payable to and for the benefit of a governmental unit; (2) it must be in the nature of a fine, penalty, or forfeiture; and (3) it must not be compensation for actual pecuniary loss."\(^{62}\) The attorney argued that the third element was not present in his case, suggesting that the judgment was compensation for actual pecuniary loss. The court found for the Attorney Grievance Commission ("Commission"), finding all three elements clearly in place. As for the attorneys argument, the court dismissed it finding that the purpose of imposing the costs was penal, the Commission was duty-bound to pursue the claim against the attorney regardless of the cost, and the court cited public policy reasons for holding that an award for costs in an attorney disciplinary proceeding is nondischargeable, finding that it is in the public's best interest to "prevent attorneys who violate professional rules of conduct from eluding punishment for professional improprieties by filing for bankruptcy."\(^{63}\) The judgment was excepted from discharge.

Attorneys should keep in mind that the client may ultimately be punished for the actions of the unqualified, unprofessional or unethical attorney. It is emphasized that retaliation in kind against


\(^{62}\) Id. at 306 (citations omitted).

\(^{63}\) Id. at 313.
obstreperous opposing counsel is not acceptable conduct as this behavior does nothing but perpetuate and intensify unprofessionalism in the practice of law, and it likewise will not be tolerated.

III. Police Powers, Reference to the United States Attorney’s Office, and Possible Bankruptcy Crimes

The unpleasant topic of bankruptcy crimes resulting from certain unprofessional acts and conduct of attorneys is sufficiently important for an independent article. Since excellent articles already exist on the subject, this serious topic will be briefly discussed here, particularly as it relates to the court’s duty and power to address egregious abuses of standards of professional and ethical conduct through resorting to referral for prosecution on the grounds of such conduct. One of the underlying purposes of the laws of Congress relating to bankruptcy is to provide the honest, but unfortunate debtor with a fresh financial start unhampered by the pressures and discouragement of pre-existing debts. To achieve this congressional goal, attorneys must play a vital role in the bankruptcy process. The justice system process understandably relies heavily on the honesty and good faith of all of the participants, including the attorneys. When attorney conduct goes beyond the level of professional or ethical indiscretion and enters the realm of criminal action, the court and its officers may be morally or statutorily obligated to refer the matter for further investigation to the appropriate body, usually the United States Attorney’s Office. Thus, the conduct and activities of an attorney during the course of litigation, discovery, arbitration, and mediation may be criminal under 18 U.S.C. §§ 152 and 1503.

64 Local Loan Co. v. Hunt, 292 U.S. 234 (1934).
66 Specifically, 18 U.S.C. § 152 states:
   A person who—
   (1) knowingly and fraudulently conceals from a custodian, trustee, marshal, or other officer of the court charged with the control or custody of property, or, in connection with a case under title 11, from creditors or the United States Trustee, any property belonging to the estate of a debtor;
   (2) knowingly and fraudulently makes a false oath or account in or in relation to any case under title 11;
   (3) knowingly and fraudulently makes a false declaration, certificate, verification, or statement under penalty of perjury as permitted under section 1746 of title 28, in or in relation to any case under title 11;
   (4) knowingly and fraudulently presents any false claim for proof against the estate of a debtor, or uses any such claim in any case under title 11, in a personal capacity or as or through an agent, proxy, or attorney;
   (5) knowingly and fraudulently receives any material amount of property from a debtor after the filing of a case under title 11, with intent to defeat the provisions of title 11;
   (6) knowingly and fraudulently gives, offers, receives, or attempts to obtain any money or property, remuneration, compensation, reward, advantage, or promise thereof for acting or forbearing to act in any case under title 11;
   (7) in a personal capacity or as an agent or officer of any person or corporation, in contemplation of a case under title 11 by or against the person or any other person or corporation, or with intent to defeat the provisions of title 11, knowingly and fraudulently transfers or conceals any of his property or the property of such other person or corporation;
   (8) after the filing of a case under title 11 or in contemplation thereof, knowingly and fraudulently conceals, destroys, mutilates, falsifies, or makes a false entry in any recorded information (including books, documents, records, and papers) relating to the property or financial affairs of a debtor; or
The foregoing criminal statutes do not make a clear distinction between an attorney, the debtor, and other parties in a bankruptcy case or proceeding. Therefore, an attorney's unprofessional conduct or unethical activities may in fact be sanctionable under the applicable criminal statute. In a case involving court-imposed criminal discipline, the United States Attorney's Office for the Northern District of Georgia has reported that an attorney who pled guilty to a mortgage fraud scheme was incarcerated, ordered to pay $593,337 in restitution, ordered to file tax returns for the past four years, and lost his law license, which was suspended by the court. 67

In United States v. Connery, 68 the Sixth Circuit Court of Appeals considered the case of an in-house counsel who aided a creditor, his employer, in filing a false proof of claim in a bankruptcy case. The attorney/defendant was thereafter convicted of numerous counts of criminally aiding and abetting his client by filing false proofs of claim. 69 It is worth noting here that the attorney was found guilty under the aiding and abetting statute under 18 U.S.C. § 2. 70

Under the statutory provisions of 18 U.S.C. § 2, it is not necessary that the attorney actually be the one who committed the crime, but rather that a crime (1) be committed by someone, (2) that the attorney knowingly associated with the entity who committed the crime, (3) that the attorney knowingly participated in some aspect of the crime's commission, and (4) that the attorney possessed the requisite mental state

67 Bankruptcy Court Decisions, Weekly News & Comment, FRAUD WATCH, p. A7, Vol. 43, Issue 20 (Nov. 9, 2004). See also Bankruptcy Court Decisions, Weekly News & Comment, FRAUD WATCH, p. A7, Vol. 43, Issue 26 (Jan. 11, 2005) (A Mississippi attorney was disbarred for continuing to serve clients after he was convicted of bankruptcy fraud. His bankruptcy fraud conviction came after he plead guilty to concealing $10,000 in client's assets in a bankruptcy petition, for which he was originally put on probation for five years with a $10,000 fine and restitution of $5,000); Bankruptcy Court Decisions, Weekly News & Comment, FRAUD WATCH, p. A7, Vol. 43, Issue 9 (August 17, 2004) (Oakland, California, attorney indicted for fraud along with his client for using the bankruptcy process to prevent creditors from obtaining a judgment lien against his client's property); Bankruptcy Court Decisions, Weekly News & Comment, p. A9, Vol. 43, Issue 17 (Oct. 12, 2004) (Disbarred Virginia attorney was indicted on 18 counts of fraud in association with filing false proof of claims against the Archdiocese of Portland for alleged sexual abuse by a priest); In re Knoll, 505 U.S. 1242 (1992) (attorney disbarred after being convicted of aiding and abetting a client's financial fraud); In re Pfingst, 53 A.D.2d 288 (N.Y. App. Div. 1976) (attorney disbarred after conviction under 18 U.S.C. §152); In re Metheany, 449 P.2d 609 (Ariz. 1969).

68 United States v. Connery, 867 F.2d 929 (6th Cir. 1989).

69 Id. at 936.

70 18 U.S.C. § 2 provides as follows:

(a) Whoever commits an offense against the United States or aids, abets, counsels, commands, induces or procures its commission, is punishable as a principal.
(b) Whoever willfully causes an act to be done which if directly performed by him or another would be an offense against the United States, is punishable as a principal.
for the crime (usually "knowingly" or "fraudulently"). Illustrative examples that might fall into this category include an attorney, knowing that a claim is fraudulent, assists the creditor client with pursuing the fraudulent claim. Also, though not specific to courtroom decorum, completing and filing or causing to be filed incorrect schedules or reports also may qualify as criminal conduct under 18 U.S.C. §§ 2 and 152(3).

Needless to say, it is strongly believed that these cases are the rare exception rather than the rule. However, it is important to note that criminal sanctions are available in appropriate cases and proceedings as a means to address egregious unprofessional or bad faith conduct of attorneys and to maintain the integrity of the judicial process in bankruptcy.

IV. Attorney Conduct During Discovery Depositions, Rule 2004 Examinations, and Examinations at Section 341 first Meetings of Creditors — Harassing, Rude Inappropriate, or Embarrassing Questions, and Obstructionist, Delaying, or Coaching Objections.

The Federal Rules of Civil Procedure, the Federal Rules of Bankruptcy Procedure, and the American College of Trial Lawyers Code of Pretrial Conduct (the "ACTL Code") set forth numerous rules relating to professional conduct of attorneys during the discovery process. These rules apply to depositions under the Federal Rules of Civil Procedure, examinations under Rule 2004 of the Federal Rules of Bankruptcy Procedure, and § 341(a) meetings of creditors under the Code. An attorney should refrain from using any form of discovery, or the scheduling of discovery, as a means of harassing or intimidating opposing counsel and/or counsel's client. According to the ACTL Code: "[a] lawyer should conduct discovery to elicit relevant facts and evidence, and not for an improper purpose, such as to harass, intimidate, or unduly burden another party or a witness."

Attorneys conducting discovery depositions, Rule 2004 examinations, and examinations of the debtor at the § 341(a) meeting of creditors should be civil and exercise proper professional and ethical...
demeanor. Concerns for professional civility and proper demeanor also extend to arbitration and mediation matters arising out of bankruptcy cases and proceedings. Harassing, rude, inappropriate, or embarrassing questions and improper coaching are unprofessional; and the parties and courts should not tolerate such behavior. The discovery focus is on the deponent - not the attorney. The discovery deponent is the source of testimony. Obstructionist and delaying tactics of attorneys also are unprofessional and should not be condoned. These matters are discussed in more detail infra.

How and when should unprofessional conduct and other disputes under the Federal Rules of Civil Procedure or under 11 U.S.C. § 341(a) and Rule 2004(a) of the Federal Rules of Bankruptcy Procedure be brought to the attention of the bankruptcy court? Who has the burden of proof arising out of such disputes? What is the proper standard of proof at a proceeding before the bankruptcy judge arising out of such dispute? Procedurally speaking, unresolved discovery disputes should be expeditiously brought to the attention of the bankruptcy court via motion practice. The aggrieved party in the discovery process, as the movant, has the ultimate burden of proof at the hearing before the court to consider the motion. The standard of proof in each proceeding is a preponderance of the evidence considering a totality of the particular facts and circumstances on a case-by-case basis.

A. Depositions

When properly utilized, discovery depositions serve a meaningful purpose. Unfortunately, discovery depositions sometimes become "theaters for posturing and maneuvering rather than the intended and efficient vehicles for the discovery of relevant facts or the perpetuation of testimony." As a result, some depositions are less cost-effective for obtaining discovery. Many courts impose sanctions upon unduly manipulative attorneys who turn discovery depositions into a "three ring circus." Motions to

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77 See Fed. R. Bankr. P. 9019(c).
78 Most courts have now adopted formal or informal mediation programs.
80 Id.
81 ACTL Code at supra n.64, at 7-8. The ACTL Code addresses depositions as follows:
(1) Lawyers should limit depositions to those that are necessary to develop the claims or defenses in the pending case or to perpetuate relevant testimony.

