BANKRUPTCY 101: PROPERTY OF THE ESTATE, DISCHARGE, AND AVOIDANCE ACTION ISSUES

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Michael F. Thomson
Dorsey & Whitney LLP
111 South Main Street, 21st Floor
Salt Lake City, Utah 84111
Tel. 801.933.8929
Fax 801.933.7373
thomson.michael@dorsey.com

<u>BANKRUPTCY 101: PROPERTY OF THE ESTATE, DISCHARGE, AND AVOIDANCE ACTION ISSUES</u>[1]

I. <u>Critical Concepts and Procedural Protections</u>. Bankruptcy law implements a number of key concepts and procedural protections. Some of these are listed below.

A. <u>The Estate and Property of the Estate</u>. When a bankruptcy petition is filed, at least a voluntary petition, an estate is created. Section 541 of the Bankruptcy Code defines of what property this estate consists. Generally, with a few limited exceptions, it consists of all legal and equitable interests of the debtor in property. The estate includes exempt property, even though an unsecured creditor or some involuntary secured creditors may not be able to participate in the value of exempt property.

B. <u>Preferences, Fraudulent Transfers, and Strong-Arm Actions</u>. Bankruptcy trustees ("Trustees"), including debtors in possession ("DIP's") in Chapter 11, are endowed with the power to avoid certain transfers and transactions. These all further the fundamental bankruptcy policy favoring equal treatment of similarly situated creditors.

C. <u>Discharge</u>. The ultimate goal in bankruptcy – when a debtor legally is excused of paying his, her, or its debts as they existed prior to bankruptcy.

II. <u>Different Types of Bankruptcy Cases</u>

A. <u>Liquidation</u>

1. <u>Chapter 7</u>. Chapter 7 encompasses the traditional concept of bankruptcy—a Trustee is appointed and the debtor's assets are collected, determined, and sold or abandoned, with net proceeds distributed to creditors according to the priority schemes of the Bankruptcy Code. The Chapter 7 bankruptcy estate is fixed at the time of the bankruptcy petition and income received by an individual debtor after the bankruptcy petition, with certain narrow exceptions, are not part of the bankruptcy estate. Debtors other than individuals do not receive a discharge in Chapter 7. <u>See</u> 11 U.S.C. § 727(a)(1). Some debtors, particularly individuals with substantial future income potential, may not be eligible for Chapter 7. <u>See</u> 11 U.S.C. § 707(b).

[1]Portions of this outline were written by Kenneth L. Cannon II of Durham Jones & Pinegar in Salt Lake City, Utah, and are used with his permission.

2. Chapter 11. Chapter 11 typically contemplates reorganization of a business. However, Congress expressly provided for the possibility that an orderly liquidation of a business could be accomplished in Chapter 11. See 11 U.S.C. § 1123(b)(4). In such a liquidating Chapter 11 case, no discharge is granted. See 11 U.S.C. § 1141(d)(3).

B. Reorganization/Restructuring

1. Chapter 11 "Ordinary" Case . Chapter 11 governs what has become the classic, some would say infamous, reorganization of a business. An "ordinary" Chapter 11 case is simply one that is not a "small business case." The DIP (or some other party) proposes a plan of reorganization which restructures the company's debts and provides to pay creditors from the future operations of the reorganized business. The same priorities apply in Chapter 7, but creditors may, as a class under a plan of reorganization, agree to permit a class of creditors to receive some distribution under the plan even if prior claims are not paid in full.

2. Chapter 11 “Individual” Case. Chapter 11 is also available to individuals and, because of debt limitations for debtors eligible to file under Chapter 13, Chapter 11 may be the only available bankruptcy chapter for some individuals. Similar to a business Chapter 11 case, an individual Chapter 11 DIP (or some other party) proposes a plan of reorganization which restructures the individual’s debts and provides to pay creditors from the future income (or the sale of assets) of the debtor. As in Chapter 13, property of the estate includes the traditional property, as of the petition date, as set forth in § 541, but also all property acquired post-petition and all earnings from services performed by the debtor post-petition, but before the case is closed, dismissed, or converted.

3. Chapter 12. Chapter 12 provides for restructuring of the business or debts of family farmers or family fishermen. It is, in certain respects, an amalgamation of Chapter 11 and Chapter 13 with important differences applicable to farmers and farming businesses.

4. Chapter 13. Chapter 13 is an income-based debt restructuring for individuals. Only individuals with regular income and less than statutorily fixed maximum levels of noncontingent, liquidated, secured debt (generally, $1,184,200) and unsecured debt (generally, $394,725). Generally, an individual consumer debtor can discharge his or her debts by devoting all of his or her disposable income for a period from three to five years to payment of these debts under a plan.

