The Impact of Bankruptcy on Collections

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You are attempting to collect your debt and your debtor files a bankruptcy petition. Now what? Once a debtor files bankruptcy, there are several steps a creditor can and should take to analyze and protect its interests. Depending on the case, it may be appropriate to consult with an experienced bankruptcy attorney right away. Of course, this is primarily an economic decision that must be made on a case-by-case basis. Factors that may be relevant to this decision are a) the collection efforts you are involved in, especially if there is pending litigation that will be subject to the automatic stay; b) the amount of the debt; c) the chapter of the Bankruptcy Code under which the case is filed; d) the amount of assets and liabilities identified by the debtor in the petition and schedules; and e) the creditor's familiarity and comfort level with the bankruptcy process. By way of example, if a creditor is owed $1,000 and the debtor is an individual who has filed a "no-asset" chapter 7 bankruptcy case, it is likely not worth the fees that would be involved in retaining an attorney. However, if the creditor is owed $25,000 and the debtor is a corporation which has filed a chapter 11 proceeding, experienced bankruptcy counsel may be vital to protecting and/or maximizing the potential recovery (or minimizing potential exposure).

The vast majority of bankruptcy cases are filed either under chapter 7, 11 or 13. A chapter 7 case is a "liquidation" case, where a trustee is appointed whose duty is to marshal the debtor's assets and liquidate them for the benefit of creditors. A chapter 7 case is either designated as an "asset case" or a "no asset case." In a no-asset case, the Trustee's role is limited in that the trustee performs a limited investigation to confirm that there are no assets to be distributed, and then certifies same to the court. Creditors do not file proofs of claim in a no-asset chapter 7 case, because there will not be any distributions. In an asset case, a chapter 7 trustee marshals and liquidates assets of the debtor, which could include prosecution of litigation claims, and distributes the proceeds to the debtor's creditors. Either businesses or individuals can file a chapter 7 case, but only individuals can receive a chapter 7 discharge. A qualifying debtor receives a discharge in chapter 7 whether the case is an asset or no-asset case.

A chapter 11 case is traditionally thought of as a "business reorganization case," but chapter 11 may also be used to liquidate. Although traditional used by businesses, individuals (usually high income individuals) may file a chapter 11 petition. While it is possible to have a trustee appointed in a chapter 11 case, the debtor, designated a debtor-in-possession or "DIP," generally continues to operate his or her business during the bankruptcy case. The DIP has many of the same powers and responsibilities as a trustee, and is a fiduciary for the estate and its creditors. The DIP, or trustee if one has been appointed, proposes a reorganizing or liquidating plan to exit the bankruptcy case.

A chapter 13 case is also a reorganization case, but for individuals only. The chapter 13 plan is sometimes called a "wage earner plan." In most chapter 13 cases, the debtor contributes a portion of his or her monthly income to a standing chapter 13 trustee pursuant to a chapter 13 plan for either 3 or 5 years, which is distributed to creditors. In addition to being available for individuals only, there are other restrictions on the availability of relief under chapter 13, including certain secured and unsecured debt limitations and a requirement that the debtor earns regular monthly income.

There are other, less-utilized bankruptcy chapters. Chapter 9 is available for municipalities. Chapter 12 is similar to Chapter 13 but with distinctions for family farmers. Chapter 15 relates to international cases.

A. Steps to Take When a Debtor Files Bankruptcy

Upon learning that a person or business who is indebted to you has filed for bankruptcy, there are several critical steps that should be taken to protect your interests.

1. Calendar Deadlines

Upon learning of the bankruptcy case, a creditor should promptly determine and calendar all applicable deadlines. **THIS STEP IS CRITICAL, AS THE COURT DOES NOT HAVE THE DISCRETION TO EXTEND SOME OF THESE DEADLINES. YOU MAY BE WAIVING SUBSTANTIVE RIGHTS IF YOU MISS THESE DEADLINES.** Some of these deadlines will appear on the Notice of Case Commencement that all creditors should receive, and others will be apparent from a review of the case docket which is available online through use of the Bankruptcy Court's electronic filing system. Creditor's should consult the Court's website for information on obtaining a logon and password.

The important calendar dates include the deadline to file proofs of claim, and the deadlines to object to dischargeability and/or discharge. Other dates may not be so obvious, and may require calculation and review of applicable provisions of the Bankruptcy Code and/or Bankruptcy Rules. For example, the deadline to object to a debtor's claimed exemptions is 30-days from the date that the meeting of creditors under section 341 of the Bankruptcy Code is *concluded*. Similarly, the termination of the exclusivity period (the time in which only the debtor or trustee may propose a chapter 11 plan) and the deadline for a debtor or trustee to seek to assume or reject unexpired leases or executory contracts varies by case. If these issues are relevant to a particular creditor's relationship with the debtor, experienced bankruptcy counsel should be consulted.