(4) During a deposition, lawyers should conduct themselves with decorum and should never verbally abuse or harass the witness or unnecessarily prolong the deposition.
compel and motions for sanctions can be used as effective tools to promote meaningful discovery. The bankruptcy court is not a "legal playground" where attorneys are permitted to indulge in elaborate and unprofessional games of "catch-me-if-you-can."\(^\text{82}\)

In *In re First City Bancorporation of Texas, Inc.*,\(^\text{83}\) the Fifth Circuit Court of Appeals imposed monetary sanctions of $25,000 on a vituperative attorney who engaged in professional misconduct during discovery depositions. In that case, the attorney's "egregious, obnoxious, and insulting behavior" included characterizing the Assistant United States Attorney and other attorneys with offensive names including "stooge," "puppet," "weak pussyfooting deadhead," "inept," "a bunch of starving slobs," and "an underling who graduated from a 29th-tier law school."\(^\text{84}\) The recalcitrant and rude attorney also referred to various other attorneys, law firms, and their clients by using other incredibly degrading names.\(^\text{85}\) The bankruptcy court found under the circumstances that the attorney's "egregious, obnoxious, and insulting behavior... constituted an unwarranted imposition upon and an affront to the bankruptcy court and the parties and practitioners who have appeared in this bankruptcy that should not have to be endured in the future."\(^\text{86}\)

The bankruptcy court then barred the attorney from practicing in the bankruptcy court for the Northern District of Texas "unless he first obtained written permission from the court."\(^\text{87}\) The court also imposed a $22,500 monetary sanction against the abusive and insulting attorney.\(^\text{88}\) The attorney appealed the order, which was remanded on appeal to the bankruptcy court to reconsider the sanctions.\(^\text{89}\) On remand, the bankruptcy court removed the bar from practicing in its bankruptcy courts, but increased the monetary


\(^\text{83}\) 282 F.3d 864 (5th Cir. 2002).

\(^\text{84}\) Id. at 866.

\(^\text{85}\) Id.

\(^\text{86}\) Id.

\(^\text{87}\) Id.

\(^\text{88}\) Id.

\(^\text{89}\) *In re First City*, 282 F.3d at 866.
sanction to $25,000. The attorney again appealed the order of the bankruptcy court to the district court which affirmed the bankruptcy court. The attorney then appealed the district court’s decision to the Fifth Circuit. The Fifth Circuit found that “the sanctioning court must use the least restrictive sanction necessary to deter the inappropriate behavior.” The Fifth Circuit also upheld the $25,000 monetary sanction as not abusive of the bankruptcy court’s discretionary sanctioning power.

Similarly, the Seventh Circuit Court of Appeals imposed monetary sanctions on an aggressively defiant attorney who conducted discovery depositions in an unproductive, obstructionist, and harassing manner, as well as the attorney in the same law firm who merely signed the notice of discovery deposition. In *In re Rimsat, Ltd.*, the sanctioned attorney, among other things, argued and asked harassing questions of the witness. When the attorney asked the witness about a conversation between the witness and another party, the rude attorney said: “I want to know everything she said to you . . . every single word she uttered . . . .” The attorney then began to argue with the witness and counsel for the witness, and implied that the witness intended to be dishonest and improperly invoke the attorney-client privilege. The attorney shortly thereafter ended the discovery deposition without questioning the witness at all about the actual issue in the case. After a motion for sanctions and notice and a hearing, the bankruptcy court sanctioned the attorney for his unprofessional conduct by charging to him the costs of the deposition, a total of $10,890.81, and by revoking the *pro hac vice* status of the questioning attorney and his associates. The attorneys appealed to the district court, which affirmed the sanctions. The attorneys then appealed to the Seventh Circuit, which also affirmed the sanctions.

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90 Id. at 866-67.
91 Id.
92 Id.
93 Id.
94 *In re Rimsat, Ltd.*, 212 F.3d 1039 (7th Cir. 2000).
95 Id. at 1042.
96 Id.
97 Id.
98 Id. at 1043.
99 Id. at 1039.
100 Id.
101 Id.
The bankruptcy court for the District of Puerto Rico similarly has held that an attorney may be sanctioned for obstructive and unprofessional conduct during discovery depositions.\(^{103}\) In *Amezaga*, the attorney "engaged in extensive and unnecessary colloquy, asserted groundless objections, improperly objected and took every opportunity to interrupt and argue with opposing counsel."\(^{104}\) The court noted that "[w]hile this style may project zealfulness[,] 'Rambo litigation ... does not promote the just, speedy, and inexpensive determination of every action,' as is required by FED. R. CIV. P. 1 and is not tolerated by this court."\(^{105}\) The court went on to hold that the attorney's unprofessional conduct "served to effectively obstruct the success of the discovery deposition and violated numerous mandates contained in the Federal Rules of Civil Procedure."\(^{106}\) The court imposed monetary sanctions against the attorney for the cost and attorney fees incurred by the opposing party as a result of the unsuccessful deposition.\(^{107}\) The court also imposed a $500 sanction for "unnecessary delays and waste of judicial resources caused by conduct which is contrary to the Federal Rules of Civil Procedure."\(^{108}\)

Rule 37 of the Federal Rules of Civil Procedure, made applicable to bankruptcy adversary proceedings and contested matters pursuant to Rules 7037 and 9014(c) of the Federal Rules of Bankruptcy Procedure, provides generally for sanctions against parties or persons, including attorneys, unjustifiably resisting discovery. Rule 37(a), *inter alia*, addresses the subjects of expenses and sanctions for various acts. Subdivision (b) of Rule 37 deals with sanctions for failure to comply with a court order; orders of contempt may be entered in appropriate cases. Rule 9011 of the Federal Rules of Bankruptcy Procedure also allows for the imposition of sanctions upon attorneys and law firms responsible for certain conduct combined with a procedure to bring such egregious matters before the court. Additionally, 28 U.S.C. § 1927 provides that any attorney admitted to conduct cases in any court of the United States or

\(^{101}\) Id.

\(^{102}\) Id. at 1049.

\(^{103}\) *In re Amezaga*, 195 B.R. 221 (D. P.R. 1996).

\(^{104}\) Id. at 228.

\(^{105}\) Id. (quoting *Van Pilsum v. Iowa State Univ. of Science and Technology*, 152 F.R.D. 179, 181 (S.D. Iowa 1993)).

\(^{106}\) Id. at 228.

\(^{107}\) Id. at 229.

\(^{108}\) Id.
any Territory thereof who impermissibly multiplies the proceedings in any case unreasonably and vexatiously may be liable for excessive costs, expenses, and attorneys' fees reasonably incurred because of such conduct. Rule 9011\textsuperscript{109} of the Federal Rules of Bankruptcy Procedure provides for further sanctions under appropriate circumstances. Also, as a sanction, the court held in In re Rimsat, Ltd., supra, that an attorney's pro hac vice status in appropriate cases could be revoked.

As discussed supra in Section II, matters involving egregious, unprofessional conduct are subject to judicial disciplinary action and/or referral to independent, specialized bodies that have been created to investigate charges of unprofessional conduct.

B. Rule 2004 Examinations Under the Federal Rules of Bankruptcy Procedure

Rule 2004 of the Federal Rules of Bankruptcy Procedure is a basic discovery tool or device utilized by parties in interest in bankruptcy cases and proceedings, especially by bankruptcy trustees and examiners. Rule 2004(a) specifies the procedural manner of moving for an examination; it allows an examination of any entity\textsuperscript{110} on motion filed with the court. No adversary proceeding pursuant to Rule 7001(1) - (10) of the Federal Rules of Bankruptcy Procedure or contested matter pursuant to Rule 9014 of the Federal Rules of Bankruptcy Procedure need be instituted as a prerequisite to obtaining an order for an examination pursuant to the discovery devices of Rule 2004.\textsuperscript{111}

The scope of an examination pursuant to Rule 2004 is extremely broad and has been compared to "a fishing expedition."\textsuperscript{112} A Rule 2004 examination also has been referred to as "unfettered and broad" in scope. Interestingly, Rule 2004 is unique to bankruptcy law and procedure. It affords few of the procedural safeguards that an examination under, for example, Rule 26 of the Federal Rules of Civil Procedure does.\textsuperscript{113}

\footnotesize{\textsuperscript{109}It is noted that FED. R. BANKR. P. 9011(d) provides that subdivisions (a) (Signature); (b) (Representations to the Court); and (c) (Sanctions) do not apply to disclosures and discovery requests, etc. that are subject to the provisions of FED. R. BANKR. P. 7026 through 7037.}

\footnotesize{\textsuperscript{110}The term "entity" is broadly defined in § 101(15) of the Code.}

\footnotesize{\textsuperscript{111}Interestingly, if an adversary proceeding or contested matter is pending; Rule 2004 ordinarily should not be used. The scheme of discovery provided for in Rules 7026-7037 of the Federal Rules of Bankruptcy Procedure should be utilized instead.}

\footnotesize{\textsuperscript{112}See, e.g., In re Szadkowski, 198 B.R. 140 (Bankr. D. Md. 1996) (holding that discovery under Rule 2004(a) allows broad fishing expedition into entity's affairs for the purpose of obtaining information relevant to administration of bankruptcy estate). See also In re M4 Enterprises, Inc., 190 B.R. 471 (Bankr. N.D. Ga. 1995) (holding that the policy behind Rule 2004(a) is to promote open-aired examination even for those on a "fishing expedition").}

\footnotesize{\textsuperscript{113}In re GHR Energy Corp., 33 B.R. 451, 454 (Bankr. D. Mass. 1983).}
Examinations under Rule 2004 are broadly allowed for the intended "purpose of discovering assets and unearthing frauds."\textsuperscript{114} However, there are limits to the scope of examination pursuant to Rule 2004. For example, it may not be used for "purposes of abuse and harassment," and it cannot stray into matters, that are not relevant to the basic inquiry.\textsuperscript{115} The bankruptcy judge resolves objections to questions that arise during the Rule 2004 examination at a later time, after the filing by the aggrieved party of a motion, and after notice and a hearing. A general purpose of the examination pursuant to Rule 2004 is to locate assets, to make those assets available for creditors under the statutory scheme of distribution, and to assist in upholding the integrity of the bankruptcy system. Examinations that are oppressive and burdensome are not permitted under Rule 2004.\textsuperscript{116} The doctrine of privileged communications, if applicable, applies to an examination pursuant to Rule 2004.\textsuperscript{117}

To prevent abuse, the parties and the courts have numerous and varied "police tools" to utilize, as in the discovery deposition process, in order to fashion a proper result after considering appropriate sanctions in light of a totality of the particular facts and circumstances.\textsuperscript{118} Independent bodies that investigate attorney conduct may assist in enforcement, as may the criminal justice system, as discussed supra.