III. Discharge and Denial of Discharge

A. General Overview of the Bankruptcy Discharge. Under 11 U.S.C. §§ 727, 1141(d), 1228, and 1328, the bankruptcy court must grant a discharge to an individual debtor unless one or more of the specific grounds for the denial of discharge is proven by a creditor or a trustee. Generally speaking, the discharge relieves the debtor from all debts that arose before the petition date. A discharge declares void any personal liability on a judgment pertaining to a discharged debt and operates as an injunction against any act to collect a discharged debt. The purpose of the discharge is to relieve the debtor of all legal responsibility for discharged debt, and to assist in generating a "fresh start" for the debtor. The discharge is subject to two separate kinds of challenges, the first is a denial of discharge, and the second is nondischargeability of particular debts.

B. Denial of Chapter 7 Discharge. Creditors and/or the trustee may file a complaint objecting to discharge and asking that the debtor's request for a discharge be denied. The statutory grounds for objecting to a discharge are found in 11 U.S.C. § 727. The most common of these grounds is for transfers of assets with actual intent to hinder, delay, or defraud creditors, fraudulent concealment of assets, failure to keep or preserve books and records, the making of a false oath in connection with the case, and failure to cooperate with the court and prosecution of the case. See Rupp v. Biorge (In re Biorge), 536 B.R. 24 (Bankr. D. Utah 2015) (evidence of intent to hinder or delay creditors from reaching assets is sufficient to deny discharge under 727(a)(2)(A), and reckless disregard for truth satisfies "knowingly and fraudulently" prong of 727(a)(4)(A)). A discharge will also be denied if the debtor has obtained a prior discharge in a chapter 7 or chapter 11 bankruptcy case commenced within the eight years preceding the petition.

The burden of proof for showing a denial of discharge is squarely on the objecting party, i.e. the creditor or the trustee, because courts generally construe the provisions granting discharge liberally. Generally speaking, the denial of discharge is disfavored and courts will construe such provisions strictly against the creditor or trustee.

C. Nondischargeability of Particular Debts. Certain types of debts are nondischargeable even though a debtor would have the right to receive a discharge of debts generally. Under 11 U.S.C. § 523, there are 19 categories of debts that are excepted from discharge. Such categories include debts for taxes, debts obtained by fraud, false pretenses, false representation, debts for "domestic support obligations", and debts for willful and malicious injury to another entity or an entity's property.

An action to determine whether a particular debt is excepted from a debtor's discharge, which means a non-dischargeable debt, may be instigated by a creditor. Such an action is an adversary proceeding and must be initiated by filing a complaint in bankruptcy court within 60 days of the date first set for the meeting of creditors. The creditor seeking to have its debt excepted from discharge bears the burden of proof. To prevail in the action the creditor must only prove its case by a preponderance of the evidence. See Grogan v. Garner, 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed.2d 755 (1991).

Note that fraudulent intent may be inferred from the totality of the circumstances. For an example of a bad check case, see Groetken v. Davis (In re Davis), 246 B.R. 646 (10th Cir. BAP 2000), in which the BAP discusses the kind of evidence that needs to be presented. The court held that fraudulent intent of a debtor may be inferred from the totality of the circumstances based upon the timing of the presentation of a bad check, and not upon representations in the check or that the debtor made at the time of presentation of the check. See also Zions First Nat'l Bank v. Taylor (In re Taylor), 528 B.R. 826 (Bankr. D. Utah 2015) (court excepts debt from discharge under 523(a)(2)(A), rejects debtor's "pure heart, empty head" defense and holds that "willful blindness will not allow a debtor to avoid liability for his actions").

For domestic support obligations, §523(a)(15) no longer has a balancing test for dischargeability, resulting in property settlements and hold harmless provisions (which are in favor of a spouse, former spouse, or child of the debtor) arising from a divorce or separation being nondischargeable in Chapter 7. In addition, §523(c)(1) makes the nondischargeability of such debts (in Chapter 7) self-executing with no adversary proceeding required.

