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Bankruptcy

ARTHUR WEITZNER* AND RICHARD ROISMAN**

The authors summarize the significant differences between the new Bankruptcy Code, which became effective in 1979, and the Bankruptcy Act that governed bankruptcies prior to 1979. They also discuss those features of the new law which preserve important principles of the old. They first consider the changes in the bankruptcy court, in its procedures and the powers of its officers. They then examine the changes in the relationships between the debtor and the creditors and between the various creditors. Finally, the authors analyze aspects of the new Code that affect common commercial activities and are of special interest to the practitioner.

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I. INTRODUCTION

The "Bankruptcy Code of 1978," which became effective on October 1, 1979, is the latest expression of the federal government's policy of promoting the uniform and efficient treatment of the assets of insolvents throughout the United States.¹ The Constitution provides that Congress shall have the power to create uni-

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1. Bankruptcy Code of 1978, 11 U.S.C.A. §§ 101-1501 (West 1979) [hereinafter referred to as the "Code" as distinguished from the Bankruptcy Act, ch. 541, 30 Stat. 544 (1898) (repealed 1978) which will be referred to as the "Act"].

form bankruptcy laws for the nation.² Congress has given effect to that clause of the Constitution by providing that the United States district courts shall have original jurisdiction over matters in bankruptcy and that this jurisdiction is exclusive of that of the states.³ Both the framers of the Constitution and the legislators of the bankruptcy statutes thought that a continued freedom of commerce among the various states requires that the laws of insolvency be uniform. This uniformity would ensure that cobblers in New England, cotton growers in Dixie, and hotel operators in Florida would have similar reasonable expectations as to the risks of doing business with those who become insolvent. The nationwide similarity of expectations about insolvency reinforces the virtual uniformity of modern corporate law and of commercial law under the Uniform Commercial Code. Debtors and creditors throughout the United States can therefore deal in states other than their own with little fear that unfamiliar law will confuse their legal relationships with each other.

Bankruptcy is a procedure for handling debtors who cannot meet their obligations. It provides a system for the liquidation of obligations and the discharge or forgiveness of debts. Since bankruptcies are a symptom of weakness in the economy, they occur more often in times of recession. In the absence of some orderly insolvency procedure, business failures during recessions would usually result in a complete loss for creditors and equity holders.⁴ The dire effects of business collapses have led Congress to try to soften these blows by passing sections of the bankruptcy statute allowing for the rehabilitation of debtors under the supervision of the bankruptcy court rather than for a mere discharge of debts.

An example of such a rehabilitative provision was the Chandler Act,⁵ passed in 1938 in response to the Great Depression. Chapter XI of the Chandler Act became very popular, used so widely that virtually all proceedings of a rehabilitative nature were

2. 28 U.S.C. § 1471(a) (1976).

3. U.S. CONST. art. I, § 8, cl. 4 provides Congress with the power "[t]o establish . . . uniform laws on the subject of Bankruptcies throughout the United States." *Id.* Collier makes the observation that although related to commerce, the Bankruptcy Clause was not included within the Commerce Clause and that therefore, "it is fair to infer that the draftsmen did not wish to restrict the bankruptcy grant as they had done the power over commerce." 1 COLLIER ON BANKRUPTCY ¶ .02 (15th ed. 1979) [hereinafter cited as COLLIER]. See generally Countryman, *A History of American Bankruptcy Law*, 81 COM. L.J. 226 (1976).

4. See generally Report of the Commission on the Bankruptcy Laws of the United States, H.R. DOC. NO. 93-137, 93d Cong., 1st Sess. 33 (1973).

5. Chandler Act, ch. 575, 52 Stat. 840 (1938) (repealed 1978). See also Bankruptcy Act § 77 (repealed 1978) (railroad reorganizations).

called "Chapter Elevens."⁶ The new Code has preserved this popular name; most business rehabilitative cases will now be conducted pursuant to Chapter 11 of the Bankruptcy Code. The Chandler Act's wage earner section, Chapter XIII, has been reweoven into a new Chapter 13 that includes the rehabilitation of proprietorships and other small businesses, as well as wage earners.⁷

This article analyzes the important changes the Bankruptcy Code has brought to federal insolvency law. Where appropriate, the authors will compare the new laws with the old, comment on the policies lying behind the changes, and point out pragmatic considerations for practitioners. The article will cover those sections of the Code common to all proceedings: jurisdiction, parties, court officers, case administration, liquidations, discharge, and exemptions from discharge. In addition, the article will analyze certain material developments that particularly affect commercial transactions. These include the changes in the law of preferential transfers and the interaction of bankruptcy law with leases. Changes in reorganization proceedings, however, lie beyond the scope of this article.

II. PROCEDURAL AND JURISDICTIONAL CHANGES

The bankruptcy reform legislation has resulted in the overhaul of the judicial apparatus for administering the insolvency law as well as in substantive changes in that law. This portion of the article deals with the revised system of bankruptcy procedure under the Code.

A. *The Bankruptcy Court and Judge*

As amended, title 28 of the United States Code now provides specifically for bankruptcy courts.⁸ The creation of these new courts resulted from a compromise between the two Houses of Congress. The House of Representatives sought the creation of an independent article III court;⁹ however, the Senate prevailed in making the bankruptcy court a functionally independent adjunct of the district court.¹⁰ Those who supported the establishment of a

6. This consolidation removes from litigation the issue of the appropriate chapter under which to proceed. Klein, *The Bankruptcy Reform Act of 1978*, 53 AM. BANKR. L.J. 1, 8 (1979).

7. See 11 U.S.C.A. § 1304 (West 1979).

8. 11 U.S.C.A. § 201(a) (West 1979) (amending 28 U.S.C. §§ 151-160 (1976)).

9. H.R. REP. No. 95-595, 95th Cong., 1st Sess. 21 (1978) reprinted in COLLIER (Appendix 2, 15th ed. 1979) [hereinafter cited as HOUSE REPORT].

10. 28 U.S.C. § 151(a) (1976).

wholly independent court argued that independence would make bankruptcy courts better able to attract qualified judges and would provide debtors and creditors an impartial and specialized forum that would promote the quick and efficient administration of a bankrupt's estate.¹¹

There have been significant changes in the role of the court's primary judicial officer, the bankruptcy judge. Formerly, all cases upon filing were assigned to a district judge who automatically referred them to the referee in bankruptcy.¹² In 1973, the title of referee was changed to that of bankruptcy judge; however, the officer's duties remained the same.¹³ Congress now has limited the bankruptcy judge's functions to the adjudication of issues of law and fact. Under the prior system, the bankruptcy judge not only decided disputed legal and factual questions¹⁴ but also was responsible for routine administrative tasks, such as the entry of routine orders and the supervision of case docketing.¹⁵ Congress believed, with questionable validity,¹⁶ that the discharge of detailed administrative duties by the court gave it an early familiarity with the facts and issues in a particular case that influenced the court in its subsequent rulings on issues of fact and law in the same case. The judge would, for instance, rule on jurisdictional questions both at the first meeting and later. Congress believed that the influence of the court's earlier rulings prejudiced those who sought to litigate against the trustee or debtor. To alleviate this imagined problem, the Code provides that the judge may not preside at the first meeting of creditors and no longer has administrative duties.¹⁷

Various changes have been made in the appointment process for bankruptcy judges and in their term of office, to give them more prestige and independence. Effective April 1, 1984, "[t]he President shall appoint, by and with the advice and consent of the Senate, bankruptcy judges for the several judicial districts."¹⁸ The

11. See HOUSE REPORT, *supra* note 9, at 13.

12. Bankruptcy Act § 22 (repealed 1978); FED. R. BANKR. P. 102. This rule is superseded by the Code which provides for the filing of all petitions with the bankruptcy court. 11 U.S.C.A. §§ 301-304 (West 1979).

13. H.R. Doc. No. 93-137, 93d Cong., 1st Sess. 33 (1973).

14. Bankruptcy Act § 2 (repealed 1978).

15. *Id.*

16. Indeed, the Senate would have continued the practice of having the court preside over the first meeting of creditors. See 124 CONG. REC. H11,092 (daily ed. Sept. 28, 1978).

17. 11 U.S.C.A. § 341(c) (West 1979).

18. 28 U.S.C.A. app. § 162 (West 1979). To alleviate concern that this process would delay the administration of bankrupts' estates, Congress has provided that upon expiration of his term a bankruptcy judge may continue to perform his duties until a successor is

former law gave the district court this power. For the purposes of attracting more qualified judges, their term of office has been extended from six to fourteen years¹⁹ and their compensation has been increased.²⁰

The Code also modifies the procedure for appeals. Under the Act, appeals were taken in the first instance to the district judge initially assigned to the case, and thereafter to the court of appeals for the appropriate circuit. Although retaining this process,²¹ the Code also empowers the circuit court of appeals through its chief judge to designate panels of bankruptcy judges to hear appeals from the judgments, orders, and decrees of bankruptcy courts in that circuit. These panels will consist of three judges other than the one who decided the matter below.²² Litigants may appeal from the decisions of this tribunal to the circuit court as a matter of right.²³

B. Trustees

As was true under prior law, the trustee is the legal representative of the bankrupt's estate and, as such, may sue or be sued.²⁴ The Code imposes upon the trustee many of the same affirmative duties he formerly had.²⁵ These include the duties to liquidate the estate and account for the cash received,²⁶ to review the claims against the estate and object to those he deems improper,²⁷ to investigate the affairs of the debtor and oppose a discharge if he thinks it advisable to do so,²⁸ to furnish information concerning the administration of the estate as the parties in interest request,²⁹ to operate the business of the debtor when so authorized, and to

named. *Id.* § 153(a).

19. *Id.* § 153(a).

20. *Id.* § 154. Each bankruptcy judge is to receive an annual salary of \$50,000 subject to adjustment under the Federal Salary Act.

21. 28 U.S.C. §§ 1334, 1408 (1976).

22. *Id.* §§ 160(a), 1482.

23. *Id.* § 1293(b).

24. 11 U.S.C.A. § 323(b) (West 1979).

25. Bankruptcy Act § 47 (repealed 1978).

26. 11 U.S.C.A. § 704(1), (2) (West 1979). It should be noted that the trustee may, under the Code, invest the money of the estate so "as [to] yield the maximum reasonable net return on such money, taking into account the safety of such deposit or investment. *Id.* § 704(2); cf. Bankruptcy Act § 61 (repealed 1978) (requiring that the trustee use designated banking institutions as depositories for the money of estates).

27. 11 U.S.C.A. § 704(4) (West 1979).

28. *Id.* § 704(5).

29. *Id.* § 704(6) (unless the court orders otherwise).

close the estate through the filing of a final account of administration with the court.³⁰

The creation of the office of interim trustee has buttressed the authority of the permanent trustee.³¹ The Code provides that at the inception of every case, the judge shall appoint an interim trustee.³² This interim trustee serves until the first meeting of creditors and thereafter if a new trustee is not elected.³³ The interim trustee will usually become the permanent trustee. The term "receiver" has been abolished, and those functions previously performed by the receiver are now to be performed by the interim trustee.³⁴ Congress apparently intends to discourage creditors from selecting their own trustee for a bankrupt's estate by providing them with an "interim" trustee, appointed by the judge before the first meeting of creditors and ready to assume the powers and duties of a permanent trustee. Congress seems to have edged toward shifting control of the bankruptcy process from the hands of the creditors to those of the bankruptcy bureaucracy.

