VI. Creditors' Rights and Restrictions in Bankruptcy

A. Dismissal or Conversion of Case
Sections 348, 349, 706, 707,1307(c), 1112

Conversion and dismissal are delineated in each of the three major forms of bankruptcy (Chapters 7, 11 and 13). The general effect of a dismissal or conversion is found in Sections 348 and 349 of Title 11 of the United States Code of Laws (the "Bankruptcy Code"). Hereinafter, references to a Section shall be a reference to a section within the Bankruptcy Code unless otherwise specified.

A.1. Conversion

A.1.1 From Chapter 7 to Another Chapter

Section 706(a) provides that the debtor may convert a Chapter 7 case to a Chapter 11, 12, or 13 as long as the case has not been previously converted from another chapter. Waivers that prohibit the conversion of bankruptcy cases to or from a Chapter 7 are unenforceable. As it relates to creditors or other parties in interest, they may make a motion to convert a case under Chapter 7 to only Chapter 11. See Section 706(b) (allowing for conversion to Chapter 11); Section 706(c) (prohibiting conversion to Chapter 12 or 13 without debtor's consent). The creditor bears the burden of showing conversion to Chapter 11 will benefit all of the parties in interest and the decision on whether to convert is left to the sound discretion of the trial court. See 124 Cong. Rec. H11,098 (September 28, 1978); S.17414 (October 6, 1978). Conversion is contingent on the eligibility of the debtor to be a proper debtor under the new chapter. Section 706(d).

A.1.2. From Chapter 7 to Chapter 13

A Chapter 7 Debtor may convert his case to a Chapter 13 even after the debtor has received a Chapter 7 discharge. *In re Young*, 237 F.3d 1168 (10th Cir. 2001); *In re Mosby*, 244 B.R. 79 (Bankr. E.D. Va. 2000); *but see In re Hauswirth*, 242 B.R. 95 (Bankr. N.D. Ga. 1999) (debtor can only receive one discharge and Chapter 7 discharge must first be vacated or Chapter13 case must be filed in a separate case).

For plan purposes, under 706(a) the conversion date from a Chapter 7 to a Chapter 13 is the date of the order providing for the conversion, not the date the motion is filed. *In re Calder*, 973 F.2d 862 (10th Cir. 1992).

A.1.3. Creditors Rights in Motion to Convert.

In the case of *In re Finney*, 992 F.2d 43 (4th Cir. 1993), the Fourth Circuit had before it a debtor that had refused to cooperate with the Chapter 7 Trustee and had engaged in post-petition undisclosed transfers of his assets. This activity cost the debtor his Chapter 7 discharge. The debtor moved to convert the case to a Chapter 11. The Fourth Circuit held that the court could dismiss the Chapter 11 case or reconvert the case to a Chapter 7 if it found subjective bad faith or that the Chapter 11 was objectively futile. However, the Fourth Circuit also held that the debtor was entitled to a hearing on the issue of objective futility.

A.1.4. From Chapter 13 to another Chapter

Section 1307(a) gives the debtor an absolute right to convert a Chapter 13 into a Chapter 7. Also, Section 1307(b) gives the debtor the absolute right to dismiss his Chapter 13 case. The only time this right is restricted is when the debtor had previously converted the case from another Chapter to Chapter 13. Since the debtor has the absolute right to dismiss, most creditors do not seek to convert the case to another Chapter. Nevertheless, Section 1307(c) does provide certain enumerated reasons for converting the case to Chapter 7 or dismissing the case in the best interests of the creditors if the moving part can show (1) unreasonable delay (2) nonpayment of the required fees and charges (3) failure to timely file a plan; (4) failure to commence making payments; (5) denial of confirmation; (6) a material default; (7) revocation of the order of confirmation; (8) termination of the current plan pursuant to its own terms; or (9) if the U.S. Trustee's office requests conversion because of the debtor failure to provide certain required information. Section 1307(c). Similarly, the case can be converted to Chapter 11. Section 1307(d). If the debtor is a farmer, the case cannot be converted without the debtor's consent. Section 1307(e).

A.1.5. From Chapter 11 to another Chapter.

Section 1112(a) also gives the debtor the ability to convert a Chapter 11 to a chapter 7 unless 1. The debtor is no longer the debtor in possession,

2. The case was commenced as an involuntary case, or

3. The case was converted on someone else's request.

Section 1112(b) states that the court, the Trustee or any party in interest can move to convert the case to a Chapter 7 and the Court may so convert the case after notice and hearing. The moving party bears the burden of showing cause for the conversion.

A court may convert a case from a Chapter 11 to a Chapter 7 if the debtor seeks Chapter 11 protection for subjective bad faith or if the case is objectively futile. *Finney v. Smith*, 141 B.R. 94 (E.D. Va. 1192) *aff'd and modified* 992 F.2d 43 (4th Cir. 1993).

In the case of *In re Phoenix Medical Technology, Inc.*, C/A No. 00-07253-W (Bankr. D.S.C. 3/30/2001), the South Carolina Bankruptcy Court, the Court found that sufficient cause existed to convert the Chapter 11 case to a Chapter 7 through a two-step process: (1) the Court examined whether "cause" exists to dismiss the Chapter

11 proceeding or convert it to a Chapter 7 and (2) the Court examined whether to dismiss or convert was in "the best interest of creditors and the estate." The Court found the following facts supported conversion (1) there had never been any prospect of rehabilitation of Debtor's business, (2) during the bankruptcy case, Debtor had continued to borrow substantial sums of money beyond its revenues from its primary secured creditor and post-petition lender for the stated purpose of preserving and eventually selling its assets for the benefit of all of its creditors, (3) the format of borrowing was approved based upon the assurances of counsel and the representation that the liquidation would be quick, to minimize expense, and produce a dividend to unsecured creditors; however, the delay in the case was overall unreasonable and while Debtor had incurred a significant post-petition debt, only limited sales had taken place; (4) debtor failed to timely act in regards to the motions filed in the case requesting the Court's approval of the post-petition financing agreement and borrowed funds prior to court approval and (5) the Court was further concerned that the arrangement involving the payment of Debtor counsel's fees tainted his independence in the case.

In the case of *In re Carowinds Boulevard Homes, Inc.*, C/A No. 00-10572-W (Bankr. D.S.C. 12/20/2000)(JW), the Court denied the creditors' Motion to Convert the Chapter 11 case to a Chapter 7 even though (1) the Debtor improperly used a secured parties collateral, (2) the debtor was significantly out-of-trust, (3) the Debtor made untruthful statements regarding the location of the collateral, and (4) the present management's failed to distance itself from the pre-petition management. In so denying, the Court recognized that conversion is a drastic remedy and noted that the case was only 21 days old at the time of the hearing on the Motion to Convert. Even though the Court refused to convert the case, the Court did order the appointment of a Chapter 11 Trustee.

However, in the case of *In re Long Bay Dunes Homeowners Association, Inc.*, C-99-06930-W (Bankr. D.S.C. 11/8/1999), the South Carolina Bankruptcy Court granted the Motion to Dismiss the Chapter 11 Bankruptcy.

The Court applied the two-pronged test set forth by the Fourth Circuit in *Carolin* and considered whether the reorganization was objectively futile and whether the case was filed in subjective bad faith. The Court concluded that there was no valuable ongoing business activity to protect by filing a Chapter 11 and that a confirmation of the plan could not be met pursuant to §1129 because the only unimpaired class had indicated their objection to the plan.

Timing seems to have a great deal to do with the success of a motion to dismiss or convert. Local Rule 2081-1(c) of the South Carolina Bankruptcy Court provides that a debtor has 180 days from the date of the petition to file a plan and disclosure statement. If the debtor fails to meet this deadline, this alone justifies the conversion or dismissal of a case.

After the Chapter 11 plan has been confirmed the debtor is no longer a debtor in possession and cannot convert the case into a Chapter 7. *In re T.S.P. Indus., Inc*., 120 B.R. 107 (Bankr. N.D. Ill. 1990).

1.A.6. Effect of Conversion

The effect of Conversion is governed by Section 348. A conversion constitutes a new order for relief, but does not change the petition's filing date. A claim arising after the original order for relief but after conversion is treated as a pre-petition claim (that still may be entitled to priority status as an administrative claim).

Conversion of a case does not reset the period for objecting to the debtor's exemptions. *In re Bell,* 225 F.3d 203 (2d Cir. 2000). However, the conversion from a Chapter 11 to a Chapter 7 generates a new period for filing complaints objecting the discharge of a debt. *F & M Marquette Nat'l Bank v. Ritchards*, 780 F.2d 24 (8^{th} Cir. 1985).

Conversion of the case does not change rulings made during the previous chapter proceeding and would not revive a lien set aside during the previous chapter proceeding. *In re Cooke*, 169 B.R. 662 (Bankr. W.D. Mo.

19994). Also, some case law holds that a confirmed plans of reorganization bind creditors, not just in cases that are converted but also in state court proceedings. *See McNaughton-McKay Electric Co., Inc. v. Andrich*, 482 S.E.2d 564 (S.C. Ct. App. 1997) (creditor had to adjust amount claimed by the amount agreed to in confirmed plan of reorganization).

Lastly, under 348 (f) if a debtor converts a chapter 13 into a chapter 7 the property's valuations and allowed secured claims will apply in the converted case (reduced by the amount paid in the Chapter 13).

A.2. Dismissal

A.2.1. Creditors Rights to Seek to Dismiss Chapter 7.

Under Section 707(a) a Court may dismiss a Chapter 7, only after notice and a hearing and after a finding of cause (such as unreasonable delay and nonpayment of any fees). Under Section 707(a), Courts often differ on what is cause (lack of good faith , bad faith, etc.) to dismiss a case. Cases often show that dismissal may not be always appropriate where the debtor acted in bad faith or is abusing the bankruptcy system and the dismissal will only serve to injure creditors. *See generally In re Turpen*, 244 B.R. 431 (B.A.P. 8th Cir. 2000); *In re Simmons*, 200 F.3d 738 (11th Cir. 2000).

A.2.2. The Court and U.S. Trustee Substantial Abuse Determination in Chapter 7.

Under Section 707(b), the Court or an United States Trustee (not a creditor) can move to dismiss the case if the debtor's debts are primarily consumer debts and the petition is a substantial abuse of Chapter 7. Primarily consumer debt has been defined as more than 50% of the total debt. *In re Stewart*, 175 F.3d796 (10th Cir.1999).

Determining if substantial abuse exists under the circumstances include evaluating factors such as: (1) sudden illness, calamity, disability, or unemployment; (2) cash advances for consumer purchases in excess of the ability to pay; (3) excessive family budget; (4) accurate reflection of the debtor's true financial status in the debtor's schedules and statement of income and expenses; (5) the debtor's good faith; (6) if the debtor enjoys a stable source of future income; (7) if the debtor is elligible for a chapter 13; (8) if state remedies exist to ease the financial troubles; (9) the degree of relief available through private negotiation; and (10) if the debtor's expenses are able to be reduced without depriving him of necessities. *In re Stewart*, 175 F.3d 796 (10th Cir. 1999).

2.A.3. Dismissal in Chapter 13.

Under Section 1307, after notice and hearing a party in interest or the United States Trustee may dismiss a chapter 13 case for cause if the dismissal is in the best interest of the creditors and the estate. Section 1307(c) provides ten (10) examples of cause for dismissal or conversion. The last two can only be exercised by the United States Trustee.

2.A.4. Dismissal in Chapter 11.

Section 1112 also allows a party in interest or the United States Trustee to dismiss the case after notice, and a hearing where cause is established. A dismissal under 349(a) is normally without prejudice and the debtor can refile and obtain discharge from those debts that were previously filed in first case. The court can dismiss the case with prejudice which forbids the debtor from freely discharging her debts for a specified period of time. A dismissal "revests the property of the estate in the entity in which such property was vested immediately before the commencement of the case." 349(b)(3).

In the case of *In re Hartley*, 187 B.R. 506 (Bkrtcy. D.S.C. 1995), the Court dismissed Debtor's Chapter 13 based upon debtors and debtor's spouses previous filings. However, in the case of *In re Heath*, 188 B.R. 17 (Bkrtcy. D.S.C. 1995), the Chapter 13 debtor's case was not dismissed for lack of good faith, just because the husband had filed a previous Chapter 13. The court did not impute this filing to this debtor because of a divorce and general animosity towards each other.

As it relates to dismissals with prejudice, in the case of *In re Marett*, 96-72959-W (Bkrtcy.D.S.C. 11/13/96), the court dismissed Chapter 13 with prejudice for 180 days and sanctioned debtor for repetitive filing and for lack of feasibility, failure to pay and failure to file documents and provide information.

If the original bankruptcy is dismissed, the creditor in a subsequent case, can recalculate his claim and interest on that original claim. *In re Whitmore,* 154 B.R. 314 (Bankr. D. Nev. 1993). The dismissal of a case reinstates a void lien unless the court orders otherwise. *In re Sadler,* 935 F.2d 918 (7th Cir. 1991).

Dismissal of a case does not immediately strip the bankruptcy court of jurisdiction over a related adversary proceeding. *In re Porgis*, 44 F.3d 159 (2nd Cir. 1995).

If a confirmed Chapter 13 case is dismissed, then the funds must still be dispersed pursuant to the plan and not returned to the debtor. *In re Bell*, 248 B.R. 236 (Bankr. W.D. N.Y. 2000).

Creditors should note that they can move for dismissal under 1307 or 1112. Also that they can move that the case be dismissed with prejudice. Furthermore, a dismissal frees up all property encumbered by the bankruptcy.

B. Appointment of a Trustee or Examiner

Section 321 dictates who may serve as a trustee while 322 governs the Trustee's qualifications and bonds. Section 323 provides that the Trustee is the representative of the estate and that he has the capacity to both sue and be sued.

B.1. The Trustee's Ability to Waive the Debtor's Attorney-Client Privilege

The Trustee can waive a corporate debtor's attorney client privilege for prepetition communications. *Commodity Futures Trading Comm,n v. Weintraub*, 471 U.S. 343 (1983). Whether he can waive an individual debtor's attorney client privilege for prepetition communications is presently uncertain.

The decision by the United States Supreme Court in *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 105 S.Ct. 1986, 85 L.Ed. 2d 372 (1985) is recognized as a seminal case in the area of attorney-client privilege. In *Weintraub,* the Supreme Court held that the attorney-client privilege was available to a corporation, that the privilege passed from the corporation management to a Chapter 7 Trustee, and that the privilege could be waived by the Chapter 7 trustee for pre-petition attorney-client communication. The Supreme Court left the issue of an individual debtor's assertion of a privilege to the courts to decide on a case-by-case basis. That Court noted that:

> Our holding today has no bearing on the problem of individual bankruptcy, which we have no reason to address in this case. . . . An individual . . . can act for himself; there is no 'management' that controls a solvent individual's attorney-client privilege. If control over that privilege passes to a trustee, it must be under some theory different from the one we embrace in this case.

Weintraub, 471-U.S. at 356-357, 105 S. Ct. at 1995.

Several courts since *Weintraub* have considered the issue of the Trustee's rights to waive the individuals' attorney client privilege. The Bankruptcy Court for the District of Colorado in *In Re Foster*, 217 B.R. 631 (Bankr. Colo. 1997) provides the most thoroughly reasoned case on the issue of passage of attorney-client information in an individual chapter 7 case. That court held:

> The right to assert an attorney-client privilege is acquired by the trustee in bankruptcy in a situation where . . . the trustee has become entitled to and the estate

> is owner of assets in the nature of a debtor's pre-petition causes of action against third parties.

Id. at 635. In *Foster*, the trustee was requesting the turnover of recorded information relating to the debtor's property and financial affairs in order to pursue causes of actions for breach of promissory note, breach of consulting agreement, breach of personal guarantee, fraud in the inducement and general fraud. The Court found that neither the attorney-client privilege, the work-product doctrine nor the constitutional rights asserted by the debtor, bar the production of documents requested by the trustee from debtors' counsel. The Court concluded that "the right to assert, or to waive, the attorney-client privilege, passes from the debtor to a bankruptcy trustee where . . . it involves recovery of assets of the estate in the nature of pre-petition civil action." *Id*. at 638.

Similarly, in the case of *In Re Bazemore*, 216 B.R. 1020 (Bankr. S.D.Ga. 1998), the Court confronted the issue of whether or not the trustee in a Chapter 7 individual bankruptcy has the authority to waive the attorney-client privilege of the debtor and require the debtor's insurance company appointed attorney to be deposed regarding his representation of the debtor in the state court action. The Court concluded that the examination would aid the trustee in determining whether the bankruptcy estate of the debtor had a cause of action against the attorney and the insurance company for malpractice or bad faith. The Court concluding that the trustee could waive the privilege and held:

> when the trustee seeks to determine whether the bankruptcy estate holds a cause of action against an insurance company and the attorney it appointed for potential bad faith in settlement and malpractice during a state court case, which judgment precipitated the debtors' bankruptcy, the trustee holds the right to waive the attorney-client privilege.

Id. at 1025.

