Liquidation Cases under the Bankruptcy Reform Act of 1978

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I. INTRODUCTION

In 1898 Congress passed a bill creating a comprehensive system of bankruptcy throughout the United States.[1] Although several bankruptcy acts had preceded it, the Act of 1898 was much more comprehensive and far reaching. The Act of 1898 was amended numerous times over the next eighty years, with the greatest overhaul occurring in 1938.

In 1978, Congress again passed a new bankruptcy statute which President Carter signed into law on November 6, 1978.[2] Except for certain provisions relating to appointments of bankruptcy judges and similar matters, the major part of the new Bankruptcy Code became effective on October 1, 1979. All cases filed on or after that date are governed by the new law.

In order for the practitioner or student to familiarize himself with the Bankruptcy Reform Act of 1978, it is of utmost importance to have a complete grasp of the previous Act. For convenience in this article, the Bankruptcy Act of 1898 is called the "Act" while the Bankruptcy Reform Act of 1978 is called the "Bankruptcy Code."

The amended Act provided a system of creditor control of bankruptcy cases under the supervision of a referee in bankruptcy[3] who was appointed

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1. Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544.

2. The Bankruptcy Reform Act of 1978 consists of four titles.
Title I enacts a new Title 11 of the United States Code which replaces the entire Bankruptcy Act of 1898, as amended. Most of the Reform Act appears in Title 11, which is divided into eight odd numbered chapters (1-15). Title II of the Reform Act amends Title 28 of the United States Code and the Federal Rules of Evidence. Title II generally deals with the nature of the new Bankruptcy Court. Title III amends other federal statutes, and Title IV governs the transition period between the date of promulgation and April 1, 1984 when all provisions of the new law will be effective.

3. The name "Referee in Bankruptcy" was changed to "Bankruptcy Judge" in 1973 by Bankr. R. 901(7).

by the United States District Judge. Generally, the Act established two types of relief for a debtor: liquidation and rehabilitation. Liquidation cases involved the appointment or election of a trustee to collect and liquidate all of the bankrupt's nonexempt property for distribution to creditors in accordance with the priorities established by section 64 of the Act. Prior to the close of the liquidation case, the honest bankrupt received a discharge of those of his debts which the Act rendered "non-enforceable."

The rehabilitation cases were governed by Chapters X, XI, XII, and XIII of the Act. Depending on which chapter a debtor chose, the result of the filing could be an adjustment of all or part of his debts and even a change in the ownership of stock in a corporation. In some cases, a court fiduciary was appointed to administer, preserve, and protect the debtor's assets during the reorganization proceeding. Except in the Chapter X case in which a reorganization trustee had to be appointed in nearly every case, the court fiduciary usually was appointed when the creditors and court lacked faith in the ability of the debtor to manage his assets during the pendency of the case.

The Act provided that a rehabilitation case could be concluded in one of three ways: 1) the court could dismiss the case; 2) a plan to satisfy debts could be proposed by the debtor (or possibly other parties) and be approved by creditors and the court; or 3) the court could convert the case to another type of reorganization proceeding under a different chapter or to a liquidation case.

The Act contained both the substantive law and some rules of procedure. As more procedure was needed, the Supreme Court of the United States was authorized by Congress to prescribe other rules.[4] The most in-depth revision of bankruptcy procedure was accomplished in 1973 with the promulgation of the Bankruptcy Rules. These rules governed the procedure used in liquidation and rehabilitation cases.

II. Procedures Under the Bankruptcy Code

Unlike its predecessor, the Bankruptcy Code contains little procedure and consists almost entirely of substantive law. Until new rules of procedure are promulgated, the Bankruptcy Rules of the old Act govern procedures under the Code, unless clearly inconsistent with the Code.[5] The Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States has produced a preliminary draft of rules (known as the Interim Bankruptcy Rules) which was distributed to the bench and bar in late summer of 1979.[6] Many districts throughout the country have adopted all or at least some of these rules as local rules pending promulgation of

4. 28 U.S.C. § 2075 (1976).
5. 11 U.S.C.A. § 405(d) (West 1979).
6. 1979 U.S. Code Cong. & Ad. News 2127.

new rules by the Supreme Court. The practitioner is well advised to check with the clerk of the bankruptcy court in his particular district prior to filing a case or participating in a pending matter to determine what rules of procedure are in effect.