C. Examinations at § 341 Meetings of Creditors Under the Bankruptcy Code

Subsection (a) of § 341 of the Code mandates that there be a meeting of creditors conducted within a reasonable time after the order for relief in a case under the Code. Section 343 of the Code requires the debtor to appear at the § 341(a) meeting of creditors and submit to an examination under oath that is administered by the United States trustee or bankruptcy administrator. In contrast to procedures under the former Bankruptcy Act and Bankruptcy Rules of Procedure, section 341(c) of the Code expressly prohibits the bankruptcy judge from presiding at, or even attending, a meeting of creditors or meeting of equity holders.

\textsuperscript{114}Id.; see also in re Ionosphere Clubs, Inc., 156 B.R. 414 (S.D.N.Y. 1993), aff'd 17 F. 3d 600 (2d Cir. 1994).

\textsuperscript{115}E.g., In re Mitco, Inc., 44 B.R. 35, 36 (Bankr. E.D.Wis. 1984).

\textsuperscript{116}E.g., Vantage Petroleum Corp., 34 B.R. 650, 652 (Bankr. E.D.N.Y. 1983).

\textsuperscript{117}The doctrine of privilege is governed by Rule 501 of the Federal Rules of Evidence, and is made applicable to bankruptcy cases by virtue of Rule 9017 of the Federal Rules of Bankruptcy Procedure.

A meeting of creditors held in accordance with § 341(a) is not an adjudicative proceeding; it is a non-judicial meeting. Nonetheless, unprofessional conduct of attorneys and trustees at such meetings is sanctionable by the court. This statutorily required meeting of creditors is held in “all bankruptcy cases so that creditors and other parties in interest including a bankruptcy trustee may broadly examine and question the debtor.” Civility and proper demeanor should prevail at the § 341(a) meeting of creditors. The United States trustee or bankruptcy administrator, or his or her designee, presides over the § 341(a) meeting of creditors. Disputed objections to questions or other unresolved problems that arise during the non-judicial meeting of creditors, however, are decided by a bankruptcy judge at a later time, after notice and a hearing.

The § 341(a) meeting of creditors operates under the Code as the functional equivalent of a quasi-discovery deposition. Unlike a discovery deposition, the sworn testimony of the debtor at a § 341(a) meeting of creditors ordinarily is not admissible as direct evidence in a later Rule 7001(1)-(10) adversary proceeding or Rule 9014 contested matter. However, the debtor’s sworn testimony at the § 341(a) meeting of creditors ordinarily may be used in a subsequent proceeding including an adversary proceeding, a contested matter, or a criminal action as, for example, an admission against interest or for impeachment purposes.

Because the § 341(a) meeting of creditors under the Code is not a Part VII adversary proceeding or a contested matter governed by Rule 9014 of the Federal Rules of Bankruptcy Procedure, neither the Federal Rules of Civil Procedure nor the Federal Rules of Evidence are expressly applicable at the meeting. Further, non-attorney creditors who attend such meetings may participate and ask questions of the debtor, and not be found guilty of engaging in the unauthorized practice of law. To prevent abuse

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1 In re Kincaid, 146 B.R. 387, 388 (W.D. Tenn. 1992).
2 Id. at 388.
3 Id.
4 Id.
52 Id.
62 Id. at 389, quoting Handbook for Chapter 7 Trustees at pp. 66-68 (1986).
at the § 341(a) meeting of creditors, the parties and the courts should use the same “police tools” discussed supra. For example, orders to compel and for sanctions may be entered where appropriate, after notice and hearing.

V. Inappropriate Personal Attacks and Derogatory or Offensive Statements Made During Oral Arguments or Negotiations

In the heat of legal combat, an attorney may get caught up in the issue and become too zealous and overly aggressive as an advocate for his/her client. Such excitement may cause the attorney to engage in inappropriate, vicious attacks or other unacceptable conduct or offensive statements during oral arguments, negotiations, or other proceedings. Attorneys must exercise emotional control or face reprimand or sanctions by the court or a state board of professional responsibility for such inappropriate and unprofessional conduct. Simply put, attorneys are accountable for their unprofessional actions or inactions.

The Second Circuit Court of Appeals addressed a situation of an offending attorney who made personal attacks and obnoxious statements in his brief and oral arguments.\textsuperscript{126} In \textit{In re 60 East 80th Street Equities, Inc.}, the debtor’s attorney, in his appellate brief addressing the order of the bankruptcy court, made “disparaging and unsubstantiated allegations that the bankruptcy court and the trustee were engaged in civil and criminal misconduct.”\textsuperscript{127}

The attorney in \textit{In re 60 East 80th Street Equities, Inc.} continued with a disparaging laundry list of offensive name-calling and accusational statements that were in reality completely unfounded. The attorney also accused the bankruptcy trustee of “fraud, deceit and misrepresentation,” and of being an “idiot who pocketed the purchase price of the judgments.”\textsuperscript{128} The district court affirmed the bankruptcy court’s order and awarded sanctions \textit{sua sponte} against the recalcitrant attorney.\textsuperscript{129} The court imposed monetary sanctions against the attorney in the amount of $5,000, which was half of what the bankruptcy

\textsuperscript{126} \textit{In re 60 East 80th Street Equities, Inc.}, 218 F.3d 109 (2d Cir. 2000).

\textsuperscript{127} \textit{Id.} at 113.

\textsuperscript{128} \textit{Id.}

\textsuperscript{129} \textit{Id.} (The sanctions were awarded pursuant to 28 U.S.C. § 1927 for “maintain[ing] this appeal in bad faith for the purpose of multiplying the proceedings in the case unreasonably and vexatiously,” and for making “spurious allegations of criminality in his brief against the Bankruptcy Judge and the Trustee.”)
trustee estimated as the cost of responding to the appeal from the bankruptcy court's decision.130 The
attorney appealed the imposition of sanctions to the Second Circuit.131 In the appellate brief, the attorney
continued calling the court offensive names and dispensing unfounded accusational statements.132 The
Second Circuit upheld the sanctions imposed by the lower court.133 The court further ordered double
costs and attorneys' fees of $5000, and stated that the court "shall not accept any more papers from [the
debtor's attorney] except upon proof of payment of the sanctions imposed by this Court and the District
Court."134

In another attorney discipline matter, the United States district court for the Eastern District of
Tennessee in *Lockheed Martin Energy Systems, Inc. v. Slavin*135 found that the offending
defendant/attorney violated Rule 11 of the Federal Rules of Civil Procedure in six specific ways, which
included:

(5) pursuing a campaign of personal attacks on Lockheed and asserting irrelevant
matters to portray Lockheed as an entity of ill repute, undeserving of legal rights and
protections, without any legal or rational basis to believe such materials were germane in
any way to the Court's determination: and

(6) pursuing a campaign of personal attacks on Mr. Horde and asserting irrelevant
matters to malign Mr. Horde's character in an attempt to persuade the Court to discredit
anything filed by Mr. Horde on behalf of his client, without any legal or rational basis to
believe such materials were material in any way to the Court's determination.136

The *Slavin* court imposed numerous sanctions against the offending attorney, including a
reprimand, requirement of a written apology, payment of costs and expenses, and an additional
$10,000.00 sanction that would be suspended provided the attorney complied with the other sanctions
and not engage in "conduct violative of Rule 11 before any Court, whether federal or state, judicial or
administrative."137

130/*In re 60 East 80th Street Equities, 218 F.3d.at 115.
131/*Id.
132/*Id.
133/*Id. at 118.
134/*Id. at 121.
136/*Id. at 458.
137/*Id. at 461-2.
VI. Unsupported “Lawyer Testimony” During Oral Arguments

Understandably, "lawyer talk" during oral arguments ordinarily is not proof in a lawsuit. It should be emphasized that an attorney's oral statements during arguments are not made under oath and, of course, are not subject to cross-examination. The Code of Trial Conduct promulgated by the American College of Trial Lawyers states that:

(a) In appearing in a professional capacity before a tribunal, a lawyer should not: . . . (5) in trial, allude to any matter that the lawyer does not reasonably believe is relevant or that will not be supported by admissible evidence, assert personal knowledge of facts in issue except when testifying as a witness, or state a personal opinion as to the justness of a cause, the credibility of a witness, the culpability of a civil litigant or the guilt or innocence of an accused . . . .138

“Lawyer talk or testimony” made during oral arguments may be objected to as being violative of the Code of Trial Conduct and also as being abusive and offensive. Hearsay grounds additionally may exist, especially if the lawyer is asserting hearsay as truth of the matter asserted.139 In some instances, the conduct and statements of the lawyer may serve as testimony of that lawyer during oral arguments in a later proceeding.140 By way of illustration, this conduct may include how the attorney acts, the introduction or non-introduction of inadmissible evidence, inappropriate opening statements, the pleadings, witness questioning, and “the invocation of rules excluding incompetent evidence and of privileges.”141 In some instances, these actions may even be seen and dealt with as party admissions.142

Further, “[i]f litigation behavior is allowed to be used as evidence, this may lead to the introduction of rebutting evidence that otherwise would not be offered.”143 If, however, “the rebutting evidence has slight probative value and would take a great deal of time or be very burdensome to present, it may be excluded under the general principle set forth in Federal Rule of Evidence 403.”144 “Under certain

140Id. at 695-96.
141Id. at 701.
142Id.
143Id. at 702.
144Id.; see FED. R. BANKR. P. 9017.
circumstances this principle might justify admitting evidence of relevant litigation behavior while excluding other evidence designed to rebut it.\textsuperscript{145}

If attorneys do present unsupported statements during oral arguments, this also may lead to issues involving trial management.\textsuperscript{146} For example, "[i]f in closing argument defense counsel asks the trier of fact to draw an inference from plaintiff's counsel's behavior - for instance from a question put to a witness - plaintiff may ask that the trier be prohibited from drawing the inference or that plaintiff be allowed to reopen the case to introduce rebutting evidence. If the plaintiff had the burden to obtain clarification of the law and failed to do so, there is not [sic] reason to disrupt the usual order of trial by allowing him to introduce rebutting evidence after the defendant's closing argument."\textsuperscript{147}

This scenario may also present the issue of the ethical prohibition of an attorney acting as a witness in a case in which he/she is the attorney.\textsuperscript{148} Some may argue that "simply by using the lawyer's conduct as an item of evidence, this prohibition will be violated."\textsuperscript{149} Others may argue that "the prohibition will be violated because if the lawyer's conduct is used as an item of evidence, this may lead to rebuttal testimony by the lawyer to explain his conduct."\textsuperscript{150} There are, however, exceptions to this rule, and "perhaps an exception should be recognized when it is the lawyer's trial conduct itself that is offered by the opponent as evidence against the client and the lawyer takes the stand to rebut the adverse implications of this conduct."\textsuperscript{151}