D. Chapter 13's Not-So-"Super" Discharge. BAPCPA all but eliminated the super discharge in a Chapter 13 by expanding the list of debts excepted from a Chapter 13 discharge under §1328(a). While the Bankruptcy Code, prior to BAPCPA, excepted from the Chapter 13 discharge only certain tax claims, support obligations, student loans, alcohol related injury claims, and restitution or criminal fines, BAPCPA greatly expanded the list in §1328(a)(2) and §1328(a)(4) to specifically include previously dischargeable tax claims, fraud claims, unlisted claims, fraud by a fiduciary claims, and restitution or damages claims in a civil action arising from willful or malicious acts by the debtor. In addition, the debtor's discharge is conditioned, by §1328(a), upon the debtor's certification that all domestic support obligations, both post-petition and those included in the Plan, have been paid.

Under §1328(a)(2), the discharge for taxes in Chapter 7 and 13 is now very similar. Chapter 13 is no longer available as a partial payment remedy, if the tax obligation arose from nonfiled returns or returns late-filed within two years of the petition date, and taxes with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax.

E. Chapter 11 Individual Discharge. An individual debtor under Chapter 11 does not receive a discharge of debts upon confirmation of the debtor's plan. See 1141(d)(5). Instead, the individual Chapter 11 debtor must wait to receive the discharge until "all payments under the plan" have been "complet[ed]." Id.

Generally speaking, the foregoing rule (combined with Section 1129(a)(15)) requires a Chapter 11 individual debtor to pay 5 years of projected disposable income[2] to receive a discharge. However, the Court may grant a Chapter 11 discharge on the effective date of the plan where "all payments under the plan" have been completed on the effective date (such as where all estate assets are transferred to a liquidating trustee and no further payments will be made by the debtor), or where "cause" has been shown for the entry of a discharge prior to completion of all payments under the plan. See In re Sheridan, 391 B.R. 287 (Bankr. E.D.N.C. 2008).

Also, the Court can provide for an early discharge to an individual debtor who has not completed payments under a confirmed plan if (1) the value of what creditors have received under the plan is at least as much as they would have received in a Chapter 7 liquidation (with the measuring date for value being the effective date of the plan), and (2) modification of the plan is not practicable.

IV. Avoiding Powers Or, Nasty Things that Can Happen to the Uninitiated and Unwary, and for that Matter, the Initiated and Wary Or, How Can They Do that to Me?

A. Avoiding Powers, Generally. The Bankruptcy Code provides an arsenal of avoiding powers to the Trustee or DIP. These include avoidance of "preferences," "fraudulent transfers," and "unauthorized postpetition transfers," and the undoing of "executory" contracts and unexpired leases. Under the so-called strong-arm provisions, the Trustee is endowed with the powers and leverage of an ideal, hypothetical intervening lien creditor, a judgment creditor, a bona fide purchaser of real property, and virtually any avoiding power under state law. Why? Because equally placed creditors are to be treated equally and, if a creditor receives a beneficial position within a certain period before bankruptcy, this policy of equal treatment is violated.

B. Preferences. Under section 547(b) an avoidable preference is a transfer of property of the debtor, to or for the benefit of a creditor, on account of antecedent debt, made while the debtor was insolvent (insolvency is rebuttably presumed for the ninety days prior to bankruptcy), made within ninety days (or, if the preference recipient is an insider, within one year), that enables the creditor to receive more than it would have received in Chapter 7. Each element of a preference must be found. The lack of any element makes a transfer unavoidable. Transfers of property amounting to avoidable preferences can include the perfection of a security interest, obtaining a judgment, or obtaining a security interest.

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[2] While it may be argued that a Chapter 11 individual debtor is subject to the same "projected disposable income" requirements as a Chapter 13 debtor (such as means test-based expenses as opposed to judicially-determined expense standards), at least one bankruptcy court in the 10th Circuit has rejected that argument. See In re Roedemeier, 374 B.R. 264 (Bankr. D. Kan. 2007) (criticized on other grounds by In re Stephens, 704 F.3d 1279 (10th Cir. 2013) (holding that absolute priority rule applies to individual Chapter 11 debtors, and thus no property held by debtor on petition date may be retained where dissenting class of creditors has not been paid in full)).

C. <u>Defenses to Preferences</u>. Because of the significant imposition preference liability can be for an entity doing business with a financially distressed company, and to encourage companies to continue to do business with such distressed companies, there are a number of effective defenses to a preference action under section 547(c). Included most prominently among these are the following.

1. <u>Ordinary course</u>. If a transfer was incurred and paid in the ordinary course of business of the parties, <u>or</u> in line with terms utilized in the industry, the transfer may not be avoidable.

2. <u>Contemporaneous exchange</u>. If the parties contemplated that they would make a substantially contemporaneous exchange and if, in fact, the transaction involved a substantially contemporaneous exchange, the transfer cannot be avoided as a preference.