The liquidation bankruptcy case under the Code will superficially appear very similar to its counterpart filed under the Act. The filing of an involuntary or a voluntary petition commences the case.[7] New terminology provides for an "order for relief"[8] to replace the eighty year old "adjudication,"[9] although both terms are fairly synonymous. Once an order for relief is entered, a "meeting of creditors,"[10] rather than a "first meeting of creditors"[11] is held. An observer with bad eyesight sitting in the rear of the courtroom will notice little difference, unless he recognizes that the voice of the presiding officer is not that of the bankruptcy judge. Under the Code, the bankruptcy judge is absolutely forbidden from attending the meeting of creditors.[12] The Code does not indicate who will preside at the meeting; however, Rule 2003(b)(1) of the Interim Bankruptcy Rules designates the clerk of the bankruptcy court as the presiding officer at the meeting of creditors.

The bankrupt—now called "debtor"[13] under the Code—will submit to examination by the trustee and creditors at the meeting of creditors.[14] As indicated above, few superficial changes are apparent. However, the Code provides for the appointment of an interim trustee from a panel approved by the Director of the Administrative Office of the United States Courts at the time of the entry of the order for relief.[15] The interim trustee will continue as trustee unless creditors elect another individual at the meeting of creditors.[16]

In the consumer liquidation case, an entirely new procedure has been created to handle reaffirmation agreements.[17] Under the Act, the propriety of reaffirmation agreements was left entirely to the bankrupt and creditor. Now, under the Code, those agreements must be approved by the bankruptcy judge at the discharge hearing held near the end of the case.[18] The bankruptcy judge will advise the debtor of his right not to reaffirm any of his debts and will then rule on the propriety of any agreements brought to

7. 11 U.S.C.A. §§ 301-303 (West 1979). Section 302 pertains to joint cases.
8. *Id. See also* 11 U.S.C.A. § 102(6) (West 1979).
9. 11 U.S.C. § 1(2)(1976).
10. 11 U.S.C.A. § 341 (West 1979).
11. 11 U.S.C. § 91 (1976); Bankr. R. 204.
12. 11 U.S.C.A. § 341 (West 1979).
13. *Id.* § 12.
14. *Id.* § 343.
15. *Id.* § 701. In ten pilot districts, the United States trustee system governs appointment of interim trustees. *See* 11 U.S.C.A. § 1501 (West 1979).
16. *Id.* § 702(d).
17. *Id.* § 524(c).
18. *Id.* § 524(d).

the court by the debtor.[19] Failure to obtain approval of a reaffirmation agreement renders it unenforceable.[20]

In the business liquidation case, the trustee will collect and liquidate the debtor's assets in much the same manner as under the Act. However, the jurisdiction of the bankruptcy court is greatly expanded to encompass all matters pertaining to the debtor's property. No longer does the practitioner need to be concerned with the distinction between summary and plenary jurisdiction, and the trustee will now have the bankruptcy court as his primary forum for litigation.[21]

Distribution of the liquidated estate to creditors is still made in accordance with a list of priorities. Those provided in section 64 of the Act have been revamped. The priorities set forth in section 507 of the Code are as follows: 1) administrative expenses, fees, and charges assessed against the estate; 2) in an involuntary case, claims which arise in the ordinary course of the debtor's business after the commencement of the case, but prior to the appointment of a trustee or the entry of the order for relief; 3) unsecured claims for wages, salaries, or commissions;[22] 4) unsecured claims for contributions to employee benefit plans;[23] 5) unsecured claims of individuals up to $900 "arising from the deposit, before the commencement of the case, of money in conjunction with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of those individuals, that were not delivered or provided;"[24] 6) certain taxes and customs claims; and 7) all other unsecured claims. In addition, there is a "super priority" provided in section 507(b) of the Code for claims arising from the inadequacy of "adequate protection" given the holder of a secured claim under section 363 of the Code.[25]

III. Changes in Substantive Law in the Consumer Liquidation Case

The Code is consumer oriented. While creditor attacks on a debtor's discharge remain authorized,[26] the concept that only the honest debtor will receive relief remains unchanged. There are some changes relating to acts

19. *Id. See* Interim Bankr. R. 4004. There is no reason why a creditor may not submit an application for approval of a reaffirmation agreement, but the rule only speaks of applications by the debtor.