Lastly, *In Re Smith*, 24 B.R. 3 (Bankr. S.D. Fla. 1982) is also a case with facts similar to this case. In *Smith*, a wrongful death state judgment caused the debtor to file for bankruptcy. The trustee was attempting to depose the debtor to determine if the estate might have a cause of action for bad faith refusal to settle and malpractice against the liability insurance carrier and appointed attorney of the debtor. The Court held that "any attorney-client privilege which the debtor had passes by operation of the law to the bankruptcy trustee." *Smith*, 24 B.R. at 5. (Citing *O.P.M. Leasing Services, Inc.*, 13 B.R. 64 (S.D.N.Y. 1981); *Citibank, N.A. v. Andros,* 666 F.2d 1192 (8th Cir. 1981); and *In re Blier Cedar Co., Inc*., 10 B.R. 993 (Bankr. Me. 1981). In *Smith*, the debtor refused to answer a number of questions at his 2004 examination invoking his privilege through his attorney. The Court noted in *Smith* that the debtor's position was argued primarily by the insurance company lawyers who defended the debtor in the wrongful death action.

Nevertheless, there is a line of cases finding that a trustee does not have the power to waive the attorney-client privilege of the individual debtor and these cases focus on personal harm to or control over the debtor. See *e.g. In Re Silivio*, 27 B.R. 28 (Bankr. S.D. Fla. 1982) (Where an individual owner of the stock of a bankruptcy corporation also filed for bankruptcy, the trustee could not waive the privilege for the individual because the disclosure could involve criminal conduct and thus, loss of personal freedom).

B.2. The Appointment of a Trustee

B.2.1. The Chapter 7 Trustee

Section 701 provides for the immediate appointment of a Chapter 7 interim trustee. In South Carolina, this Trustee is appointed from a panel of private trustees. If a creditor is uncomfortable with the appointed trustee, the creditor can then call for the election of a new trustee under Section 702. This creditor must be a fixed unsecured creditor entitled to a distribution of property of the estate. The creditor cannot be an insider. This election is held at the 341 first meeting of creditors. A candidate is elected the new trustee if 20% of those unsecured creditors vote for him and he receives a majority of votes of the creditors who hold a majority of the claims. If a vacancy occurs, a new trustee will be elected or appointed under 703.

The Trustee in a Chapter 7 case has the authority to bring law suits under state law or federal law and may, with court order, continue the conduct of the debtor's business. Further, the Court may allow a Chapter 7 Trustee to transfer an avoiding power to a creditor if the creditor is pursuing interests common to the benefit of all creditors. *In re P.R.T.C.*, 177 F.3d 774 (9^{th} Cir. 1999).

B.2.2. Chapter 11 Trustee

Section 1104 governs the appointment of a trustee or examiner in chapter 11 cases. The trustee replaces the debtor in possession to operate the business and manage the reorganization efforts. An examiner investigates the business without replacing the debtor in possession. Upon request of a party in interest and after notice and a hearing the court must order the appointment of a trustee for a showing of cause or if the appointment is in the best interest of creditors, equity holders, and the estate. An examiner may also be appointed in the same way for the same basic circumstances. An examiner MUST be appointed if the unsecured debts exceed 5 million dollars. The Court can terminate the trustee or examiner pursuant to Section 1105. Section 1106 provides the specific duties of the trustee or examiner, which incorporates many of the applicable provisions of the Chapter 7 trustee, including investigating the debtor in possession and the business and filing reports, etc. The Court may appoint an examiner *sua sponte*. *In re First Am. Health Care of Georgia Inc.*, 208 B.R. 992 (Bankr. S.D. Ga. 1996).

Factors in determining if there is cause to appoint a Trustee include: (1) the existence and materiality of any misconduct on the part of the debtor-in-possession; (2) the evenhandedness in dealings with insiders or affiliates; (3) the existence of preferences or fraudulent transfers; (4) the unwillingness or inability of management to pursue the estate's causes of action; (5) conflicts of interest on the part of management of the debtor-in-possession; and (6) self-dealing by management or waste of corporate assets. *In re Intercat, Inc.* 247 B.R. 911 (Bankr. S.D. Ga. 2000). Even though the code specifically enumerates these reasons, a court need not find any of the enumerated subsections in 1104(a)(1) to appoint a trustee. It is sufficient that the appointment be in the best interest of creditors. *In re Oklahoma Refining Co.*, 838 F.2d 1133 (10th Cir. 1988).

Neither a debtor nor a debtor's principal have standing to bring an adversary proceeding after a chapter 11 trustee has been appointed. *In re Dawnwood Properties*, 209 F.3d 114 (2d Cir. 2000).

B.2.3. The Chapter 13 Trustee

Section 1302 governs both the standing trustee and Chapter 13 trustee appointed to particular cases. Section 1302(b) delineates the trustee's responsibilities and incorporates many of the duties of a chapter 7 and/or 11 debtor in possession. The trustee is required to appear before the court at the Chapter 13 confirmation hearing and upon any modification. The trustee must also monitor payments under the plan.

Creditors should be aware of the trustee's responsibilities under the appropriate bankruptcy chapter. If the creditor is unhappy with the trustee, then that creditor may be able to get the trustee removed or later take legal action against the trustee.

C. Determination of Secured Status and Valuation of Security Interest

C.1. Amount of Secured Claim

Section 506 determines the amount of a secured claim. Section 506(a) provides that a creditor with a right of setoff or a lien has a secured claim ONLY to the amount subject to setoff or the value of the collateral. Section 506(b) states that if the collateral's value is greater than the amount of the claim, then the amount of the secured claim is the amount of the setoff or that amount of the collateral along with any interest or expenses of the creditor. Under Section 506(c) the trustee may recover from the collateral the reasonable and necessary costs of securing the estate, like insurance. Finally, Section 506(d) voids liens that are secured by claims that are not properly allowed in bankruptcy proceedings. But see *In re Virello*, 98-03751-W (Bkrtcy.D.S.C. 3/31/99) (a Chapter 7 debtor does not have standing to use 506(d) to void a lien on real property which is abandoned or likely to be abandoned and therefore of no benefit to the estate).

C.2. Valuation Hearing or Confirmation Hearing

Creditors can call for a section 506(a) valuation hearing or the hearing may accompany the confirmation hearing as long as Bankruptcy Rule 3012 is properly followed. If amount in collateral is greater than amount on lien, then creditor is in good shape and is oversecured. If the value of the collateral is less then amount of the debt, the creditor is undersecured. For oversecured creditors, under 506(b) post petition interest is permitted and the recovery of fees and costs may be permitted when they are reasonable and are provided for in the agreement under which the claim arose. *See Rake v. Wade*, 508 U.S. 464, 113 S.ct. 2187, 124 L.ed. 2d 424 (1993) (Chapter 13 debtor required to pay postpetition, preconfirmation interest to oversecured creditor holding mortgage on principal residence regardless of whether mortgage provides for such interest).

C.3. Value is the Replacement Value

The value used by the Courts is the replacement value. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S.Ct. 1879, 138 L.Ed. 2d 148 (1997). Valuation of collateral securing a creditor's claim is flexible and is not limited to a single point in time for purposes of determining whether a creditor is entitled to accrue interest under 506(b). *In re T-H New Orleans Ltd. Partnership,* 116 F.3d 790 (5th Cir. 1987).

C.4. Attorney Fees are Reasonable Attorney Fees

As it relates to attorney fees awarded in a foreclosure action, in the case of *In re Epps,* 99-00026-W (Bkrtcy. D.S.C. 7/9/99), the Court held that the debtor was precluded from challenging a pre-petition state court award of attorney's fees pursuant to the Rooker-Feldman Doctrine. Nevertheless, Court allowed the Chapter 13 Trustee to challenge the reasonableness of the attorney's fees.

D. Adequate Protection of Secured Creditor's Interests

D.1. Secured Creditors are entitled to Adequate Protection

Adequate protection is protection afforded to the holders of secured claims. The concept of adequate protection preserves the secured creditors position at the time of bankruptcy. Section 361 provides three ways to provide adequate protection over a property interest. Adequate protection may be achieved by using cash payments, replacement liens, or any other method that provide an equivalent of the entity's interest in property.

D.2. Relief from the Automatic Stay for Lack of Adequate Protection.

Section 362(d)(1) states that a party in interest (a creditor) can move to lift the stay for cause, including a lack of adequate protection in the property. Section 506 is intertwined with 361 as the valuation of the collateral is very important in determining if the creditor is adequately protected. 363(e) provides that the court will stop the sale/lease of property to maintain adequate protection. Finally 364(d) allows a second lien to be given to obtain additional credit as long as adequate protection is given to the existing lien holder.

D.3. What constitutes adequate protection?

The following could provide adequate protection: a large equity cushion, requirement of payments to the creditor, or a interest in a stream of future rents. Section 361 protects a broad range of creditor interests and will depend on the factual situation in each case concerning both the nature and the use of the collateral. A substantial equity cushion can obviate the need for any other adequate protection. *In re Mellor*, 734 F.2d 1396 (9th Cir. 1984).

The statutory scheme of Section 361 indicates that adequate protection is intended to encompass a broad range of creditor interests and does not mandate an interpretation of the creditor's interest as a whole of the economic bargain. It is clearly susceptible to differing applications over a wide range of fact situations and will depend on the nature of the collateral and the proposed use of the collateral. *In re Briggs Transp. Co.*, 780 F.2d 1339 (8th Cir. 1985).

E. Obtaining relief from the Automatic Stay

E.1. General Rules for Relief

Relief from the automatic stay is governed by 362(d). A party in interest may move for relief of the stay, which the court will properly grant after notice and a hearing. To get relief from the stay the creditor must satisfy both parts of the 362(d) test. First, the stay can be lifted for cause, including a lack of adequate protection and second, if the debtor does not have equity in the property and the property is not needed for an effective reorganization. 362(d)(3) then provides specific rules when the bankruptcy concerns a single asset real estate case. 362(e) provides that thirty days after the motion for relief, the stay shall be lifted unless the court after both notice and a hearing orders the stay to continue in effect pending the conclusion of or as a result of a final determination of 362(d).

All liens including, including those senior and junior to the movant’s lien, are considered in determining whether the debtor has equity in the property. *In re Indian Palms Assoc*., 61 F.3d 197 (3d Cir. 1995).

For property to be necessary for an effective reorganization, there must be reasonable possibility of a successful reorganization within a reasonable time. *United Savings Ass’n of Texas v. Timbers of Inwood Forest Assoc., Ltd.* 484 U.S. 365(1988).

E.2. Automatic Stay and Marital Disputes

The bankruptcy court may properly lift the automatic stay in an equitable distribution suit if (1) the state court has special expertise in handling domestic matters, (2) judicial economy is promoted because the state proceedings may be completed quickly and inexpensively, and (3) the entry of the judgment in state court does not harm the estate or the interests of other creditors because the bankruptcy court retains jurisdiction to determine the amount the former spoMay 8, 2003use is to be paid on the claim. *In re Robbins,* 964 F.2d 342 (4th Cir. 1992); *In re Dole*, 96-77677-W (Bkrtcy.D.S.C. 2/21/97) (Court modified automatic stay to allow the state family court to decide issues related to support, equitably division of marital property and to allow the debtor to obtain a divorce decree.

As it relates to a creditor’s rights in marital disputes, in the case of *In re Koenig*, C/A No. 00-11188-W (Bankr. D. S.C. Dec. 7, 2001) a Creditor had a claim against Debtor's estranged husband secured by a note on which Debtor was not liable sought relief from stay to pursue foreclosure of the collateral in Debtor's possession. In Debtor's Chapter 13 plan, she treated the debt by providing that it was to be paid outside of the plan by her estranged husband. The estranged husband failed to make payments for several months. When Creditor sought relief from the stay, Debtor objected because Creditor failed to file an objection to its treatment in the plan. The Court rejected the argument, finding that a line of cases Debtor cited were inapposite to the circumstances of this case and that there is no res judicata effect of the plan because its language is insufficient to extinguish Creditor's lien nor did it clearly prohibit Creditor from foreclosing its lien. Moreover, the Court determined Creditor was not adequately protected, no payments are being made to Creditor, and there is no equity cushion.

E.3. Pre-Petition Agreements Waving Automatic Stay

In South Carolina, the Bankruptcy Courts generally will enforce a knowing and voluntary waiver of the automatic stay. *See In re Darrell Creek Associates, L.P.*, 187 B.R. 908 (Bkrtcy. D.S.C. 1995) (waiver-of-stay agreement executed prepetition by a Chapter 11 debtor provided cause for lifting the automatic stay to allow the mortgagee to foreclose.) However, in circumstances where the debtor performs under the terms of the agreement, the Bankruptcy Court will retain jurisdiction to determine the extent to which the automatic stay has been waived. In the case of *In re Drawdy*, No. 01-04844-W (Bankr. D.S.C. 09/20/01), the creditor sought to enforce a pre-petition waiver agreement, included in a state court order, whereby Debtors waived their right to object in the event Creditor sought relief from the automatic stay. Nevertheless, the Court reasoned it was not barred because (1) the waiver provision was operative only in the event of Debtors's default of the agreement and the Court found that Debtors complied with the agreement; (2) the state court did not determine the issue of the automatic stay's applicability; and (3) the waiver agreement is not self-executing but is only one factor a court considers when determining whether relief from stay is appropriate. The Court ruled that the agreement was not enforceable because Debtors had performed according to its modified terms. The Court denied Creditor's motion for relief from stay. *See Also*, *In re Riley*, 188 B.R. 191 (Bkrtcy. D.S.C. 1995)(A prepetition forbearance agreement that was executed by a Chapter 13 debtor-mortgagor and a mortgagee and which contained a waiver of stay provision did not continue beyond the cure of default that existed when the agreement was entered.)

E.4. Creditor's Rights Upon Foreclosure Sale

In the case of *In re Holmes*, 99-08796-B (Bankr. D.S.C. 11/23/1999), the mortgage creditor filed a motion for relief from the automatic stay. Prior to the filing of the Chapter 13 petition, a foreclosure action had terminated, with the mortgage creditor as the successful bidder at the foreclosure sale. Even though the Master's Deed was signed, it had yet to be recorded. The Court relied on precedent to conclude that upon foreclosure on the property, the debtor is divested of any interest, including the equity of redemption; thus, the property in question was no longer property of the bankruptcy estate. As a result, the Court concluded that such facts constituted sufficient "cause" to grant relief from the stay pursuant to §§362(d)(1). However, the Court recognized that the debtor had raised a significant question regarding whether the service of the Summons and Complaint in the foreclosure action was effective. In applying the Rooker-Feldman doctrine, the Court concluded that the determination of proper service was left to the state courts; however, to provide an opportunity for the debtor to address the issue of proper service with the state court, the Court granted the Motion but made it effective at a later date.

Similarly, in the case of *In re Watts*, C/A No. 00-06791-W (Bankr. D.S.C. 10/27/2000) the United States of America, on behalf of the Rural Development, filed a Motion to Terminate Automatic Stay. In this case, a judgment of foreclosure and sale had been entered in the United States District Court and the property had been sold at the foreclosure sale. Debtor objected to the Motion arguing that the sale was not fully completed and further asserting that, pursuant to Section 1322(c)(1), she had the right to cure the mortgage arrears owed to the Creditor because the sale was yet to be completed under applicable non-bankruptcy law. First, the Court followed precedent in this district to hold that the property no longer constituted property of the estate and Debtor possessed neither a legal nor an equitable interest in the property once the auctioneer''s hammer fell. Furthermore, as it related to §§1322(c)(1), the Court recognized that courts interpreting this section were split in their decisions, but it ultimately adopted the reasoning of the courts that have held that the language of §§1322(c)(1) is clear and unambiguous in establishing the date of the actual foreclosure sale as the cut-off date for curing mortgage defaults. The Court once again emphasized that upon the falling of the gavel, the debtor was left with bare legal title and "‘‘[t]he additional steps of obtaining court approval, awaiting the expiration of any cure period . . . , paying the purchase price, and recording the deed may be necessary to consummate the sale, but that does not alter the fact that the purchaser''s right to acquire the property has intervened." The Court ultimately found that relief from the automatic stay pursuant to §§362(d) was warranted.

E.5. Creditor's rights upon repossession.

Generally, repossessed property remains property of the estate. Property in the hands of a creditor is subject to a turnover action by the debtor or trustee. If the creditor fails to voluntarily turnover the property, he may be subject to sanctions, such as attorney fees. However, the creditor could force the issue by bringing a motion for relief from the stay because of lack of adequate protection.

In the case of *Jennings v. R & R Cars and Trucks (In re Jennings)*, No. 01-02330-W; Adv. No. 01-80044-W (Bankr. D.S.C. 9/17/01) the court found that the creditor failed to voluntarily turn over the property and entered an Order that determined damages for failing to turnover and violation of the automatic stay. Previously, in an adversary proceeding, the Court ordered the Creditor to return the vehicle, lawfully repossessed prepetition. By the time the Order was entered, Debtors's case had been dismissed, but the Court later vacated the dismissal order. Afterward, Debtors brought a contempt action against Creditor claiming it failed to comply with the turnover order. The Court found Creditor in contempt and again ordered it to return the vehicle immediately to Debtors. In determining damages, the Court considered the effect of the dismissal of the case and held that the vacation of the dismissal did not retroactively reinstate the automatic stay during the period when the case was dismissed; however, by reinstating the case, the automatic stay was simultaneously reimposed from the date of reinstatement. Therefore, the Creditor was liable for damages for violating the automatic stay after the case was reinstated as well as during the time before the dismissal when the evidence proved that Creditor knew about the turnover action. The Court also considered whether damages might be negated because Creditor orally notified Debtors that the vehicle was available for Debtors to take possession. After examining prior cases in this District and in rejecting this argument, the Court held that Section 542(a) placed an affirmative duty on creditors in possession of estate property to deliver it to the estate. Regarding the issue of when turnover is required, the Court held that the duty to turn over is triggered upon a debtor's notification to the creditor of the bankruptcy filing, written demand for turnover, and proof of insurance.