During opening statements, counsel does have "an obligation not to refer to evidence he/she knows he/she does not have or is not going to introduce, or that he/she knows would be barred by an exclusionary rule."\textsuperscript{152}

\textsuperscript{145}Mansfield, supra n. 139, at 702-3.
\textsuperscript{146}Id. at 703.
\textsuperscript{147}Id. at 703-04.
\textsuperscript{148}Id. at 704.
\textsuperscript{149}Id.
\textsuperscript{150}Id.
\textsuperscript{151}Id. at 706.
\textsuperscript{152}Id. at 717.
VII. Cloaking Improper Conduct or Communications From View of Bankruptcy Court Under the Guise of “Settlement Negotiation”

The ACTL Code provides that: “A lawyer should never make settlement proposals that are designed to antagonize or further polarize the parties . . . [a] lawyer should never engage in settlement negotiations for the purpose of delaying discovery or gaining an unfair advantage . . . [i]n participating in settlement negotiations and alternative methods of resolving disputes, lawyers should practice the same courtesy, candor, and cooperation expected of them during other pretrial proceedings.”\(^{153}\)

Additionally, Rule 408 of the Federal Rules of Evidence, entitled Compromise and Offers of Compromise, applies in cases under the Code by virtue of Rule 9017 of the Federal Rules of Bankruptcy Procedure. Pursuant to Rule 408, neither an offer to compromise, nor acceptance of such offer, nor an actual completed compromise of a disputed claim is admissible to prove liability for or invalidity of the claim or its amount. Likewise, evidence of conduct or statements made in compromise negotiations is not admissible.\(^{154}\)

It is said that the reasons recognized for exclusion under Rule 408 are:

- irrelevance, since the offer or compromise may, depending upon the circumstances, involve a purchase or attempt to purchase peace rather than an admission of liability; and
- policy, in that compromises, favored by public policy would be discouraged by admitting the evidence.

Attorneys who intentionally and inappropriately cloak improper conduct or communications from view of the bankruptcy court under the guise of “settlement negotiation” engage in unprofessional conduct. Attorneys are required to be zealous officers of the court, and have a duty of candor and honesty to the court. Such unprofessional conduct impugns the integrity of the profession and the judicial system itself.

VIII. Utilization of Self-Serving Written Correspondence and E-Mail as Exhibits to Pleadings

Self-serving declarations of attorneys made during the course of a title 11 case or proceeding “are not admissible in evidence as proof of the facts asserted.”\(^{155}\) A self-serving declaration “is a declaration made at some time and place out of court, and does not include testimony which one gives as a witness at

\(^{153}\)ACTL Code, at 10.

\(^{154}\)Rule 408 does not require the exclusion of any evidence otherwise discoverable merely because it is presented in the course of compromise negotiations. This Rule also does not require exclusion when the evidence is offered for another purpose, such as proving bias or prejudice of a witness, negating a contention of undue delay, or proving an effort to obstruct a criminal investigation or prosecution.

the trial. The objection to the admission of this kind of evidence is its hearsay character; the phrase ‘self-serving’ does not describe an independent ground of objection.\textsuperscript{156}

An attorney’s statement, however, may be “self-serving in one respect, but contrary to another interest. In such a case, the court must balance the competing interests to determine their predominant nature and ultimately the level of trustworthiness of the statement.”\textsuperscript{157} The Supreme Court of Alabama addressed this issue in \textit{Crawford v. Holmes & Waddell, Inc.}\textsuperscript{158} In \textit{Crawford}, the court held that letters and exhibits admitted in that case were admissible as tending to show the plaintiff’s conception of the contract.\textsuperscript{159} The court stated:

The general rule of evidence . . . “that a party cannot make evidence for himself by his written communications address to the other party, as to the character of dealings with them, or the liability of the party to whom they are addressed, in the absence of any reply assenting to the same,” is in accord with the rule of our decisions.

There are, however, some exceptions to this general rule, and one of these is that unanswered letters are admitted in favor of the writer when they are of the res gestae of the transaction under investigation.

Another statement of this exception to the rule is that such letters are admissible, though they contain self-serving declarations and are not a part of the mutual correspondence, when they relate to existing contracts between the parties.\textsuperscript{160}

\textbf{IX. Discovery Disputes and How and When to Bring Such Disputes to the Attention of the Bankruptcy Court}

Like the Federal Rules of Civil Procedure and the Federal Rules of Bankruptcy Procedure, the Code of Pretrial Conduct also addresses discovery disputes. More specifically, Standard 5(5) of the Code of Pretrial Conduct states that: “When a discovery dispute arises, opposing lawyers should attempt to resolve the dispute by working cooperatively together. Lawyers should refrain from filing motions to

\textsuperscript{156} Id.

\textsuperscript{157} Id.

\textsuperscript{158} 280 Ala. 89 (1966).

\textsuperscript{159} Id. at 91.

\textsuperscript{160} Id. In contrast, the Colorado Court of Appeals declined to admit self-serving correspondence as an exhibit because it lacked any foundation as to its authenticity. \textit{Thrifty Rent-A-Car System of Colorado v. Chuck Ruwart Chevrolet, Inc.}, 500 P.2d 172, 175 (Colo. Ct. App. 1972) (not selected for official publication).
compel or for sanctions unless they have genuinely tried, but failed, to resolve the dispute through all reasonable avenues of compromise and resolution. 161

Discovery problems that cannot be consensually resolved by the parties should be promptly submitted to the bankruptcy court for resolution via motion practice. The moving party ordinarily has the burden of proof in such matters. The standard of proof is by a preponderance of the evidence considering a totality of the particular facts and circumstances and applicable law. Local rules and procedures addressing such matters should be carefully considered.

X. Conclusions

As zealous professional advocates and concerned officers of the justice system, bankruptcy attorneys, as do all other attorneys, have ethical and statutory obligations to promote justice, to provide equitable and efficient processes of dispute resolution, and to respect core values of honesty, fairness, and good faith on which that process depends. 162 Many local judicial guidelines of professional courtesy exist. 163 Efficient practice and professional conduct serve to minimize conflicts while discouraging unduly

161 ACTL Code at 4.


163 For example, the Memphis Bar Association has published the following Guidelines for Professional Courtesy and Conduct:

I. COURTESY, CIVILITY AND PROFESSIONALISM

1. A lawyer should treat the opponent, the opposing party, the court and the members of the court staff with courtesy and civility, conducting business in a professional manner at all times.
2. A lawyer has no right, even when called upon by a client to do so, to abuse or to indulge in offensive conduct toward the opposite party. A lawyer should always treat adverse witnesses and parties with fairness and due consideration.
3. While in adversary proceedings, clients are litigants, and while ill feelings may exist between them, such ill feeling(s) should not influence a lawyer’s conduct, attitude, or demeanor towards opposing lawyers.
4. A lawyer should do all that is necessary to ensure that clients, the public, and other lawyers respect the judicial system. To this end, a lawyer should:
   (a) Never knowingly misstate fact or law, regardless of any pressure to do so.
   (b) Not engage in tactics that complicate or delay matters unnecessarily.
   (c) Avoid creating unrealistic expectations of a client or the public.
   (d) Avoid denigrating the legal profession, the court system or adversary counsel.
5. A lawyer should encourage methods and practices which simplify and make less expensive the rendering of legal services.
6. A lawyer should never institute or pursue a legal procedure solely for the lawyer’s own profit where there is no reasonable expectation that it will advance or contribute to the best interest of the client.
7. A lawyer should preserve and respect the law by observing all duties to the community and to the Profession. To this end, a lawyer should:
   (a) Contribute time and expertise to those unable to otherwise afford representation of their interests.
   (b) Participate in public service and public education activities through personal involvement and financial contributions, and encourage fellow lawyers to do the same.
   (c) Work to develop among lawyers a strong commitment to the ideals of integrity, honesty, competence, fairness, independence, courage, and dedication to the public interest.
8. A lawyer should recognize the importance of communication with both clients and adversaries. A lawyer should return all telephone calls and respond to all correspondence promptly.
9. A lawyer should never deceive the court or another lawyer.
10. A lawyer should honor promises or commitments made to another lawyer.
11. A lawyer should make every reasonable effort to cooperate with opposing counsel.
12. A lawyer should maintain a cordial and respectful relationship with opposing counsel.
13. A lawyer should seek sanctions against opposing counsel only where required for the protection of the client or of the legal system and not for mere tactical advantage.
aggressive and abusive attorney conduct during the course of litigation, discovery, arbitration, or mediation.

Attorneys have an obligation to be courteous, tolerant, patient, civil, and polite to the court and staff of the court; this duty further extends to bankruptcy trustees and administrators, clients, opposing parties and their counsel, and witnesses of the parties. It is not inconsistent for an attorney to zealously represent a client while maintaining civility with his/her opposing counsel. Despite common misconceptions, effective advocacy does not require antagonistic, obnoxious and unprofessional "Rambo" tactics. An attorney should be ever mindful of his/her broader professional duty to the judicial system and should demonstrate concern for public perceptions of the legal profession and its members. More to the point, attorneys should not be overly contentious, combative, or bellicose. Courtesy, cooperation, and respect for the court, trustees, bankruptcy administrators, clients, opposing counsel, and witnesses are, in reality, professional strengths and virtues - not weaknesses. Personal dignity and professional integrity are vital to the legal profession and the judicial process and public confidence. Attorneys who do not live up to ethical and professional standards and the accompanying rules of conduct, for whatever reason(s), essentially proceed at their own peril.

Bankruptcy courts, in accordance with 28 U.S.C. § 157(b)(1), ordinarily may enter final orders in response to unprofessional conduct as are just under the totality of the facts and circumstances of a particular case or proceeding to prevent undue manipulation and abuse of the judicial process and to protect the integrity of the bankruptcy court, its bar, the justice system as a whole, and the public. The terms of attorney disciplinary orders are reviewed on appeal for an abuse of discretion; findings of fact are not overturned unless they are clearly erroneous.

Understandably, the bankruptcy courts cannot afford to condone or tolerate unprofessional attorney conduct, and no one should seriously quarrel with this obvious statement. Of course, in a perfect bankruptcy world, the issue of unprofessional attorney conduct would never arise. Nevertheless, as earthly professionals and human beings, attorneys are expected to act with courtesy, civility, and

14. A lawyer should not make unfounded accusations of unethical conduct about opposing counsel.
15. A lawyer should never intentionally embarrass another lawyer and should avoid personal criticism of another lawyer.
16. A lawyer should always be punctual.
professionalism. They should never retaliate in kind in response to unprofessional or unethical conduct of other attorneys. Failure to act in a professional manner may result in dire consequences for attorneys (and judges). However, the court imposing the sanctions must use the least restrictive sanction necessary to deter inappropriate behavior. In other words, a court should exercise restraint when considering use of its inherent power to impose sanctions.