2. **Review Important Pleadings**

a. **The Petition**

A bankruptcy case is initiated by the filing of a "petition." (The petition and many other Bankruptcy Forms are available in the internet. The New Jersey Bankruptcy Court's website is www.njb.uscourts.gov, and the Southern District of New York Bankruptcy Court's website is www.nysb.uscourts.gov). There are several important pieces of information on the petition, including: 1) the jurisdiction where the case was filed; 2) the chapter under which the case was filed (usually chapter 7, 11 or 13); 3) the debtor's estimate of the number of creditors; and 4) the debtor's estimate of the value of assets and liabilities. The debtor must sign the petition under penalty of perjury.

b. **Schedules of Assets and Liabilities and Statement of Financial Affairs**

Regardless of the chapter, all debtors must file certain bankruptcy Schedules of Assets and Liabilities and Statement of Financial Affairs. The schedules should contain a detailed listing of all of the debtor's assets and liabilities. For example, all real property in which the debtor has an interest is to be listed on Schedule A, along with an indication of the value of the property and existing liens. Personal property is listed on Schedule B. For individual debtors, property claimed as exempt is listed on Schedule C. Creditors are identified on Schedules D, E and F, relating to secured, priority and unsecured claims, respectively. If the debtor is a party to any executory contracts or unexpired leases, they should be listed on Schedule G. If any other parties are co-obligors with the debtor on any claim, such information is provided on Schedule H. For individual debtors, details regarding monthly income and expenses are listed on Schedules I and J, respectively.

These Schedules contain important information not only for the bankruptcy case, but this information may assist your collection efforts if the debtor's bankruptcy case is dismissed. If the creditor has a judgment against the debtor, Schedule B may provide information on personal property, like bank accounts, that a creditor may levy upon if the case is dismissed. Also, in New Jersey a judgment creditor must obtain a court order to levy upon real property only after exhausting personal property. <u>See</u> NJ Court Rule 4:59-1(d). This Rule requires the judgment creditor to certify the steps that he or she has taken to locate and proceed against personal property and should assist the judgment creditor in exhausting personal property. Schedule B, which is filed under penalty of perjury, should be an accurate list of all the debtor's personal property. A debtor's failure to accurately complete the Schedules may provide a basis to dismiss the bankruptcy case.

The Statement of Financial Affairs contains a variety of questions that the debtor must respond to, and may also provide creditors with significant insight into the debtor's assets and liabilities, as well as potential issues that could come up in the case. For example, the debtor is required to identify all pending lawsuits that it was involved in when the case was filed. Also, the debtor is required to identify all transfers made within 90 days of the bankruptcy filing. This is important because it indicate transfers that the estate fiduciary (either a trustee or a debtor in possession) may sue to recover. More on this at section F, below.

c. Chapter 11 "First Day Motions"

In many business Chapter 11 cases, the DIP files a number of motions known as "first-day motions" designed to ease the transition into Chapter 11 and ensure that the debtor has the requisite authority to operate while in bankruptcy. Among the most common are motions to pay pre-petition wages to employees, to continue using a pre-existing cash management system, to use cash collateral and/or obtain debtor-in-possession financing, and to provide adequate assurance to utility providers. Often filed with the first-day motions is a declaration from one of the debtor's executives in support of the motions. This declaration can provide great insight into the case, including why the debtor filed for bankruptcy and what the expectations are for how the case will proceed.

Careful consideration should be given to the relief being requested in the cash collateral and/or debtor-in-possession financing motions, especially if your claim against the debtor is secured. To the extent one or more lenders asserts a secured claim on the debtor's cash, the cash collateral and/or debtor-in-possession financing motions should require various forms of adequate protection in order for the debtor to get authority to use the cash to fund operations in bankruptcy. However, the scope of the protection requested may significantly affect or limit the potential recovery for other creditors later in the case, for example, if the debtor offers a replacement lien on previously unencumbered assets and/or a lien on avoidance actions. Adequate protection may also include monthly payments to a secured creditor.

A common motion in larger cases that may be of particular interest to creditors is a "critical vendor" motion, through which the debtor seeks authority to pay all or a portion of certain pre-petition claims owed to vendors or suppliers which the debtor believes are crucial to continued operation. Vendors that have been found to be critical include produce suppliers and trash haulers in grocery stores bankruptcies. Inclusion on a critical vendor motion can be the difference between receiving a large payment on account of a pre-petition claim and receiving nothing or pennies on the dollar if relegated to the treatment ultimately approved for all general unsecured creditors.