3. <u>New value</u>. If, after receiving a transfer that would be a preference, the creditor advances new value to the debtor, its preference liability is reduced to the extent of the new value.

D. <u>"Fraudulent" Transfers</u>. The term "fraudulent transfer" sounds ominous. Under section 548 and section 544(b), which essentially incorporates state law, fraudulent transfers can be set aside by a bankruptcy court to the theoretical benefit of creditors who were harmed by the transfer. There are two types of fraudulent transfer: one involving actual fraudulent intent and the other involving "constructive" fraud.

1. <u>Actual Fraud</u>. If a debtor engages in a transaction with intent to hinder, delay, or defraud its creditors, the transaction can be avoided as a fraudulent transfer. Remember, it is not just defrauding its creditors, it also can be hindering or delaying its creditors. Case law developed a wide-ranging list of "badges" of fraud because fraudulent intent was often difficult to prove directly.

2. <u>Constructive Fraud</u>. Because it is often difficult to prove actual fraud, the concept of constructive fraud developed. To be avoided as a fraudulent transfer, it must be proven that the debtor received less than "a reasonably equivalent value" <u>and</u> was insolvent at the time of the transfer, was rendered insolvent by the transfer, or was left with "unreasonably small capital" following the transfer. The easiest example of a constructively fraudulent transfer is the transfer for no or minimal consideration by one spouse to another or by a parent to a child of a significant asset, such as a house, when the transferring spouse or parent is insolvent.

3. <u>The Rule in Moore v. Bay</u>. State law generally allows an unsecured creditor to avoid a fraudulent transfer to the extent that that creditor has been damaged by that transfer. Almost all states have by now enacted a

fraudulent transfer law, such as the Uniform Fraudulent Transfer Act. In Utah (as of May 9, 2017), the Uniform Voidable Transactions Act is the law. Under section 544(b) a Trustee in bankruptcy (including a DIP) can assert the rights of an unsecured creditor under state fraudulent transfer law. This is sometimes critical because state fraudulent transfer laws have longer statutes of limitation than section 548's two year limit. Although an unsecured creditor can avoid a fraudulent transfer only to the extent of its damage (if it is owed $1.00 it can avoid a $1 billion fraudulent transfer only to the extent of $1.00). Under the 1931 United States Supreme Court decision in Moore v. Bay, 284 U.S. 4 (1931), however, a Trustee in bankruptcy, standing in that same creditor's place, can avoid the entire $1 billion fraudulent transfer.

4. The BFP Decision. Prior to the United States Supreme Court's decision in BFP v. Resolution Trust Corporation, 511 U.S. 531 (1994), many decisions had followed the Fifth Circuit's lead in Durrett v. Washington National Insurance Co., 621 F.2d 201 (5th Cir. 1980), by holding that a foreclosure under state law could be a fraudulent transfer if the debtor was insolvent at the time and the foreclosure resulted in less than reasonably equivalent consideration being provided. The Supreme Court ruled, however, that a foreclosure regularly conducted, and in compliance with state law, in which there is no collusion is presumptively not a fraudulent transfer.

5. Upstream and Cross-stream Transactions. Often subsidiaries and affiliates are called upon to provide guarantees of parent or sister corporations' debts. If the subsidiary is insolvent when it provides this guaranty for its parent or affiliate, it is almost certainly a fraudulent transfer because it does not receive reasonably equivalent consideration for the guarantee.

E. Section 544(a). Under section 544(a) of the Bankruptcy Code, a Trustee in bankruptcy (including a DIP in possession) is endowed with the rights and powers of a hypothetical intervening lien creditor, a judgment lien creditor, and a creditor who advances credit, all as of the bankruptcy petition date. Thus, for example, if a secured creditor fails timely to perfect a security interest under the Uniform Commercial Code, the Trustee can "avoid" the perfection of the security interest and render the secured creditor unsecured. Similarly, if a properly perfected security interest is later terminated by an erroneously filed UCC-3, the mistake cannot be corrected post-petition. See Official Committee of Unsecured Creditors v. JPMorgan Chase Bank, N.A. (In re Motors Liquidation Co.), 777 F.3d 100 (2d Cir. 2015) (holding that creditor authorized the filing of UCC-3 termination statement, even though it never intended to terminate the security interest related to the loan in question).

F. Section 544(b). Under the so-called "strong-arm" powers of the Bankruptcy Code, the Trustee in bankruptcy can stand in the shoes of an unsecured creditor at state law to avoid transactions under state law.