In conclusion, it is expressly observed that the vast majority of today's attorneys sufficiently comply with the governing and applicable rules and standards of ethical conduct and also act responsibly with all due deference to professional courtesy and civility; and they are to be highly commended and respected for doing so. Unfortunately, it seems that far too much time, effort, and costs are devoted to the dark underside of the legal profession. The harsh reality is that a few unprofessional attorneys conduct their "trade/business" at the great expense and time of other attorneys, their clients, the court, the justice system as a whole, and the public. Yet, there is no nobler profession than that of the law!
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AND
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SECTION I
Ethical Issues And Fee Applications


(A) Sanctions for a Consumer Debtor’s Attorney Under Section 707(b)

S. 256, Section 102 amends Section 707(b) of the Code. As a result, the attorney for a Chapter 7 debtor is exposed to increased liability and is expected to shoulder new responsibilities:

· Under Subparagraph (4)(A), upon a motion by any party in interest or upon the court’s own initiative, an attorney may be forced to compensate a trustee who successfully pursues a Section 707(b) motion if the court determines that the Chapter 7 filing violated Fed. R. Bankr. P. 9011;

· Subparagraph (4)(B) permits the court, whether upon its own initiative or the motion of a party interest, to award a civil penalty against the attorney to be paid to the trustee or United States trustee;

· Subparagraph (4)(C) signifies that an attorney’s signature certifies that the attorney has “performed a reasonable investigation into the circumstances that gave rise to the petition, pleading or written motion” and found that it was “well grounded in fact” and was not reliant upon an impermissible interpretation of law; and

· Subparagraph (4)(D) establishes that an attorney’s signature constitutes that the attorney has no information leading him or her to believe the petition is incorrect.

(B) New Requirement to be an Individual Debtor Under Section 109(h) and Its Potential Effect on Involuntary Consumer Bankruptcies

Pursuant to S. 256, Section 106, Section 109(h) now requires individual debtors to receive credit counseling from a nonprofit credit or budget-counseling agency as approved by new Section 111 of the Code. Individuals excepted from this requirement include debtors who:

· Filed in a district that does not have adequate counseling services as determined by the United States trustee;
· Filed a motion explaining exigent circumstances and informing the court they unsuccessfully sought briefing five days before their filing; and

· Are incapacitated, disabled, or are on active military duty in a combat zone.

Since individuals are required to receive debt counseling before they may be considered debtors unless an exception applies, involuntary consumer bankruptcy filings may be extremely restricted.

(C) **Minimum Requirements for Nonprofit Budget and Credit Counseling Agencies**

Information about nonprofit budget and credit counseling agencies is found in Section 111, an addition to the Code. The United States Trustee must keep a list of approved agencies. An agency is required to “provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides.” Before approval, each agency must meet the following minimum criteria:

· Maintain a board of directors that has a majority of members that are outside directors and “will not directly or indirectly benefit financially from the outcome of the counseling services;”

· Charge a reasonable fee, if a fee is charged at all, and provide services whether or not the client is able to pay;

· Uphold the integrity of client trust funds by conducting annual audits and maintaining suitable bonding for employees;

· Provide complete disclosures including costs of the program and “how such costs will be paid”;

· Analyze each client’s financial situation focusing on the client’s current financial condition, reasons the client has financial difficulty, and creation of a responsive plan;

· Employ counselors who have “adequate” experience and training;

· Prohibit “commissions or bonuses based on the outcome of the counseling services provided” paid to the counselors;

· “[D]emonstrate adequate experience and background in providing credit counseling”, and

· Sustain “financial resources” to ensure agency support services so that all repayment plans may be completed.
(D) **Exclusive Jurisdiction of Section 327 Matters in District Where Bankruptcy is Commenced or Pending**

Section 1334(e)(2) of the Code, as added by Section 324 of S. 256, grants the district in which the bankruptcy petition was filed or is pending exclusive jurisdiction "over all claims or causes of action that involve construction of [S]ection 327."

(E) **Section 330(a)’s Methodology to Calculate Trustee Compensation**

Under Subparagraph (a)(3) and pursuant to S. 256, Section 407, the phrase “trustee under [C]hapter 11” has been included as a person whose compensation, like an examiner or professional person, is based upon the following:

- The time spent on tasks;
- Rates charged for such services;
- Whether the tasks were “necessary” and “beneficial”;
- The reasonableness of the time spent on the tasks;
- The certification or experience with bankruptcy with respect to a professional person only (an addition made pursuant to S. 256, Section 415); and
- The reasonableness based on rates charged by similarly skilled practitioners in other bankruptcy matters.

Since Chapter 11 trustees are specifically mentioned in Subparagraph (a)(3) while Chapter 7 trustees are not, it may be assumed that compensation for Chapter 7 trustees, but not for Chapter 11 trustees, is determined by new Subparagraph (a)(7) which states: "In determining the amount of reasonable compensation to be awarded a trustee, the court shall treat compensation as a commission, based on [S]ection 326."

(F) **Clarification of Fee Arrangements for Professional Persons Under Section 328**

Section 328, as amended by S. 256, Section 1206; now expressly approves fixed fees or percentage fees for professional persons.

(G) **Payment of a Chapter 7 Trustee When a Case Has Been Converted to Chapter 13 or Refiled Under Chapter 13**

If a case has been converted or dismissed under Section 707(b), a trustee may receive some funds based on an amount previously awarded. Under new Section 1326(b)(3), as enacted by S. 256, Section 1224; the trustee is paid based on a formula. In essence, the trustee may receive, per month for the life of the plan, the greater of $25 or 5% of the average monthly payment made to general unsecured creditors. Generally, most plans
will not exceed an average of $500 per month for unsecured creditors. Therefore, over a five-year plan, a trustee is likely to receive a maximum of $1500.

(H) Appointment of a Trustee in Chapter 11 if Management Has Engaged in “Fraud, Dishonesty or Criminal Conduct”

Section 1405 of S. 256 adds Subparagraph (e) to Section 1104 of the Code. Now, the United States trustee “shall move for the appointment of a trustee” if there are “reasonable grounds to suspect” that the debtor’s current management “participated in actual fraud, dishonesty or criminal conduct in the debtor or the debtor’s public financial reporting.”

(I) Additional Duties of a Trustee or Debtor in Possession in a “Small Business” Chapter 11

Section 1116, a new addition to the Code, sets forth additional responsibilities when the debtor is considered a “small business.” In such a case the trustee or debtor in possession must also:

· Append a balance sheet, statement of operations, cash-flow statement, and federal income tax return or swear under penalty of perjury that these documents have not been prepared;

· Attend meetings scheduled by the court or United States trustee unless, after notice and a hearing, the court excuses such;

· Meet all deadlines for the filing of schedules and statement of financial affairs unless the court, after notice and a hearing, grants an extension;

· File all required post-petition reports;

· In light of Section 363(c)(2), maintain “customary and appropriate” insurance for the debtor’s industry;

· Subject to Section 362(c)(2), pay all taxes that are deemed an administrative expense except those that are being appropriately contested;

· File all government filings (including tax returns) in a timely fashion; and

· Permit the United States trustee to review the debtor’s business records and inspect the debtor’s premises upon adequate written notice or a waiver of notice by the debtor.
II. Compensation Issues in Chapter 7 Bankruptcies

(A) Chapter 7 Debtor’s Attorneys Cannot Receive Payment from the Estate for Post-Conversion Work (Laime v. United States Trustee, 540 U.S. 526 (2004))

In Laime, the petitioner had been retained to serve as counsel for the Chapter 11 debtor. The case was eventually converted to Chapter 7, but Laime continued to perform services on the debtor’s behalf. Eventually, Laime filed a fee application that included a request for payment for post-conversion work. The United States trustee objected to payment out of the pool of unencumbered estate funds.

The United States Supreme Court turned to a text of Section 330 in light of its amendment by the Bankruptcy Reform Act of 1994. While agreeing that the language of the current Section 330(a)(1) was clumsy, the Court refused to find an ambiguity based on improper grammar in a statute. Since the amendment deleted any reference to “the debtor’s attorney,” the petitioner was precluded from receiving payment under Section 330(a)(1).

The petitioner argued that a plain reading of Section 330(a)(1) would prohibit debtors from obtaining necessary counsel. The Court addressed this assertion by emphasizing that a debtor’s attorney in a Chapter 12 or Chapter 13 bankruptcy is still entitled to reasonable compensation. Further, with reference to Section 327(a) and (e), the Court stated it was possible for a Chapter 7 debtor’s attorney to receive payment if the trustee approves. Finally, the Court concluded that the “common practice” for Chapter 7 debtors’ attorneys to ensure their compensation is via a retainer, and the Court’s interpretation of Section 330(a)(1) does not disturb this method.

(B) Dischargeability of Fees for Pre-Petition Work (Rittenhouse v. Eisen, -- F.3d --, 2005 WL 774306 (6th Cir. April 7, 2005))

In Rittenhouse, a debtor failed to pay a previously agreed-upon sum to her attorney for services rendered prior to her Chapter 7 filing. The United States Trustee successfully moved the court to prevent collection of the fees. The Sixth Circuit Court of Appeals affirmed.

In reaching its decision, the Court of Appeals focused on a plain reading of Sections 727(b) and 523(a). Section 727(b) permits a discharge of all debts except those listed in Section 523(a). None of the nineteen exceptions in Section 523(a) applied to pre-petition attorney’s fees; therefore, the debt was dischargeable.

The appellant presented two arguments: (1) the Section 329 requirement of disclosure by the debtor’s attorney for all payments or agreements to pay within one year of the filing would be made meaningless and (2) the benefits of bankruptcy would be unavailable to debtors who could not pay for an attorney upfront.
First, the court determined that Section 329 still serves a substantial purpose as authority for the bankruptcy court to determine if pre-paid attorney’s fees are reasonable and to recover any excessive amount, to investigate any affirmed debts for attorney’s fees to ensure they are reasonable, and to decide if non-dischargeable, post-petition debts to attorneys are unreasonable.

In turning to the second argument, the court deferred to the legislature. The court conceded that prior to filing for bankruptcy, a debtor could be forced to forego payments to suppliers of necessities resulting in a negative impact on the general public. However, the court held this was a policy issue requiring Congressional attention.

(C) Decisions from Other Circuit Courts of Appeals Regarding Dischargeability of Fees Under Chapter 7 for Pre-Petition Services

Rittenhouse noted that three other circuits have determined whether pre-petition attorney’s fees are dischargeable: In re Fickling, 361 F.3d 172 (2d Cir. 2004) (holding that attorney’s fees incurred after the filing of a Chapter 11 petition but before the conversion of the case to Chapter 7 are dischargeable under Section 727); Bethea v. Adams & Assoc., 352 F.3d 1125 (7th Cir. 2003) (holding debts arising out of a prepetition agreement are dischargeable); and In re Biggar, 110 F.3d 685 (9th cir. 1997) (discharging fees sought post-petition for pre-petition work).