Many chapter 11 cases today are filed to effectuate a quick sale of most or all of the debtor's assets. In such a case, it is common for a debtor to include with its initial motions a request for approval of procedures for the sale of the debtor's assets. Often, the debtor will have made arrangements with a prospective buyer before filing bankruptcy, who will act as a "stalking horse" bidder. Courts now regularly approve procedures where the debtor will have a limited period to market the assets to seek competing bids, after which an auction will be conducted. Creditors should review the proposed sale terms, as this will significantly affect, and may be determinative of, the funds which will ultimately be available for distribution to creditors.

3. **Review and Stop Collection Activities**

Section 362 of the Bankruptcy Code imposes an "automatic stay" on all collection activities against a debtor once a bankruptcy case has been filed. This is effectively a federal injunction that arises when a bankruptcy case is filed. The automatic stay halts any pending litigation against the debtor (as to the debtor only - and not as to co-defendants), and requires that any restraints or other collection efforts be ceased. Upon learning of a bankruptcy filing, a creditor should immediately ascertain what collection efforts are in process and take quick action to stop same. The failure to stop collection efforts may result in a lawsuit filed against the creditor by the debtor in the bankruptcy case (an "adversary proceeding") seeking damages for violating the automatic stay. Even seemingly innocuous collection efforts, such as mailing a monthly statement indicating an amount presently due, may be in violation of the stay and may precipitate a lawsuit, depending on the type of case and the attorney representing the debtor.

The automatic stay does not stay collection efforts and lawsuits against other persons or entities liable on the creditor's claim (with the limited exception of the Chapter 13 co-debtor stay, discussed below). For example, if a creditor is prosecuting a lawsuit against a primary obligor and a guarantor, a bankruptcy by the primary obligor does not automatically stay the action against the guarantor. Notwithstanding the limited reach of the automatic stay, the judge in a pending federal or state action may administratively stay the action if one defendant files a bankruptcy petition. In this circumstance, the attorney representing the creditor may need to file a motion to lift the administrative stay and proceed against non-debtor defendants.

4. File a Notice of Appearance

Creditors who are represented by attorneys may wish to have their attorneys file a "notice of appearance" with the court. This is a document that is filed on the docket of the case notifying the debtor, any trustee and all other parties in interest that the creditor is represented. There are several advantages to filing a notice of appearance, most notably of which is that the attorney will receive electronic notifications of all filings in the case, and so will be able to promptly take action if a motion or other pleading is filed which may affect the creditor's interest. One potential downside is the possibility that filing a notice of appearance may subject the creditor to the jurisdiction of the bankruptcy court. Most experienced bankruptcy attorneys include limiting language in their notice of appearance to disclaim any such acceptance of jurisdiction, but the effect of such language has not been tested. In reality, because litigants in bankruptcy court enjoy nationwide service of process, this is in most situations of minimal concern.

5. Decide Whether to Attend The 341 Meeting

All bankruptcy cases include a meeting of creditors pursuant section 341 of the Bankruptcy Code (the "341 Meeting"). In chapter 7 and chapter 13 cases, the meeting is conducted by the chapter 7 and chapter 13 trustee, respectively. In chapter 11 cases, where no trustee has been appointed, the meeting is conducted by the Office of the United States Trustee. The date of the 341 Meeting will be set forth on the Notice of Case Commencement sent to creditors at the beginning of the case. Creditors, and or their counsel, should call to confirm the date before attending as these meetings are frequently adjourned.

Creditor's attorneys attending the meeting may be permitted to ask the debtor a limited number of questions. If a creditor wishes to undertake a more extensive questioning of the debtor, a formal examination under Bankruptcy Rule 2004 is the more appropriate tool. Creditors attending the 341 Meeting should advise the Trustee of any anomalies in the debtor's Schedules or otherwise.

6. <u>Decide Whether to Join a Committee</u>

This step generally only applies to unsecured creditors. In chapter 11 cases, the Office of the US Trustee will circulate a notice to large unsecured creditors inviting them to attend a formation meeting, at which the US Trustee may, if there is sufficient creditor interest, appoint an Official Committee of Unsecured Creditors (the "Committee"). In large cases with many creditors, a Committee can be invaluable as individual creditors do not wish to spend the time and money to police the debtor's activities -- which actions really benefit all creditors. The Committee retains its own professionals, who are paid by the bankruptcy estate. Careful consideration should be given whether or not a creditor wishes to be a member of the Committee. As a committee member, the creditor must act as a fiduciary for all creditors, and there may be some instances where the interests of a single creditor may diverge from the interest of the creditor body as a whole. In smaller chapter 11 case, or one with few creditors, the formation of a committee may not be cost-efficient, and may significantly deplete estate assets which could otherwise be available for distributions to creditors.