The national pilot trustee program, which will operate in certain judicial districts but not in Florida, is another sign of Congress' intent to bureaucratize the bankruptcy process.³⁵ Under the pilot program, to become effective on April 1, 1984, the Attorney General will appoint a United States trustee.³⁶ This trustee will establish a panel of available private trustees but may also serve as trustee in any specific case.³⁷ By January 3, 1984, the Attorney General shall report to Congress, the President, and the judicial conference of the United States on the feasibility of the program. The Attorney General shall submit a recommendation concerning the advisability of installing the national trustee program on a per-

30. *Id.* § 704(7), (8). The trustee is required to notify the taxing authorities and make periodic reports regarding the operation of the business as the court requires. *Id.*

31. 28 U.S.C. § 604(f) (1976).

32. 11 U.S.C.A. § 701(a) (West 1979).

33. *Id.* § 701(b).

34. *Id.* § 105(b). "The Bankruptcy Code has ample provision for the appointment of trustees when needed. Any appointment of a receiver would simply circumvent the established procedures." HOUSE REPORT, *supra* note 9, at 316.

35. 11 U.S.C.A. §§ 408(a), 1501 (West 1979) (listing 10 districts designed for the pilot program).

36. 28 U.S.C. § 581(a) (1976). The United States Trustee is subject to removal for cause. *Id.* § 581(c).

37. 11 U.S.C.A. § 586(a)(1), (2) (West 1979). It is contemplated that the administrative tasks performed under the Act by the bankruptcy judge will now be performed by the United States Trustee. *Id.* § 586(a)(3).

manent basis throughout the United States.³⁸

The Code provisions for the compensation of trustees further evidence the intent of Congress to reduce the creditors' control over the bankruptcy process. The Code greatly reduces the compensation for the permanent trustee and eliminates it for the interim trustee.³⁹ In a period of high inflation, the only rationale for cutting the trustee's compensation would seem to be the discouraging of private parties from acting as trustees and the dissuasion of the creditors from electing a private trustee in the face of difficulties in attracting capable and honest people to serve as trustees for insufficient pay.

Shifting power over the insolvency process to bureaucrats, however, will make the process slower and less efficient. Furthermore, a bankruptcy bureaucracy has no interest in preserving the property of creditors. Congress has apparently forgotten that it is the creditors' money that is involved in bankruptcy proceedings.

C. *First Meeting of Creditors*

The first meeting of creditors is a procedure in which the creditors can examine the debtor to determine what assets he has and in which the creditors may elect a permanent trustee. The changes the Code brings to the first meeting, like the changes the Code brings to other bankruptcy procedures, weaken the position of the creditors.

The Code provides that the interim trustee and those creditors present at the first meeting of creditors will examine the debtor to test the accuracy of his claims.⁴⁰ The bankruptcy judge will no longer preside over the first meeting. This change leaves open the question of who is to preside. Initially, one might think that the interim trustee would preside. The interim bankruptcy rules adopted by the districts, however, provide that a clerk will preside.⁴¹ As a lay person, unfamiliar with propositions of law, the clerk will be unable to rule on objections. The meeting could disintegrate into a disorganized free-for-all. The absence of the judge will itself impede the orderly conduct of the first meeting. The authority his presence under the former procedure lent the first

38. 11 U.S.C.A. § 408(b) (West 1979).

39. Compare Bankruptcy Act § 48c(1) (repealed 1978) with 11 U.S.C.A. § 326(a) (1979). See Mann, *The New Bankruptcy Code—Some Early Problems and Suggested Solutions*, 85 COM. L.J. 17, 18 (1980).

40. 11 U.S.C.A. § 343 (West 1979); HOUSE REPORT, *supra* note 9, at 331.

41. Suggested Interim Bankruptcy Rule 2003(b)(1).

meeting no doubt had a great psychological impact on the debtor. His ability to examine the debtor increased the pressure on the debtor to testify truthfully about his assets and liabilities. This pressure will now evaporate.

These changes in the first meeting, furthermore, will probably not accomplish Congress's purpose of avoiding judicial prejudice through the judge's participation in the first meeting and judicial cronyism in appointing receivers and trustees. The judge appoints the interim trustee⁴² who, in most cases, will become the permanent trustee.⁴³ It is only natural that the judge will have confidence in his appointees. Thus, the judge still could be prejudiced by the recommendations of the trustee in contested matters. It therefore appears that this new system will not correct the problems that Congress perceived but will create others. If Congress felt that the image of bankruptcy procedure needed a renovation, the removal of the judge from the first meeting of creditors was not the way to accomplish this cosmetic alteration.

The first meeting of creditors also is the time for the election of the permanent trustee. In most cases, the interim trustee will continue on as permanent trustee.⁴⁴ Unsecured creditors, however, may vote for a different trustee if they wish. The election of a trustee is valid only if creditors eligible to vote are voting at least twenty percent of the allowable, undisputed, fixed, liquidated, unsecured claims entitled to distribution.⁴⁵

A creditor may vote only if he holds an "allowable, undisputed, fixed, liquidated, unsecured claim of a kind entitled to distribution . . . ; does not have an interest materially adverse . . . to the interest of creditors entitled to such distribution; and is not an insider."⁴⁶ Claims are presumed allowed for the purposes of voting, unless they are insufficient on their face.⁴⁷ The prior law required for election of the trustee a simple majority in the amount of unsecured claims and the number of unsecured creditors voting at the meeting of creditors.⁴⁸

42. 11 U.S.C.A. § 701(a) (West 1979).

43. *Id.* § 702(d).

44. *Id.*

45. *Id.* § 702(c).

46. *Id.* § 702(a). The term "materially adverse" is used in FED. R. BANKR. P. 207(d) and requires the court to consider the nature, size and degree of the adverse interest. HOUSE REPORT at 378. An "insider" is a new term defined at 11 U.S.C. § 101(25) (1979).

47. FED. R. BANKR. P. 207(a); 11 U.S.C.A. § 502 (West 1979) deems a claim of interest allowed, absent the objection of a party in interest.

48. Bankruptcy Act § 56(a) (repealed 1978); FED. R. BANKR. P. 207(b).

The effect of these changes will be to weaken the first meeting of creditors as an effective means of ensuring creditor control of the bankruptcy process.

D. Jurisdiction

The Code brings about major changes in the subject matter jurisdiction of the bankruptcy courts by abolishing the distinction between "summary" and "plenary" jurisdiction, a distinction which dates back over a century.⁴⁹ In deciding whether summary or plenary jurisdiction lay, the essential issue formerly turned on the possession of the property in question. If the litigation involved the determination of rights to property in the possession of the trustee, then the case lay within the summary and exclusive jurisdiction of the court.⁵⁰ On the other hand, a proceeding to determine the rights to property within the possession of a bona fide claimant adverse to the trustee was plenary in nature. The bankruptcy court lacked power to determine matters within the plenary jurisdiction, absent the consent of the adverse claimant.⁵¹ Accordingly, if the trustee were to assert rights against an adverse claimant he would have to do so in either a state court or a federal court, as appropriate.⁵²

Although much could be said in favor of this bifurcated jurisdictional setup,⁵³ this preliminary determination of summary or plenary jurisdiction was often just something extra to litigate. Fre-

49. Bankrupt Act of 1867, ch. 176, § 2, 14 Stat. 517 (1867) (superseded 1898); see *Lathrop v. Drake*, 91 U.S. 516, 518 (1875).

50. See *White v. Schloerb*, 178 U.S. 542 (1900). This exclusive jurisdiction extended to proceedings to determine the rights of parties holding liens obtained through legal or equitable proceedings within four months of bankruptcy. Bankruptcy Act § 23b (repealed 1978).

51. *Id.* If an adverse claim is real and substantial in that it "discloses a contested matter of right, involving some fair doubt and reasonable room for controversy, . . . in matters either of fact or law," then the bankruptcy court must decline to determine the merits of the case and the trustee must resort to a plenary suit. *Harrison v. Chamberlin*, 271 U.S. 191 (1926); *Bel Marin Keys Community Servs. Dist. v. Lines*, 18 C.B.C. 199 (9th Cir. 1978).

52. Bankruptcy Act § 23b (repealed 1978); see *In re Norsesian*, 16 C.B.C. 527 (M.D. Fla. 1977) (mere filing of a claim in the absence of a Bankruptcy Act § 57g counterclaim or a controversy with regard to whether a claim should be allowed is not consent to summary jurisdiction by the claimant); cf. *In re Rondon*, No. 75-B-1571 (S.D.N.Y. 1978) (filing proof of a claim in an adversary proceeding by a trustee asserting a fraudulent conveyance is consent to summary jurisdiction as to the existence of the fraudulent transfer); *In re Behring and Behring*, 445 F.2d 1096 (5th Cir.), cert. denied, 404 U.S. 991 (1971) (where it is necessary to consider a counterclaim in order to allow or disallow a claim, the counterclaim is within the summary jurisdiction of the bankruptcy court).

53. It can be said that the system enables state courts to resolve issues of state property law.

quently, a virtual trial on the merits was needed to determine if the adverse claimant was subject to the summary jurisdiction of the court.⁵⁴ This inefficient situation led to reform legislation. Congress found it necessary to eliminate the "serious delays, expense and duplications associated with the . . . dichotomy between summary and plenary jurisdiction, a wasteful remnant of the referee system left over from the pre-Chandler Act era."⁵⁵

The abolition of the distinction between summary and plenary jurisdiction expands the jurisdiction of the bankruptcy court. All matters involving the liquidation of the bankrupt's estate are to be tried in the bankruptcy court and before the bankruptcy judge.⁵⁶ The bankruptcy court also has jurisdiction over all property of the debtor, anywhere in the United States, as of the commencement of the case.⁵⁷ The court may abstain in the interest of justice from hearing a particular proceeding; this decision to abstain is not reviewable by appeal or otherwise.⁵⁸ As an example, if a few creditors brought an involuntary bankruptcy proceeding in a judicial district across the country from the districts in which the bulk of the bankrupt's creditors resided and did business, the bankruptcy court might abstain from taking jurisdiction. Cases of abstention will probably be rare. The parties will usually try all issues in the bankruptcy court.

E. *The Course of Bankruptcy Proceedings*

There are two ways to begin bankruptcy proceedings under the Code. The debtor may file a voluntary petition⁵⁹ on his own behalf. Against it, the creditors of an insolvent debtor may file an involuntary petition.⁶⁰ These same two methods existed under the Bankruptcy Act.⁶¹ The Code makes greater changes in the requirements for an involuntary petition than in those for a voluntary

54. See, e.g., *In re Naviera Azta, S.A.*, 500 F.2d 390, 391 (5th Cir. 1974); *In re Abraham*, 421 F.2d 226 (5th Cir. 1970).