In CK Liquidation, Ropes and Grays, LLP (“R&G”) was retained to represent the debtor in its Chapter 11 reorganization. As part of the agreement, R&G received a retainer. After the court approved a sale of virtually all of the debtor’s assets, the case was converted to a Chapter 7 upon the debtor’s motion. Subsequent to conversion, R&G filed the post-petition list of creditors, attended the Section 341 meeting, and “generally assisted the trustee with such transition as the trustee required to familiarize himself with the case.” R&G’s final fee application included a request for $7,820 in post-conversion fees. The United States Trustee objected based on his contention that Laime precluded a debtor’s attorney from receiving payment for post-conversion work unless the Chapter 7 trustee employs the attorney.

First, the court concluded that Laime did not address whether an attorney who performed services for a converted Chapter 11 debtor could obtain payment for post-conversion work from a pre-petition security retainer. Thus, Laime was not dispositive. Next, the court viewed the pre-petition retainer as encumbered property, irrespective of its alleged status as property of the estate. Relying on the applicable state law, the court determined that R&G had a lien against the retainer funds. So long as there are undisbursed funds and a valid claim, subject to review by the court, the debtor’s attorney may utilize a pre-petition retainer as compensation for services.
Attorneys Can Draw Down a Pre-Petition Retainer for Pre-Petition Work But Cannot Draw Down a Pre-Petition Retainer for Post-Petition Work for a Debtor (Fiegen Law Firm, P.C. v. Fokkena (In re On-Line Services Ltd.), -- B.R. --, 2005 WL 600361 (8th Cir. BAP March 16, 2005))

In On-Line Services, the Fiegen Law Firm ("Fiegen") obtained a $9,000 retainer to represent On-Line in its Chapter 7 bankruptcy. A trustee was appointed, but the trustee did not hire Fiegen as special counsel. Fiegen continued to do work for the debtor. Eventually, Fiegen filed a $6,977.77 bill for legal services: $3,693.27 for pre-petition work and $2,284.50 for post-petition services.

The court determined that the retainer was property of the estate; however, it was subject to a retaining lien to the extent the lien was for a reasonable amount based upon pre-petition services rendered. The reasonableness of pre-petition services is determined under Section 329.

The court, relying on Laiime and Eighth Circuit cases, stated that Fiegen could not be awarded estate funds for post-petition work. Any lien for unperformed services did not survive the filing of the petition. Specifically, "[a] security retainer, to the extent it is valid, is extinguished on the petition date with respect to any future advances."

Disgorgement of Retainer Held as Interim Compensation (Specker Motor Sales, Co. v. Eisen, Case No. 03-1893 (6th Cir. Dec. 17, 2004))

Specker Motor Sales filed Chapter 11 bankruptcy on March 18, 1997, and Donald Bays ("Bays") was authorized to serve as counsel to the debtor. As part of the agreement, Bays received a $10,000 retainer. On September 24, 1997, the case was converted to Chapter 7. On February 4, 2002, Bays's final application for $17,343.10 was approved. The bankruptcy court let him keep the $10,000 retainer as interim compensation. After final liquidation, the court determined that each of the administrative claimants, including Bays, was entitled to a pro rata share of only $973.41. Thus, the bankruptcy court ordered Bays to disgorge $9,026.59. Bays objected on the grounds that the $10,000 had already been paid out of the estate.

The Sixth Circuit Court of Appeals held that interim compensation could be adjusted and is subject to disgorgement. Based on the plain meaning of Section 726(b), all like-situated creditors get a pro-rata share. To permit a professional who received a retainer to keep that retainer would upset the Code's carefully considered balance of payments. The court notes that "interim compensation is never anything but an administrative expense." As such, disgorgement of interim compensation is always a viable option to ensure pro rata distribution.
III. Chapter 7 Trustee’s Compensation When Case is Converted

(A) **Chapter 7 Trustee May Receive Quantum Merit Award When Case is Converted in Spite of Section 326(a) (In re Moore, 235 B.R. 414 (Bankr. W.D. Ky. 1999))**

The debtor initially filed a Chapter 7 bankruptcy. At the Section 341 meeting, the Chapter 7 trustee uncovered several sums of money that had not been included in the petition. The debtor converted his case to Chapter 13.

After conversion, the Chapter 7 trustee filed a fee application requesting compensation. The bankruptcy court decided, en banc, that the Chapter 7 trustee had discovered assets that led to a much greater pay out under Chapter 13 than the creditors would have received under Chapter 7. As such, the trustee was entitled to a quantum meruit award payable as a Chapter 13 administrative expense.

Before figuring the amount, the court must first determine if the trustee’s “substantial” efforts resulted in a benefit to the creditors. After considering the advantage enjoyed by the creditors due to the trustee’s work, the court will look to “the amount of services performed by the [t]rustee.” The court expressly states that this method would not apply if the trustee applies for compensation as the attorney for the Chapter 7 estate.

(B) **Other Cases Allowing a Chapter 7 Trustee to Receive a Quantum Meruit Award for Service Provided Pre-Conversion**

A majority of courts favor a quantum meruit award for a Chapter 7 trustee who has conducted work that benefits the creditors in lieu of a literal application of Section 326(a). *In re Main Realty & Management, LLC*, 277 B.R. 1, 8 (Bankr. D. Conn. 2002). As listed in Main Realty, some of these include: *In re Rodriguez*, 240 B.R. 912 (Bankr. D. Colo. 1999) (granting quantum meruit compensation when the Chapter 7 trustee’s investigation and adversary proceeding led to a conversion); *In re Washington*, 232 B.R. 814 (Bankr. S.D. Fla. 1999) (allowing quantum meruit award because trustee found several undisclosed assets before conversion to Chapter 13); and *In re Colburn*, 231 B.R. 778 (Bankr. D. Or. 1999) (permitting fees on a quantum meruit basis since trustee’s work led to Chapter 13 conversion for a Chapter 7 “no asset” case). See also *In re Horton*, 2004 Bankr. LEXIS 1408 (Bankr. S.D. Ohio 2004).

(C) **Cases Applying a Strict Application of Section 326(a) to Prevent an Award of Compensation for Chapter 7 Trustee Upon Conversion**

Under Chapter 7, a trustee’s payment is limited to a percentage of funds disbursed to creditors. Some courts have refused to compensate a Chapter 7 trustee for services conducted in a subsequently converted case. Those that have utilized this rationale include *In re Murphy*, 272 B.R. 483 (Bankr. D. Colo. 2002) (rejecting a Chapter 7 trustee’s application for fees in a converted case based on Section 326(a)).
IV. Maximum Compensation for Trustees


In re Moss reviews procedures and Code provisions relating to a Chapter 7 trustee’s application for the maximum amount of fees allowable under Section 326(a). Upon the debtor’s objection, the court concluded that the trustee did not meet his burden for maximum compensation.

In determining a trustee’s fees, the Moss Court applied Section 330 (“Compensation of Officers”) before Section 326 (“Limitation on Compensation of Trustee”). Stated differently, a court must first calculate the “reasonable” compensation of the trustee under Section 330 and then apply Section 326 to limit the amount if necessary.

Section 330 contains factors used to determine the “reasonableness” of a request for compensation, and the trustee must prove, by a preponderance of the evidence, that the requested fees are “reasonable” and necessary. The court noted that a fee application must comply with Fed. R. Bankr. P. 2016(a) (requiring the trustee to keep accurate records including time expended) and any local bankruptcy rules.

Once a court has the trustee’s fee application, the court makes a reasonableness decision using the lodestar method. First, the court multiplies the proven number of hours expended by a reasonable hourly rate to determine the lodestar figure. Second, the lodestar figure is adjusted up or down to reach a reasonable result. Courts look to the factors enumerated in Johnson v. Georgia Highway Express, Inc., 488 F.2d 714 (5th Cir. 1974), for both steps: (1) the time and labor required; (2) the novelty and difficulty of the question; (3) the skill requisite to perform the legal service; (4) the preclusion of other employment by the attorney due to acceptance of the case; (5) the customary fee; (6) whether the fee is fixed or contingent; (7) time limitations imposed by the client or the circumstances; (8) the amount involved and the results obtained; (9) the experience, reputation, and ability of the attorney; (10) the “undesirability” of the case; (11) the nature and length of the professional relationship with the client; and (12) awards in similar cases.

In Moss, the court recognized that the trustee ably performed his duties and limited the costs of administration, but more was needed to permit an upward adjustment of the lodestar figure. Also, the court acknowledged that trustees often received a meager compensation for the many “no asset” cases; however, awarding a trustee an upward adjustment for this reason alone would amount to a tax on particular debtors and their creditors.
In *MiniScribe*, a trustee was awarded the maximum percentage under Section 326 for recovery of a pool of money by the bankruptcy court with a lodestar multiplier of 3.5. The district court rejected the sum as excessive, denied the use of the common fund method of calculation in this case, and remanded to the bankruptcy court. On remand, the bankruptcy court reapplied the common fund method. Eventually, the case reached the court of appeals.

The Tenth Circuit Court of Appeals faced a choice between application of the lodestar test to gauge trustee's fees and the common fund approach. The common fund approach awards a percentage of a pool of funds recovered for the benefit of third parties (e.g. an attorney that recovers money for her clients). Noting very little case law on the differences between the lodestar test and the common fund approach in ascertaining a trustee’s compensation, the *MiniScribe* Court's review lead to a decision endorsing the lodestar test as the method to calculate a Chapter 7 trustee’s fees.

The *MiniScribe* Court first held that reasonableness must be determined under Section 330 before the maximum amounts can be set under Section 326. Then, the court investigated use of the common fund approach. It resolved that the common fund approach was inappropriate for the following reasons:

1. Section 326 serves only as a cap and does not establish the trustee's entitlement to a commission or percentage of amounts disbursed from the estate; 
2. there is no principled relationship between the amounts disbursed by a debtor corporation and reasonable compensation based on the trustee's actual efforts; 
3. there is no support in case law for a common fund approach; 
4. setting reasonable compensation based on a percentage of the debtor's disbursements would create a substantial risk of abuse in the selection and appointment of trustees by the United States trustee; and 
5. a percentage compensation approach could discourage courts from appointing a trustee when it might otherwise be appropriate.