7. File a Proof of Claim or a Request for Administrative Expenses

In many cases, a creditor needs to file a proof of claim to assert its right to distribution from the bankruptcy estate. At the outset of the case, the creditor should determine if there is a "bar date" for filing proofs of claim, so it can ensure that claims are timely filed. The Notice of Case Commencement sent to creditors at the beginning of the case will list the bar date, or advise creditors that claims should not be filed unless notified by the Court. With some exceptions, claims are submitted using Official Bankruptcy Forms, which are available on the Courts' websites. The exception to this is in larger chapter 11 cases, where a specific claim form may be approved by the Court which is designed to address the specific issues in that case.

There are some cases where a proof of claim need not be filed. Proofs of claim are not necessary in no-asset chapter 7 cases, or in chapter 11 cases where the creditor's claim is correctly listed on the debtor's schedules and is not identified as either "contingent, disputed or unliquidated." On the other hand, if the case is an asset-chapter 7, a chapter 13 or a chapter 11 and the claim is not listed, has been listed incorrectly or has been identified as contingent, disputed or unliquidated, a proof of claim should be filed. If you are uncertain, consult an experienced bankruptcy attorney.

Filing a proof of claim acts to accept bankruptcy court jurisdiction over disputes arising from the proof of claim (note-this is a different concern than the personal jurisdiction issue in connection with notices of appearance). This is not generally a concern and, in most cases, the value to be gained from asserting and protecting a creditor's claim in bankruptcy (and thus, hopefully, enabling the creditor to receive a distribution) outweighs such risks. If this is a concern in a particular cases, experienced bankruptcy counsel should be consulted.

Creditors should also note that if multiple debtors' case are being administered together, the creditor may need to file multiple proofs of claim to preserve claims against each debtor who owes the creditor. Filing a proof of claim in only the "lead case" may result in a waiver of claims against the other debtors, which could significantly impact ultimate recovery.

An administrative expense is a special type of claim that is given priority in the bankruptcy case, and may sometimes be paid during the pendency of the case. A non-exclusive list of types of administrative expense claims is set forth in Section 503(b) of the Bankruptcy Code. In New Jersey, the local bankruptcy rules provide a form for filing an administrative expense. You should consult an experienced bankruptcy attorney if you believe you may be entitled to an administrative expense claim.

8. <u>Discovery – The Rule 2004 Examination</u>

The Bankruptcy Rules provide a mechanism, through Rule 2004, that allows any party involved in a bankruptcy case to take the examination of any entity. While the text of the rule indicates the requirement of a court order, local rules in various jurisdictions have altered the procedure for initiating a Rule 2004 examination. For example, in New Jersey, local rules provide that a party should simply send a subpoena to the party to be examined, without first obtaining a court order, and that the court only becomes involved if the party refuses to comply or files a motion for a protective order. In New York, a court order is still required. Typically, you can call opposing counsel and work to schedule the examination for a mutually agreeable time.

The scope of the examination that is permitted is incredibly broad, and court opinions regularly refer to it as permitting a "fishing expedition." A Rule 2004 examination can be a great tool for creditors who think they may have grounds to object to the debtor's discharge or to the dischargeability of their debt, and can use Rule 2004 to obtain facts and evidence in support of such an action before filing a complaint. The 2004 examination is also useful if you have had trouble getting a judgment debtor to appear for a post-judgment deposition.

9. Determine if Your Claim is Secured or Unsecured

This determination may not be as obvious as you think. A secured creditor is someone who has a lien or some other specifically enforceable interest in property of the debtor, such as a mortgage on real property or a security agreement evidenced by a UCC financing statement. But, depending on the nature of the security interest, the lien may be avoidable in the bankruptcy case if not properly perfected (i.e., by recording the mortgage or filing the UCC Financing Statement with the appropriate governmental agency). A potential problem for the creditor arises if a lien was granted, or only perfected, within 90 days of the bankruptcy filing (or within 1 year if the creditor is an insider of the debtor, like a principal that lends a company money and takes back a lien on company assets), the lien may be avoidable as a preference. This is a particular problem for judgment creditors who docket their judgment as a lien with the New Jersey Superior Court within 90 days of the bankruptcy filing. The judgment creditor who "dockets," but fails to continue to diligently pursue collection may face another challenge to his or her secured status under the trustee's "strong-arm" powers, discussed in subsection F, below.