55. S. REP. NO. 95-989, 95th Cong., 2d Sess. 17 (1978), reprinted in [1979] U.S. CODE CONG. & AD. NEWS 5803.

56. 28 U.S.C. § 1471 (1976).

57. *Id.* § 1471(e).

58. *Id.* § 1471(d). Note that the bankruptcy court after notice and a hearing may dismiss a case (total abstention) or suspend proceedings under the Code if the interests of creditors and the debtor would be better served by such action. 11 U.S.C.A. § 305 (West 1979).

59. 11 U.S.C.A. § 301 (West 1979).

60. *Id.* § 303.

61. Bankruptcy Act §§ 3, 4 (repealed 1978).

petition.

The technical requirements for becoming an involuntary debtor resemble those under the prior law.⁶² So do the requirements for becoming a creditor petitioner to an involuntary petition.⁶³ Certain entities such as farmers,⁶⁴ including corporate farmers,⁶⁵ and corporations that are neither moneyed, business, nor commercial companies, may not become involuntary debtors. Banks and insurance companies fall into the class of corporations which cannot become involuntary debtors.⁶⁶ At least three creditors must join in the involuntary petition unless there are fewer than twelve creditors altogether.⁶⁷ The jurisdictional amount for the creditor claims has been increased from \$500.00 to \$5,000.00.⁶⁸

An involuntary proceeding commences with the filing of the petition. The petition must set forth the names and addresses of the petitioners, the name of the debtor, a statement of venue and jurisdiction, and allegations of grounds for an "order for relief."⁶⁹ If the debtor chooses to contest the petition, he may file an answer.⁷⁰ If he fails to file a timely answer, the court may enter an order for relief at once.⁷¹ If the debtor does answer, the court shall conduct a trial and enter an order for relief if the petitioners prove their allegations.⁷² The court may, upon an application by a party in interest, appoint an interim trustee while the trial is pending.⁷³ If a party moves the court to require the petitioners to post a

62. 11 U.S.C.A. § 303(a) (West 1979).

63. *Id.* § 303(b)(1), (2).

64. *Id.* § 101(17). This definition of "farmer" is not limited to an "individual."

65. *See id.* § 101(30) (definition of "person" includes a corporation).

66. *Id.* § 303(a).

67. *Id.* § 303(b)(1), (2).

68. *Id.* Note that this increase in jurisdictional amount applies to both liquidation proceedings and reorganizations under Chapter 11. This is to eliminate an "artificial difference between the two chapters that would provide an incentive for one or the other." HOUSE REPORT, *supra* note 9, at 322.

69. FED. R. BANKR. P. 104 has been superseded by the Code which has abolished acts of bankruptcy. *See* 11 U.S.C.A. § 303 (West 1979). Therefore, use suggested Interim Form No. 9 until such time as new rules and forms are promulgated or the courts or Congress adopts the interim forms.

70. 11 U.S.C.A. § 303(d) (West 1979).

71. *Id.* § 303(h).

72. *Id.*

73. *Id.* § 303(g). The appointment of an interim trustee may occur only after notice to the debtor and a hearing. There must be a showing that the appointment is "necessary to preserve the property of the estate or to prevent loss to the estate." *Id.* The trustee, pursuant to *id.* § 704, may take possession of the property of the estate and operate the business of the debtor. The debtor, however, may regain possession of this property if he files a bond as the court requires. *Id.* § 303(g).

bond, the court may so require after a preliminary hearing on the merits.⁷⁴

The Code relaxes the burden of proof of the petitioners in an involuntary proceeding by diminishing the number and specificity of the elements they must establish to obtain an order for relief. The Act required the petitioning creditors to prove two things: that the alleged bankrupt was insolvent, and that the alleged bankrupt had committed one of the six enumerated acts of bankruptcy.⁷⁵ Under the Code, these old elements, sometimes difficult to prove, have been eliminated. The petitioners now need prove only one of the following two propositions: that the debtor is generally not paying his obligations as they become due,⁷⁶ or that, within 120 days before the filing of the petition, a custodian other than a trustee, receiver, or other agent was authorized to take charge of less than substantially all the property of the debtor for the purpose of enforcing a lien against that property.⁷⁷ The need to prove insolvency under the legal standard has been eliminated. The legal standard has been replaced by an approximation of the equitable test of insolvency: whether the debtor is unable to meet its obligations as they fall due.⁷⁸ Probably, the first ground will be the one most often employed by petitioning creditors, as the one that more closely comports with reason and the general conception of when a person is insolvent. All complicated proofs concerning balance sheets, appraisal of remote or contingent assets, and the prior discovery of some mystical act of bankruptcy have been obviated.

If the involuntary petition is timely controverted, the petitioners must prove at trial one of the two aforementioned grounds for an order for relief.⁷⁹ Most petitions probably will be brought upon allegations that the debtor is generally not paying its obligations as they fall due. It remains to be seen how liberally the courts will construe the term "generally not paying its obligations."⁸⁰ One may hope for a liberal construction to protect petitioning creditors

74. *Id.* § 303(e).

75. Bankruptcy Act § 3a (repealed 1978).

76. 11 U.S.C.A. § 303(h)(1) (West 1979).

77. *Id.* § 303(h)(2).

78. See note 80 *infra*.

79. 11 U.S.C.A. § 303(h) (West 1979).

80. There is arguably a distinction between this test and the so-called "equity insolvency test." Compare *id.* § 303(h)(1) with Bankruptcy Act § 77(a) which provides: "Any railroad corporation may file a petition stating that it is insolvent or *unable to meet its debts as they mature . . .*" *Id.* (emphasis added).

by enabling them to carry their burden if they prove that they are not being paid and that their claims are bona fide and past due. A close reading of the second ground for an order for relief⁸¹ reveals that Congress intends to eliminate unnecessary litigation over real estate foreclosures in which a custodian takes charge of almost all of the property of the debtor. In most cases in which this occurs, the debtor will not be paying its obligations as they fall due. The outraged creditors will therefore still have a way of getting into bankruptcy court.

The requirements for a voluntary dismissal of the proceeding⁸² are the same as they were under the prior law.⁸³ Petitioners may dismiss voluntarily after notice to all of the creditors and in the following circumstances: upon motion of the petitioner; upon consent of all petitioners and debtors; or for want of prosecution.⁸⁴ A voluntary dismissal, including one for want of prosecution, is without prejudice to the petitioners' right to refile.⁸⁵

Petitioners may use a voluntary dismissal to save themselves the costs of further litigation after the commencement of the involuntary proceeding effects the result they desire, the payment or composition of their claims by the debtor. Creditors used to file involuntary petitions as a drastic last measure to secure payment of the compromise of claims from an obstinate debtor who believed that he could stall payment through lengthy state court proceedings. The barriers that the required elements of proof set before a creditor who sought to use an involuntary petition discouraged the use of this effective collection device. By relaxing the creditors' burdens of proof, the Code encourages the use of involuntary petitions. There may be numerous filings of such petitions as creditors and their attorneys become increasingly familiar with this new tool. One should note, however, the provision of the Code that if petitioning creditors cannot prove their case at the time of trial, the court may tax petitioners with the debtor's costs, including reasonable attorney's fees.⁸⁶ If an interim trustee has taken posses-

81. 11 U.S.C.A. § 303(h)(2) (West 1979). Note the broad and descriptive Code definition of "custodian." *Id.* § 101(10).

82. *Id.* § 303(j).

83. Bankruptcy Act § 59g (repealed 1978).

84. 11 U.S.C.A. § 303(j) (West 1979); FED. R. BANKR. P. 120; see 11 U.S.C. § 349 (effect of dismissal). The rationale for the requirement of notice to all of the creditors is that it prevents collusive settlements among the debtor and the petitioning creditors to the exclusion and prejudice of nonparticipating creditors. HOUSE REPORT, *supra* note 9, at 324.

85. HOUSE REPORT, *supra* note 9, at 324.

86. 11 U.S.C.A. § 303(i)(1) (West 1979).

sion of the debtor's properties, the court may award a prevailing debtor the damages proximately caused by the filing of the involuntary petition. If the petitioners filed in bad faith, the court may award the debtor punitive damages.⁸⁷ These stringent penalties for the unsuccessful commencement of an involuntary proceeding are really no different from the potential damages in a malicious prosecution action. They should serve as no deterrent to the bona fide petitioners.

Although the insolvency of an account debtor remains the number one nightmare of creditors, the procedural changes imposed by the Code permit the diligent creditor to rescue the assets for the creditors before the debtor has the opportunity to dissipate them. The lessened difficulty for creditors in winning an order for relief after filing an involuntary petition helps to counterbalance the decreased power the creditors have over the course of the proceedings.

F. Automatic Stay

No discussion of bankruptcy can be complete without mention of the automatic stay.⁸⁸ The stay is a form of injunctive relief afforded as a matter of right to debtors in bankruptcy. It is unique to this system.

In the enforcement of obligations, whether secured or unsecured, all actions are automatically stayed as of the filing of the petition.⁸⁹ The Code lists the types of actions which are stayed and the types which are not.⁹⁰ The purpose of the stay is to enable the debtor to have all of his claims determined by the bankruptcy court in order to relieve the debtor from harassment and the consequent frustration of his rehabilitation or equitable liquidation.

The most important modification in the provision for stays under the new law is the imposition of time limits on the court in

87. *Id.* § 303(i)(2).

88. *Id.* § 362.

89. Compare Bankruptcy Act § 11a (repealed 1978) and FED. R. BANKR. P. 401(a) (suits founded upon claims from which a discharge would be a complete release are enjoined until adjudication or dismissal of the petition) with 11 U.S.C.A. § 362(a) (West 1979). Note also that under the Bankruptcy Act the bankruptcy court was authorized to enjoin any creditor at any time, whether his claim was dischargeable or not, from instituting or continuing an action on any debt. Bankruptcy Act § 17c(4) (repealed 1978).

90. 11 U.S.C.A. § 362(a), (b) (West 1979). The exceptions to the application of the automatic stay are set out in subsection (b). These actions, however, are not immune from injunction. See *id.* § 105; 28 U.S.C. § 1481 (1976) (bankruptcy court given powers of courts of law, equity and admiralty); HOUSE REPORT, *supra* note 9, at 342.

ruling on a motion to dissolve a stay. The Code specifies that thirty days after a request for relief from the stay has been made, the stay ends unless the court after notice and a hearing orders the stay continued.⁹¹ This hearing may be a preliminary hearing or a final determination. If it is preliminary, a final hearing must commence within thirty days after the preliminary ruling.⁹²

Other departures from the Act are the inclusion of creditor setoffs and proceedings before the tax court within the class of stayed actions.⁹³

The grounds for dissolving an automatic stay include the lack of adequate protection for the property interest of a petitioning creditor, the debtor's lack of equity in property in which the creditor has an interest, and the property's not being necessary for a reorganization.⁹⁴ The grant of relief can terminate, modify, or condition the stay.⁹⁵

III. THE RELATIONSHIPS, RIGHTS, AND DUTIES OF THE PARTIES TO A BANKRUPTCY PROCEEDING

A. *The Debtor*

The Code provides that any natural person or corporation residing, domiciled, or holding property in the United States may file a voluntary petition pursuant to Chapter 7.⁹⁶ The entity, however, may not be a railroad, insurance company, bank, or savings and loan association.⁹⁷ A municipality may be a debtor under Chapter 9.⁹⁸

Under the Code, the individual may file a petition for a liquidation proceeding to obtain a discharge. A discharge is a cancellation of all debts—a theoretical fresh start in life. For corporations,

91. 11 U.S.C.A. § 362(e) (West 1979).