20. 11 U.S.C.A. § 524(c) (West 1979).

21. *Id.* §§ 1471-1481. The Bankruptcy Court's jurisdiction is pervasive.

22. *Id.* § 507(a)(3)(A),(B).

23. *Id.* § 507(a)(4)(A),(B).

24. *Id.* § 507 (a)(5).

25. The "super priority" even takes priority over administrative expenses including the trustee's fees and expenses. *See* 124 Cong. Rec. H11,095 (daily ed. Sept. 28, 1978) and S17,411 (daily ed. Oct. 6, 1978).

26. *See* 11 U.S.C.A. § 727 (West 1979) which concerns objections to the entire discharge of the debtor and 11 U.S.C.A. § 523 (West 1979) which pertains to the dischargeability of a particular debt.

or conduct of the debtor which would bar the debtor's complete discharge, and acts or conduct which would simply result in nondischargeability for a particular debt.

The first of these changes is that only an individual may receive a discharge.[27] In addition, certain acts previously grouped as "offense[s] punishable by imprisonment" under section 152[28] now are enumerated specifically without reference to them as crimes.[29] Another major change deleted the giving of a false financial statement to obtain credit for a business as a ground for denial of discharge.[30]

Of particular significance is the change regarding the effect of previous discharges in wage earner plan cases. Under the Act, a discharge in a wage earner plan case within six years prior to filing the new bankruptcy petition would bar a discharge in the new case unless there had been a 100% payment under the wage earner plan.[31] This is modified under the Code; a previous discharge within six years in a wage earner plan case will not bar a discharge in a new case if the payout under the plan: 1) was 70% of the claims and 2) the plan was proposed in good faith and was the debtor's best effort.[32]

A significant change also has been made in the nondischargeability of student loans. The statutory basis for nondischargeability of student loans was not in the Act, rather it was in Title 20 of the United States Code.[33] The applicability of the section basically was limited to federally insured loans. Under the Code, however, any debt "for an educational loan made, insured, or guaranteed by a governmental unit, or made under any program funded in whole or in part by a governmental unit or a non-profit institution of higher education," is nondischargeable unless the loan first became due more than five years ("exclusive of any applicable suspension of the repayment period") before the filing of the petition, or unless failure to discharge the debt would impose an "undue hardship" on the debtor and the debtor's dependents.[34]

Use of a false financial statement to obtain credit continues to be a ground for holding the debt nondischargeable.[35] However, if a creditor requests a determination of dischargeability on this ground and fails to prevail, the creditor will be subject to a judgment against him for costs and reasonable attorney fees.[36]

Obtaining a discharge is the paramount reason for an individual to seek

27. 11 U.S.C.A. § 727(a)(1)(West 1979).
28. 11 U.S.C. § 32(c)(1)(1976).
29. 11 U.S.C.A. § 727(a)(4)(West 1979).
30. This was formerly found in 11 U.S.C. § 32(c)(3)(1976).
31. 11 U.S.C. § 32(c)(5)(1976).
32. 11 U.S.C.A. § 727(a)(9)(West 1979).
33. 20 U.S.C.A. § 1087-3 (West 1978).
34. 11 U.S.C.A. § 523(a)(8)(West 1979).
35. *Id.* § 523(a)(2)(B).
36. *Id.* § 523(d).

relief under the Code. Because of this, prior to filing a petition, the lawyer is well advised to review each and every ground for denial of a discharge and for finding certain debts to be nondischargeable.