E.6. The Automatic Stay and Third Parties.

Generally, the filing of a bankruptcy petition protects the debtor. However, under some limited number of circumstances, the automatic stay is extended to protect partners of a general partnership, the general partner of a limited partnership, and officers, directors and principals of a corporations, where the judgment against these would be a judgment against the corporation itself. Unless, one of these exceptional circumstances exist, the automatic stay will not generally be extended to include third parties.

In the case of *In re Kinard*, C/A No. 01-03621-W (Bankr. D. S.C. Nov. 21, 2001), the Creditor motioned for relief from the automatic stay with respect to Debtor's collateral, a 5.7 acre vacant parcel of land generating no income, as well as collateral pledged by a third party who had not filed for bankruptcy protection. Debtor objected to the motion and sought an injunction protecting the third party. The Court first decided that Debtor's automatic stay does not extend to the third party or its collateral; consequently, the foreclosure process could continue against the third party's collateral. In addition, the Court declined to grant the extraordinary relief of issuing an injunction to protect the third party because Debtor failed to demonstrate irreparable injury to the Debtor, lack of substantial harm to others if the injunction were granted, the promotion of public interest by issuing the injunction, and a reasonable likelihood of successful reorganization.

In the case of *In re Ragin*, C/A No. 99-11323-D (Bankr. D.S.C. 3/3/2000), the Court granted the Motion for Relief from the Automatic Stay and the Motion for Relief from Co-Debtor Stay filed by the Bank. The Bank was the holder of a second mortgage lien on a parcel of real property. The Note was signed by both Debtor and a third party, but the property that secured the Note was solely owned by the third party. The Court held that, in addition to the relief granted under Section 1301(c), the Bank was also entitled to a modification of the automatic stay for purposes of completing its Foreclosure Action.

E.7. Creditor's Rights in Single Asset Real Estate Cases

In the case of *In re Kinard*, C/A No. 01-03621-W (Bankr. D. S.C. Nov. 21, 2001), the Court granted relief from the automatic stay pursuant to Section 362(d)(2). Debtor argued that the real property collateral will appreciate in the future and that its later sale will be the only way for him to reorganize. The Court ruled that, in order for property to be necessary for reorganization, a debtor must show a reasonable possibility of a successful reorganization and this possibility must be based on more than speculation. The Court found that the potential sale of the real property was too speculative. In addition, the court ruled that Creditor is entitled to relief from the stay pursuant to Section 362(d)(3) because the real property collateral is single asset real estate and Debtor failed to file a plan of reorganization or make monthly payments to secured creditors within the ninety day period prescribed by the code section. Debtor argued the real property is not single asset real estate because it is vacant land that does not presently generate income. The Court disagreed, ruling that raw land generating no income falls within the definition of single asset real estate. Finally, the Court ruled that relief from the stay was appropriate pursuant to Section 362(d)(1) because Debtor's reorganization is objectively futile and because the case was filed in subjective bad faith, evidenced by repeat filings intended to stave off foreclosure sales.

E.8. Creditor's Rights and Purchases Just Prior to Bankruptcy

In the case of *In re Madden*, 99-08282-W (Bankr. D.S.C. 12/21/1999) the Court denied Creditor's Motion for Relief from the Automatic Stay even though the Debtor filed a Chapter 13 bankruptcy proceeding approximately two months after purchasing a truck and Debtors made no payments prepetition on the vehicle. The Court found that the truck was necessary for an effective reorganization, thus precluding relief from the stay pursuant to §§362(d)(2) because Debtors worked separate shifts and needed the vehicle for transportation. Furthermore, the Court found that even though the time between the purchase of the truck and the filing of the bankruptcy case was short, there were no indications that the bankruptcy was filed in bad faith thus precluding relief from the stay pursuant to Section 362(d)(1).

E.9. Annulling the Automatic Stay to Correct Mistakes

Generally, the Bankruptcy Court is a court of equity. If a creditor makes a mistake, such as mistakenly satisfying a mortgage the Court will grant the relief necessary to allow the creditor to correct his mistake, so long as it does not harm another creditor. In the case of *In re Scott*, C/A No. 00-07468-W (Bankr. D.S.C. 1/1/2001), the court went so far as to annul the automatic stay so as to allow the creditor to properly file its mortgage. The Creditor filed a Motion seeking the annulment of the automatic stay to validate the post-petition perfection of a mortgage on Debtor's home. Debtor had mortgaged his property and subsequent to the execution of the mortgage, the creditor forwarded the mortgage for filing in the proper office, but failed to include necessary information; therefore, the mortgage was never properly recorded pre-petition. Debtor argued that if the automatic stay was annulled in this case, the creditor would be permitted to better its position post-petition in that its lien would be perfected against third parties. Debtor also argued that the post-petition validation of the recording would prevent Debtor of his ability to file an avoidance action under Section 544. The Court found that in Chapter 7 cases a debtor does not ordinarily have standing under the strong-arm provision of Section 544(a). Having decided that Debtor could not have brought a Section 544 action in this case, the Court next addressed the issue of whether the stay could have been retroactively annulled. The Court found that "cause" existed as required by Section 361(d)(1) to annul the stay retroactively to allow the perfection of the creditors' mortgage and further found that there was no equity in the property and it was not necessary for reorganization, thus warranting retroactive relief from the automatic stay also pursuant to Section 362(d)(2).

E.10. Creditor’s Rights when Subsequent Owner files Bankruptcy

In the case of *In re Trapp*, C/A No. 00-09987-W (Bankr. D.S.C. 1/5/2001), the mortgagee had entered into a Mortgage and Note with the Brewers, who subsequently sold the mortgaged property to Debtor, without the

Mortgagee's consent nor knowledge. Debtor then filed for relief under Chapter 13 and proposed to cure the arrears on the debt and recommence monthly payments to the Mortgagee. The Mortgagee filed a Motion to Modify Stay and Objection to Plan of Reorganization asserting that it was entitled to relief from the automatic stay pursuant to 11 U.S.C. §§362(d)(1) and (2) to permit it to proceed in State Court with foreclosure and eviction proceedings and further objecting to any treatment in Debtor's Chapter 13 Plan on the grounds that there is no debtor-creditor relationship between Debtor and Mortgagee and that therefore the mortgage debt was not a "claim". Furthermore, the mortgagee argued that the Plan may not cure and reinstate Mortgagee's claim, which was accelerated upon the expiration of the right to cure. The Court first concluded that a Chapter 13 debtor who is not in contractual privity with the mortgagee can repay a mortgage lien through the plan because the mortgagee holds a "claim" against the debtor's estate, even though there is no privity between the mortgagee and the debtor. Furthermore, the Court concluded that the fact that the debt to the Mortgagee was accelerated due to debtors' default did not prohibit the curing of such default through the Chapter 13 Plan.

F. Unexpired Leases and Executory Contracts

Unexpired Leases and Executory Contracts are governed by Section 363 and 365. Section 363 governs the postpetition use, lease and sale of estate property. This section also governs “cash collateral.” Section 363(b) provides the Trustee with the ability to “use, sell or lease” estate property outside the ordinary course of the estate. Section 363(c) provides the trustee with instances when the property can be sold, leased or used pursuant to the ordinary course of business. The Trustee must also lease all property pursuant to any relief granted from the stay.

Section 365(a) specifically provides the Trustee with the ability to assume, or reject any debtor's executory contract or unexpired lease. Note that neither "executory contract" nor "unexpired lease" is defined in the Bankruptcy Code. Subsections (b), (c) and (d) state limitations on the Trustee's power to assign or assume a lease or executory contract. If the executory contract or lease is in default, the Trustee still may assume the contract or lease, but the trustee must either cure, compensate, or provide adequate assurance of future performance under the lease. The Court must usually approve these assignments.

The court uses a business judgment standard in determining whether to approve a rejection, assumption or assignment. *In re G.I. Indus*., 204 F.3d 1276 (9th Cir. 2000). An executory contract or unexpired lease becomes property of the estate when it is assumed by the trustee. *Id.*

A creditor with an interest in the lease does not have standing to raise a section 365(d)(4) contention that the property covered in the lease is not part of the bankruptcy estate. *In re James Wilson Assoc.*, 965 F.2d 160 (7th Cir. 1992).

Section 365(b)(1)(B) does not create an independent right to a fee award. To recover fees the lessor must demonstrate that the lease contains a clear contractual provision allocating the right to collect fees, the provision is lawful, and that the lossess are for actual pecuniary lossess resulting from the defaults under the lease - attorneys actions were taken primarily to collect sums due under the lease or to enforce an obligation of the leasee. *In re Shangri-La, Inc*., 167 F.3d 843 (4th Cir. 1999).

G. Priorities

Priorities are governed by Section 507. Section 507(a) delineates the categories of claims that are entitled to priority in bankruptcy cases. Pursuant to 104(b) the dollar cap on some priority claims increases every 3 years to correspond to the Consumer Price Index. 507 mandates the order of payment of these (unsecured/partially secured) creditors. Practice dictates that each subsection of 507(a) is to be fully paid to the creditors before moving on to the next subsection. If the debtor delineates all of his funds, then that last subsection's creditors are paid pro-rata. All later creditors receive nothing. Priorities should be given a narrow, strict interpretation. *In re Birmingham-Nashville Express Inc*., 224 F.3d 511 (6th Cir. 2000).The 9 priority subsections are as follows:

1. Administrative expenses under Section 503(b) - These expenses include the "actual, necessary costs and expenses of preserving the estate, including wages, salaries or commissions, certain fines and taxes. Administrative expenses also may include bank charges, insurance, assumed lease obligations, leases, executory contracts. Such things as a prepetition pension plan, lump sum employment contracts and criminal fines or environmental penalties are not administrative expenses. Once a lease is assumed, even if later rejected, its an administrative expense. *In re Klein Sleep Prods, Inc*. 78 F.3d 18 (2d Cir. 1996). A broker's commission is a proper administrative expense after the broker has delivered a ready and willing buyer pursuant to the brokerage contract. *In re Ferncrest Court Partners Ltd.*, 66 F.3d 778 (6th Cir. 1995). "Creditors may not claim lump sum payments, as administrative expenses, due upon termination pursuant to their employment contracts with the debtor because (1) the claims did not arise from a transaction with the debtor possession; (2) the consideration supporting the right to payment was neither supplied nor beneficial to debtor in possession; and (3) the payments were not actual and necessary costs and expenses of preserving the estate." *In re Comm. Fin. Servs.* , 246 F.3d 1291 (10th Cir. 2001).

2. Unsecured Claims under 502(f) - in involuntary cases claims that arise after commencement but before the order of relief that arise in the ordinary course of the debtor's business or financial affairs receive priority status. These are known as involuntary gap creditors.

3. Unsecured claims for wages, salaries and commissions- Up to $4,650.00 per individual or corporation for salaries, wages and commissions earned within 90 days of filing the petition or the end of the debtor's business (whichever occurs first) receive 3rd priority. These claims arise with all types of employees from the traditional to home nursing care workers.

4. Unsecured claims for contributing to an employee benefit plan -These claims must arise from services given within 180 days before the filing of the petition or the end of the debtor's business. The total amount allowed is now $4,650.00 (the maximum amount allowed under subsection 3) multiplied by the number of employees covered under the plan less the actual distributions these employees previously received under subsection (a)(3).

5. Unsecured claims of those who raise/store grain or are fishermen - Each such individual may have a priority claim of up to $4, 650.00.

6. Consumer Creditors priority - This priority is for consumers who have deposited money for the purchase, lease or rental of property or services. The property or services must be for personal, household or family use. Each individual may have a claim of up to $2,100.00. This priority is to cover the debtor's inexpensive couch or microwave on lay-a-way.

7. Alimony and Child Support debts - All "support" debts receive 7th priority. These debts are also nondischargeable. Note that this priority may not encompass debts incurred with property settlements. 507(a)(7)(B) specifically provides for priority only for "alimony, maintenance or support."Guardian ad litem fees and expenses are also given priority under this subsection.

8. Unsecured Governmental Claims/Tax Claims - Income taxes for which a return is due within 3 years before the filing of the case are given priority under subsection 8. To receive priority, the tax assessment must also be within 240 days before the filing date. All property taxes due in the year before the commencement of the case also receive 8th priority. The question of when a tax is assessed is a matter of federal law, so that when federal taxes are in dispute, the Court must look to the definition of the Internal Revenue Code, which provides that assessment is the notation in the Secretary of the Treasury's records. State law assessment occurs when the liability becomes final under state law. *In re Lewis*, 199 F.3d 249 (5th Cir. 2000).

9. Unsecured Claims to the FDIC - Any unsecured claim to the FDIC or related entity for failing to maintain capital receive 9th priority.

Section 507(b) gives a "superpriorty" status to secured claims that have received adequate protection but still incur a claim. Finally, 507(d) provides that any subrogated entity does not receive the priority rights of the official holder.

H. Reaffirmation

Reaffirmation is an agreement provided for under Section 524(c) where the debtor and the creditor consensually agree that the debtor is going to reaffirm the debt. So even though the debtor receives a discharge, the debtor is still bound to the pay the total debt. A Reaffirmation agreement should involve a renegotiation of the debt and the terms and/or total debt may be different from the original debt. Reaffirmations should contain an attorney affidavit whereby the attorney states that he examined and investigated the reaffirmation to his client. Reaffirmations are not supposed to pose an undue hardship on the debtor. If the reaffirmation is not evidenced by the proper paperwork, the reaffirmation can be annulled. Reaffirmations are related to Redemptions and the concept of "Ride Through". Section 722 allows a debtor to "redeem tangible personal property intended primarily for personal, household, or family use." Redemption permits the debtor to "pay off" the loan or the collateral. The amount needed for a redemption may be reduced if a debtor can use some of his state or Section 506 exemptions. A reaffirmation or a redemption agreement will not be approved if the agreement will cause "undue hardship" on the debtor pursuant to 524(a)(6)(A)(i). 521(2)(A) provides that a creditor and debtor may agree to "ride through" the bankruptcy for a particular debt. Ride-through is not very advantageous to the creditor and is also not permitted in all circuits.

If the code requirements of 524(c) and (d), including the requirement that it be entered into prior to discharge are not met, even if it is signed by the parties, a reaffirmation agreement is unenforceable. *In re Kinion*, 207 F.3d 751 (5th Cir. 2000).

A reaffirmation agreement should involve a renegotiation of the debt and the terms may be different than the original contract terms. *In re Strong*, 232 B.R. 921 (Bankr. E.D. Tenn. 1999).

I. Discharge and Objection to Discharge

Generally, one of the primary purposes of the United States Bankruptcy Code (Title 11 of the United States Code of Laws) is to provide individual debtors with a "fresh start." The fresh start is provided by (1) allowing the debtor to keep certain minimal assets and (2) discharging the debtor from his obligations to pay his debts.

Generally, courts construe objections to the debtor's discharge against the objector and liberally in favor of the debtor. *See, e.g., In re Scarlata,* 979 F.2d 521 (7th Cir.1992); *In re Hunter,* 780 F.2d 1577 (11th Cir. Fla. 1986); *Rosen v. Bezner*, 996 F.2d 1527 (3d Cir. 1993) (Section 727 is construed liberally in favor of the debtor); *Insurance Co. of N. Am. v. Cohn (In re Cohn),* 54 F.3d 1108 (3d Cir. 1995) (same).

However, discharge is a privilege granted to the honest debtor and not a right accorded to all bankrupts and as the Supreme Court once said discharge is only for the "honest but unfortunate debtor." *Grogan v. Garner, 498 U.S. 279, 112 L. Ed. 2d 755, 111 S. Ct. 654 (1991); In re Burgess, 955 F.2d 134 (1st Cir. Mass. 1992); see also In re Horridge*, 127 B.R. 798 (S.D. Tex. 1991) (discharge not a matter of right); *In re Pimpinella*, 133 B.R. 694 (Bankr. E.D.N.Y. 1991) (same). While some have suggested that the debtor should use pre-exemption planning to "go as far as you can," this attitude does not comport well with the idea of the honest but unfortunate debtor. Cristol, A., Cassidy, W. and Walden, A. Exemption Planning: How Far May You Go?, 48 S.C.Law. R. 715, 742 (1997). With the recent change relating to the Individual Retirement Account (an "IRA"), providing for an unlimited exemption for IRA's under South Carolina law, we may see an increase in pre-petition planning by debtor. *See In re Outen*, 97-08675-W, (March 18, 1998) (IRA is included as exempt under South Carolina homestead exemptions); *but see Rowland v. Strickland,* 362 S.E.2d 892 (Ct App. 1987) (judgment creditor may attach IRA account as not exempt from alienation). With this increase in pre-petition planning, we may see an increase in complaints objecting to the discharge of the debtor's obligations.

Section 727 provides for the denial of the debtor's discharge in Chapter 7 cases. Section 1328 provides for the denial of the debtor's discharge in Chapter 13 cases. Section 523 provides for the non-discharge of certain obligations under certain conditions. This discussions will focus on Section 523.

Section 523 provides that certain specific obligations of the debtor may be excepted from discharge under two conditions. The first condition is that the debt must be determined to be not subject to a discharge. The second condition is that the obligation must meet certain criteria. This paper will first discuss the practical aspects of the trial of issues relating to the discharge and then will discuss the substantive criteria used to determine whether the debt will be discharged.

I.1. The Practical Aspects of Objecting to Discharge

I.1.1. Bring a Law Suit.