The court also referenced a key difference between a trustee and a litigator: the trustee receives periodic compensation in the role of a fiduciary while a litigator has a completely different skill set, fronts the costs of litigation in some cases, and receives a contingency based on his/her recovery. Additionally, Section 330 specifically requires consideration of the time spent on services. If a common fund method were permissible, this factor would not be given proper weight. Finally, there is no Code provision expressly allowing a trustee to work on a contingency basis the way there is for the attorney of a trustee.
V. Reevaluation of Payment Terms

(A) Test to Determine if Fee Arrangement has been Pre-Approved (Nischwitz v. Miskovic (In re Airspect Air, Inc.), 385 F.3d 915 (6th Cir. 2004))

Nischwitz, an attorney, was approved by the bankruptcy court to serve as special counsel for a debtor in possession to prosecute a breach of contract claim. The attorney’s application to the court specified a $7,000 retainer fee and a contingency fee arrangement providing for between 33%-50% of any settlement or award. The bankruptcy court issued an ordering stating that “Airspect [the debtor in possession] is authorized to pay the sum of $7,000 of corporate funds as partial retainer for expenses.” Furthermore, Nischwitz was required to “submit application for fees to this Court for approval.”

Once the lawsuit was resolved, Nischwitz sought over $189,000 in compensation. The bankruptcy court denied his request and determined that $37,050, as calculated using an hourly rate, was reasonable. Nischwitz appealed to the Sixth Circuit Court of Appeals Bankruptcy Appellate Panel. The Panel reversed because the judge had approved the contingency fee pursuant to Section 328. The court was obligated to pay the contingency fee unless it proved improvident. The bankruptcy court decided it had improvidently approved the agreement. Turning to Section 330, the bankruptcy court concluded that $37,050 was reasonable. Also, the bankruptcy court concluded that its order did not approve Nischwitz’s contingency fee pursuant to Section 328. Once again, the Bankruptcy Appellate Panel reversed, and the matter was brought before the Sixth Circuit Court of Appeals.

The United States Court of Appeals for the Sixth Circuit found that an order that only indirectly approved a contingency fee agreement did not satisfy the Section 328. If Section 328 does not apply, compensation is judged for reasonableness under Section 330.

The Sixth Circuit adopted a “totality of the circumstances” test under which the court looks to factual circumstances of the professional’s motion for pre-approval of compensation and the court’s subsequent order. For a court to pre-approve a contingency fee arrangement pursuant to Section 328, the court should check for the following factors:

1. whether the debtor’s motion for appointment specifically requested fee pre-approval; (2) whether the court’s order assessed the reasonableness of the fee; and (3) whether either the order or the motion expressly invoked Section 328.

In re Airspect Air, Inc., 385 F.3d at 922. Neither Nischwitz’s motion for pre-approval nor the court’s order mentioned the terms of the contingency agreement or the reasonableness of the fee. The court concluded that the arrangement was not pre-approved and remanded the case to the Bankruptcy Appellate Panel to determine if $37,050 was reasonable under Section 330.
(B) Decisions from Other Circuit Courts of Appeals

Airspec referenced decisions from the United States Courts of Appeals for the Third and Ninth Circuits. The Third Circuit requires the order approving a compensation agreement to “unambiguously state specific terms and conditions” that are approved, or otherwise, the lodestar analysis is conducted to determine reasonableness. Zolfo, Cooper & Co. v. Sunbeam-Oster Co., Inc., 50 F.3d 253 (3d Cir. 1995). The Ninth Circuit is even stricter in its requirements. For valid pre-approval of a payment arrangement, the professional’s application must specifically invoke Section 328. In re Circle K Corp., 279 F.3d 669 (9th Cir. 2002). Deeming those two tests too strict, the Sixth Circuit adopted the more flexible “totality of the circumstances” test for determining pre-approval of contingency fee arrangements.

VI. Fees Limited to Work that Benefits the Estate

(A) In General: The Bankruptcy Code’s rules regarding disinterestedness also govern the lawyers’ behavior during the case. Section 327 prohibits the attorney from holding or representing an interest adverse to the estate and requires the attorney to be “disinterested.” Section 328(c) makes clear that the attorney must remain disinterested throughout the case as a precondition to an award of fees. That section provides:

(c) Except as provided in section 327(c), 327(e), or 1107(b) of this title, the court may deny allowance of compensation for services and reimbursement of expenses of a professional person employed under section 327 or 1103 of this title if, at any time during such professional person’s employment under section 327 or 1103 of this title, such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed.

Section 330(a) provides another way to approach the problem. Short of a finding of disinterestedness, the court could deny the attorney’s application for fees upon a finding that the legal work was not necessary or was not reasonably likely to provide a benefit to the estate. Section 330 provides in part:

(a)(1) After notice to the parties in interest and the United States Trustee and a hearing, and subject to sections 326, 328, and 329, the court may award to a trustee, an examiner, a professional person employed under section 327 or 1103--

(A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, professional person, or attorney and by any paraprofessional person employed by any such person; and

(B) reimbursement for actual, necessary expenses . . .
(4)(A) Except as provided in subparagraph (B), the court shall not allow compensation for--

(i) unnecessary duplication of services; or

(ii) services that were not--

(I) reasonably likely to benefit the debtor's estate; or

(II) necessary to the administration of the case.

Cases addressing contested fee applications have used both approaches to limit attorneys’ fees when courts have concluded that the attorney has taken actions that were designed to benefit one group of interested parties at the expense of others.

(B) In re Kendavis Ind. Int'l Ltd., 91 B.R. 742 (Bankr. N.D. Tex. 1988) remains the best example of a case finding that the debtor in possession’s lawyer’s actions during a case provided evidence that the attorney was not disinterested. In Kendavis, the court also found evidence of a lack of disinterestedness in correspondence between the attorney and the shareholders of the debtor. The court made clear that the ethical obligation of the attorney for the debtor in possession is to exercise independent professional judgment on behalf of its client. Actions that benefited only shareholders evidenced an unwillingness to exercise that judgment and resulted in the denial of $2 million of fees.

(C) In re Office Products of America, 136 B.R. 983 (Bankr. W.D. Tex 1992), provides a different take on the analysis. In that case, the court was confronted with claims that the attorney for the debtor in possession had failed to remain disinterested. The court rejected the approach stating:

The trustee would have this court hold that, in essence, proposing such a plan necessarily created a conflict of interest, and debtor's counsel, by advancing that plan in the face of creditor opposition, developed a conflict of interest, justifying their disqualification under § 327(a) and a concomitant disallowance of their fees under § 328(c).

There are serious policy ramifications to such a holding, however, which auger against deciding the case on that basis. The cramdown provisions of the Code are an expression of congressional intent regarding the importance of reorganization values even in the face of considerable creditor opposition, provided those creditors' interests are appropriately protected. H.Rep. No. 595, 95th Cong., 1st Sess. 220-21, 416-18 (1977). Were we to hold here that pursuing those goals over the objections of creditors in and of itself created a conflict of interest, lawyers would be discouraged from even representing debtors in the face of creditor opposition (even if the plan could pass muster under § 1129(b)), for fear of not being paid.

Such a result is so antithetical to the structure of the reorganization chapters that we must retreat from such a harsh ruling. If there is a basis for the trustee's objections to the fees requested, this is not it (at least not under the facts of this case). We turn to the other arguments raised by the trustee.
Id. at 986-87. Thus, rather than use a blanket approach to the question, the court chose to examine the attorney's fee application on an issue by issue basis.

In conducting this examination, the court focused on the requirement of Section 330 that compensation be awarded only if the services rendered were necessary to the estate. The court concluded:

The fee detail does indeed suggest that there was a point in time when the debtor knew or should have known that pursuit of this plan flew in the face of § 1129(a), yet the debtor pushed on anyway. At that point, the services of counsel were no longer "necessary," as the debtor was no longer at that point discharging its duties as fiduciary of the estate, was no longer pursuing legitimate reorganization. Instead, the fight against conversion and the insistence on pursuing the plan served interests other than those of the estate, namely maintaining then-current management's control over the enterprise. Counsel could no longer expect to be compensated for its services at this point under the standards set by § 330(a), for its services were no longer "actual, necessary" services associated with representing the debtor-in- possession in the discharge of its fiduciary duties to the estate and its beneficiaries, the creditors.

Id. at 990-91. Thus, the court recognized a responsibility on the part of the attorney to exercise his or her own judgment as to whether continued efforts at reorganization are futile. At that point, counsel proceeds only at the risk that fees for those continued efforts will be denied.

(D) *In re Wilde Horse Enterprises, Inc.*, 136 B.R. 830 (Bankr. C.D. Calif. 1991), the court denied the attorney for the debtor in possession all of her fees because the attorney failed to investigate the circumstances surrounding the sale of assets of the estate to a party related to the debtor's principals. In the opinion, the court provided an extensive review of the obligations of the attorney for the debtor in possession:

An attorney's "client" is the person or entity on whose behalf the lawyer acts. In certain proceedings an attorney may have more than one client, and where this is so, they owe duties of loyalty to all the interests represented. The duty of loyalty includes a duty of candor--candor to all the interests represented. "A lawyer like a trustee is bound to higher standards than the morals of the marketplace." *MGIC Indemnity Corporation v. Weisman*, 803 F.2d 500, 504 (9th Cir. 1986). "Professional ethics requires of a lawyer a decent sense of responsibility to all those he [or she] serves." *Id.*, at 504.

Because the attorney for debtor in possession is a fiduciary of the estate and an officer of the Court, the duty to advise the client goes beyond responding the client's requests for advice. It requires an active concern
for the interests of the estate, and its beneficiaries, the unsecured creditors. Consequently, the attorney may not simply close his or her eyes to matters having a legal and practical consequence for the estate—especially where the consequences may have an adverse effect. The attorney has the duty to remind the debtor in possession, and its principals, of its duties under the Code, and to assist the debtor in fulfilling those duties.

186 B.R. at 840. The court went on to analyze the red flags that should have resulted in further investigation and concluded that the attorney had utterly failed to uphold her duty to the court and the estate.

(E) *In ICM Notes, Ltd., v. Andrews and Kurth, L.L.P., 278 B.R. 117 (S.D. Tex. 2002)*, a secured creditor, extending the analysis of cases holding that the attorney owes a duty to the estate, brought a breach of fiduciary duty claim against the attorneys for the debtor in possession. The court rejected the claim, holding that an attorney for a DIP does not owe a duty to specific creditors, stating:

[In a bankruptcy proceeding, the debtor, secured creditors, unsecured creditors, and other related parties have different and competing interests... The Bankruptcy Code requires that a debtor's attorney be disinterested and not represent the interest of any party to the bankruptcy case other than the debtor. The Code contains prohibitions against conflicts of interest and requires that compensation be paid from an estate only if the services provided by counsel benefit the estate. 11 U.S. C. §§ 327, 328. A finding that debtor's counsel owes a particular duty to an individual creditor in a Chapter 11 bankruptcy proceeding would prevent counsel from representing his client in accordance with the provisions of the Bankruptcy Code. Further, ICM Notes [the secured creditor] was an adverse party to ICM, Inc., the debtor, and was fully represented by its own counsel during the course of the bankruptcy proceedings. A ruling that counsel of a debtor-in-possession owes a fiduciary duty to a particular creditor is contrary to the tenet of the Bankruptcy Code mandating that debtor's counsel be disinterested. Therefore, the Court finds that counsel for a debtor-in-possession does not owe any fiduciary duties to a particular creditor.]