Homestead exemptions also have been overhauled for the consumer debtor. Unlike the Act which gave the bankrupt whatever exemption the state law provided, a debtor under the Code may choose either the new liberal federal exemption or the state exemption.[37] Any state may pass a law precluding use of the federal exemption, and several states already have enacted such laws.[38] The federal exemption provides for specific exemption of up to $7,500 of equity in a debtor's residence, up to $1,200 of equity in a debtor's automobile, and up to $200 for each item of household or personal property. The unused balance of the $7,500 may be used in conjunction with the exemption of other property. Even cash may be exempted under the Code.[39]

The consumer debtor also has two important new rights which have no counterpart in the Act. First, the nonpossessory, nonpurchase money security interest in household goods is voidable by the debtor.[40] Thus, a debtor may avoid the nonpurchase money security interest granted a finance company in the debtor's household furniture. A second right given a consumer debtor is the right of redemption.[41] Under the Act, a debtor who owned consumer property which was pledged to a secured creditor and which was worth less than the debt, either had to reaffirm the entire indebtedness or surrender the collateral. If, for example, the debtor's automobile was pledged to a bank and was worth $1,000, but the indebtedness owed the bank was $2,000, the debtor would have to reaffirm the entire $2,000 indebtedness if he desired to keep the car, unless the secured creditor agreed to reduce the amount of indebtedness. Under the Code, a debtor may redeem the automobile, or most other consumer related property, by paying the creditor the fair market value of the collateral. Thus, in the above hypothetical, the debtor could ask the court to set the fair market value of the car and authorize redemption under section 722.

An unresolved issue is whether the redemption may be paid to the creditor over a period of time rather than in cash. Section 722 requires the debtor to pay the creditor the market value of the collateral—theoretically the same value the creditor could realize if the debtor surrendered the collateral. An installment payout of this market value would be worth less than a single cash payment. If the creditor were required to accept an

37. *Id.* § 522.

38. *Id.* § 522(b).

39. *Id.* § 522(d).

40. Id. § 522(f). This section effectively abrogates U.C.C. sections authorizing these security interests. While these security interests are still enforceable until bankruptcy, once a debtor files a Chapter 7 case, the debtor may avoid them.

41. *Id.* § 722. When a debtor, for whatever reason, cannot avoid a security interest in consumer related property under § 522(f), he may redeem the property under this section.

installment payout, he would thus be receiving less than market value. One interesting argument advanced by some practitioners is that an installment payout of *more* than the fair market value figure could be the equivalent of a cash payment. Thus, in the above hypothetical, a 24-month payout of $1,500 might, for example, be the equivalent of a cash payment of the fair market value ($1,000). As of the writing of this article, no cases have been decided on this issue, but it is likely that the matter will be laid to rest shortly.

IV. Substantive Law Changes in Asset Cases

The Code gives broad powers to a trustee in an asset case to collect preferences and fraudulent transfers. The basic power to avoid unperfected security interests under the so-called strong arm clause of section 70 of the Act remains unchanged.[42] As stated earlier, litigation on preferences and fraudulent conveyances need not be in plenary proceedings in the district or state court.[43] Under the Code, two preference periods are established. For an "insider,"[44] the time period is one year.[45] For all others, the time period is ninety days.[46] Proof of reasonable cause to believe that the debtor was insolvent is required for transactions occurring between ninety days and one year prior to the filing of the petition.[47] However, although insolvency is a requisite for establishing a preference, insolvency is presumed during the ninety day period prior to the filing of the petition.[48] This is, of course, a rebuttable presumption. A payment made by the debtor in the ordinary course of his financial affairs is excluded from attack as a preference when the payment is made not more than forty-five days after the debt was incurred.[49]

In regard to fraudulent conveyances,[50] no significant changes were effected by the Code,[51] with the exception of the elimination of section 67(d)(3).[52] This section, which dealt with loans to insolvents, was infrequently used and had more practical applicability to commercial rather than consumer cases.[53]

42. *Id.* § 544(a).
43. *See* note 21 *supra.*
44. 11 U.S.C.A. § 101(25)(West 1979).
45. *Id.* § 547(b).
46. *Id.*
47. *Id.*
48. *Id.* § 547(f).
49. *Id.* § 547(c)(2).
50. Formerly found in 11 U.S.C. § 107(d)(1976).
51. 11 U.S.C.A. § 548 (West 1979).
52. Formerly found in 11 U.S.C. § 107(d)(3)(1976).
53. Although § 67(d)(3) has been repealed, the basis for the section, Dean v. Davis, 242 U.S. 438 (1917), still exists.