92. *Id.* If it holds a preliminary hearing, the court shall continue the stay if there is a reasonable probability that the debtor will prevail at the final hearing. *Id.* § 362(e)(1), (2).

Suggested Interim Bankruptcy Rule 4001 provides a thirty day deadline within which time the court must *conclude* a final hearing. Also, a procedure is suggested for obtaining ex parte relief available under 11 U.S.C.A. § 362(f) (West 1979).

93. 11 U.S.C.A. § 362(7), (8) (West 1979).

94. *Id.* § 362(d).

95. *Id.* Although the movant has the burden of proof with regard to the debtor's equity in the property, the debtor has the burden of proof on all other issues. *Id.* § 362(g).

96. *Id.* § 109(a); see *In re Israel-British Bank (London) Ltd.*, 536 F.2d 509 (2d Cir.), *cert. denied*, 429 U.S. 978 (1976).

97. 11 U.S.C.A. § 109(b) (West 1979).

A railroad may be a debtor, however, under Chapter 11. See *id.* § 109(d); Bankruptcy Act § 77 (repealed 1978).

98. 11 U.S.C.A. § 109(c) (West 1979).

which have no true existence after the filing of the petition for liquidation, the proceeding simply marshalls assets for distribution to creditors, since corporations may no longer obtain a discharge.⁹⁹

There have also been changes in the rules concerning discharge for natural persons. Before the Code was passed, a debtor who issued a false written financial statement in conjunction with the obtaining of credit for a business could be denied a discharge from all debts of the business.¹⁰⁰ This exception to discharge has been under attack for the last forty years in both the legislature and the courts. The Code eliminates it.¹⁰¹ Although the debtor entitled to a discharge is supposed to be an "honest" debtor, Congress has decided that the publication of a materially false financial statement is not so serious a transgression as to bar discharge altogether.¹⁰² The creditor who relies upon this false statement when extending credit to the debtor, however, may petition the court to have his obligation exempted from the order of discharge.¹⁰³

Under the new law, but not under the old, the debtor must appear at a hearing where he is informed of his discharge and its effect.¹⁰⁴ The court, at that time, will caution the debtor about the reaffirmation of debts.¹⁰⁵ If the debt is a consumer obligation, a reaffirmation by the debtor would not be binding unless approved by the court. The court must find that the reaffirmation agreement does not impose an undue hardship on the debtor or a dependent of the debtor, is in the best interest of the debtor, or is entered into in good faith and in settlement of litigation.¹⁰⁶ If the debt is not a consumer obligation, the court will inform the debtor that he has no duty to reaffirm any debts and will explain the effects of a

99. Under prior law, the debts of partnerships and corporations could be discharged. Compare *id.* § 727(a)(1) with Bankruptcy Act § 14c (repealed 1978).

100. Bankruptcy Act § 14c(3) (repealed 1978).

101. For example, in 1960, Congress limited the objection to a discharge of all debts to instances of reliance upon materially false financial statements made by businessmen. Pub. L. No. 86-621, 74 Stat. 408 (1960) (amending Bankruptcy Act § 14c) (repealed 1978). Of course, the more sophisticated creditor sought an exception for his claim and merely threatened the use of Bankruptcy Act § 14c(3). See note 104 *infra*. See generally 1 D. COWANS, BANKRUPTCY LAW AND PRACTICE § 111 (2d ed. 1978).

102. See 11 U.S.C.A. § 727 (West 1979). See generally Zaretsky, *The Fraud Exception to Discharge Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 253 (1979).

103. 11 U.S.C.A. § 503(a)(2)(B) (West 1979); Bankruptcy Act § 17a(2) (repealed 1978).

104. 11 U.S.C.A. §§ 521(4), 524(d) (West 1979).

105. *Id.* § 524(d).

106. *Id.* § 524(c)(4).

reaffirmation.¹⁰⁷

The Code's protection of the debtor from governmental discrimination on account of the discharge reinforces the fresh start the discharge gives the debtor. The Code provides that no governmental unit may

deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant, to discriminate with respect to such a grant against, deny employment to, terminate the employment of, or discriminate with respect to employment against, a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act, has been insolvent before the commencement of the case under this title, or during the case but before the debtor is granted or denied a discharge, or has not paid a debt that is dischargeable in the case under this title or that was discharged under the Bankruptcy Act.¹⁰⁸

This section is a codification of prior federal case law. It eliminates all doubt concerning the legislature's intention of affording the debtor a fresh start. It has been a practice of various state licensing boards in the areas of motorist responsibility and construction contracting to suspend the driver's license or building license of parties who file in bankruptcy if the debtor seeks a discharge either of uninsured motorist claims or of debts arising out of construction activities. In overruling such state action, Congress is stating that its laws concerning bankruptcy shall remain the supreme law of the land.¹⁰⁹

The duties of the debtor now are basically the same as they were under prior law.¹¹⁰ The debtor must file a list of creditors, a schedule of assets and liabilities, and a statement of his financial affairs,¹¹¹ cooperate with the trustee,¹¹² turn over to the trustee all

107. *Id.* § 524(d)(1)(A).

108. *Id.* § 525 (protection against discriminatory treatment) (codifying *Perez v. Campbell*, 402 U.S. 637 (1971) (provision in Arizona Motor Vehicle Safety Responsibility Act which suspended driving privileges for nonpayment of judgments arising out of automobile accident lawsuits, even after a discharge to the judgment debtor, held in direct conflict with Bankruptcy Act § 17 and thus violative of the supremacy clause)).

109. *Id.*

110. Compare Bankruptcy Act § 7 with 11 U.S.C.A. § 521 (West 1979) and FED. R. BANKR. P. 108, 109, 402.

111. 11 U.S.C.A. § 521(1) (West 1979).

112. *Id.* § 521(2).

property of the estate and any recorded information relating to the estate,¹¹³ and attend the new hearings concerning discharge¹¹⁴ and the first meeting of creditors.¹¹⁵

B. *The Creditors*

As under prior law,¹¹⁶ the Code classifies creditors (the persons holding claims against the debtor) as either unsecured, secured, or priority creditors.¹¹⁷ Under the Code, unsecured creditors continue to be those claimants who extended credit to the debtor under normal credit terms and are usually trade creditors or unsecured lenders. The Code makes only changes in wording in this area.¹¹⁸ But the Code substantially modifies the law on secured and priority creditors.

The Code allows a secured creditor a secured claim only for the value of the collateral and an unsecured claim as to the balance of the debtor's obligation.¹¹⁹ The purpose of this provision is to prohibit arbitrariness on the part of secured lenders. Examples of such arbitrariness occurred often under the Act in consumer bankruptcies and in cases where the debtor's major asset was real estate. When multiple creditors had mortgages on the same piece of real estate, the third, fourth, or later mortgages would probably have no real value, since their claims would always face possible preemption by the prior mortgages. Under the Act, even these third or fourth mortgagees would be all but immune from the bankruptcy process. They would have, in effect, a veto power over any reorganization plan.¹²⁰ Under the Code, the bankruptcy court can take into account the valuelessness of these subordinate claims by treating subordinate mortgagees as unsecured creditors to the extent of most of their claims. Also, reorganizations may now take place without the consent of the subordinate mortgagees.

In consumer bankruptcies, the Code has provided the individual debtor the right to redeem certain encumbered property by paying to the holder of the security interest an amount equal to

113. *Id.* § 521(3).

114. *Id.* §§ 521(4), 524(d).

115. *Id.* § 343.

116. *See* Bankruptcy Act § 57h (repealed 1978); FED. R. BANKR. P. 306(d).

117. *See* 11 U.S.C.A. §§ 724, 726, 507 (West 1979).

118. *Id.* § 506 (abolishing the use of the term "creditor" in this context and substituting the term "claim"); *see* FED. R. BANKR. P. 306(d).

119. 11 U.S.C.A. § 506 (West 1979).

120. *See* Bankruptcy Act § 356 (repealed 1978).

the value of the collateral.¹²¹ The debtor may do this for "exempt property" that by its nature does not form part of the estate available for distribution to creditors, if the security interest is not possessory and not a purchase money security interest.¹²² Redemption by paying the secured creditor only the value of the collateral is also possible when the trustee has abandoned the property and thereby removed it from the bankruptcy estate.¹²³ Formerly, secured creditors would hound the consumer debtor. Small loan companies might threaten to replevy the household goods that had been pledged unless the note was reaffirmed or the obligation otherwise compromised. The bankrupt was at the mercy of the secured creditor. Under the Code, however, the court will be the final arbiter of the value of the collateral and will afford the debtor the opportunity for complete relief within the bankruptcy proceeding. The debtor will be able to preserve enough of his assets to assure him of being able to start a new life.

These changes are crucial to practitioners representing any party to a security agreement in a bankruptcy proceeding. For the practitioner representing the debtor, it is essential that the liens on the underlying collateral be set forth with specificity and that an accurate valuation be placed upon the collateral in the debtor's petition to enable prompt and efficient adjustment of the claim by the court as necessary. Of course, the temptation may be great for the bankrupt to "steal back" the collateral for a low price; however, the secured creditors have the right to challenge the debtor's valuation.¹²⁴ Another check on the debtor is that if the extension of credit has been induced with a false financial statement a false valuation by the debtor could prevent the discharge of the debtor's obligation to the secured creditor he tried to cheat. While representing the secured party, practitioners should make sure that the debtor's valuations are realistic and, if they are, recommend a settlement based upon them. This precaution will cost the creditor

121. 11 U.S.C.A. § 722 (West 1979).

122. 11 U.S.C.A. § 522(f)(2) (West 1979).

123. *Id.* Property that is of inconsequential value to the estate may be abandoned by the trustee after notice and a hearing or the trustee may be compelled to abandon such property upon request of a party in interest. *Id.* § 554(a), (b). Fully encumbered consumer goods are of no value to the estate; therefore, a consumer debtor can file a creditor claim, *id.* § 501(c), cause a determination of the amount by which the claim is secured, *id.* § 506(a), and pay or possibly refinance the amount of the current value of the collateral, *id.* § 722. See generally Lacy, *South Carolina's Statutory Exemptions and Consumer Bankruptcy*, 30 S.C. L. Rev. 643, 673-87 (1979).

124. 11 U.S.C.A. § 506(a) (West 1979).

less than would repossession and resale of the collateral. If both parties are aware of their rights and duties in light of the revised Code, a swift adjustment of all debts, both secured and unsecured, may be achieved through an insolvency proceeding. As officers of the court, practitioners have a duty to attempt to bring about this result.