Under Section 523(a), a creditor, or someone standing in the creditor's shoes, must object to the discharge of a particular debt through an adversary proceeding. Rule 7001, Fed.R. Bankr. P. *See also In re Kennerley*, 995 F.2d 145, 146-47 (9th Cir. Cal. 1993) *(*A motion to lift the automatic stay is not either a valid complaint to determine dischargeability or a motion to extend the deadline under Bankr. R. 4007(c)).

I.1.1.1 Standing.

To obtain standing to bring a complaint objecting to discharge, the plaintiff must show (1) it is a creditor, (2) it is the assignee of a creditor,(*See Westbank v. Grossman (In re Grossman),* 174 B.R. 972 (Bankr. N.D. Ill. 1994) (assignment of judgment rights)) or (3) it is subrogated to the claims of a creditor. Subrogation may occur in relation to nondischargeable taxes, as discussed below and when the debts ordinarily would not be dischargeable but they are paid by some insurance company or surety. *Old Republic Sur. Co. v. Richardson (In re Richardson),* 178 B.R. 19 (Bankr. D.D.C. 1995) (public policy behind exceptions to discharge for breach of fiduciary duty is punitive in nature and intended to discourage improper conduct; public policy would be frustrated if debtor could avoid liability by allowing surety to cover a debt and then discharge the debt to the surety in bankruptcy; whether plaintiff had fiduciary relationship with the debtor irrelevant). See *In re Snellgrove*, 15 B.R. 149 (Bankr. S.D. Fla. 1981) (debt to surety nondischargeable to extent of debtor's embezzlement of creditor's funds).

I.1.1.2 Class Actions.

Although not seen in the District of South Carolina, Bankruptcy Courts have permitted class action suits to challenge the dischargeability of similarly situated debts. *Santa v. Lebner (In re Lebner)*, 197 B.R. 180 (Bankr. D. Mass. 1996). In so finding, the Bankruptcy Court for the District of Massachusetts indicated that a majority of the bankruptcy courts addressing the issue agreed to allowing the suits through class actions.

I.1.1.3 Jurisdiction.

Objections to discharge are core proceedings. 28 USC §158(b)(2)(I) and (J). In South Carolina, these core proceedings have been referred to the Bankruptcy Court for determination. 28 USC §157 (on allowing referrals). Under Code § 523(c), the Bankruptcy Court has exclusive jurisdiction to determine the dischargeability of debts for: (1) Section 523(a)(2) (debts created by false pretenses, false representation, actual fraud, or by use of a false financial statement); (2) Section 523(a)(4) (debts for fraud or defalcation while acting in a fiduciary capacity, or for embezzlement, or larceny); (3) Section 523(a)(6) (debts for willful and malicious injury by the debtor to another entity or to the property of another entity); and (4) Section 523(a)(15) (certain debts arising from divorce or separation which are not excepted under Code § 523(a)(5)). Other courts are given concurrent jurisdiction for the remaining objections to discharge.

I.1.1.4. Abstention.

In those situations where another court has jurisdiction, the Bankruptcy Court could abstain from hearing a dischargeability issue. *See* 28 USC § 1334 (discussing both discretionary and mandatory abstention). In a practical sense this abstention is most often used in questions dealing with the dischargeability of claims involving multiple personal injury suits (see *In re Robbins*, 964 F.2d 342 (4th Cir. N.C. 1992); *Wood v. Fiedler*, 548 F.2d 216 (8th Cir. Minn. 1977); *Austin v. Wendell-West Co.*, 539 F.2d 71 (9th Cir. Wash. 1976)) or in family support obligations where state courts are more familiar with the criteria for measuring support requirements. *Brothers v. Tremaine (In re Tremaine)*, 188 B.R. 380 (Bankr. S.D. Ohio 1995) (abstaining from dischargeability proceeding under Code § 523(a)(5) with respect to alleged alimony). Sometimes it is used relating to tax claims but the abstention in tax claims seems to be limited to situations involving no asset chapter 7 cases. *See In re Gossman*, 206 B.R. 264 (Bankr. N.D. Ga. 1997); *Shapiro v. United States (In re Shapiro)*, 188 B.R. 140 (Bankr. E.D. Pa. 1995) (Court abstained from hearing debtor's adversary proceeding to determine amount of nondischargeable debt where such determination would have no effect on creditors in the no-asset bankruptcy case which had been fully administered). If another court renders a determination on dischargeability, that determination is given preclusive effect in the bankruptcy court. *E.g., In re Galbreath*, 83 B.R. 549 (Bankr. S.D. Ill. 1988).

I.1.2. Bring the Suit Timely.

I.1.2.1 Within 60 days after the first date set for the meeting of creditors.

For causes of action within the exclusive jurisdiction of the bankruptcy court, the complaint objecting to discharge must be filed "not later than 60 days following the first date set for the meeting of creditors held pursuant to § 341(a)." Fed.R. Bankr. P. 4007(c). A motion to extend the 60-day period must be made prior to the end of the period and must be made by the creditor. Fed. R. Bankr. P. 9006(b)(3) permits an enlargement of time. If you don't bring the complaint, no amount of excusable neglect will save the creditor and unless the creditor relies upon an incorrect bar date being provided by the court, the bankruptcy court will not allow the late filing of a claim objecting to discharge. *Neeley v. Murchison*, 815 F.2d 345 (5th Cir. 1987); *In re Alton*, 837 F.2d 457 (11th Cir. 1988); *In re Anwiler*, 958 F.2d 925 (9th Cir. 1992), *cert. denied*, 121 L. Ed. 2d 171, 113 S. Ct. 236 (1992) (court has equitable power to permit untimely filing where the clerk gave an incorrect bar date); *Themy v. Yu (In re Themy)*, 6 F.3d 688 (10th Cir. 1993) (courts have "almost uniformly allowed an out-of-time filing when the creditor relies upon a bankruptcy court notice setting an incorrect deadline"). Some courts have held that a late filed complaint denies the court of jurisdiction and the case is dismissed even if the defense of failure to timely file is not raised by the debtor. *Dollinger v. Poskanzer*, 146 B.R. 125 (D.N.J. 1992) (bar date for filing dischargeability complaint is jurisdictional, and thus debtor's failure to plead untimeliness in answer is not a waiver of time bar); *But see In re Santos*, 112 B.R. 1001 (Bankr. 9th Cir. 1990) (dischargeability complaint bar date is not jurisdictional, and thus debtor can waive defense of untimeliness). Still other courts have found other exceptional circumstances to allow them to accept late-filed objections to discharge. *See In re Dewalt*, 961 F.2d 848 (9th Cir. 1992) (unscheduled creditor's late-filed complaint acceptable because notice of bankruptcy filing only 7 days before the bar date was insufficient under Code § 523(a)(3)(B), the court required at least 30 days' notice or knowledge of the bankruptcy to satisfy Section 523(a)(3)(B)); *In re Crumley*, 73 B.R. 996 (Bankr. E.D. Tenn. 1987) (due process required acceptance of creditor's late filed Section 523(a)(2), (4) or (6) objection because creditor was without notice of bar date); *Shaheen v. Penrose (In re Shaheen)*, 174 B.R. 424 (E.D. Va. 1994) (30-day notice required by Bankruptcy Rule applied to objections to discharge and thus late filed complaint was timely where creditor received notice of bankruptcy only 12 days before bar date).

For dischargeability issues not within the exclusive jurisdiction of the bankruptcy court, under Rule 4007(b), these complaints may be filed at any time. There is no bar date for filing complaints based on alimony and child support, driving while intoxicated, student loans, and taxes. These types of debts are not automatically discharged. Thus, in these instances, a debtor may have an incentive to bring the complaint in the form of a declaratory judgment action.

Under Bankruptcy Rule 1019(2), if a Chapter 11 case is converted to Chapter 7, a new filing period commences. If the Chapter 11 case partially concluded by way of a confirmed plan, that confirmed plan discharged the debt and the new time period can be used only for post confirmation issues of discharge. *In re Pavlovich*, 952 F.2d 114 (5th Cir. La. 1992) (conversion to Chapter 7 after confirmation of individual debtor's Chapter 11 plan precludes creditors whose claims were dealt with under the plan from challenging discharge or dischargeability; however, creditor may challenge discharge based on post-confirmation conduct). Further, if a case started as a Chapter 7, converts to a Chapter 11 and then is converted back to a Chapter 7, there is some authority that the reconversion will not start a new period. *See, e.g., F & M Marquette Nat. Bank v. Richards*, 780 F.2d 24 (8th Cir. Minn. 1985) (reconversion did not start new period)*; In re Jones*, 966 F.2d 169 (5th Cir. Tex. 1992) (reconversion did start a new period for filing objections to discharge pursuant to Fed. R. Bankr. P. 1019(2) and 4004).

I.1.2.2. If you don't know the bar date, find it out.

A creditor with actual notice of the bankruptcy but not the bar date must take reasonable steps to ascertain the bar date or lose the right to object. *In re Sam*, 894 F.2d 778 (5th Cir. 1990)*; In re Rhodes*, 61 B.R. 626 (Bankr. 9th Cir. Cal. 1986).

I.1.2.2 File the Complaint or File the Extension.

On the bar date, the creditor must file the complaint or the extension. Some courts have held that the motion is made upon filing. *See In re Miller*, 188 B.R. 1021 (Bankr. S.D. Fla. 1995) (motion to extend bar date pursuant to Bankruptcy Rule 4007(c) is "made" when filed with court, not when served on debtor). However other courts hold that a motion is "made" when it is served on the debtor as long as the motion is filed within a reasonable time after service. *E.g.*, *In re Friscia*, 123 B.R. 9 (Bankr. E.D.N.Y. 1991). The Eleventh Circuit has adopted the former approach and requires the filing of the motion. *Coggin v. Coggin (In re Coggin)*, 30 F.3d 1443 (11th Cir. Ala. 1994).

I.1.2.3. Others can't obtain an extension for the creditor.

The Chapter 7 panel trustee and the Chapter 13 panel trustee doesn't have the ability to get an extension on behalf of creditors to object to discharge. *In re Farmer,* 786 F.2d 618 (4th Cir. 1986)*; Vaccariello v. Lagrotteria*, 43 B.R. 1007 (N.D. Ill. 1984); *but see Marshall v. Demos (In re Demos)*, 57 F.3d 1037 (11th Cir. 1995) (the court "validly entered" order granting motion by Chapter 7 trustee to extend the time for all creditors to file objections to discharge).

I.1.3. Allege the entire factual basis for the creditor's claim.

An amendment to a complaint objecting to discharge that changes the legal theory or adds another claim arising out of the same transaction or occurrence relates back to the original complaint. *In re Tester*, 56 B.R. 208 (W.D. Va. 1985) (Code § 523(a)(4) complaint permitted to be amended to add § 523(a)(6) claim). Thus, if the creditor has alleged all of the factual basis for asserting an objection to discharge, the creditor stands a better chance of the court determining in its favor that "the amended pleading arose out of the conduct, transaction, or occurrence set forth or attempted to be set forth in the original pleading." Fed. R. Civ. P. 15(c)(2). For a discussion of the application of Bankruptcy Rule 7015 (which incorporates Fed. R. Civ. P. 15); see also *Flexi-Van v. Perez (In re Perez)*, 172 B.R. 284 (Bankr. E.D.N.Y. 1994)(amendment in discharge context); *In re Gunn*, 111 B.R. 291

(Bankr. 9th Cir. Cal. 1990) (complaint alleging §§ 523(a)(2)(A) and (B) and 727(a)(5) causes of action amended after two years of discovery to allege § 727(a)(3) and (4) because all claims arose out of same transaction); *CIT Group/Factoring Mfrs. Hanover, Inc. v. Srour*, 138 B.R. 413 (Bankr. S.D.N.Y. 1992) (action under Code § 727(a)(2) and (4) amended to seek relief under § 523(a)(4), because claims arose out of the same conduct, transaction or occurrence); *Bank of Chester County v. Cohen*, 139 B.R. 327 (Bankr. E.D. Pa. 1992) (complaint originally filed under § 523(a)(2)(A) amended to assert Section 523(a)(2)(B) and 727(a)(2)(A) where actions in the amended complaint were based on the same conduct, transaction and occurrence as the original); but see *In re Union Bank of Middle East, Ltd.*, 127 B.R. 514 (E.D.N.Y. 1991) (amendment of Code § 523(a)(2)(A) complaint to include § 523(a)(4) claim not allowed); *In re Harrison*, 71 B.R. 457 (Bankr. D. Minn. 1987) (§ 727(a) claim was not sufficiently similar to § 523(a)(6)); *Rufenacht, Bromagen, & Hertz, Inc. v. Russell*, 69 B.R. 394 (D. Kan. 1987) (§ 727 complaints may be timely amended to assert a § 523 claim); *In re McClellan*, 60 B.R. 719 (Bankr. E.D. Va. 1986) (amendment from § 727(a)(2) relief to action under § 523(a)(2) was not allowed); *In re Grant*, 45 B.R. 262 (Bankr. D. Me. 1984) (§ 727 complaint could not be amended to allege § 523 cause of action because of "insufficient identity" between claims).

I.1.4. Don't ask for a jury trial

Discharge proceedings are equitable actions tried without juries. *In re Hallahan*, 936 F.2d 1496 (7th Cir. 1991)*; In re Johnson*, 110 B.R. 433 (Bankr. W.D. Mo. 1990)*; but see In re Jensen*, 946 F.2d 369 (5th Cir. 1991) (in dicta suggesting that debtor did not waive the right to a jury trial but denying debtor jury trial because creditor filed a proof of claim regarding the debt); *Longo v. McLaren (In re McLaren)*, 3 F.3d 958 (6th Cir. Ohio 1993). Even when the creditor seeks a money judgment, the bankruptcy court gets to make the determination. *In re*

McLaren, 3 F.3d 958 (6th Cir. 1993); *In re Hallahan*, 936 F.2d 1496 (7th Cir. 1991); *Harris v. U.S. Fire Ins. Co.*, 162 B.R. 466 (E.D. Va. 1994); *Citibank (South Dakota) N.A. v. Fisher (In re Fisher),* 186 B.R. 70 (Bankr. W.D. Ky. 1995).

In situations involving personal injury torts, the claim must be determined by the District Court and the parties are still entitled to a jury trial on the claim itself. See 28 U.S.C. §1411. Nevertheless, the question of discharge is determined by the court. *See In re Thompson,* 140 B.R. 979 (N.D. Ill. 1992).

I.1.5. The Creditor has the burden of proof.

The creditor has the burden to prove that the claim is not subject to discharge by a preponderance of the evidence. *Grogan v. Garner,* 498 U.S. 279, 111 S.Ct. 654, 112 L. Ed. 2d 755 (1991).

I.1.5.1. Collateral Estoppel.

If a state court has already made a determination, the Creditor may be benefitted by the doctrine of collateral estoppel or issue preclusion. *Grogan v. Garner,* 498 U.S. 279, 111 S. Ct. 654, 112 L. Ed. 2d 755 (1991). But you still need to show that the elements of the claim made in state court are the same elements associated with the Bankruptcy Court's determination of dischargeability. *In re Tsamasfyros*, 940 F.2d 605 (6th Cir. Ohio 1981). The elements of issue preclusion are (1) the issue to be decided by the bankruptcy court is identical to that involved in the prior litigation, (2) the issue was actually litigated, (3) the issue was determined by a valid and final judgment, (4) the determination of the issue was essential to the judgment, and (5) the standard of proof in the prior litigation was at least as high as the standard in the present litigation. *Spilman v. Harley*, 656 F.2d 224 (6th Cir. Ohio 1981). The application of issue preclusion will be discussed with the substantive aspects of the suit below.

I.1.6. Use caution when settling nondischargeable obligations.

It has been held that where an obligation was created from embezzlement and this obligation is settled through a promissory note to repay and release, the debt has been held to be dischargeable absent fraud surrounding the note. *In re West*, 22 F.3d 775 (7th Cir. 1994); *but see United States v. Spicer*, 57 F.3d 1152 (D.C. Cir. 1995), *cert. denied*, 116 S.Ct. 701, 133 L. Ed. 2d 658 (1996) (type of debt is not altered through settlement agreement as settlement "makes the dishonest debtor no more honest, and no more entitled to relief").

I.2. The Substantive Aspects of Objecting to Discharge

Section 523(a) provides that the following debts are not discharged: (1) certain kinds of taxes, (2) claims created by certain wrongful acts of the debtor, (3) unlisted and unscheduled claims; (4) claims resulting from the fraud or defalcation by a fiduciary, (5) alimony, maintenance and support for a spouse or child, (6) willful and malicious injury, (7) fines, penalties and forfeitures to a governmental unit, (8) student loans, (9) claims of wrongful death or personal injury resulting from the operation of a motor vehicle while intoxicated, (10) claims surviving prior bankruptcies, (11 and 12) claims relating to federally insured depository institutions, (13) restitution orders, (14) debts incurred to pay a tax that wasn't dischargeable, (15) claims associated with a divorce degree or settlement agreement not provide for in Section 523(5), (16) post petition fees or assessments by homeowners associations, (17) fees for filing cases, motions, complaints or appeals, and (18) funds owed to a state or state agency for support. This paper will discuss each of these sections in turn.

I.2.1. Certain taxes.

The following taxes and customs duty are excepted discharge:

(A) Taxes and duties entitled to priority;

(B) Taxes for which a return was never filed or was late-filed less than two years before the bankruptcy case commenced; and

(C) Taxes associated with the debtor's filing of a fraudulent return or willful attempt to evade or defeat a tax.