If a creditor's claim is secured, the creditor's rights to its collateral, such as repossession, are limited by the automatic stay as discussed below, although in certain instances a court may grant relief from the automatic stay to permit the creditor to exercise its rights in its collateral. If a creditor's security interest extends to the debtor's cash, then it is entitled to certain "adequate protection" before the debtor may use the cash. In order for a debtor to use cash collateral, it must either obtain the secured creditor's consent or a court order under section 363 of the Bankruptcy Code. In such cases, secured creditors may insist on detailed cash collateral orders which provide various forms of protection for the secured creditor, including monthly payments, replacement liens, super-priority claims, periodic reporting and certain findings as to the validity and enforceability of the creditor's claims.

Additionally, creditors may hold claims for set off or recoupment. A right to set off is found where a creditor and a debtor both owe each other money, so that the creditor can reduce the amount it pays to the debtor by the amount owed to the creditor from the debtor. Set off is considered a secured claim in bankruptcy, and relief from the automatic stay must be obtained before a creditor may be permitted to effectuate set off. Set off requires mutuality of obligations (e.g., no third party involved), and a creditor may only set off a prepetition obligation against another pre-petition obligation (or a post-petition obligation against a post-petition obligation). Recoupment, on the other hand, is considered an equitable defense, and not a secured claim, and thus relief from stay is not required. Recoupment requires that offsetting obligations arise under the same transaction-e.g., mutual obligations under the same contract or invoice.

B. Chapter 7-Liquidation, Automatic Stay, Dischargeability

1. Automatic Stay

As noted above, the automatic stay goes into effect in almost all bankruptcy cases, regardless of chapter. The purpose of the automatic stay is to give the debtor an opportunity to catch its breath from collection efforts so that assets may be marshalled and distributed equally to creditors. There are certain exemptions to the automatic stay, listed in section 362(b) of the Bankruptcy Code. The automatic stay may also be limited for repeat filers. If the debtor subject to a creditor's claim has previously filed one or more bankruptcy petitions, then the creditor should consult an experienced bankruptcy attorney to discuss the applicability of the automatic stay.

Creditors may seek relief from the automatic stay to continue collection activities. Generally speaking, unsecured creditors are not afforded relief from stay to continue collection activities because such claims will be discharged in the bankruptcy and the creditor is limited to whatever distribution it may receive from the estate. Secured creditors, however, retain their rights in collateral. The Bankruptcy Code provides that such creditor may seek relief from the automatic stay for cause. While cause is not defined in the Bankruptcy Code, it includes lack of adequate protection, such as diminishing equity in collateral. Other things, such as the debtor's failure to pay real property taxes or to maintain proper insurance may also be sufficient cause for stay relief.

The Bankruptcy Code also provides that a secured creditor is entitled to stay relief if the debtor does not have any equity in property serving as the creditor's collateral, and such property is not necessary to an effective reorganization. Because there is no "reorganization" in a chapter 7 proceeding, stay relief should be granted if the debtor does not have any equity in collateral. In this circumstance, the trustee will often seek to abandon the property to the debtor or the secured creditor. Please note that even in the circumstance where a trustee seeks to abandon property, the secured creditor should still obtain stay relief before attempting to repossess the collateral.

Creditors should be aware of section 362(h) of the Bankruptcy Code, which permits any individual injured by a willful violation of the automatic stay to recover actual damages including costs and attorneys' fees. Punitive damages are also possible in appropriate circumstances.

2. <u>Discharge and Dischargeability</u>

a. <u>Discharge - Bankruptcy Code Section 727</u>

A debtor's discharge in a chapter 7 case may be challenged through the commencement of an adversary proceeding pursuant to section 727 of the Bankruptcy Code. Such an action must be filed within 60 days of the date scheduled for the first meeting of creditors under section 341. Such actions may be commenced by the trustee, the US Trustee or any creditor. Section 727(a) sets forth the list of causes for bringing such an action, including, most notably, the removal, destruction, mutilation or concealment of assets within one year of the bankruptcy filing or after the filing, the destruction or concealment of documents from which the debtor's financial condition or business transactions might be ascertained, or the failure to explain satisfactorily any loss of assets or deficiency of assets to meet the debtor's liabilities. Under section 727(d) (l), the debtor's discharge can also be revoked for fraud that was not discovered until after the discharge, provided that the action is commenced within one year of the discharge, or later under specific limited circumstances.