C. Priority Claimants

Throughout the history of bankruptcy legislation, Congress has sought to single out certain classes of claimants for priority treatment in the distribution of a debtor's assets. As ever, the first priority is afforded to those claimants who have incurred "actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case, and any taxes on, measured by, or withheld from such wages, salaries, or commissions are allowable as administrative expenses."¹²⁵ Included in this category are the fees of the trustee and other officers of the court.¹²⁶ A "super" priority within the class of first priority administrative claims is afforded creditors who extend unsecured credit to the trustee authorized to operate the business of the debtor and thus to incur an unsecured debt in the ordinary course of business.¹²⁷ Also, some creditors are entitled to a special priority known as "adequate protection," either because a court-ordered stay of other proceedings is damaging their property interests or because they hold interests in property subject to use, sale, or lease by the trustee. These claimants may have their claims satisfied before all other administrative claims if

125. HOUSE REPORT, *supra* note 9, at 355. The priorities section is 11 U.S.C.A. § 507 (West 1979), referring to "administrative claims allowable under section 503(b)." *Id.* § 507(a)(1). Distribution of the property of the estate is controlled by *id.* § 726, subject to *id.* § 510, which relates to subordination agreements and equitable subordination. This latter section codifies existing case law. See *Pepper v. Litton*, 308 U.S. 295 (1939). "In the exercise of its equitable jurisdiction the bankruptcy court has the power to shift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate." *Id.* at 307-08.

The Fifth Circuit has recognized three conditions which must be satisfied prior to the exercise of the power of equitable subordination: "(i) The claimant must have engaged in some type of inequitable conduct. (ii) The misconduct must have resulted in injury to the creditors or an unfair advantage on the claimant. (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act." [citations omitted]. *In re Mobile Steel Co.*, 563 F.2d 692, 699-700 (5th Cir. 1977) (equitable considerations can justify only the subordination of claims, not their disallowance); see Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 VAND. L. REV. 83, 86 (1961).

126. 11 U.S.C.A. § 502(b)(1)(A) (West 1979).

127. *Id.* § 507(b).

they do not receive such protection.¹²⁸

The second priority is for the claimant who extended credit to the debtor after the filing of an involuntary petition and before the entry of an order for relief: the so-called "involuntary gap" creditor.¹²⁹ Because the Code authorizes the debtor to continue in the operation of his business or his financial affairs as if the petition had not been filed pending trial on the involuntary petition,¹³⁰ creditors may continue to extend credit to the debtor and will then need priority protection to deal with the debtor with an assurance that their claims probably will be paid. Although the claim of the involuntary gap creditor was provable under the Act,¹³¹ he was treated as an unsecured, nonpriority claimant. In light of the increased incentives under the Code for the filing of an involuntary petition, this change is a welcome one.

The next priority class is that of claimants "for wages, salaries, or commissions, including vacation, severance and sick leave pay—(a) earned by an individual within 90 days before the filing of the petition or the date of the *cessation* of the debtor's business, whichever occurs first; but only to the extent of \$2,000.00 for each such individual."¹³² There are several changes here. The amount allowed for this priority claim has been increased.¹³³ Although the Act had required that the wages had to have been earned within three months of the *commencement* of the proceedings,¹³⁴ the

128. *Id.* "Adequate protection," *id.* § 361, may be required of the trustee or the debtor in possession after notice and a hearing to insure that the secured creditor will receive the benefit of his bargain and that the co-owner of property with the debtor will not be prejudiced in his property interests by the latter's financial problems. The Code illustrates three means of providing adequate protection: (1) the making of periodic cash payments to offset any decrease in the value of a creditor or co-owner's interest that has resulted from the operation of the automatic stay provision, *id.* § 362, the use, sale or lease of the property pursuant to *id.* § 363, or the grant of a lien under *id.* § 364; (2) providing an additional lien or replacement lien to compensate for a decrease in value resulting from an automatic stay; and (3) the granting of such other relief, other than the allowance of a claim as an administrative expense, as will result in the realization by the co-owner or secured creditor of the indubitable equivalent of that party's interest in the property, the value of which was decreased by the stay. *Id.* § 361.

This provision is derived from *In re Bermec Corp.*, 445 F.2d 367 (2d Cir. 1971), a case in which a Chapter X petition was permitted upon a finding that the trustees would be able to pay the "economic depreciation" on the secured equipment (trucks and tractor-trailers) so as to preserve the status quo for the secured creditors. *Id.* at 369.

129. 11 U.S.C.A. §§ 507(a)(2), 502(f) (West 1979).

130. *Id.* § 303(f).

131. Bankruptcy Act § 63b (repealed 1978).

132. 11 U.S.C.A. § 507(a)(4) (West 1979) (emphasis added).

133. See Bankruptcy Act § 64a(2) (repealed 1978).

134. *Id.*

Code dates the critical period from the *cessation* of the debtor's business and thereby protects the wage claimant from a nonpriority status when the business ceases and a petition is not readily filed. The inclusion of vacation, severance and sick pay, and other fringe benefits with wages "recognizes the realities of labor contract negotiations, under which wage demands are often reduced if adequate fringe benefits are substituted."¹³⁵

The fourth category of priority claims is new. It consists of contributions made by a bankrupt employer to employee benefits plans.¹³⁶ This section overrules *United States v. Embassy Restaurant*,¹³⁷ which held such contributions outside the Act's definition of "wages . . . due to workmen."¹³⁸ The new provision allows priority for a claim of contributions arising from services rendered within 180 days of the cessation of the business or the commencement of the proceeding, whichever occurs first. The claim must not exceed an amount equal to \$2,000 for each employee covered by the plan, less the aggregate amount the employees are entitled to recover under the priorities for wage claims and other employee benefit plans.¹³⁹

Another new category of priority claimants is that of deposits, lay-away plans, security deposits on leases, and advanced payments for purchases of personal, family, or household goods and services not yet delivered or provided. An individual must have made the payments, and the priority is limited to a claim not exceeding \$900.¹⁴⁰ As the House report makes apparent, consumers have encountered grave problems in connection with bankrupt retailers and providers of service:

A consumer that pays money in a lay-away plan or as a deposit on merchandise, or that buys a service contract or a contract for lessons or a gym membership, is a general unsecured creditor of the business to which he has given his money. Very few consumers are aware of their status as general unsecured creditors. If the merchant . . . files under the bankruptcy laws, the consumer is usually left holding the bag. Though he assumed his deposit was tantamount to a trust fund, he gets nothing from the estate of the debtor, because the assets available provide little return to unsecured creditors. Because of his ignorance and his inabil-

135. HOUSE REPORT, *supra* note 9, at 357.

136. 11 U.S.C.A. § 507(a)(4) (West 1979).

137. 359 U.S. 29 (1959).

138. Bankruptcy Act § 64a(2) (repealed 1978).

139. 11 U.S.C.A. § 507(a)(4) (West 1979).

140. *Id.* § 507(a)(5).

ity to bargain with a retail merchant, he is unable to do a credit investigation or obtain special terms from the merchant, as a true creditor may do.¹⁴¹

The sixth priority is afforded to various tax claims.¹⁴² Basically, a governmental unit is afforded priority treatment for prepetition taxes. Taxes incurred by the bankruptcy estate will be given first priority treatment as priority administrative expenses.¹⁴³

IV. THE IMPACT OF THE NEW BANKRUPTCY CODE ON COMMON COMMERCIAL TRANSACTIONS

A. Preferences

The policy of the bankruptcy laws is to provide for the equitable distribution of the unencumbered assets of a financially embarrassed debtor. It is therefore desirable to discourage creditors from "racing to the courthouse to dismember the debtor during his slide into bankruptcy."¹⁴⁴ The Code, even more than the Act, discourages the "race of diligence" and thereby promotes the policy of equitable distribution by granting to the trustee greater power to avoid certain transfers made to or for the benefit of creditors shortly before bankruptcy. These transfers are known as "preferences." Property recovered when the trustee avoids a preference is preserved for all of the creditors of the debtor, not merely those who have been diligent in obtaining judicial liens or have otherwise pressured the debtor into giving them preferential treatment.

A preferential transfer has five elements, all of which must be present for the trustee to have the power of avoidance.

First, a preference requires that there has been a transfer of property "to or for the benefit of the creditor."¹⁴⁵ The term "transfer" is broadly defined in the Code to include "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property including retention of title as a security interest."¹⁴⁶ In addi-

141. HOUSE REPORT, *supra* note 9, at 188.

142. 11 U.S.C.A. § 507(a)(6) (West 1979).

143. See generally 3 COLLIER, *supra* note 3, at ¶ 507.04[5]; Webster, *Tax Aspects of the Bankruptcy Reform Act of 1978*, 10 TAX ADVISER 220, 223 (1979).

144. HOUSE REPORT, *supra* note 9, at 177.

145. 11 U.S.C.A. § 547(b)(1) (West 1979).

146. *Id.* § 101(40). The definition of a "transfer," as broad as it is, does not encompass a setoff. This reflects the intent of the legislature that the avoidance of a setoff is to be governed by *id.* § 553 and not by *id.* § 547. See 124 CONG. REC. H11,090 (daily ed. Sept. 28, 1978). See generally Clark, *Preferences Under the Old and New Bankruptcy Acts*, 12

tion, the Code expands the definition of a "creditor" to include the holders of any pre-petition claims and holders of certain claims deemed to arise prior to the petition.¹⁴⁷ This expanded definition is consistent with the Code's abolition of the concept of "provability" and with the addition to the definition of "claim" to include "any right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, secured or unsecured"¹⁴⁸ These changes make it possible for all sorts of transfers by the debtor to virtually all types of creditors to be avoided under the new preference section, if meeting the other requirements for a preference.¹⁴⁹ The property transferred, however, must be nonexempt property, which would be available for distribution to all creditors.¹⁵⁰

The second element of a preference is that the transfer be "for or on account of an antecedent debt."¹⁵¹ A preference requires this element because only the payment of an antecedent debt will deplete the assets of the debtor available for distribution and thereby prejudice other creditors. The pre-existing obligation of the debtor to pay the transferee creates consideration for the transfer. The transfer is thus distinct from a fraudulent conveyance, for which there is inadequate consideration.¹⁵²

Third, a preference requires the transfer to have been made while the debtor was insolvent.¹⁵³ The Code eliminates the requirement of the Act that the transferee have had a reasonable belief

U.C.C. L.J. 154, 166 (1979).

147. Compare Bankruptcy Act § 1(11) (repealed 1978) with 11 U.S.C.A. § 101(9) (West 1979).

148. 11 U.S.C.A. § 101(4)(A) (West 1979). The definition also includes an equitable remedy for breach of performance if the breach gives rise to a right to payment. See *id.* § 101(4)(B); HOUSE REPORT, *supra* note 9, at 309.

149. 4 COLLIER, *supra* note 3, at ¶ 547.17; see, e.g., Bankruptcy Act § 67a (repealed 1978) (invalidating judicial liens).

150. *In re Smith*, 366 F. Supp. 1213 (D. Idaho 1973) (transfer of validly exempted property not a voidable preference) (equity in homestead); see *In re Hausman*, 209 F. Supp. 219 (M.D. Ga. 1962) (life insurance policy).