11 U.S.C. §523(a)(1). Other than these specifically enumerated exceptions, taxes are generally discharged in bankruptcy. If the underlying tax obligation is not dischargeable, pre-petition interest, post petition interest and penalties on these taxes are not dischargeable. *In re Larson*, 862 F.2d 112 (7th Cir. 1988) (pre-petition interest); *In re Hanna*, 872 F.2d 829 (8th Cir. 1989)(post petition interest); *In re Burns*, 887 F.2d 1541 (11th Cir. 1989) (post petition interest); 11 USC § 523(a)(7) (fines, penalties, and forfeitures payable to a governmental unit are exempt from discharge); *but see In re Woodward*, 113 B.R. 680 (Bankr. D. Or. 1990) (citing cases holding that post-petition interest is dischargeable). Non compensatory tax penalties are generally dischargeable.

I.2.1.1 Priority Taxes.

Section 523(a)(1)(A) excepts from discharge the debtor's obligation to pay: (1) withholding taxes, (2) recently incurred taxes, and (3) taxes incurred during the period of time between an involuntary petition and the court's appointment of a trustee or order for relief. 11 USC § 507(a)(2), incorporating 11 USC § 502(f). This section incorporates Sections 507(a)(2) and 507(a)(8) in determining the dischargeability of the taxes. Both secured tax claims and unsecured tax claims are not discharged. *See In re Latulippe*, 13 B.R. 526 (Bankr. D. Vt. 1981) (the legislative history expresses an intent to make secured, as well as unsecured, tax claims nondischargeable).

To get the bankruptcy court to make a determination of whether certain taxes are dischargable, the debtor may desire to bring the action. *See* §523(c). Further, the provision in this section that provides for the continuing of the debt beyond bankruptcy "whether or not a claim" has been filed appears to be quite ominous. Specifically, the Tenth Circuit has found that the Internal Revenue Service may make a claim for taxes for a particular year, accept thedistribution provided by the Bankruptcy Court, and then audit the records to make additional claims for that same year. *DePaolo v. United States ex rel. IRS (In re DePaolo),* 45 F.3d 373 (10th Cir. Wyo. 1995).

Generally, the taxes and customs duties excepted from discharge fall within the following categories:

(1) taxes on or measured by income or gross receipts; 11 USC §507(a)(8)(A)

(2) assessed property taxes; 11 USC § 507(a)(8)(B). See also *In re Davis,* 11 B.R. 621 (Bankr. N.D. Tex. 1981) (the term "assessed" includes the procedure by which the property is listed, valued, and the pro rata tax claim determined).

(3) taxes required to be collected or withheld and for which the debtor is liable in any capacity (“trust fund taxes”); 11 USC § 507(a)(8)(C). See *In re King*, 117 B.R. 339 (Bankr. W.D. Tenn. 1990) (state sales taxes are nondischargeable trust fund taxes); *In re Fernandez,* 130 B.R. 757 (Bankr. W.D. Mich. 1991) (100% penalty for failure of responsible party to pay withholding taxes is included in this section rather than Section 523(a)(7) on penalties); *United States v. Sotelo,* 436 U.S. 268, 98 S. Ct. 1795, 56 L. Ed. 2d 275 (1978) (under Bankruptcy Act 100% penalty on this section and not under penalty section).

(4) certain employment taxes; 11 USC § 507(a)(8)(D).

(5) certain excise taxes; 11 USC § 507(a)(8)(E). See *In re Payne,* 27 B.R. 809 (Bankr. D. Kan. 1983) (excise tax is a tax "imposed on the performance of an act, the engaging in an occupation or the enjoyment of a privilege"); *In re Grynberg,* 986 F.2d 367 (10th Cir. Colo. 1993), *cert. denied*, 114 S.Ct. 57, 126 L. Ed. 2d 27 (1993) (excise taxes include gift taxes); *In re Beaman,* 9 B.R. 539 (Bankr. D. Or. 1980) (excise tax includes amount to be paid to State in repayment for uninsured debtor's employee’s injuries); *Yoder v. Ohio Bureau of Workers' Compensation (In re Suburban Motor Freight),* 998 F.2d 338 (6th Cir. 1993) (unpaid workers' compensation premiums are excise taxes).

(6) customs duties on certain imported merchandise; 11 U.S.C. §507(a)(8)(F).

(7) any penalty in compensation for actual pecuniary loss. 11 U.S.C. §507(a)(8)(G).

The only type these taxes that aren't limited to a specific period of time (either two years pre-petition or three years prepetition) are "trust fund taxes". *Rosenow v. Illinois, Dept. of Revenue,* 715 F.2d 277 (7th Cir. Ill. 1983). Most of the taxes are given priority only for a limited time. This temporal aspect also affects the payment of the tax claims. If necessary for an effective reorganization, the court may instruct the taxing authority to apply payments to non-dischargeable taxes prior to applying payments to dischargeable taxes claims. *United States v. Energy Resources Co.,* 495 U.S. 545, 110 S.Ct. 2139, 109 L. Ed. 2d 580 (1990). However, courts have rejected the debtor's request to instruct the taxing authority as to the application of the payments in a Chapter 7 or liquidating Chapter 11 setting. *See In re Schilling*, 177 B.R. 862 (Bankr. N.D. Ohio 1995) (declining to instruct Internal Revenue Service as to allocation of tax payments between dischargeable and nondischargeable tax obligations in a Chapter 7 case); *In re Suburban Motor Freight,* 161 B.R. 640 (S.D. Ohio 1993) (not applicable to Chapter 7 corporate debtor); *but see In re Deer Park,* 136 B.R. 815 (Bankr. 9th Cir. Cal. 1992) (debtor can direct application in liquidating Chapter 11 plan), *aff'd,* 10 F.3d 1478 (9th Cir. 1993).

If a surety pays the claim, under some cases, that surety is subrogated to the rights of the taxing authority to the extent that the surety's claim is rendered not dischargeable. *In re Fields,* 926 F.2d 501 (5th Cir. 1991), *cert. denied*, 112 S.Ct. 371, 116 L. Ed. 2d 323 (1991); *In re Waite*, 698 F.2d 1177 (11th Cir. 1983), *reh'g denied*, 703 F.2d 582 (11th Cir. 1983), *reh'g denied*, 703 F.2d 582 (11th Cir. Ga. 1983) *but see National Collection Agency, Inc. v. Trahan,* 624 F.2d 906 (9th Cir. 1980) (decided under the bankruptcy act).

I.2.1.2 Late Filed Taxes.

If the Debtor fails to file a return or filed a late return within the two years immediately preceeding the bankruptcy case, Section 523(a)(1)(B) excepts from discharge debts the debts relating to the return. The debtor's intent or lack of knowledge concerning the requirement to pay the tax is not a defense to an objection to discharge under this section. *Spain v. United States (In re Spain)*, 182 B.R. 233 (Bankr. S.D. Ill. 1995). Similarly, even though 26 U.S.C. §602(b)(1) allows the Secretary of the Treasury to prepare a substitute return, this substitute return is not equivelent to the tax payer filing a return. *In re Bergstrom*, 949 F.2d 341 (10th Cir. Wyo. 1991); *In re Pruitt*, 107 B.R. 764 (Bankr. D. Wyo. 1989); *In re Hofmann*, 76 B.R. 853 (Bankr. S.D. Fla. 1987); *Delaney v. United States (In re Delaney)*, 177 B.R. 251 (Bankr. E.D. La. 1994); *but see Gless v. USA/IRS (In re Gless)*, 181 B.R. 414 (Bankr. D. Neb. 1993) (where debtor cooperated with the Secretary of the Treasury in preparing and filing the return).

If the return is filed but the filing is late the government is afforded at least two years to effect collection before the debtor can discharge the debt. At the same time, if the debtor completely fails to file a tax return, taxes for years ending within three years are also excepted from discharge. 11 USC § 507(a)(8)(A)(i) (incorporated into 11 USC § 523 by subsection (a)(1)(A)). The three-year period begins on the date the return is originally due. *Pan American Van Lines v. United States*, 607 F.2d 1299 (9th Cir. Cal. 1979); *In re Wood*, 866 F.2d 1367 (11th Cir. Fla. 1989).

I.2.1.3 Fraudulent Return or Willful Attempt to Evade Tax.

Section 523(a)(1)(C) provides that debts for taxes relating to fraudulent returns or for which the debtor "willfully attempted in any manner to evade or defeat such tax" are nondischargeable. *Cassidy v. Commissioner*, 814 F.2d 477 (7th Cir. 1987). Acts such as (1) claiming an imaginary child as a dependent have been determined to fall within this exception to discharge (*In re Harris*, 59 B.R. 545 (Bankr. W.D. Va. 1986)); (2) using false W-2 Forms *(In re Gilder*, 122 B.R. 593 (Bankr. M.D. Fla. 1990)*; Ketchum v. United States*, 177 B.R. 628 (E.D. Mo. 1995); and (3) titling real property in the names of others to evade the taxes *(In re Jones*, 116 B.R. 810 (Bankr. D. Kan. 1990).

The Internal Revenue Service has the burden of proof to establish: (1) debtor's knowledge of the falsehood; (2) debtor's intent to evade the taxes; and (3) an underpayment of taxes. *Brackin v. United States, IRS*, 148 B.R. 953 (N.D. Ala. 1992); *In re Kirk*, 98 B.R. 51 (Bankr. M.D. Fla. 1989); *In re Hopkins*, 133 B.R. 102 (Bankr. N.D. Ohio 1991). The court applies a the totality of circumstances test in determing each of these three elements. *Berzon v. United States*, 145 B.R. 247 (Bankr. N.D. Ill. 1992); *In re Kirk*, 98 B.R. 51 (Bankr. M.D. Fla. 1989). Intent is inferred from such factors as significant understatements, failure to file returns, habitual late filings, failure to cooperate with the IRS, and implausible or inconsistent behavior. *Toti v. United States*, 149 B.R. 829 (E.D. Mich. 1993), *aff'd*, 24 F.3d 806 (6th Cir. Mich. 1994), *cert. denied*, 115 S.Ct. 482, 130 L. Ed. 2d 395 (1994); *In re Jones*, 116 B.R. 810 (Bankr. D. Kan. 1990).

The courts hold that any attempt to evade or defeat a tax, including omissions and commisions, and any willful attempt to avoid paying a tax fall within this provision. *Toti v. United States (In re Toti)*, 24 F.3d 806 (6th Cir. Mich. 1994), *cert. denied*, 115 S.Ct. 482, 130 L. Ed. 2d 395 (1994) (acts of omission and comission fall within Section 523(a)(1)(C)); *Bruner v. United States (In re Bruner)*, 55 F.3d 195 (5th Cir. La. 1995) (following Toti); *but see Internal Revenue Code. Haas v. IRS (In re Haas)*, 48 F.3d 1153 (11th Cir. Ala. 1995) (Congress, which knew how to distinguish between evasion of tax and evasion of payment and this section does not apply to evasion of payment); *see generally*, *Ketchum v. United States*, 177 B.R. 628 (E.D. Mo. 1995) (a good discussion of the case law).

I.2.2. For Claims When the Debtor made False Representations.

The dischargeability of claims based upon false representations made by the debtor fall within two categories (1) false representations other than a statement respecting financial condition and (2) false statements relating to financial conditions.

I.2.2.1. Not relating to financial condition.

The distinction between "false pretenses, a false representation, or actual fraud" appears to be the level of intentional conduct. "The 'fraud' referred to . . . means positive fraud, or fraud in fact, involving moral turpitude or intentional wrong . . .". *Neal v. Clark,* 95 U.S. 704, 24 L. Ed. 586 (1878); *In re Black,* 787 F.2d 503 (10th Cir. 1986); *Stanley H. Silverblatt Electrical Contractor, Inc. v. Marino,* 139 B.R. 380 (Bankr. D. Md. 1992). Actual fraud may also form the basis for an objection to discharge under Section 523(a)(6) for willful and malicious injury. *See Printy v. Dean Witter Reynolds, Inc.,* 110 F.3d 853 (1st Cir. 1997) (surveying circuit court opinions from the Third, Fourth, Fifth, Sixth, Eighth, Ninth, and Eleventh circuits interpreting "malicious").

The elements of a cause of action under this portion Section 523(a)(1)(A), appear to be:

1. A present material misrepresentation, either oral or in writing. *See In re Buttendorf,* 11 B.R. 558 (Bankr. D. Vt. 1981) (promises of future performance are insufficient); *In re Bogstad,* 779 F.2d 370 (7th Cir. 1985) (an important or substantial misrepresenation is needed); *Engler v. Van Steinburg,* 744 F.2d 1060 (4th Cir. 1984) (representation may be made orally or in writing); *In re Van Horne,* 823 F.2d 1285 (8th Cir. Iowa 1987) (silence or concealment may constitute the false representation).

2. Knowledge that the representation is false. *In re Colvin,* 117 B.R. 484 (Bankr. E.D. Mo. 1990) (discharge granted where mentally challenged debtor did not know the falsity of her statements); see also *Morimura, Arai & Co. v. Taback*, 279 U.S. 24, 73 L. Ed. 586, 49 S. Ct. 212 (1929) ("reckless indifference to actual facts" is equivalent to intentional misrepresentation).

3. Intent to defraud or deceive. *In re Devers,* 759 F.2d 751 (9th Cir. 1985); *FDIC v. Reisman,* 149 B.R. 31 (Bankr. S.D.N.Y. 1993) (intent to deceive may be inferred from surrounding circumstances). This intention is usually determined by the totality of the cicumstances surrounding the representation. *Sinclair Oil Corp. v. Jones (In re Jones),* 31 F.3d 659, (8th Cir. 1994).

4. Justifiable Reliance by the creditor. *Field v. Mans,* 133 L. Ed. 2d 351, 116 S. Ct. 437 (1995); *See Greenfield State Bank v. Copeland,* 330 F.2d 767 (9th Cir. Cal. 1964) (no reliance in fact because the loan was granted before the representation); *In re Geyen,* 11 B.R. 70 (Bankr. W.D. La. 1981) (after the fact representations were not relied upon); *City Bank & Trust Co. v. Vann (In re Vann),* 67 F.3d 277 (11th Cir. 1995) (justifiable reliance means a creditor's conduct should be determined by the creditor's own capacity and knowledge); *In re Kirsh,* 973 F.2d 1454 (9th Cir. Cal. 1992) ("justifiable reliance" is required not "actual reliance" or "reasonable reliance").

5. Damage. *In re Collins,* 946 F.2d 815 (11th Cir. 1991); *In re Siriani,* 967 F.2d 302 (9th Cir. 1992).

As to these elements it should be understood that the courts are continually developing the concept of common law fraud and this area will incorporate that development. *Wingate v. Attalla (In re Attalla),* 176 B.R. 650 (Bankr. D.N.H. 1994) (Section 523(a)(2)(A) "has always been understood to incorporate common law development" of the concept).

I.2.2.2. Relating to Financial Conditions.

Section 523(a)(2)(B) requires that these representations be: (1) in writing, (2) material, (3) reasonably relied upon, and (4) made with the intention to deceive. The second and fourth elements are the same as the elements provided for under Section 523(a)(2)(A).

The first element is that representations relating to financial condition must be in writing. Oral statements relating to financial condition do not form the basis for an objection to discharge. *Engler v. Van Steinburg,* 744 F.2d 1060 (4th Cir. 1984) (oral statement that property not subject to liens insufficient).

The third element, reasonable reliance, is a higher burden and requires more than just "justifiable reliance." Some courts require the creditor to show that it engaged in further investigation of the written financial statement of the debtor. *Kentile Floors, Inc. v. Winham,* 440 F.2d 1128 (9th Cir. Ariz. 1971) (creditor "acted unreasonably if it acted upon the . . . statement in extending credit without any further investigation."); *see also In re Smith,* 424 F. Supp. 858 (M.D. La. 1976); *Sweet v. Ritter Finance Co.,* 263 F. Supp. 540 (W.D. Va. 1967). The further investigation requirement appears to require the creditor to merely follow industry practices in relying upon the financial statement. *See In re Patch,* 24 B.R. 563 (D. Md. 1982); *In re Ardelean,* 28 B.R. 299 (Bankr. N.D. Ill. 1983).

In renewal situations, when the false documentation is only part of the renewal, the courts are split on whether a creditor must provide "new money" as a necessary element. *In re Gerlach,* 897 F.2d 1048 (10th Cir. Colo. 1990) (new money not required); *Cho Hung Bank v. Kim (In re Kim),* 62 F.3d 1511 (9th Cir. Cal. 1995) (although no additional money was provided, the court required an extension of repayment due date to form consideration associated with nondischargeability under Code § 523(a)(2)). For the courts requiring consideration, some hold that only the amount of the "new money" is except from discharge. *In re Barnacle,* 44 B.R. 50 (Bankr.

D. Minn. 1984); *In re Wright,* 52 B.R. 27 (Bankr. W.D. Pa. 1985); *In re Curl,* 64 B.R. 14 (Bankr. W.D. Mo. 1986). Other courts except the debt represented by both the previous obligation and new money. *In re Carter,* 11 B.R. 992 (Bankr. M.D. Tenn. 1981); *In re Greenidge,* 75 B.R. 245 (Bankr. M.D. Ga. 1987); *In re Duncan,* 123 B.R. 383 (Bankr. C.D. Cal. 1991).