Creditors should also note that a complaint under section 727 does not relate to a creditor's specific claim, but to all of the debtor's debts. If a debtor is denied a discharge under section 727, then the trustee will assemble and distribute all assets available, but <u>all</u> creditors will still be able to pursue their claims against the debtor after the bankruptcy case is closed. For this reason, individual creditors rarely pursue actions under section 727.

b. <u>Non-Dischargeability-Bankruptcy Code Section 523</u>

Unlike an action under section 727, section 523 of the Bankruptcy Code permits a creditor to except a <u>particular</u> debt from the discharge. Thus, while other debts are discharged, a debt qualified under section 523 can "ride through" and thus still be enforceable after the bankruptcy is closed. Some obligations, such as domestic support obligations and student loans, are presumed non-dischargeable and no adversary proceeding is required.

Other debts may be deemed non-dischargeable, but require a court determination following an adversary proceeding (or, in some jurisdictions, a motion). These include debts incurred by false pretenses, false representations or actual fraud, debts incurred through the use of a false financial statement, debts incurred through larceny or fraud while acting in a fiduciary capacity or by embezzlement, and debts relating to willful and malicious injuries. As noted above, creditors should note at the outset of the case the deadline to assert that a debt is non-dischargeable, or that a debtor should not be entitled to a discharge. The deadline for filing a complaint to determine the dischargeability of a debt is 60 days after the first date set for the meeting of creditors under section 341 of the Bankruptcy Code.

If a creditor's claim was not reduced to judgment pre-petition, the creditor may seek to have the Bankruptcy Court enter a money judgment in connection with a section 523 action. Such a judgment is considered a "foreign judgment" by the New Jersey state courts and should be domesticated in New Jersey under New Jersey's Uniform Enforcement of Foreign Judgments Act, N.J.S.A. 2A:49A-25 *et seq*.

c. Whether to Proceed Under Section 523, 727 or Both

When faced with a debtor who appears to have engaged in various nefarious and/or fraudulent conduct, a creditor may be faced with a decision of whether to object to the entire discharge under section 727 and/or the dischargeability of the creditor's particular debt under section 523. One consideration that should be considered is that the commencement of a lawsuit under section 727 turns the creditor into a fiduciary for all other creditors because all creditors will benefit if the discharge is denied. Thus, the court will typically not permit the creditor to dismiss or settle the 727 action if the only compensation goes to the creditor. Additionally, if the creditor is confident of his grounds for a 523 action, it would be to his economic advantage remains after the bankruptcy, while all others are discharged. Thus, it may often be advisable to only commence an action under section 523, and not 727. Alternatively, if the trustee or another creditor has already commenced an action under 727, and appears likely to prevail, it may make sense to bring the action under 523 but request that it be stayed pending resolution of the 727 action, as the dischargeability or not of a particular claim is moot if the debtor does not receive a discharge.

C. Chapters 11 and 13 -Reorganization, Automatic Stay, Dischargeability

1. Chapter 11 Reorganization

Chapter 11 is generally utilized by businesses and high income individuals. In a Chapter 11 case, the debtor files a plan of reorganization, along with a disclosure statement which explains the plan in detail. Creditors should pay particular attention to these documents as they will set forth the proposed treatment of creditors. Creditors whose claims are impaired by the plan have the opportunity to vote for or against the plan. Secured creditors especially should consult bankruptcy counsel to determine whether their claims are impaired and to review their options prior to voting.

The debtor may also seek to accomplish other objectives than payment of its creditors through the plan, such as a release of principals of the debtor, which are only permitted in certain limited circumstances. The U.S. Trustee's office reviews the plan for some provisions which may be objectionable. Individual creditors should also careful review the plan documents and consult experienced bankruptcy counsel with any questions.

2. Chapter 13 Reorganization

Chapter 13 is designed for an individual to reorganize by paying a portion of his/her monthly income to pay creditors under a plan. To be eligible for chapter 13, pursuant to section 109(e) of the Bankruptcy Code, the debtor must be an individual with regular income and non-contingent, liquidated unsecured debts of less than

$394,725 and non-contingent, liquidated secured debts of less than $1,184,200. These debt limits are updated every 3 years. The next update will occur on April 1, 2019.

The chapter 13 "plan" is a less complex process than in Chapter 11. Chapter 13 lacks the voting provisions inherent in Chapter 11, but there are various requirements in Chapter 13 that must be satisfied for a plan to be confirmed. The trustee in chapter 13 is not imbued with the broad powers typically utilized in chapters 7 or 11, but is a "standing trustee" whose primary function is to monitor the chapter 13 case to ensure compliance with the rules and applicable code provisions, and to collect plan payments and make distributions to creditors. While the chapter 13 trustee does not liquidate assets as a chapter 7 trustee does, one requirement for confirmation of a chapter 13 plan is that unsecured creditors must receive at least as much as they would in a chapter 7 liquidation.