228 B.R. at 126 (citations omitted).

(F) *In re Phoenix Group Corporation, 305 B.R. 447 (Bankr. N.D. Tex. 2003)* the court brought the connection between the attorney’s duty to the estate and the attorney’s compensation full circle when it overruled the debtor's objection to a fee application filed by the counsel for the DIP. The basis of the objection was that the law firm failed to seek a trustee in a related case and failed to object to the plan filed in that related case. The court noted several cases that discuss the duty of the attorney to the estate and noted that the attorney was under an obligation to rely on its professional judgment in determining whether the requested actions would be contrary to its ethical and fiduciary obligations. 305 B.R. at 452.
VII. Disgorgement and Denial of Fees for Unethical Conduct

(A) Disgorgement is Appropriate if Examiner is Disinterested (In re Big Rivers Elec. Corp., 355 F.3d 415 (6th Cir. 2003))

The Chapter 11 debtor, Big Rivers Electric Corporation, was a publicly-regulated utility. J. Baxter Schilling was appointed as examiner to facilitate a global agreement with creditors and to negotiate a plan of reorganization. Shortly after his appointment, Schilling sought, and in at least one case obtained, the agreement of some large unsecured creditors to pay him a “success fee” of three percent of their enhanced recovery from the estate. During the course of his employment as examiner, Schilling filed interim fee applications that contained Disclosure Statements asserting that he had no improper interests that were adverse to the estate. Although the court noted that Schilling was, in large part, responsible for the development of a reorganization plan that included several million dollars new value for creditors, the United States Court of Appeals for the Sixth Circuit affirmed the disgorgement of all fees paid to Schilling and his law firm, a sum of nearly one million dollars.

Pursuant to Section 1104(b), an examiner must be a “disinterested person.” In Section 101(14)(E), the Code defines a disinterested person as an individual that does not have a materially adverse interest to the estate, any creditors, or any security holders because of a relationship with the debtor “or for any other reason.” The court concluded that Congress intended examiners to uphold the same fiduciary duties as trustees.

The court examined the duties of an examiner in a bankruptcy case. Based upon Section 101(14), an examiner cannot have an interest that is adverse to any party in the bankruptcy at any time. Further, examiners are required to disclose any perceived agreements relating to compensation. Also, examiners owe a duty of loyalty to the debtor and creditors.

The court found that Schilling did not properly discharge his duties. He was not disinterested because of his agreement with a creditor for a “success fee.” Schilling did not properly disclose his understanding that some of the creditors would augment his compensation. The court also agreed that Schilling violated his duty of loyalty by entering into, or attempting to enter into, side agreements with some creditors and by misrepresenting his actions to the bankruptcy court. By going outside of Section 330(a), Schilling attempted to impermissibly increase his compensation in a self-interested manner. Finally, the court of appeals approved disgorgement of all fees whenever an examiner becomes disinterested.

(B) Denial of Compensation Permitted if Professional is not Disinterested (Schilling v. Smith, 2003 U.S. Dist. LEXIS 16865 (W.D. Ky. 2003))

In Smith, the bankruptcy court again disallowed all of the trustee’s fees for his failure to remain disinterested while serving as a trustee and attorney for the trustee in a Chapter 7 case. Schilling, as trustee, filed a complaint against Smith, the debtor, objecting to his
discharge. Schilling alleged the debtor's brother had received a fraudulent conveyance. The trustee and the debtor entered into an agreement settling the matter. Schilling included a provision in the settlement agreement that specified the debtor would not object to the allowance of claims. Additionally, the debtor agreed to support Schilling's request for previously disallowed attorney's fees.

In an effort to justify his trustee fees, Schilling then filed seven claims after the bar date and after the period in which the trustee may file claims under Federal Bankruptcy Rules 3002 and 3004. The bankruptcy court found that both the settlement agreement and the tardily filed claims violated Schilling's requirement to remain disinterested and his duty to the debtor and the estate. The district court upheld the denial of the trustee's compensation and disgorgement of previously awarded fees.

(C) Conflict Arising from Attorney's Representation of Debtor That Filed a Proof of Claim in Another Bankruptcy and the Attorney's Representation of a Creditor Contesting Payment to the Other Debtor's Estate (In re Grieb Printing, Co., 297 B.R. 82 (Bankr. W.D. Ky. 2003))

Schilling once again faced sanction for a conflict of interest in Grieb Printing. Schilling was appointed trustee in the Grieb Printing bankruptcy. The court approved Schilling's application to serve as attorney for the trustee. In his dual capacity, he filed a proof of claim in the LMC bankruptcy case, an unrelated proceeding. Subsequently, Schilling was contacted by Michael Heideman. Heideman sought Schilling's representation in the LMC bankruptcy regarding a dispute over insurance funds. Schilling did not recall the proof of claim he filed on behalf of Grieb Printing in the LMC bankruptcy. Schilling did not conduct a conflicts check using a computerized database of his current and former clients. Schilling agreed to represent Heideman in the LMC bankruptcy.

The court found Schilling's representation of Heideman and Grieb Printing to be a conflict of interest. When Schilling agreed to serve as Heideman's attorney, he argued for Heideman's ownership of certain proceeds that would otherwise belong to the estate. If the funds were part of the estate, there would have been more funds for the proof of claim Schiliing filed on behalf of Grieb Printing. A conflict of interest is measured by whether an attorney could have made unbiased decisions for both of his or her clients. Therefore, while serving as attorney on behalf of Heideman, Schilling advanced an interest that was adverse to the estate and was subject to sanction under Section 328(c). For much the same reason, Schilling as the trustee became liable for sanctions under Section 326(d) when he allowed Schilling the attorney to undertake representation of Heideman.
VIII. Other Cases of Interest

(A) Conflict of Interest Created where Debtor’s Attorney’s Fee for Redemption is Funded through Redemption Loan Agreement; Excessive Fee for Redemption. *(In re Miller, 312 B.R. 626 (Bankr. S.D. Ohio 2004))*

In *Miller*, the debtor’s attorney prepared and filed an uncontested motion to redeem the debtor’s automobile. Upon the entry of the motion, the United States Trustee filed a motion to examine the fees the debtor’s attorney received for preparing the motion. The attorney’s Disclosure of Compensation form listed a fee of $750 but was silent regarding whether this fee would cover legal work for redemptions. The motion to redeem was also silent regarding additional attorney’s fees for the work relating to the motion. Notwithstanding this lack of disclosure to the court, the debtor’s attorney received a fee of $400 from the lender, 722 Redemption Funding, Inc. The amount was included in the loan made by the lender to the debtor to finance the redemption.

The court held that $400 was an excessive fee for filing a pro-forma redemption motion and also held that the method of funding the fees created a conflict of interest and that the structure of the transaction was designed to keep the debtors unaware that they were paying anything for the redemption work. The court ordered the firm to refund the $400 plus interest to the debtor.

(B) Willful Violation of Fee Disclosure Obligations Requires Complete Disgorgement of all Fees. *(In re McCrary & Dunlap Construction Co., LLC, 263 B.R. 574 (M.D. Tenn. 2001)).*

In *McCrary*, special counsel for the debtor failed to file fee applications or receive prior court approval for payments of fees from the estate. Counsel also failed to disclose the source of retainers received by the largest unsecured creditor of the debtor. The bankruptcy court required disgorgement of 10% of the payments received plus $500 for one of the retainers, reasoning that the violations were not willful. In its decision, the bankruptcy court took note of the fact that counsel sincerely apologized and that the firm was relatively new to bankruptcy.

On appeal, the district court held that the bankruptcy court abused its discretion in failing to require full disgorgement of the fees. In its opinion, the district court noted that the firm had touted its bankruptcy experience in its application for employment and in its belated fee application. The court went on to note:

Even if the lawyers had been entirely new to bankruptcy practice, this would not have served to excuse their violation of the Rules and Code. As the Second Circuit noted in *In re Arlan’s Dept. Stores, Inc.*, “if [the firm] was incompetent in bankruptcy matters, as it now urges, that fact either should have been brought to the attention of the bankruptcy court when [the lawyer] sought the employment or
[the lawyer] should have immediately and assiduously undertaken a study of bankruptcy rules and procedures." 615 F.2d 925, 939 (2d Cir. 1979). 263 B.R. at 583.

(C) Conflict of Interest Found where Creditors Committee Sought to Retain Wholly Owned Subsidiary of Creditors’ Committee Counsel (In re Greystone Holdings, L.L.C., 305 B.R. 456 (Bankr. N.D. Ohio 2003)

In Greystone, the United States Trustee objected to the Creditors’ Committee employment of financial advising firm that was a wholly owned subsidiary of the firm that was serving as counsel to the committee. The court held that the firm’s ownership of the financial advisor created a significant potential for conflict, since the ownership structure and shared financial goals would prevent the law firm from objectively reviewing the financial advisor’s fee applications. The court stopped short, however of adopting a per se rule against such arrangements.

(D) Fee Application Issues (In re Condor Systems, Inc., Case Nos. 01-55472-JRG and 01-55473-JRG (Bankr. N.D. Cal. 2004))

Counsel for the Chapter 11 debtor filed its final fee application. On March 23, 2004, an audit was ordered. The Court recognized that a professional person may be compensated a reasonable amount for “actual, necessary services rendered” and reimbursement of “actual, necessary expenses.” Clearly, double-billing entries are disallowed. Further, entries for correspondence with “vague characterizations of services performed with no detail concerning the general subject matter” are not permitted. The court notes that, generally, only one professional may charge for intra-office conferences and meetings. The court took issue with paralegal activity that was, in essence, clerical services. Clerical services are considered overhead and are not within the purview of Section 330(a) as an activity worthy of compensation.

(E) A Specialized Store Selling Bankruptcy Forms and Advising Debtors About Exemption is the Unauthorized Practice of Law (Brooks v. United States Trustee, Civil Action No. 5:04-352-JMH (E.D. Ky. Dec. 21, 2004))

Brooks owned a store that sold kits containing forms for filing bankruptcy. The United States Trustee for Region 8 filed a motion with the bankruptcy court to compel compliance with Section 110. The bankruptcy court held that Brooks “engaged in the unauthorized practice of law” as a “bankruptcy petition preparer.”

Brooks appealed to the district court. She asserted that she was not engaged in the unauthorized practice of law. The court noted a “bankruptcy petition preparer” was a person who prepared a bankruptcy filing for a fee. The bankruptcy court found the Brooks had aided debtors by offering advice and actually filling in some forms. She was compensated because she sold the forms for $88.90 even though the forms could be downloaded for free or could be purchased at retail stores for $24.99. Furthermore, she admitted she had assisted debtors with their exemption forms. The district court held that the bankruptcy court’s orders were not clearly erroneous.