When the documentation is part of the original loan procedure, the debt arising from a renewal of the loan is should also be nondischargeable. *In re Liming,* 797 F.2d 895 (10th Cir. Okla. 1986) (creditor should not be forced to call loan after discovering falsity of financial statement in order to maintain rights). The idea is that a debtor shouldn't be able to benefit from a renewal because the renewal "makes the dishonest debtor no more honest, and no more entitled to relief Congress intended to reserve for the honest debtor." *United States v. Spicer,* 57 F.3d 1152 (D.C. Cir. 1995), *cert. denied,* 116 S.Ct. 701, 133 L. Ed. 2d 658 (1996)*; see also Fuller v. Johannessen (In re Johannessen),* 76 F.3d 347 (11th Cir. Fla. 1996) ("the debtor's fraud should not be discharged simply because the debtor entered into a settlement agreement.").

I.2.2.3 Purchasing of luxury goods on the eve of bankruptcy

It is generally thought that when a debtor makes a purchase using a credit card, the debtor is impliedly representing that he intends to pay the credit card company for that purchase. *American Express Travel Related Servs. Co. v. Mc Kinnon (In re Mc Kinnon),* 192 B.R. 768 (Bankr. N.D. Ala. 1996) (majority of courts have adopted the implied representation theory); *Colonial Nat'l Bank USA v. Leventhal (In re Leventhal),* 194 B.R. 26 (Bankr. S.D.N.Y. 1996) (same). Because of this general theory, in the Bankruptcy Amendments and Federal Judgship Act of 1984, Congress adopted an subsection (C) to Section 523(a)(2). Basically, Section 523(a)(2)(C) excepts from discharge luxury purchases.

The Bankruptcy Reform Act of 1994 amended Section 523(a)(2)(C) by increasing the monetary values assocaited with luxury purchases. Specifically, consumer debts of more than $1,000 owing to a single creditor for luxury goods or services which are incurred within 60 days of the bankruptty petition are now presumed to be excepted from discharge. In additin, if the debtor received aggregate cash advances during the 60 days immediately preceding the bankruptcy of more than $1,000, these advances are presumed to be excepted from discharge. Advances for goods and services reasonably necessary to support the debtor or the debtor's dependents are not "luxury goods and services." *In re Koch,* 83 B.R. 898 (Bankr. E.D. Pa. 1988); *In re Claar,* 72 B.R. 319 (Bankr. M.D. Fla. 1987); *In re Smith,* 54 B.R. 299 (Bankr. S.D. Iowa 1985).

I.2.3. Unscheduled and Unlisted Creditors.

Section 523(a)(3) divides creditors into two categories: (1) those creditors that have claims against the debtor because of the debtor's wrongful acts under Section 523(a)(2), Section 523(a)(4) and Section 523(a)(6), and (2) all other creditors.

I.2.3.1 Creditors having claims "of the kind" specified under 523(a)(2), (4) and (6).

If the creditor is not scheduled and doesn't have knowledge of the bankruptcy in time to file a dischargeability complaint, the creditor's claim is not discharged under this section. Courts have not yet determined the extent to which a creditor must show that his claim is "of the kind" specificed under Section 523(a)(2), (4) and (6). Some require a full trial of the claim others require a lesser degree of proof. See *Fidelity Nat'l Title Ins. Co. v. Franklin (In re Franklin),* 179 B.R. 913 (Bankr. E.D. Cal. 1995) (full trial with applicable substatnive law and proof for unscheduled fraud claim); *In re Haga,* 131 B.R. 320 (Bankr. W.D. Tex. 1991) (creditor need only show it has "a viable or colorable claim"); *In re Thompson*, 177 B.R. 443 (Bankr. E.D.N.Y. 1995) (debtor has burden of proof to show not a claim under Section 523(a)(2), (4) or (6)).

I.2.3.2 For creditors with claims not "of the kind" specified under 523(a)(2), (4) and (6).

For the second set of creditors, if the debtor knows of the creditor and fails to list and schedule the creditor, the claim is not discharged by the bankruptcy proceeding, unless the creditor receives notice or has actual knowledge of the filing of the bankruptcy in time to file a proof of claim. If the debtor knows of the creditor and knows the correct address of the creditor, the claim is similarly not discharged if the debtor fails to correctly list the creditor. *In re Gelman,* 5 B.R. 230 (Bankr. S.D. Fla. 1980) (exception applies where, knowing correct address, debtor gave wrong address and creditor had no actual knowledge of case); *Beverly Lumber Co. v. Nicholson (In re Nicholson),* 170 B.R. 153 (Bankr. W.D. Mo. 1994) (proper list includes viable addresses); *In re Faden,* 170 B.R. 304 (Bankr. S.D. Tex. 1994) (notice to subsidiary of creditor insufficient).

I.2.3.3 Notice of Knowledge requirement.

If the creditor has notice or knowledge of the bankruptcy, even though unscheduled and unlist, the creditor bears the burden of finding out the bar dates and filing a proof of claim. *In re Price,* 79 B.R. 888 (Bankr. 9th Cir. 1987), *aff'd,* 871 F.2d 97 (9th Cir. 1989). However, the creditor must receive the information by more than rumor. *In re Stratton,* 29 B.R. 93 (Bankr. W.D. Ky. 1983) (unsubstantiated rumor of bankruptcy is not sufficient); *In re Bosse,* 122 B.R. 410 (Bankr. C.D. Cal. 1990) (mere statement of intent to file made by debtor insufficient). The knowledge has to be (1) that the case was actually filed and (2) the location of the bankruptcy. *In re Layman,* 131 B.R. 495 (M.D. Fla. 1991).

If no bar debt for filing proofs of claims is set, such as a no-asset Chapter 7 case, the Bankruptcy Court for the District of South Carolina has held that it is technically never too late to file a timely proof of claim. Thus, the Bankruptcy Court for the District of South Carolina has concluded that an unscheduled creditor in a no-asset Chapter 7 case cannot take advantage of the exception provided by Code § 523(a)(3)(A) and the claim is discharged. In re Gardner, 194 B.R. 576 (Bankr. D.S.C. 1996). The Bankruptcy Court for the District of South Carolina has not addressed the issue of whether the Court should reopen a bankrutpcy case where an unscheduled debt was the result of an intentional design, fraud, or improper motive rather than due solely to negligence or inadvertence. *Stone v. Caplan (In re Stone),* 10 F.3d 285, 291 (5th Cir. 1994) (if part of an intentional design, fraud or improper motive, failure to include claim in no asset bankruptcy would render claim not subject to discharge).

I.2.4. Fraud and defalcation by a Fiduciary, embezzlement or larceny.

If the debtor acted in a fiduciary capacity, Section 523(a)(4) provides that the claims of fraud and defalcation against the fiduciary are not subject to discharge. In addition, all acts of embezzelment and larceny are exempted from discharge whether or not the debtor was acting in a fidiciary capacity.

I.2.4.1 Fraud by a fiduciary.

The fraud associated with a fiduciary's actions appears to be similar to the fraud found in Section 523(a)(2), however, the burden upon the creditor is lessened by the fiduciary's duty of good faith, loyalty and full disclosure. In addition, the creditor appears to have the right to rely upon the fiduciary as a matter of law.

The definition of "fiduciary" includes persons acting under an objectively manifested, pre-existing, and binding relationship. *Davis v. Aetna Acceptance Co.*, 293 U.S. 328, 55 S.Ct. 151, 79 L. Ed. 393 (1934); *LSP Investment v. Bennett,* 989 F.2d 779 (5th Cir. Tex. 1993); *Lewis v. Scott (In re Lewis),* 97 F.3d 1182 (9th Cir. 1996).

The express trust may arise from contract, from statute, or may be inferred from conduct but some courts have required an identifiable trust corpus. *Evans v. Pollard (In re Evans),* 161 B.R. 474 (9th Cir. 1992) (breach of general fiduciary obligations are insufficient and claim must involve money or property entrusted to the fiduciary). Even though the trust may be inferred, this exception has been held not to apply to equitable, implied or constructive trusts. *In re Stone,* 91 B.R. 589 (D. Utah 1988); *In re Freeman,* 101 B.R. 698 (Bankr. E.D. Okla. 1989).

I.2.4.2 Defalcation by a fiduciary.

Defalcation is the "misappropriation of trust funds or money held in a fiduciary capacity; failure to properly account for such funds." Black's Law Dictionary, (5th Ed. 1961); *see also In re Matheson,* 10 B.R. 652 (Bankr. S.D. Ala. 1981) (using trust fund for any purpose other than the intended purpose constitutes defalcation); *In re Duttenhofer,* 12 B.R. 926 (Bankr. C.D. Cal. 1981) (inability to account for use of trust funds is defalcation); *In re Beach,* 13 B.R. 759 (Bankr. M.D. Ala. 1981) (failure to account for and turn over money collected is defalcation); *In re Gonzales,* 22 B.R. 58 (Bankr. 9th Cir. Cal. 1982) (misapplying construction funds is defalcation). Defalcation does not require an intentional conduct and may simply be a willful neglect of duty. *See In re Moreno,* 892 F.2d 417 (5th Cir. 1990).

Upon insolvency, corporate officers and directors are fiduciaries of the creditors of the corporation. *In re Bernard,* 87 F.2d 705 (2d Cir. N.Y. 1937) (based on common law and statute, the Honorable Learned Hand found a fiduciary relationship between corporate officers and creditors); *See also In re Long,* 774 F.2d 875 (8th Cir. 1985) (upon insolvency, director has a fiduciary duty owing to creditors); *In re Chavez,* 140 B.R. 413 (Bankr. W.D. Tex. 1992) (complaint filed against former president and chief executive officer of bank for defalcation); *Berres v. Bruning,* 143 B.R. 253 (D. Colo. 1992) (common law creates a fiduciary relationship upon insolvency). In this context, defalcation occurs when "a payment by an officer of his own claim, or that of another officer, . . . when he knew that the corporation was insolvent and that the interests of other creditors would be sacrificed for the benefit of its fiduciaries." *In re Bernard,* 87 F.2d 705 (2d Cir. N.Y. 1937). Defalcation may also occur when the director or officer transfers property to himself or herself. *Lawrence T. Lasagna, Inc. v. Foster,* 609 F.2d 392 (9th Cir. 1979), *cert. denied,* 446 U.S. 919, 100 S.Ct. 1853, 64 L. Ed. 2d 273 (1980); *In re Metz,* 6 F.2d 962 (2d Cir. N.Y. 1925).

Also, general partners of a limited partnership and managing partners are often found to be fiduciaries of the partnership. *Bennett v. Bennett (In re Bennett),* 989 F.2d 779 (5th Cir. 1993), *reh'g, en banc, denied*, 993 F.2d 1545 (5th Cir. 1993) (managing partner of limited partnership is a fiduciary); *In re Short,* 818 F.2d 693 (9th Cir. 1987) (managing joint venturer was a fiduciary); *Cundy v. Woods (In re Woods),* 175 B.R. 78 (Bankr. D. Colo. 1994) (joint venturers and management committee members have fiduciary obligations). The law is less clear on general partners of a general partnership. *See LSP Investment v. Bennett,* 989 F.2d 779 (5th Cir. Tex. 1993), *reh'g, en banc, denied,* 993 F.2d 1545 (5th Cir. Tex. 1993) (citing cases finding the general partner is a fiduciary in footnote 6 and citing cases finding that the general partner is not a fiduciary in footnote 7).

I.2.4.3 Embezzelment.

"Embezzlement" is defined as "the fraudulent appropriation of property by a person to whom such property has been entrusted or into whose hands it has lawfully come." *Chrysler First Commercial Corp. v. Nobel (In re Nobel),* 179 B.R. 313 (Bankr. M.D. Fla. 1995); *In re Jardula,* 122 B.R. 649 (Bankr. E.D.N.Y. 1990) (quoting *Moore v. United States,* 160 U.S. 268, 16 S.Ct. 294, 40 L. Ed. 422 (1895)). The establish embezzlement the creditor must show: (1) the appropriation of money or property; (2) for the debtor's use or benefit; and (3) done with fraudulent intent. *In re Patton*, 129 B.R. 113 (Bankr. W.D. Tex. 1991). For embezzelment, the fraudulent intent is established by a showing of dishonesty in fact. *In re Black,* 787 F.2d 503 (10th Cir. Utah 1986). This section has been applied to a wide variety of property, not just the embezzlement of money. *E.g.*, *In re Mastrangelo,* 34 B.R. 399 (Bankr. D. Mass. 1983) (diamonds); *In re Berkemeier,* 51 B.R. 5 (Bankr. S.D. Ind. 1983) (fertilizer). As with fraud, the intent is usually inferred from the debtor's actions and the totality of circumstances. *Hall v. Blanton,* 149 B.R. 393 (Bankr. E.D. Va. 1992); *In re Beasley,* 62 B.R. 653 (Bankr. W.D. Mo. 1986); *Savonarola v. Beran,* 79 B.R. 493 (Bankr. N.D. Fla. 1987); *In re Bevilacqua,* 53 B.R. 331 (Bankr. S.D.N.Y. 1985).

I.2.4.4 Larceny.

"Larceny" is defined as the wrongful taking of the property of another with fraudulent intent. *In re Rose,* 934 F.2d 901 (7th Cir. Ill. 1991). The fraudulent intent in larceny is merely the intent to convert the property to one's own use without consent. *In re Shinew,* 33 B.R. 588 (Bankr. N.D. Ohio 1983). With Larceny, the wrongful conduct is in the initial taking of the property. With embezzelment, the wrongful conduct is after the property comes into the possession of the debtor. *In re Weber,* 892 F.2d 534 (7th Cir. Wis. 1989).

In this regard, embezzelment and larceny are similar to the South Carolina criminal acts of breach of trust and larceny at common law. Breach of trust is part of the criminal statutes found at S. C. Code Ann. §16-13-230(1997) ("S.C. Code"). Basically, breach of trust is larceny after trust, which includes all of the elements of larceny (stealing), except the unlawful taking in the beginning. *See State v. Owings*, 205 S.C. 314, 31 S.E.2d 906 (1944). In the case of *State v. Jordan*, 255 S.C. 86, 177 S.E.2d 464 (1970), the defendant was given money to purchase stock for the victim. The defendant used some of the money to purchase groceries for himself, rather than to purchase the stock. Thus, he breached the trust and was guilty of the crime of breach of trust. Larceny occurs when the possession of the property is obtained through artifice, trick, or other fraud. *State v. McCann*, 167 S.C. 393, 166 S.E. 411 (1932).

I.2.5. Alimony, Maintenance and Support

Under Section 523(a)(5), to be exempt from discharge, the obligation to pay support must have some legal basis, such as the obligation of one spouse to pay another. *Audubon v. Shufeldt*, 181 U.S. 575, 21 S.Ct. 735, 45 L. Ed. 1009 (1901) ("on the natural and legal duty of a husband to support the wife")*; Wetmore v. Markoe,* 196 U.S. 68, 25 S.Ct. 172, 49 L. Ed. 390 (1904). If there is no legal duty to support, the obligation may be found to be dischargable. *Norris v. Norris*, 324 F.2d 826 (9th Cir. Cal. 1963) (annuled marriage does not form legal basis for support); *In re Doyle*, 70 B.R. 106 (Bankr. 9th Cir. 1986) (payments to non-spouse companion may be discharge). The obligation of a parent to support the child is always found to be non-dischargeable. *In re Magee*, 111 B.R. 359 (M.D. Fla. 1990); *Mullally v. Carter*, 67 B.R. 535 (N.D. Ill. 1986) (obligation from paternity action); *In re Seibert*, 914 F.2d 102 (7th Cir. 1990) (paternity can be determined as part of the dischargeability process).

The issue of whether the obligation is nondischargeable support is determined by federal law. *Sylvester v. Sylvester*, 865 F.2d 1164 (10th Cir. 1989); *In re Harrell*, 754 F.2d 902 (11th Cir. 1985); *In re Calhoun*, 715 F.2d 1103 (6th Cir. 1983); *In re Williams*, 703 F.2d 1055 (8th Cir. 1983); *In re Spong*, 661 F.2d 6 (2d Cir. N.Y. 1981); *In re Long*, 794 F.2d 928 (4th Cir. 1986); *Shaver v. Shaver*, 736 F.2d 1314 (9th Cir. 1984). Even if state law does not provide for alimony and support, some obligation may still be found non-dischargable under this provision. *See In re Nunnally*, 506 F.2d 1024 (5th Cir. 1975), *reh'g denied*, 509 F.2d 576 (5th Cir. Tex. 1975), *reh'g denied*, 509 F.2d 576 (5th Cir. Tex. 1975) (Texas law does not allow alimony or support, nevertheless obligation held to be non-dischargeable under this provision); *In re Biggs,* 907 F.2d 503 (5th Cir. 1990) (although no alimony allowed, there are alimony substitutes for dischargeability issues).

The Honorable Learned Hand suggested that the courts are to examine the underlying duty that created the obligation and not the written terms of the obligation in determining whether an obligation is for support. *In re Adams*, 25 F.2d 640 (2d Cir. N.Y. 1928). Since that opinion, the federal courts have generally examined whether there is an underlying obligation to support and whether the intent of the parties was to fulfill that obligation through the mechanism at issue. However, some courts ignore the underlying obligation and focus on the form or mechanism in an effort to determine whether the mechanism provides for support. *See In re Fox,* 5 B.R. 317 (Bankr. N.D. Tex. 1980) (if obligation terminates on death or remarriage, it is alimony or support); see also *In re Maitlen,* 658 F.2d 466 (7th Cir. Ind. 1981); *In re Taff,* 10 B.R. 101 (Bankr. D. Conn. 1981); *In re Snyder,* 7 B.R. 147 (W.D. Va. 1980).