One major issue in chapter 13 deals with mortgages on the debtor's personal residence. Section 506 of the Bankruptcy Code, which applies to all chapters, permits a debtor to "bifurcate" secured claim into its secured and unsecured components. For example, if a secured creditor's collateral is worth only $500,000, and a secured creditor is owed $1,000,000, then the claim may be bifurcated such that the secured creditor is deemed to have a $500,000 secured claim and a $500,000 unsecured claim. Chapter 13 places a limitation on this if the claim is secured <u>solely</u> by the Debtor's personal residence, in which case bifurcation is not permitted. Courts have generally interpreted this to mean that if there is $1 of equity in the residence to collateralize the secured creditor's mortgage, then the claim may not be modified. Thus, courts will permit a debtor to "strip off" a junior mortgage, so long as the Debtor can prove that the value of senior mortgages exceeds the value of the property, such that there is not even $1 of equity for the junior mortgagee.

3. Automatic Stay

The provisions of the automatic stay discussed in connection with Chapter 7 are equally applicable in a chapter 11 and 13 cases. Stay relief may be more difficult to obtain in chapter 11 or 13 than chapter 7, because the Debtor may be able to demonstrate that collateral is necessary for an effective reorganization.

One special case that usually only occurs in Chapter 11 is the single asset real estate debtor. The Bankruptcy Code defines a single asset real estate debtor as one that owns "real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto." A secured creditor of such a debtor whose security includes an assignment of leases and rents, may be able to quickly get stay relief because case law in New Jersey provides that an absolute assignment of leases and rents transfers the rental income to the secured creditor, such that the rents are not property of the estate and may not be used to reorganize. In this circumstance, the secured creditor should consult experienced bankruptcy counsel.

Another special case occurs in Chapter 13 where section 1301 of the Bankruptcy Code provides a unique "co-debtor stay" which is otherwise not found in other chapters of the code. Under that section, a stay goes into effect which prohibits collection efforts by creditors with regard to consumer debts from an individual which is liable on such debt with the debtor, unless such individual became liable in the ordinary course of such individual's business, or the case is closed or converted to chapter 7. Thus, section 1301 abrogates the normal rule that the automatic stay only prohibits collection activities against the debtor, and provides additional protection for co-obligors, assuming these criteria are met.

3. Dischargeability

The provisions regarding dischargeability of particular debts under section 523 of the Bankruptcy Code are equally applicable in Chapter 11 and 13 cases. In Chapter 11, a debtor obtains a discharge when its bankruptcy plan is confirmed by the Court, assuming the plan provides for the discharge. In Chapter 13, the debtor is not eligible for a discharge until he or she finishes making payments under their 3 or 5 year plan. After payments are completed, the debtor can apply for a discharge. Under section 1328 of the Bankruptcy Code, a chapter 13 discharge is very broad, and discharges most unsecured obligations.

D. Means Testing, "Abusive Filing" and Dismissal

1. Means Testing

The Means Test, provided in section 707(b)(2)(A) of the Bankruptcy Code is a determination of whether a chapter 7 bankruptcy case is presumptively subject to dismissal as an abuse of the provisions of chapter 7. An abuse is presumed when the amount of the debtor's income, after deduction of certain expenses and other amounts, exceeds specified thresholds. The means test was enacted by Congress to eliminate the broad differences in court opinions interpreting the prior "substantial abuse" standard. In New Jersey, if the debtor's debts are primarily consumer debts and the debtor's income exceeds the state's median income, the debtor must complete the means test. Section 707(b)(2)(C) provides that the debtor must file a statement along with the Schedules of Assets and Liabilities, which statement shows his or her monthly income and the calculations that determine whether a presumption arises.

2. Abusive Filing and Motions to Dismiss

The concept of "abusive filing" represents an intent by Congress to prevent debtors from abusing the bankruptcy system to simply frustrate creditors. Code provisions limiting exemptions and permitting creditors to seek to dismiss bankruptcy cases have all been added to preclude the misuse of the system. Additionally, the Office of the United States Trustee has taken on an additional focus on abusive cases, particularly as a result in the decline in the number of chapter 11 filings.

In addition to the Means Test in Chapter 7 cases (discussed above), sections 1112 and 1307 of the Bankruptcy Code provide for dismissal of Chapter 11 and Chapter 13 cases, respectively, for cause. Both of these sections contain non-exclusive lists of circumstances that may provide cause for dismissal, such as gross mismanagement, unauthorized use of a creditor's cash collateral, and a material default by the debtor of a term of a confirmed plan. In addition to these sections, a debtor's case may be dismissed for failure to comply with other sections of the Bankruptcy Code. For example, a Chapter 13 case may be dismissed if the debts exceed the limitations set forth in section 109(e) of the Bankruptcy Code. A creditor who believes cause exists should file a motion to dismiss the case.