V. Other Changes in Asset Cases

The concept of the trustee's title to property is abolished. The Code establishes the "estate" which the trustee controls and manages and which is comprised of the debtor's property.[54] Since an interim trustee is appointed immediately after the order for relief, there is no need for a "receiver" to preserve and protect the debtor's assets prior to the appointment or election of a trustee. This time-honored office is therefore abolished.[55] The creditors may, however, elect a creditor's committee to aid the trustee in carrying out his duties and responsibilities.[56]

Election of a trustee is no longer accomplished by the vote of a simple majority in number and amount of creditors holding filed claims who vote at the first meeting.[57] More stringent requirements have been established under the Code for the election of a trustee.[58] As a result, it is unlikely that creditors will often elect the trustee.

Of much interest to attorneys is the Code's liberalization of compensation for professionals. The court-made standard that fees for bankruptcy lawyers be at the "lower end of the spectrum of reasonableness"[59] is thankfully repealed in favor of the more liberal view that the bankruptcy practitioner should receive compensation at rates comparable to those charged by lawyers in other fields of law.[60] It appears that bankruptcy lawyers have finally been elevated by Congress to at least the same level as their brethren in other areas of practice![61]

Unfortunately, Congress did not see fit to liberalize compensation for trustees to any great degree. Under the Act, a trustee in a liquidation proceeding was compensated on a reducing percentage basis of "all moneys disbursed"—on a $500,000 estate the compensation to a trustee was $5,415.[62] The Code has retained the reducing percentage concept, although

54. 11 U.S.C.A. § 541(a)(West 1979).

55. In fact, § 105(b) prohibits the bankruptcy court from appointing a receiver in any bankruptcy case.

56. 11 U.S.C.A. § 705 (West 1979).

57. Bankr. R. 209.

58. 11 U.S.C.A. § 702(a)-(c)(West 1979). The interim trustee continues to serve and becomes the trustee if the creditors fail to elect a trustee.

59. *In Re* First Colonial Corp. of America, 544 F.2d 1291, 1299 (5th Cir. 1977).

60. 11 U.S.C.A. § 330(a)(1)(West 1979).

61. *But see* S. Rep. No. 989, 95th Cong., 2d Sess. 40-41, *reprinted in* [1978] U.S. Code & Ad. News 5787, 5826. "The rates for similar kinds of services in private employment is one element, among others, in that balance. Compensation in private employment noted in subsection (a) is a point of reference, not a controlling determinant of what shall be allowed in bankruptcy cases."

62. 11 U.S.C. § 76(c)(1) (1976). This was determined by the following schedule:

10% on first $500.00 or less
6% on $500.01 - $1,500.00
3% on $1,500.01 - $10,000.00
2% on $10,000.01 - $25,000.00
1% on excess of $25,000.00.

the scale has been amended. The trustee's compensation on a $500,000 estate under the Code would be $5,880.[63]

Although the Code has made many changes in the bankruptcy law of this country, as with any new statute it raises as many issues as it resolves. Only judicial interpretation and subsequent amendments to the Code will resolve these issues. Still to come is a complete set of new bankruptcy rules with nationwide application and an enactment of a federal tax law applicable in bankruptcy cases.

63. 11 U.S.C.A. § 326(a) (West 1979). The new compensation rates use the following schedule:

15% on first $1,000.00 or less
6% on $1,000.01 - $3,000.00
3% on $3,000.01 - $20,000.00
2% on $20,000.01 - $50,000.00
1% on excess of $50,000.00.