The primary objective in examining either the nature of the obligation or the mechanism used to provide for the obligation is to determine the true intent of the parties. In the absence of clear intent as manifested in some writing, the courts examine various factors present at the time the debt was incurred. The factors examined are usually the same as those that a divorce court might consider in deciding whether to award support or alimony. Under this test, even obligations to pay third parties may be nondischargeable. *See In re Stranathan,* 15 B.R. 223 (Bankr. D. Neb. 1981); *In re Harrell,* 754 F.2d 902 (11th Cir. 1985) (educational expense for 19-year-old child); *In re Crawford,* 8 B.R. 552 (Bankr. D. Kan. 1981) (moving expenses are non-dischargeable when intended for support); *In re Maitlen,* 658 F.2d 466 (7th Cir. Ind. 1981) (mortgage payments are non-dischargeable when intended for support).

Different courts use a different list of factors in determining the intent of the obligation. *See, In re Singer,* 787 F.2d 1033 (6th Cir. Ohio 1986) (eleven factors); *In re Stone*, 79 B.R. 633 (Bankr. D. Md. 1987) (the eighteen factors); *In re Goin*, 808 F.2d 1391 (10th Cir. Kan. 1987) (four factors). These factors usually include:

> (1) whether the obligation terminates on the death or remarriage; (2) the written characterization of the payment; (3) whether the payments appear to balance disparate income; (4) whether the payments are to be made directly to the spouse or to a third party; (5) whether the obligation is payable in lump sum or installments; (6) whether an assumption of a debt has the effect of providing the support necessary to insure that the daily needs of the former spouse and children; and (7) whether an assumption of debt has the effect of providing the support necessary to insure a home for the spouse and children.

Friedman v. Silberfein, 138 B.R. 778 (Bankr. S.D.N.Y. 1992). Some courts also examine such things as whether the spouse has declared the obligation as a support obligation for tax purposes as indicia of the intent of the parties. *Robb-Fulton v. Robb (In re Robb),* 23 F.3d 895 (4th Cir. 1994); *See Nowak v. Nowak (In re Nowak),* 183 B.R. 568 (Bankr. D. Neb. 1995) (debtor's income taxes that claimed past payments as alimony used to support finding).

As previsously discussed, claims for support are not discharged and under Section 523(c), the creditor is not required to bring a suit to make this determination. The determination of dischargeabilty can be made at any time and in other courts. However, if the claim has been assigned to another entity or includes a liability designated as alimony, maintenance or support, then the claim may be non-dischargeable under Section 523(a)(15). As previsously discussed, the creditor does have to bring a suit for a determiation of whether the claim is dischargeable under Section 523(a)(15).

I.2.6. Willful and malicious injury.

Section 523(a)(6) has received recent attention in the case of *Kawaauhau v. Geiger*, 118 S. Ct. 974; 140 L. Ed. 2d 90; 66 U.S.L.W. 4167 (March 3, 1998). *Kawaauhau* dealt with a medical malpractice action and whether the malpractice claim was a willful and malicious inury. The Supreme Court held that it was not willful and malicious and therefore it was subject to being discharged. The facts of this case are a bit different than the ordinary malpractice case. The case didn’t involve an honest negligent mistake by a physician, instead, the case involved an intentional act of providing a lesser degree of care. In this case,

> The Kawaauhaus urge that the malpractice award fits within this exception because Dr. Geiger intentionally rendered inadequate medical care to Margaret Kawaauhau that necessarily led to her injury. According to the Kawaauhaus, Geiger deliberately chose less effective treatment because he wanted to cut costs, all the while knowing that he was providing substandard care. Such conduct, the Kawaauhaus assert, meets the "willful and malicious" specification of § 523(a)(6).

The Supreme Court held that:

> The word "willful" in (a)(6) modifies the word "injury," indicating that nondischargeability takes a deliberate or intentional injury, not merely a deliberate or intentional act that leads to injury. Had Congress meant to exempt debts resulting from unintentionally inflicted injuries, it might have described instead "willful acts that cause injury." Or, Congress might have selected an additional word or words, i.e., "reckless" or "negligent," to modify "injury."

The Court went further in also describing the claims covered by Section 523(a)(6) as follows:

> the (a)(6) formulation triggers in the lawyer's mind the category "intentional torts," as distinguished from negligent or reckless torts. Intentional torts generally require that the actor intend "the consequences of an act," not simply "the act itself." Restatement (Second) of Torts § 8A, comment a, p. 15 (1964) (emphasis omitted).

Thus, it appears that the Supreme Court has defined “willful and malicious” as “intentional.” A copy of this opinion is attached to this outline for your viewing pleasure.

I.2.6.1 Willful means intentional

Prior to this Supreme Court ruling, several courts found that "willful" meant intentional and that the intent required under the willful element was the intent to do the act which resulted in harm, not the intent to injure the creditor. *In re Britton,* 950 F.2d 602 (9th Cir. 1991); *In re Posta,* 866 F.2d 364 (10th Cir. 1989). Under *Kawaauhau*, the debtor must intend not just the act but the consequences of the act.

I.2.6.2 Malicious means done without just cause.

Prior to *Kawaauhau*, most courts examined Section 523(a)(6) as requiring a showing both intentional and malicious. Malicious required a showing that the act was done without just cause or excuse. *See, e.g., Seven Elves, Inc. v. Eskenazi,* 704 F.2d 241 (5th Cir. Tex. 1983). The malicious action did not require a showing of hatred or ill will. *In re Wooten,* 30 B.R. 357 (Bankr. N.D. Ala. 1983); *In re Chambers,* 23 B.R. 206 (Bankr. W.D. Wis. 1982); *First Nat'l Bank v. Stanley (In re Stanley),* 66 F.3d 664 (4th Cir. Md. 1995). Although not stated, it could be suspected that the *Kawaauhau* court did not want to get into the question of whether saving money by providing substandard care was "just cause or excuse."

Prior to *Kawaauhau*, some secured creditors attempted to use this section to object to the discharge of debtors that sold the collateral and then used the proceeds of the sale for purposes other than payment to the secured creditors. Even prior to *Kawaauhau*, the rule appeared to be that the mere conversion of collateral and diverting of funds for other uses did not constitute a willful and malicious injury required under Section 523(a)(6). *In re Long,* 774 F.2d 875 (8th Cir. 1985); *but see First Nat'l Bank v. Zinke (In re Zinke),* 174 B.R. 1017 (Bankr. D.N.D. 1994) (finding willful and malicious injury resulting from repeated and unauthorized disposition of collateral in contravention of the security agreement). Other courts have required a showing that the debtor made personal use of the diverted funds. *E.g.*, *Taubert v. Walsh,* 143 B.R. 691 (Bankr. N.D. Ohio 1992); *See also* C.J. Tabb, *The Scope of Fresh Start in Bankruptcy: Collateral Conversions and the Dischargeability Debate*, 59 GEORGE WASHINGTON L. REV. 56 (1990).

I.2.6.3 Punitive Damages.

Kaawauhau also places into question the issue of punitive damages. Prior to Kaawauhau, applied Section 523(a)(6) in deciding whether punitive damages were non-dischargeable. *E.g.*, *In re Miera,* 926 F.2d 741 (8th Cir. 1991); *In re Levy,* 951 F.2d 196 (9th Cir. 1991), *cert. denied*, 112 S.Ct. 2965, 119 L. Ed. 2d 586 (1992); *Gober v. Terra+Corp. (In re Gober),* 100 F.3d 1195 (5th Cir. Tex. 1996); *see also, Grogan v. Garner*, 498 U.S. 279, 111 S.Ct. 654, 112 L. Ed. 2d 755 (1991) ("Arguably, fraud judgments in cases in which the defendant did not obtain money, property, or services from the plaintiffs and those judgments that include punitive damages awards are more properly governed by § 523(a)(6) ."); *Brown v. Benson (In re Benson),* 180 B.R. 796 (Bankr. W.D. Pa. 1995) ("The vast majority of courts to address the issue have held that punitive damages are nondischargeable under § 523(a)(6).") Punitive damages may be awarded in cases where the conduct is far less culpable than the intentional standard set in Kawaauhau.

At least one circuit has taken the position that if the underlying actual damages are non-dischargeable, the punitive damages associated with the claim are non-dischargeable. *See St. Laurent v. Ambrose (In re St. Laurent),* 991 F.2d 672 (11th Cir. 1993) (under Section 523(a)(2)(A), punitive damages are nondischargeable because they flow from the same course of conduct). It is unclear the extent to which punitive damages will continue to be exempt from discharge.

I.2.7. Fines, penalties and forfietures.

Section 523(a)(7) which excepts from discharge penalties:

Other than a tax penalty

(A) relating to a tax of a kind not specified in paragraph (1) of this subsection; or

(B) imposed with respect to a transaction or event that occurred before three years before the date of the filing of the petition.

Both subsections (A) and (B) must exist before the tax penalty is excepted from discharge. *McKay v. United States,* 957 F.2d 689 (9th Cir. Cal. 1992); *In re Roberts,* 906 F.2d 1440 (10th Cir. Okla. 1990); *In re Burns,* 887 F.2d 1541 (11th Cir. Ga. 1989).

It should be noted that in Chapter 13 the result is different. Taxes are dischargeable under a Chapter 13 plan if the plan is fully consummated. 11 U.S.C. §1328(a). Only priority taxes must be paid in full in Chapter 13. 11 U.S.C. §1322(a)(2). Thus, a tax penalty whose nondischargeability is based on 11 USC § 523(a)(7)(A) and (B) is discharged under 11 USC § 1328(a) and need not be paid in full in a Chapter 13 case.

Section 101(27) defines a "governmental unit" to include all departments, agencies, and instrumentalities of states and the United States. The term is construed in the broadest sense. *See In re Haberman,* 137 B.R. 292 (Bankr. E.D. Wis. 1992) (extending application to state attorney disciplinary boards created by a state supreme court)*; Attorney Registration & Disciplinary Comm'n v. Betts,* 149 B.R. 891 (Bankr. N.D. Ill. 1993) (same). The fines, penalties, and forfeitures imposed by these various entities are nondischargeable to the extent they do not represent "compensation for actual pecuniary loss." These fines would include traffic fines and parking tickets. *E.g., In re Young,* 10 B.R. 17, (Bankr. S.D. Cal. 1980) (traffic citations are criminal fines which are nondischargeable); *In re Marini,* 28 B.R. 262 (Bankr. E.D.N.Y. 1983) (contempt fine is nondischargeable). Some penalties issued by administrative agencies such as environmental agencies are also held to fall within this section’s scope. See *In re Daugherty*, 25 B.R. 158 (Bankr. E.D. Tenn. 1982) (monetary penalty for environmental damage nondischargeable); *In re Tauscher*, 7 B.R. 918 (Bankr. E.D. Wis. 1981) (civil money penalties for violations of Fair Labor Standards Act). Lastly, court sanctions, such are Rule 9011, are not dischargeable. *In re McIntyre*, 96 B.R. 70 (Bankr. S.D. Miss. 1989) (nondischargeable under either Code § 523(a)(7) and Code § 523(a)(6)).

In South Carolina, the SC Department of Transportation requires the payment of certain funds in order to reinstate a debtor’s driver’s license. These required payments may be dischargeable. *See Williams v. Motley*, 925 F.2d 741 (4th Cir. Va. 1991) (service fees to reinstate vehicle registration and driving privileges are compensatory and not excepted from discharge).

Because of certain limiting language in Section 523(a)(13) (declaring federally ordered restitution orders non-dischargeable), State Court-ordered restitution may still be found nondischargeable under Section 523(a)(7) and court-ordered restitution imposed as a condition of probation is nondischargeable because it is viewed as part of the state's interest in rehabilitation and punishment. *Kelly v. Robinson*, 479 U.S. 36, 107 S.Ct. 353, 93 L. Ed. 2d 216 (1986) (State Court ordered restitution excepted from discharge under Section 523(a)(7)). If the purpose of the restitution order is to compensate, the obligation may be discharged. *In re Car Renovators*, 946 F.2d 780 (11th Cir. 1991), *cert. denied*, 112 S.Ct. 1949, 118 L. Ed. 2d 553 (1992).

The Fourth Circuit disctinguishes between restitution orders that seek to compensate the government from restitution orders that seek to compensate the victim. The Fourth Circuit held that the governments purpose was penal when it required the criminal to compensate the victims and therefore, found the obligations to the victims to be non-dischargeable. *United States Dep't of Hous. & Urban Dev. v. Cost Control Mktg. & Sales Management*, 64 F.3d 920 (4th Cir. Va. 1995).

It should be noted that in the Crime Control Act of 1990, Congress amended the discharge provisions of Chapter 13. Section 1328 no longer discharges restitution orders. The restitition order mentioned in Section 1328 does not distinguish between federal restitution orders and state restitution orders. Thus, if state restitution orders are not found to be included under Section 527(a)(7), debtors could face the anamoulous situation where a state court restitution order is not dischargeable in a Chapter 13, but is dischargeable in a Chapter 7 and Chapter 11.

I.2.8. Student Loans.

Section 523(8) provides that student loans are not dischargeable if (1) made, insured, or guaranteed by a governmental unit or (2) made under any program funded in whole or part by a governmental unit or a nonprofit institution. This section does not require the creditor to bring a complaint objecting to the discharge, thus the burden is on the debtor if he seeks a determination from the bankruptcy court. *Buford v. Higher Education Assistance Foundation,* 85 B.R. 579 (D. Kan. 1988); *United States v. Bradburn,* 75 B.R. 108 (S.D. Ind. 1987); *In re Frech,* 62 B.R. 235 (Bankr. D. Minn. 1986). Nevertheless, the creditor bears the burden of establishing the existence of the debt and its qualification for the debt under Code § 523(a)(8). *In re Webb,* 132 B.R. 199 (Bankr. M.D. Fla. 1991).

This exception to discharge contains one exception: cases where not discharging the loan would work an "undue hardship" upon the debtor. In 1990, the discharge provided under Chapter 13, Section 1328, was amended to prevent the discharge of otherwise non-dischargeable student loans under Section 523(a)(8). The debtor should also be aware that outside of Section 523(a)(8) there are other statutes that relate to specific types of student loans.

I.2.8.1 Made, insured or guaranteed by a governmental unit

Section 101(27) define "governmental unit," to include the United States, states, municipalities, foreign states, and their departments, agencies and instrumentalities. An educational loan is "made" by a governmental unit regardless of the immediate source of the money for the loan. *See In re Shore,* 707 F.2d 1337 (11th Cir. 1983) (immediate source was a trust with the beneficiary as the educational institution); *In re Hammarstrom,* 95 B.R. 160 (Bankr. N.D. Cal. 1989) (loan made with the intention of selling it to a nonprofit institution with the debtor's knowledge). While not considering the source of the money for the loan, the courts will consider the source of repayment and if that source is specifically identified, the court may determine the obligation to be something other than a student loan. *See In re Shipman,* 33 B.R. 80 (Bankr. W.D. Mo. 1983) (when obligation was to be paid back by labor in work-study program, court determined the obligation was not a loan); *but see In re Merchant,* 958 F2d 738, (6th Cir. 1992) (even though creditor had recourse against educational institution, loan was still excepted from discharge).

I.2.8.2. Made pursuant to a program funded by a governmental unit or nonprofit institution

Unlike governmental unit, the term "nonprofit institution" is not defined. Thus, even though some institutions are clearly nonprofit, the case law is split on whether these nonprofit instutions are allowed to claim the benefit of Section 523(a)(8). *In re Sinclair-Ganos,* 133 B.R. 382 (Bankr. W.D. Mich. 1991) (credit unions do not deserve to claim benefit of exception); *but see In re Roberts,* 149 B.R. 547 (C.D. Ill. 1993) (credit unions are nonprofit institutions); *see also, T I Fed. Credit Union v. DelBonis,* 72 F.3d 921 (1st Cir. Mass. 1995) (federal credit unions are governmental units). In deciding whether the nonprofit institution is allowed standing to object to a discharge the court will examine the corporate structure, whether dividends are paid and whether the institution competes with "for profit" institutions. *Navy Fed. Credit Union v. Simmons (In re Simmons),* 175 B.R. 624 (Bankr. E.D. Va. 1994).

I.2.8.3. Undue Hardship.

Section 523(a)(8) provides for an exception to the exception to discharge if the continuation of the obligation would result in an undue hardship. "Undue hardship" is not defined in the bankruptcy code. Nevertheless, some courts have found this issue to be a question of law, reviewable de novo on appeal. *Cheesman v. Tennessee Student Assistance Corp. (In re Cheesman),* 25 F.3d 356 (6th Cir. 1994); *In re Roberson,* 999 F.2d 1132 (7th Cir. Ill. 1993). Undue hardship is more than current financial difficulties and must include a long-term detriment. *In re Berthiaume*, 138 B.R. 516 (Bankr. W.D. Ky. 1992). In one instance, undue hardship was described "as a result of unique factors" which make the "expectation of repayment . . . virtually non-existent unless by the effort the bankrupt strips himself of all that makes life worth living." *United States v. Russo,* 708 F.2d 209 (6th Cir. 1983), *cert. denied*, 464 U.S. 993, 104 S.Ct. 487, 78 L. Ed. 2d 682 (1983).