151. 11 U.S.C.A. § 547(b)(2) (West 1979). There is a codified exception to this requirement for those transactions intended by the parties to be a contemporaneous exchange although technically on account of an antecedent debt. *Id.* § 547(c)(1); see note 176 and accompanying text *infra*.

152. See *Van Iderstine v. National Discount Co.*, 227 U.S. 575, 582 (1912). Fraudulent conveyances are dealt with in the code at 11 U.S.C.A. § 548 (West 1979) (derived from Bankruptcy Act § 67d (repealed 1978)). See generally 4 COLLIER, *supra* note 3, at ¶ 548.01.

153. 11 U.S.C.A. § 547(b)(3) (West 1979).

that the debtor was insolvent, often a source of litigation.¹⁵⁴ Furthermore, the Code includes a presumption of the debtor's insolvency "on and during the 90 days immediately preceding the date of the filing of the petition."¹⁵⁵

The fourth requirement is that the preferential transfer occur on or within ninety days before the filing of the petition.¹⁵⁶ The Act allowed the avoidance of transfers made within four months before filing.¹⁵⁷ The Code also differs from the Act on this requirement by creating a special rule for an "insider,"¹⁵⁸ more closely scrutinizing the conduct of one "who has a sufficiently close relationship with the debtor" (e.g., as a relative or partner, or an officer of a corporate debtor) than that of creditors who have dealt at

154. Compare *id.* with Bankruptcy Act § 60b (repealed 1978). The HOUSE REPORT, *supra* note 9, succinctly states the reason for the deletion of the reasonable belief requirement:

Whether or not a creditor knows or believes that his debtor is sliding into bankruptcy is important if the only purpose of the preference section is to deter the race. However, a creditor's state of mind has nothing whatsoever to do with the policy of equality of distribution, and whether or not he knows of the debtor's insolvency does little to comfort other creditors similarly situated who will receive that much less from the debtor's estate as a result of the prebankruptcy transfer to the preferred creditor. To argue that the creditor's state of mind is an important element of a preference and that creditors should not be required to disgorge what they took in supposed innocence is to ignore the strong bankruptcy policy of equality among creditors. Finally, the requirement that the trustee prove the state of mind of his opponent is nearly insurmountable, and defeats many preference actions.

HOUSE REPORT, *supra* note 9, at 178.

155. 11 U.S.C.A. § 547(f) (West 1979). The Code directs the application of FED. R. EVID. 301, which places upon the creditor the burden of production of evidence to rebut the presumption without shifting the burden of proof from the trustee. 11 U.S.C.A. §§ 251, 252 (West 1979).

156. 11 U.S.C.A. § 547(b)(4)(A) (West 1979).

157. Bankruptcy Act § 60a (repealed 1978). The change from a computation based on the calendar month to one based on counting days is, for the sake of simplicity, a welcome one. The computation is made in accordance with FED. R. CIV. P. 6(a), which directs that the day of the alleged transfer not be counted while the day the petition is filed is counted. FED. R. BANKR. P. 401(a).

The limiting of the trustee's power of avoidance to those transfers that occur within a certain period of time prior to the filing of the petition has been criticized as "reduc[ing] the preference to a sporting proposition." Note, *Preferential Transfers and the Value of the Insolvent Firm*, 87 YALE L.J. 1449, 1457 (1978) (quoting 2 G. GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 384 at 664 (1940)). The author points out the problems relating to the race of diligence and the creditor's incentive to keep secret the debtor's insolvency and the transfer "at a time when candor and cooperation are most needed." *Id.* at 1457. The author proposes the replacement of the time-limit rules with an affirmative defense for transfers not directly related to the bankruptcy. *Id.* at 1459.

158. 11 U.S.C.A. § 547(b)(4)(B) (West 1979).

arm's length with the debtor.¹⁵⁹ The trustee may avoid a transfer to an insider during the period from one year to ninety days before the filing of the petition if the insider "had reasonable cause to believe the debtor was insolvent at the time of such transfer. . . ."¹⁶⁰ The resurrection of the requirement of a reasonable belief of insolvency in this situation shows that Congress recognized the commercial reality that informal lines of communication of business information exist. An insider must be one who is in a position to take advantage of these lines of communication. The policy of discouraging the race of diligence is furthered by permitting the avoidance of transfers within one year of the filing of the petition. In this subsection, the requirement of a reasonable belief of insolvency merely reflects the realistic assumption that "insiders" likely will know of the debtor's financial situation earlier than non-insiders will.

The "insider" definition and provisions, although new to the federal bankruptcy scheme, are not unique. State preference statutes made applicable in federal bankruptcies through the operation of section 70e of the Bankruptcy Act¹⁶¹ have given the trustee the power to set aside a transfer to one deemed to have inside information concerning the debtor's financial condition, if the transfer was made more than four months before the filing of a petition in bankruptcy. In Florida, however, the enactment of the Code provision has had the effect of closing a loophole for corporate debtors. The current Florida General Corporation Act, which became effective January 1, 1976,¹⁶² did not include the prior state preference statute, which had prohibited transfers to insiders (officers, directors, and shareholders) after or in contemplation of insolvency.¹⁶³ The legislature failed to pass any statute declaring such preferential transfers invalid; this left creditors of a corporate debtor without a remedy unless the transfer to an insider occurred within four months of bankruptcy.¹⁶⁴ The Code addresses this situ-

159. HOUSE REPORT, *supra* note 9, at 312; 11 U.S.C.A. § 101(25) (West 1979). This list is merely illustrative, not exclusive. See *id.* § 102(3).

160. *Id.* § 547(b)(4)(B)(ii).

161. See Bankruptcy Act § 70e(1) (superseded by 11 U.S.C.A. § 544(b) (West 1979)).

162. FLA. STAT. §§ 607.001-.414 (1975).

163. *Id.* § 608.55 (repealed Fla. Laws ch. 75-250, § 139 (1975)).

164. FLA. STAT. § 607.144 (1979) (derived from *id.* § 608.55) merely holds a director of a corporation liable to the corporation for voting or assenting to the distribution of corporate assets contrary to the Corporation Act or the articles of incorporation, or for the value of assets distributed to shareholders during the liquidation of the corporation to the prejudice of the creditors of the corporation. It does not invalidate these preferential transfers. See generally *Ryder Truck Rental v. Missouri Beef Packers, Inc.*, 358 So. 2d 103 (1978).

ation, providing a remedy for insider preferences made up to a year prior to bankruptcy. Since most transfers of this type occur within a year before bankruptcy, the Code provision adequately protects the creditors from the insider.

The fifth and final element of a preference concerns the actual effect of transfer. This element requires that as of the date of bankruptcy the transfer enable the transferee creditor to receive "more than such creditor would receive if—(A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title."¹⁶⁵ Thus, the test has changed from an inquiry into whether the transfer has enabled a creditor to "obtain a greater percentage of his debt than some other creditor of the same class" could, to one which focuses the court's attention on the evenness of distribution *between* the classes as well as the allowability of the underlying claim.¹⁶⁶

The Code retains from the Act generally the same tests for determining when a transfer is made and perfected.¹⁶⁷ A transfer of realty is perfected, and therefore made, when it is valid as against a bona fide purchaser.¹⁶⁸ A transfer of personal property and fixtures is perfected when "a creditor on a simple contract cannot acquire a judicial lien that is superior to the interest of the transferee."¹⁶⁹ A transfer is made when it occurs if perfected at that time or within ten days thereafter. If the transfer is not perfected before the commencement of the case or within ten days after it takes effect as between the transferor and transferee, then it is *deemed* to have been made immediately prior to the filing of the petition.¹⁷⁰ Finally, for the purposes of this preference section,

165. 11 U.S.C.A. § 547(b)(5) (West 1979); see *Palmer Clay Co. v. Brown*, 297 U.S. 227, 229 (1935) (whether a creditor has been preferred determined when bankruptcy results and not at the time of the alleged preferential transfer).

166. Compare 11 U.S.C.A. § 547(b)(5) (West 1979) with Bankruptcy Act § 60a(1) (repealed 1978). A claim which is disallowed pursuant to 11 U.S.C.A. § 502(b) (West 1979) will satisfy this element because the holder of such a claim would receive nothing in distribution.

167. Compare 11 U.S.C.A. § 547(e) (West 1979) with Bankruptcy Act § 60a(2) (repealed 1978).

168. 11 U.S.C.A. § 547(e)(1)(A) (West 1979); see Bankruptcy Act § 60a(2) (repealed 1978).

169. 11 U.S.C.A. § 547(e)(1)(B) (West 1979); see Bankruptcy Act § 60a(2) (repealed 1978). The term "simple contract" is derived from Bankruptcy Act § 60a(4) (repealed 1978).

170. 11 U.S.C.A. § 527(e)(2) (West 1979). The grace period which enables the relation back of a perfection to the time of the transfer within 10 days of the extension of credit precludes a finding of a transfer on account of an antecedent debt. Bankruptcy Act § 60a(7) provided a 21-day grace period, which was inconsistent with the provisions of U.C.C. § 9-301(2). This inconsistency gave rise to confusion as to how long a secured creditor had to

no transfer can be deemed "made" until the debtor has *acquired rights in the property transferred*.¹⁷¹

This last provision overrules the cases holding that a "transfer" for the purposes of bankruptcy occurs at the time of an act by which a secured creditor protects his priority status over later creditors, rather than at the (later) time of the event perfecting the security interest in a specific item of collateral.¹⁷² Thus, for a security interest in accounts receivable,¹⁷³ a transfer is deemed to occur only when the debtor has rights in the accounts, which is when the accounts come into existence. This will happen after the secured party has filed a financing statement and thereby "so far perfected [his security interest] that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee."¹⁷⁴ This change does not, however, fully impair the use of future accounts receivable as collateral, for Congress has excepted from preferential treatment such transfers to the extent the secured party does not improve his position relative to other creditors within the ninety days prior to the filing of a petition in bankruptcy.¹⁷⁵

There are exceptions to the trustee's power of avoidance that are designed to enable a debtor to continue its normal financial relations. For example, to the extent that a debtor and creditor intend the transfer to be a "contemporaneous exchange for new value," and it is in fact a substantially contemporaneous exchange, the trustee may not avoid it.¹⁷⁶ Also immune from attack as preferential is the debtor's payment of debts no later than forty-five days after they were incurred in the ordinary course of business or financial affairs of both debtor and creditor.¹⁷⁷ In addition, the

perfect his interest. See Clark, *supra* note 146, at 158 n.16, 165. The Code eliminates this inconsistency.

171. 11 U.S.C.A. § 547(e)(3) (West 1979).

172. *E.g.*, *In re Wilco Forest Mach. Inc.*, 491 F.2d 1041 (5th Cir. 1974); *In re King-Porter Co.*, 446 F.2d 722, 730 (5th Cir. 1971); *Dubay v. Williams*, 417 F.2d 1277 (9th Cir. 1969). See generally Mann & Phillips, *Floating Liens as Preferential Transfers Under the Bankruptcy Reform Act*, 85 Com. L.J. 7, 10 (1980).