E. **Exemptions**

Exemptions are legislative determinations that certain property of a debtor should be exempt from the claims of creditors. The exemptions provided by the Bankruptcy Code, known as the federal exemptions, are found in section 522(d) of the Bankruptcy Code. The exemptions under state law are found in the state statutes which provide exemptions from execution for judgment debtors. Under the Bankruptcy Code, states are permitted to "opt-out" of the federal exemptions, thus requiring debtors who file a bankruptcy petition in that state to choose the state exemptions. New Jersey has not "opted-out" and thus permits debtors to choose either the state or federal exemptions.

The Bankruptcy Code was significantly amended in 2005. Part of this amendment was an effort to limit abuse by debtors of state homestead exemptions. To avoid forum-shopping, section 522(b)(3) now provides that the homestead exemption is determined by the debtor's state of domicile for the last 730 days, or 2 years, before the filing of the petition. If the debtor moved during that period, the choice of laws, and thus of homestead exemption, is determined by the domicile for the greatest period in the 180 days that preceded the 730 day period. Additionally, if the debtor purchased real property within 1215 days of the bankruptcy filing, the homestead exemption is limited to $160,375 pursuant to section 522(p) of the Bankruptcy Code. Although there is no homestead exemption in New Jersey, debtors in New Jersey may avail themselves of the federal exemption. Married couples may also be able to claim property as exempt in New Jersey to the extent it is owned as tenants by the entireties.

F. <u>Avoidance Actions</u>

A powerful component of the Bankruptcy Code is the avoidance action powers given to a trustee and/or debtor-in-possession. This power includes the ability to avoid a lien using the trustee's "strong-arm" powers under section 544 of the Bankruptcy Code, which allows a trustee to avoid any lien which could be overcome by a hypothetical bona fide purchaser in a non-bankruptcy setting. This section also provides that the trustee or DIP has the rights and powers of, "a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists." Practically in New Jersey this means that a judgment creditor who simply dockets a judgment, but fails to actively pursue collection and levy upon the judgment debtor's assets, may find themselves unsecured in the judgment debtor's bankruptcy case. The judgment creditor who is actively pursuing collection should consult an experienced bankruptcy attorney to take steps to protect themselves *before* the judgment debtor files a bankruptcy petition.

Additionally, the Bankruptcy Code provides for the recovery of fraudulent conveyances - either under section 548 of the Bankruptcy Code or under applicable state law. Generally speaking, a fraudulent conveyance involves either a transfer made with the intent to defraud, or, alternatively, a transfer made while the transferor was insolvent and for which the transferee failed to convey reasonably equivalent value. The most common fraudulent conveyance issue faced by creditors is when they accept payment from an insolvent debtor, oftentimes without even the knowing the debtor is insolvent.

While the factors for determining whether a transfer was actually or constructively fraudulent are usually similar under both the Bankruptcy Code and state law, the relative "look-back" period may vary significantly. Notably, section 548 of the Bankruptcy Code permits a trustee to avoid fraudulent transfers which took place up to 2 years before the bankruptcy case was filed. Many state laws have statutes which allow a transfer to be avoided extending back 4 or 6 years. In New Jersey, fraudulent conveyance actions generally must be brought within 4 years of the transfer, although that time may be tolled by a one-year discovery rule if the transfer was made with actual fraudulent intent.

The bane of many creditors in bankruptcy cases are preference lawsuits. A preference action is brought under section 547 of the Bankruptcy Code and essentially permits the estate to "claw back" certain transfers made to creditors within 90 days of the bankruptcy filing (or 1 year for insiders) to the extent such creditor was ‘"preferred" over other creditors. What this typically boils down to is that a creditor who did receive some payments, but who still has a large outstanding debt owed to it by the debtor, is forced to repay some of the money it did receive back into the estate-adding insult to injury. While the policy behind a preference claw back is to remedy the inherent unfairness resulting from some creditors having received payment while others did not-this is hardly a comfort to the creditor who already has little chance of repayment of its receivable and now has to go further into the red.

A preference claim is not an allegation of wrongdoing, it is merely a matter of getting payment at the wrong time which is subject to return as a preference.

There are, however, a variety of substantial affirmative defenses available to a preference action, including that the payments were received in the ordinary course of business, that the payment was made as part of a "contemporaneous exchange" of value with the debtor, and that the creditor supplied "subsequent new value" after receipt of the payment. Because of the availability of these defenses, preference actions often settle for a relatively small percentage of the total payments received, depending on the strength of the case and defenses.