173. The term receivable is defined as a "right to payment, whether or not such right has been earned by performance." 11 U.S.C.A. § 547(a) (West 1979). The terms "inventory" and "new value" are also defined in this section to avoid uncertainty as to their meaning. *Id.*

174. Bankruptcy Act § 60a(2) (repealed 1978).

175. See notes 180-183 and accompanying text *infra*.

176. 11 U.S.C.A. § 547(c)(1) (West 1979); see *Dean v. Davis*, 242 U.S. 438, 443 (1917).

177. 11 U.S.C.A. § 547(c)(2) (West 1979). The use of the phrase "financial affairs of the debtor" includes nonbusiness activities, such as monthly utility payments. HOUSE REPORT,

transfer of a perfected purchase money security interest gives rise to this same immunity to the extent that it secures new value.¹⁷⁸ The Code retains, with some modification, the provision enabling a creditor who has been preferred to extend to the debtor new value that, to the extent not secured, may be set off against the amount of the voidable transfer.¹⁷⁹

Perhaps the most significant exception to the trustee's avoidance power arises in favor of those creditors secured by floating liens on inventory, accounts receivable, or the proceeds of either.¹⁸⁰ The Code language is almost inscrutable, but its general meaning is that a secured creditor with interests in such property may not improve his position during the ninety-day period prior to bankruptcy.¹⁸¹ If he has not improved his position, then he has not been preferred, but to the extent that the creditor has improved his position, he has been preferred. This determination depends on a straightforward two-date test. First, the creditor's position on the ninetieth day before the bankruptcy is examined to ascertain any deficiency in the collateral necessary to satisfy the outstanding loan. Then, on the date of bankruptcy, the creditor's position is

supra note 9, at 373.

There are several areas of potential litigation with respect to this exception. The most litigious issues are likely to be whether the debt and payment have been made in the ordinary course of each party's business; when a debt is "incurred"; when the debtor obtains a property interest in the goods; and when a demand for payment has been made. 4 COLLIER, *supra* note 3, at ¶ 547.38 (citing Countryman, *Bankruptcy Preferences—Current Law and Proposed Changes*, 11 U.C.C. L.J. 95, 102 (1978)).

178. 11 U.S.C.A. § 547(c)(3) (West 1979). Compare *id.* § 547(c)(3)(B) with U.C.C. § 9-301(2) (the grace period under the Code is measured from the time the security interest attaches, while under the U.C.C. the secured party has ten days to perfect once the debtor takes possession of the collateral). Note also the requirement of a written security agreement for a so-called "enabling loan." See 4 COLLIER, *supra* note 3, at ¶ 547.39.

179. Compare 11 U.S.C.A. § 547(c)(4) (West 1979) with Bankruptcy Act § 60c (repealed 1978). A shortcoming of the prior law as drafted was the requirement that the extension of further credit be "without security of any kind." *Id.* Therefore, if a preferred creditor subsequently extended credit, partially secured, he would be unable to set off even that part of the advance that was unsecured. Case law, however, did not give the Act such a literal reading. The Code codifies the "net result" rule and thereby provides a more equitable result. See *In re Hygrade Envelope Corp.*, 393 F.2d 60, 65 (2d Cir. 1968) (looking to the value of the security taken for new advances); Kohn, *Preferential Transfers on the Eve of the Bankruptcy Amendments*, 2 PROSECUTOR 259, 273 (1968). Case law decided under the Bankruptcy Act § 60c (repealed 1978) indicated that services rendered by a firm of attorneys and accountants to the bankrupt constitute "property," the value of which could be set off against the amount otherwise recovered as a preference. *In re Ira Haupt & Co.*, 424 F.2d 722 (2d Cir. 1970). The Code takes no position on this issue.

180. 11 U.S.C.A. § 546(c)(5) (West 1979).

181. The period for insiders is one year prior to the filing of the petition in bankruptcy. 11 U.S.C.A. § 547(c)(5)(A)(ii) (West 1979).

reexamined and, to the extent the deficiency has decreased, the trustee may recover a preference.¹⁸² Note that fluctuations in the value of the collateral during the ninety days before bankruptcy do not affect the existence of a preference. Although this rule may lead to an inequitable result in certain cases, it is easy to administer.¹⁸³

A final exception provides that to the extent a statutory lien is valid under section 545 of the Code, it is immune from attack as a preference.¹⁸⁴

The effect of an avoided transfer has been changed. A recovered preference is, under the Code, automatically preserved for the benefit of the estate.¹⁸⁵ Before Congress enacted the Code, the preservation of recovered preferences for the estate was not automatic. The trustee had to move the court to preserve the preference. The court would then have to hold a hearing on the motion.¹⁸⁶ The Code requires a hearing on the fate of a recovered preference only if the trustee wishes to abandon the property on the ground that its preservation is not useful for the estate, thereby removing the property once more from the estate.¹⁸⁷ When the preservation of a recovered preference does not take place, lienors whose liens on the recovered property are junior to a lien avoided as a preference will receive a windfall. Their liens will be promoted because of the absence of the avoided senior lien, yet the property will not be subject to the claims of the unsecured creditors, because it will not be part of the bankrupt's estate. The Code eliminates this problem by providing for automatic preservation unless the trustee abandons the property after a hearing.

The framers of the new Code have attempted to preserve the policy of equitable distribution in grafting the new preference sec-

182. See Lavin, *An Introduction to the Trustee's Avoiding Powers*, 53 AM. BANKR. L.J. 173, 188-89 (1979).

11 U.S.C.A. § 553(b) (West 1979) adopts a similar improvement in the position test with respect to the trustee's right to avoid a prepetition setoff. He may do so to the extent that an "insufficiency" ("the amount, if any, by which a claim against the debtor exceeds a mutual debt owing to the debtor," *id.* § 553(b)(2)) on the date the setoff is exercised is less than an insufficiency on the later date of either ninety days before bankruptcy or the first date during the ninety days when there is an insufficiency. See generally Clark, *supra* note 146, at 166.

183. See Kohn, *supra* note 179, at 263-64.

184. 11 U.S.C.A. § 547(c)(6) (West 1979); *id.* § 545 (statutory liens).

185. Compare 11 U.S.C.A. § 551 (West 1979) with Bankruptcy Act § 67a(3) (repealed 1978).

186. Bankruptcy Act § 67a(3) (repealed 1978).

187. 11 U.S.C.A. § 551 (West 1979).

tion onto the existing state of commercial reality. Article 9 of the Uniform Commercial Code permits a clause in a security agreement giving the secured creditor a security interest in after-acquired property of the debtor, such as inventory or accounts receivable. This clause has the effect of fully insulating the secured creditor from a challenge by unsecured creditors. The uniformity of the courts in upholding these "dragnet" clauses indicated a need for the legislature to address the problem. The after-acquired property clause often resulted in a double sting to an unsecured creditor: he did not receive payment on the loan that was extended shortly before bankruptcy, and he was liable for the return of payments made within four months of bankruptcy. Even when successful in defending the case, the creditor was put to great expense and harrassment. The new provisions on the avoidance of floating liens bring about fairer results than those under the Act.

B. *Leases and Executory Contracts*

Modern bankruptcy law usually deals with the problems of the commercial lease and executory contract. In a radical departure from the law under the Act, the Code does so as well.

One of the main problems confronting the drafters of the Code was the treatment of "boiler plate" bankruptcy clauses contained in the typical commercial lease. The usual effect of these clauses is that the insolvency of the lessee, or the filing of a petition for the lessee's bankruptcy for the purpose of effecting either a liquidation or a reorganization, constitutes a material breach of the lease. This breach causes a forfeiture of the lessee's rights under the lease. The Act had made such clauses expressly enforceable.¹⁸⁸ Federal courts had long upheld the rights of landlords to declare a default upon the insolvency of the debtor.¹⁸⁹ Lease draftsmen, encouraged by federal appellate decisions, began to include language that

188. Bankruptcy Act § 70b (repealed 1978) provided in part:

Unless a lease of real property expressly otherwise provides, a rejection of the lease or of any covenant therein by the trustee of the lessor does not deprive the lessee of his estate. A general covenant or condition in a lease that it shall not be assigned shall not be construed to prevent the trustee from assuming the same at his election and subsequently assigning the same; but an express covenant that an assignment by operation of law or the bankruptcy of a specified party thereto or of either party shall terminate the lease or give the other party an election to terminate the same is enforceable.

189. *E.g.*, *Finn v. Meighan*, 325 U.S. 300 (1944). In this reorganization proceeding the Court was reluctant to enforce an express covenant of forfeiture against the trustee, but it did recognize its duty under the Act to do so. *Id.* at 303.

would enable the declaration of a breach upon the mere filing of a petition for liquidation or reorganization. Eventually, however, courts began to recognize that the subsequent forfeiture of a debtor's leasehold more often than not resulted in a complete frustration of rehabilitative efforts. Typically, in a reorganization the lease is either a principal asset of the debtor or, by its terms, a substantial liability. Reorganization proceedings often begin in consideration of this potential asset or the discharge of this liability. For a time, the courts attempted to circumvent defaults and avoid forfeitures by carving out exceptions to the Act. They were able to accomplish this end either by finding a waiver of the default in the subsequent acceptance of rent or through some other device.¹⁹⁰ Recent courts have abandoned a waiver theory and have simply refused to enforce boiler plate "bankruptcy clauses." The policies behind these decisions are the desire to rehabilitate the debtor, the need to provide for the equitable distribution of the debtor's assets upon liquidation, and equity's general abhorrence of a forfeiture.¹⁹¹

The Bankruptcy Reform Act of 1978 has adopted these policy considerations for both liquidation and reorganization proceedings. The Code declares invalid any provision in an unexpired lease or other executory contract that will operate to modify or terminate the rights of the debtor and is conditioned upon the insolvency of the debtor, the filing of a petition under the Code, or the appointment of a trustee after commencement of a bankruptcy proceeding or of a custodian before bankruptcy.¹⁹² (An executory contract under the Code is one in which both parties must render performance in the future.)¹⁹³

190. *E.g.*, *Weaver v. Hutson*, 459 F.2d 741 (4th Cir. 1972); *Speare v. Consolidated Assets Corp.*, 360 F.2d 882 (2d Cir. 1966).

191. *See In re Fontainebleau Hotel Corp.*, 515 F.2d 913 (5th Cir. 1975); *Queens Blvd. Wine & Liquor Corp.*, 503 F.2d 202 (2d Cir. 1974). *But cf. In re D.H. Overmeyer Co.*, 510 F.2d 329 (2d Cir. 1975) (debtor's conduct did not justify a grant of equitable relief from the operation of a forfeiture clause since he was consistently behind in rent payments, mortgage payments and tax obligations and did not present a feasible plan of rehabilitation).

192. *See* 11 U.S.C.A. § 365(e) (West 1979).

193. The definition of an executory contract for the purposes of rejection or assumption by the trustee is by no means clear. Professor Countryman proffers a definition of an executory contract within the bankruptcy context: "a contract under which the obligation of both the bankrupt and the other party to the contract are so unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Countryman, *Executory Contracts in Bankruptcy*, 57 MINN. L. REV. 439, 450, 460 (1972). This definition was applied in *In re Knutson*, 563 F.2d 916 (8th Cir. 1977) (airline tickets purchased by the bankrupt but not used held to be executory contracts requiring assumption or rejection by the trustee).

The Code, however, provides for an exception to this rule. This exception applies to a party whom the applicable law does not require to accept the performance of the trustee or to render performance to the trustee. The scope of this exception includes obligors under personal service contracts as well as obligors under contracts to make a loan to the debtor.¹⁹⁴ The exception operates irrespective of restrictions on assignments of rights or delegations of duties under the contract.¹⁹⁵

The Code provides that in a liquidation proceeding, the trustee must assume or reject the obligations of an unexpired lease or other executory contract within sixty days after the entry of an order for relief, unless the court for cause and within the sixty-day period grants the trustee additional time within which to act.¹⁹⁶ Failure of the trustee to assume the obligations contract within the time limit results in the trustee's being deemed to have rejected those obligations. The trustee would then be liable for breach of the rejected contract.¹⁹⁷

The Code further provides that if there has been a default in an executory contract, except for a technical breach relating to the insolvency proceedings of the debtor, the trustee may not assume the contract or lease unless he can provide adequate assurance of cure and of future performance. In addition, the trustee must be able to provide compensation for actual pecuniary loss arising out of the default.¹⁹⁸ The Code does not address the question of whether the trustee must provide adequate assurances where the bankrupt is not technically in default.¹⁹⁹ But because the Act required the trustee to demonstrate an ability to perform before assumption, even when the bankrupt was not in default, the courts probably will impose this same requirement under the Code.²⁰⁰ The Code illustrates the operation of the requirement of adequate

194. 11 U.S.C.A. § 365(e)(2) (West 1979).

195. *Id.*

196. *Id.* § 365(d)(1). This is to be distinguished from a case under the reorganization provisions of the Code. These provisions enable the trustee to assume or reject an executory contract or unexpired lease at any time prior to the confirmation of a plan, unless a party in interest requests and the court orders a specified period of time within which the trustee must act. *Id.* § 365(d)(2).

197. *Id.* § 365(d)(1).

198. *Id.* § 365(b)(1).

199. See Shanker, *The Treatment of Executory Contracts and Leases in the 1978 Bankruptcy Code*, 25 PRAC. LAW., No. 7 at 11, 15 (1979).

200. *Id.*; cf. 11 U.S.C.A. § 365(f)(2)(B) (West 1979) (adequate assurance of future performance required of an assignee of an assumed contract whether or not there has been a default).

assurances by defining what are "adequate assurances" for the future performance of a real property lease in a shopping center.²⁰¹ It is assumed that in other contexts, the bankruptcy courts will look to cases construing the Uniform Commercial Code for guidance as to what constitutes "adequate assurances."²⁰²

A compelling reason for the requirement of adequate assurances of cure and performance as a prerequisite to the trustee's assumption of executory agreements is that such an assumption will result in increased administrative expenses for the estate. This would cause a reduction in the assets available for distribution.²⁰³ For this reason, if a trustee assigns a contract after he assumes it, the proposed assignee also must provide adequate assurances of future performance. Moreover, any contract provision purporting to modify or terminate rights under the contract because of such an assignment is invalid.²⁰⁴ Furthermore, an assignment of a contract extinguishes any liability of the estate from that contract.²⁰⁵

The Code also provides for the insolvency of the landlord. The Code retains the old principle that the bankruptcy of the landlord will not serve to deprive the tenant of his leasehold.²⁰⁶ If the trustee rejects the unexpired lease, the lessee has an option. He may remain in possession and offset against his rent any damage the insolvent lessor's nonperformance has caused him, or he may treat the lease as terminated.²⁰⁷ Similar provisions ensure that a party in possession of realty under an executory contract for the sale of land may not lose the right of possession because of the trustee's rejection of the contract.²⁰⁸ The purchaser in possession may either treat the contract as terminated and have a lien for the amount of the purchase price he has paid or remain in possession and con-

201. The trustee must provide adequate assurance of rent; that percentage rent due will not decline substantially; that assumption or assignment of the lease will not breach provisions relating to radius, location, use, exclusivity in the master agreement of the shopping center; and that the tenant mix will not be disrupted. 11 U.S.C.A. § 365(b)(3) (West 1979).

202. See FLA. STAT. § 672.609(1) (1979).

203. See 2 COLLIER, *supra* note 3, at ¶ 365.01[1].

204. See 11 U.S.C.A. § 365(f) (West 1979).

205. *Id.* § 365(k).

206. *Id.* § 365(h)(1). The Act provided that "[u]nless a lease of real property expressly otherwise provides, a rejection of the lease or any covenant therein by the trustee of the lessor does not deprive the lessee of his estate." Bankruptcy Act § 70b (repealed 1978). The Code does not qualify the principle, and it is submitted that any language of the lease to the contrary will not be controlling.

207. 11 U.S.C.A. § 365(h) (West 1979). The lessee is limited in damages solely to the offset of rent and has no rights against the bankrupt's estate.

208. *Id.* § 365(i)(1).

tinue to make the payments due under the contract.²⁰⁹ Should the purchaser elect to continue in possession, he may "offset against such payments any damages occurring after the date of the rejection . . . caused by the non-performance of any obligation of the debtor" ²¹⁰ Offset is the exclusive remedy of the purchaser; there is no right to recover damages from the estate. The trustee accordingly will have no obligations under the contract except for the delivery of title to the purchaser.²¹¹

These substantial revisions of what was formerly section 70b of the Act should result in a more successful rehabilitation or liquidation for a debtor. The risks to a lessor from an insolvent lessee will be limited to possible expectation losses. The Code may foreclose both lessors and lessees from reaping a windfall due to inflationary pressures in the economy and the prevailing appreciation in land values. No one, however, will suffer unreasonable losses.

C. Exemptions

The Bankruptcy Reform Act of 1978 legislated sweeping reform in the area of exemptions. An exemption under the bankruptcy statute excludes a person's property from the body of the estate available to satisfy creditors. Congress continues to recognize the states' interest in regulating credit. The Code nevertheless contains a set of federal exemptions reflecting a national interest in "seeing that a debtor that goes through bankruptcy comes out with adequate possessions to begin his fresh start."²¹² A balance of these interests has been struck. The Code does permit individual states to preclude the debtor from taking advantage of the federal exemptions under section 522(d) of the Code instead of whatever corresponding state exemptions exist.²¹³ The Florida Legislature has exercised its right of veto. Most of the federal exemptions are thus not available to individual debtors domiciled within this state.²¹⁴

Under the Code, notwithstanding the inapplicability of other federal exemptions, a debtor in a vetoing state such as Florida may exempt "any interest in property in which the debtor had, *immedi-*

209. *Id.* § 365(j).

210. *Id.* § 365(i)(2).

211. *Id.*

212. HOUSE REPORT, *supra* note 9, at 126.

213. 11 U.S.C.A. § 522(b)(1) (West 1979) provides that an individual debtor may exempt from the bankruptcy estate property within the federal exemptions under *id.* § 522(d) "unless the State law that is applicable to the debtor . . . specifically does not so authorize."

214. FLA. STAT. § 222.20 (1979).

ately before the commencement of the case, an interest as a tenant by the entirety . . . ,” but only to the extent that the interest is exempt from process under state law.²¹⁵ Tenancies by the entirety are exempt from process in Florida.²¹⁶ Florida debtors may therefore take advantage of this provision. The debtor therefore may convert nonexempt property into exempt property on the eve of bankruptcy, as he could under the Act. This practice is generally held not to defraud the creditors.²¹⁷

Exempt property is not available for the satisfaction of most debts that arose or were deemed to have arisen before the commencement of the case. Certain claims, however, such as those for taxes, alimony, and support, may look to exempt as well as nonexempt property.²¹⁸ Furthermore, valid liens not subject to the trustee's avoidance power or liens will be enforceable on exempt property to the extent that they are granted secured status.²¹⁹ Recognizing the plight of consumer debtors in bankruptcy, Congress has given the debtor rights in exempt property that one may hope will promote complete relief and make possible a genuine fresh start. The debtor may avoid judicial liens on exempt property. He may also avoid nonpossessory, nonpurchase money security interests taken on certain household goods, tools of the trade, and health aids prescribed for the debtor or his dependents.²²⁰ The debtor is further protected in that any waiver of exemptions or of the available avoiding powers is unenforceable.²²¹

In a change from prior law, the debtor under the Code may exempt property recovered by the trustee so long as that property was not voluntarily transferred or concealed by the debtor.²²²

215. 11 U.S.C.A. § 522(b)(2)(B) (West 1979) (emphasis added). For examples of exemptions under other federal laws available in conjunction with state exemptions, see HOUSE REPORT, *supra* note 9, at 360.

216. See *Liberma v. Kelso*, 354 So. 2d 137 (Fla. 2d DCA 1978).

217. HOUSE REPORT, *supra* note 9, at 361; 3 COLLIER, *supra* note 3, at ¶ 522.08[4].

218. 11 U.S.C.A. § 522(c) (West 1979).

219. *Id.* § 522(c)(2).

220. *Id.* § 522(f). The proponents of the Code felt that a debtor should be entitled to his exemptions even though “a creditor beats the debtor in court.” HOUSE REPORT, *supra* note 9, at 126. The power to avoid certain nonpossessory, nonpurchase money security interests results from recognition of the fact that the only inherent value of such security interests is the leverage they afford the creditor. Since the collateral usually has little value to the secured party and yet is often vitally necessary to the debtor, creditors often threaten repossession to compel payment of the debt. *Id.*

221. 11 U.S.C.A. § 522(e) (West 1979).

222. *Id.* § 522(g); cf. Bankruptcy Act § 6 (repealed 1978) (“[N]o such allowance ‘for exempt property’ shall be made out of property which a bankrupt transferred or concealed and which is recovered or the transfer of which is avoided under this Act for the benefit of

Should the trustee fail to exercise the avoidance powers to recover such property, the Code permits the debtor so to act.²²³

The procedure for claiming an exemption requires that the debtor or a dependent file a list of all such property and state the applicable exemptions. This property is then exempt unless a party in interest objects.²²⁴ The objecting party has the burden of proof, and the issue shall be resolved in a summary matter by the bankruptcy judge.²²⁵

V. CONCLUSION

Has the Code strengthened our legal system? The Code seems to contain some improvements in the law mixed with some disturbing developments. The debtor now has increased procedural protections. The powerful remedy of the involuntary petition is now more readily available to creditors. The bureaucratization of the bankruptcy system, however, is an ominous sign. Congress apparently lacks faith in its own law. The Chrysler "bail-out" illustrates this lack of faith. Many of the Code's procedural reforms are designed to reduce the control of lawyers over the bankruptcy process. This reformation is illogical in a field that requires years of experience to master. Would Congress suggest that brain surgery be performed by someone other than a trained neurosurgeon? Why, then, does Congress trust this country's bankruptcy lawyers so little?

the estate").

223. 11 U.S.C.A. § 522(h) (West 1979).

224. *Id.* § 522(l).

225. *See id.*