The debtor has the burden to show undue hardship by a preponderance of the evidence and each case involving a student loan must be examined on the facts and circumstances surrounding that particular bankruptcy. *In re Betz,* 31 B.R. 565 (Bankr. W.D.N.Y. 1983) (debtor has burden); *In re Keenan,* 53 B.R. 913 (Bankr. D. Conn. 1985) (debtor has burden); *In re Garneau,* 122 B.R. 178 (Bankr. W.D.N.Y. 1990) (debtor has burden by the preponderance of the evidence); *In re Connolly*, 29 B.R. 978 (Bankr. M.D. Fla. 1983) (facts and circumstance of particular case); *In re Ford,* 22 B.R. 442 (Bankr. W.D.N.Y. 1982) (court must examine facts and circumstance of particular case); *See also In re Diaz,* 5 B.R. 253 (Bankr. W.D.N.Y. 1980) (good factual discussion of hardship).

In determining undue hardship, the courts generally examine three factors that were first discussed in the case of *In re Johnson,* 5 Bankr. Ct. Dec. (CRR) 532 (Bankr. E.D. Pa. 1979). The first factor is known as the "mechanical" test. The court examines whether the debtor's financial resources will be insufficient to enable the debtor (and any dependents of the debtor) to live at or above a subsistence level. The court examines numerous indicia including: the number of the debtor's dependents, and their ages and needs; health of the debtor and his or her dependents; access to transportation; level of education attained by the debtor; the reasonable and necessary day-to-day living expenses; marketability of the debtor's job skills; current income; and other sources of wealth. *In re Andrews,* 661 F.2d 702 (8th Cir. S.D. 1981); *Koch v. Pennsylvania Higher Educ. Assistance Agency,* 144 B.R. 959 (Bankr. W.D. Pa. 1992); *In re Armijo,* 13 B.R. 175 (Bankr. D.N.M. 1981); *In re Rice,* 13 B.R. 614 (Bankr. D.S.D. 1981); *In re Clay,* 12 B.R. 251 (Bankr. N.D. Iowa 1981); *In re Perkins,* 11 B.R. 160 (Bankr. D. Vt. 1980); *In re Conard,* 6 B.R. 151 (Bankr. W.D. Ky. 1980); *but see In re Fischer,* 23 B.R. 432 (Bankr. W.D. Ky. 1982) (motherhood is not an "undue hardship" but voluntarily assumed). If the debtor fails to establish that his financial resources are insufficient to live at or above a subsistence level, the court denies the discharge. If the debtor meets this test, the court proceeds to the second factor. *Woodcock v. Chemical Bank, NYSHESC (In re Woodcock),* 45 F.3d 363 (10th Cir. Colo. 1995), *cert. denied*, 116 S.Ct. 97, 133 L. Ed. 2d 52 (1995); *In re Johnson,* 5 Bankr. Ct. Dec. (CRR) 532 (Bankr. E.D. Pa. 1979).

The second factor is the "good faith" test. The debtor must demonstrate that he or she has made a good faith attempt to make payments on the loan. *Koch v. Pennsylvania Higher Educ. Assistance Agency,* 144 B.R. 959

(Bankr. W.D. Pa. 1992); *In re Love,* 28 B.R. 475 (Bankr. S.D. Ind. 1983); *In re Lezer,* 21 B.R. 783 (Bankr. N.D.N.Y. 1982); *In re Armijo,* 13 B.R. 175 (Bankr. D.N.M. 1981); *In re Rice,* 13 B.R. 614 (Bankr. D.S.D. 1981); *In re Clay,* 12 B.R. 251 (Bankr. N.D. Iowa 1981); *In re Archie,* 7 B.R. 715 (Bankr. E.D. Va. 1980). In addition to examining the payment history of the loan, the court will examine such factors as: efforts to get and keep a job; present employment; job history; whether the debtor's education and skills are being used to the best advantage; and attempts by the debtor to live within his or her means. If the debtor fails to meet his burden on this factor, the debt is excepted from discharge. If the debtor meets his burden, the court examines the third factor.

The third factor is referred to as the “policy test” and appears to be a category for the court to examine an any other potential reason not to allow the debtor to discharge the student loan. Some Circuit Courts have abandoned the “policy test” but employ a modified version of the remaining factors. See *Brunner v. New York State Higher Education Services Corp.*, 831 F.2d 395 (2d Cir. 1987); *In re Roberson*, 999 F.2d 1132, 1137 (7th Cir. Ill. 1993). These courts require the debtor to prove:

> (1) that the debtor cannot maintain, based on current income and expenses, a "minimal" standard of living for [himself] and [his] dependents if forced to repay the loans;
>
> (2) that additional circumstances exist indicating that this state of affairs is likely to persist for a significant portion of the repayment period of the student loans; and
>
> (3) that the debtor has made good faith efforts to repay the loans.

999 F.2d at 1137.

Except for the Johnson test and the modified Johnson test, the courts seem to provide a divergent group of tests to determine whether the debtor has met his burden of showing an undue hardship. *See In re Craig,* 64 B.R.

854 (Bankr. W.D. Pa. 1986), *appeal dismissed*, 64 B.R. 857 (W.D. Pa. 1986) (debtor must rebut presumption on nondischargeability with a showing of severe and uniquely difficult circumstances); *Mathews v. Higher Educ. Assistance Found. (In re Mathews),* 166 B.R. 940 (Bankr. D. Kan.1994) (presumption must be rebutted); *In re Ford*, 151 B.R. 135, 139 (Bankr. M.D. Tenn.1993) (same); *In re Bryant,* 72 B.R. 913 (Bankr. E.D. Pa. 1987) (Federal Poverty Income Guidelines established by the Department of Health and Human Services).

In addition to determining whether a debt is dischargeable, some courts have examined the issue of undue hardship and revised payment schedule or to reduced the amount of the nondischargeable debt. *In re Webb*, 132 B.R. 199 (Bankr. M.D. Fla. 1991) (revised payment schedule); *In re Littell*, 6 B.R. 85 (Bankr. D. Or. 1980) (reduced amount); *Silliman v. Nebraska Higher Educ. Loan Program,* 144 B.R. 748 (Bankr. N.D. Ohio 1992) (reduced amount); *Raimondo v. New York State Higher Educ. Servs. Corp. (In re Raimondo),* 183 B.R. 677 (Bankr. W.D.N.Y. 1995) (finding debtor could repay $5,000 of student loan obligations (20% of total outstanding) over ten years without undue hardship). *But see Rice v. United States (In re Rice),* 78 F.3d 1144 (6th Cir. Ohio 1996) (Bankruptcy Court may not reduce an otherwise nondischargeable debt on the basis of perceived undue hardship). In South Carolina, the amount of the obligation may be reduced. *See Ammirati v. Nellie Mae, Inc. (In re Ammirati),* 187 B.R. 902 (D.S.C. 1995), *aff'd without op.*, 85 F.3d 615 (4th Cir. S.C. 1996).

I.2.8.5. Non Bankruptcy Exceptions to Discharge of Student Loans.

Outside of Section 523(a)(8), the debtor should be aware of the following possible exceptions, depending upon the student loan itself.

1. 42 U.S.C. §254o(d)(3). Under the National Health Service Corps ("NHSC") medical training is funded as part of a program to redistribute physicians to areas in need of medical care providers.

Discharge is permitted only if (1) five years has passed since the first date that payment of damages for breach of the scholarship contract is required and (2) the Bankruptcy Court finds that failure to discharge the obligation would be unconscionable. *In re Hines*, 63 B.R. 731 (Bankr. D.S.D. 1986); Pub. L. 100-177, 101 Stat. 992 (1987) (adding unconscionable requirement); *Matthews v. United States, Nat. Health Service Corps.*, 150 B.R. 11 (Bankr. W.D. Pa. 1992);

2. 42 U.S.C. §292f(g). Under the Health Education Assistance Loan ("HEAL") obligations cannot be discharged unless (1) the passage of seven years from the first date repayment was to begin; (2) a finding that nondischarge of the debt be "unconscionable"; and (3) the Secretary of Health and Human Services has not waived certain rights. *Matthews v. Pineo*, 19 F.3d 121, 124 (3d Cir. 1994), *cert. denied*, 130 L. Ed. 2d 35, 115 S. Ct. 82 (1994) (defining unconscionable as "excessive, exorbitant," "lying outside the limits of what is reasonable or acceptable," "shocking, unfair, harsh, or unjust," or "outrageous."*); Barrows v. Illinois Student Assistance Comm'n (In re Bush Barrows),* 182 B.R. 640 (Bankr. D.N.H. 1994) (to determine "unconscionability" the court should examine the totality of the circumstances including the debtor's age, health, educational background, employment history, financial condition, earning ability and current income).

3. 37 U.S.C. §301d(c)(3). This section provides for an exception to discharge for the obligation of a medical officer in the military to pay back the retention bonus if the discharge is entered less than five years after the termination of the officer's agreement to complete a term of active duty. Pub. L. 101-510, § 611, Nov. 5, 1990.

This list is not meant to be exhaustive. If the debtor has a particular type of student loan, funded under a particular legislative program, it is recommended that the legislation associated with that particular loan is examined for any possible discharge issues.

I.2.9. For death and personal injury caused while driving under the influence.

Section 523(a)(9) has three objectives: (1) deter drunk driving; (2) ensure that those who caused injury by driving drunk do not escape liability; and (3) protect victims of drunk driving. *Lugo v. Paulsen,* 886 F.2d 602 (3d Cir. N.J. 1989); *In re Hudson,* 859 F.2d 1418 (9th Cir. Wash. 1988)). Under Section 523(a)(9), the creditor must show: (1) the debtor was legally intoxicated under state (or other applicable) law and (2) liability resulted from the operation of a motor vehicle. *Whitson v. Middleton,* 898 F.2d 950 (4th Cir. Va. 1990); *In re Phalen,* 145 B.R. 551 (Bankr. N.D. Ohio 1992). The definition of motor vehicle may be broad enough to include boats. *See Willison v. Race,* 192 B.R. 949 (W.D. Mo. 1995) (term "motor vehicle" is broad enough to include motorboats); *In re Williams,* 101 B.R. 356 (Bankr. S.D. Fla. 1989), *aff'd,* 111 B.R. 361 (S.D. Fla. 1989) (motorboat is a motor vehicle); *Schwartz v. Dunn (In re Dunn),* 203 B.R. 414 (E.D. Mich. 1996) (snowmobile a "motor vehicle"); *but see Boyce v. Greenway (In re Greenway),* 71 F.3d (5th Cir. 1996), *cert. denied,* 116 S. Ct. 2499, 135 L. Ed. 2d 191 (1996) (boat not a motor vehicle); *Schachter v. Fall (In re Fall),* 192 B.R. 16 (Bankr. D.N.H. 1995) (boat not a motor vehicle).

I.2.10. Debts from a prior case

If the debtor was previously involved in a Chapter 7 proceeding and the debtor either waived his discharge or was denied his discharge, Section 523(a)(10) excepts these same claims from discharge. Debts existing at the commencement of a case in which the debtor is denied discharge can never be discharged in a subsequent bankruptcy.

Four subsections of Section 727(a) are not listed in 523(a)(10), including subsection (a)(1) (debtor not an individual), subsection (a)(8) (discharge barred where debtor received a discharge in a previous Chapter 7 or Chapter 11 case within six years), and subsection (a)(9) (Chapter 7 discharge denied where debtor received discharge in a Chapter 12 or 13 case within six years before a subsequent Chapter 7 case and debtor failed to pay specified percentages of unsecured claims in the Chapter 12 or 13). Of these (a)(8) provides an exception to the general rule relating to prior bankruptcy debts. If the debtor didn't receive a discharge because of (a)(8), then those claims do not fall within the exception of Section 523(a)(10).

Reaffirmation of a debt is not waiver of discharge. *In re Lones,* 50 B.R. 801 (Bankr. W.D. Ky. 1985). Dismissal of a case is not a bar to discharge in a subsequent case. 11 U.S.C. § 349(a). *Britt v. Logan*, 145 B.R. 324 (Bankr. D. Kan. 1992).

As to previous determinations under Section 523(a), if a debt is determined to be non-dischargeable in one bankruptcy, this determination is res judicata in subsequent cases. *Royal American Oil & Gas Co. v. Szafranski*, 147 B.R. 976 (Bankr. N.D. Okla. 1992); *but see In re Sobh,* 61 B.R. 576 (E.D. Mich. 1986) (debtor reopened bankruptcy to relitigate student loans based on new circumstances to show undue hardship). A subsequent Chapter 13 filing could get a different result. *In re Lilley*, 185 B.R. 489 (E.D. Pa. 1995) ("Congress did not intend to foreclose categorically the benefit of Chapter 13 reorganization to a debtor who previously has filed unsuccessfully for Chapter 7 relief"); *In re Harlan*, 179 B.R. 133 (Bankr. W.D. Ark. 1995) (requiring Chapter 13 plan be proposed in good faith); *In re Chaffin*, 816 F.2d 1070 (5th Cir. 1987) (debtor converted case to Chapter 13 from Chapter 7 after a debt was found nondischargeable).

I.2.11. and 12. Insiders of Federal Depository Institutions

Sections 523(a)(11) and (a)(12) affect insiders within bank and thrift institutions who were involved in wrongful acts. These provisions do not overrule previous case law regarding honest debtors but does attempt to punish those who were in charge of failed insured depository institutions. 136 Cong Rec H13,289 (daily ed. Oct. 27, 1990).

Section 523(a)(11) excepts from discharge any final judgment, order or consent decree issued by a federal depository institutions regulatory agency or any obligation contained in any settlement agreement to which the debtor was a party that arose from any act of fraud or defalcation by the debtor while acting in a fiduciary capacity with respect to any insured depository institution or insured credit union. *In re Harris*, 135 B.R. 434 (Bankr. S.D. Fla. 1992) (creditor may choose to seek judgment in forum other than bankruptcy court).

Section 523(a)(12) excepts from discharge those claims arising from malicious or reckless actions or omissions by a debtor in fulfilling any commitment to maintain minimum capital at an insured depository institution. The act need only be reckless and as we have seen under Section 523(a)(6), this standard is lower than the intentional standard found in Section 523(a)(6).

The regulatory agency seeking a determination of dischargeablity must bring suit by the bar date unless it was not appointed in time to reasonably comply with the deadlines. 11 USC § 523(c)(2).

I.2.13. Federal Court Ordered Restitution.

In the Violent Crime Control and Law Enforcement Act of 1994, Pub. L. 103-322, § 320934 (Sept. 13, 1994), Section 523(a)(13) was added to address federal restitution orders. This Section excepts from discharge restitution ordered in cases arising under Title 18 of the United States Code. No provision is made to except restitution ordered by state courts. As previously discussed, the exception to the discharge in Chapter 13 cases under Section 1328(a), however, applies to all restitution orders. Thus, if Section 523(a)(6) or (7) is not applied for restitution orders of a state court the debtor could receive a discharge in Chapter 7 or 11 but not in Chapter 13.

Sometimes, an award of costs is included in a restitution order to compensate for "a pecuniary loss." These awards are not included in Section 523(a)(7). However, this type of award may be viewed as nondischargeable under Section 523(a)(13).

I.2.14. Loans to pay a tax

The Bankruptcy Reform Act of 1994 added Section 523(a)(14). This section excepts from discharge loans made to pay a tax "to the United States that would be nondischargeable" under Code § 523(a)(1). According to the House Report accompanying the bill, the purpose of this section is to encourage the use of credit cards in paying federal taxes. H.R. Rep. No. 103-835, 103d Cong., 2d Sess. (1994). The idea of subrogation for tax claims has been previously discussed. This section merely codified previous case law on subrogation.

I.2.15. Support Obligations not included in 523(a)(5)

In the Bankruptcy Reform Act of 1994, Section 523(a)(15) was added to address concerns over certain limiting rulings relating to Section 523(a)(5) and its requirement that the obligation be "to a spouse, former spouse or child." Section 523(a)(15) applies to all obligations found in a divorce or separation decree and is limited in only two respects. First, the exception does not apply when the debtor does not have an ability to pay the debt. Second, the exception does not apply when "discharging such debt would result in a benefit to the debtor that outweighs the detrimental consequences to a spouse, former spouse, or child of the debtor."

Courts have taken different approaches to the burden of proof: (1) debtor has burden of proof after creditor establishes the debt arose from divorce proceeding; (2) creditor has burden of proof but debtor has burden of going forward once creditor has established the debt arose from divorce proceeding; (3) once established that debt arose from divorce proceeding, burden is on debtor under Section 523(a)(15)(A) but remains on creditor under Section

523(a)(15)(B); and (4) creditor has burden throughout the proceeding. *Willey v. Willey (In re Willey)*, 198 B.R. 1007 (Bankr. S.D. Fla. 1996) (citing cases for each approach).

In the first limitation, courts generally examine the debtor's "ability to pay" based upon the "disposable income test." *Hill v. Hill (In re Hill)*, 184 B.R. 750 (Bankr. N.D. Ill. 1995) (discussing different approaches to determining when expenses are "reasonably necessary"); *Carroll v. Carroll (In re Carroll)*, 187 B.R. 197 (Bankr. S.D. Ohio 1995) (using disposable income test); *McGinnis v. McGinnis (In re McGinnis)*, 194 B.R. 917 (Bankr. N.D. Ala. 1996) (citing cases) (reviewing debtor's current status); *Belcher v. Owens (In re Owens)*, 191 B.R. 669 (Bankr. E.D. Ky. 1996) (adopting "disposable income test" of Code § 1325(b)); *Taylor v. Taylor (In re Taylor)*, 191 B.R. 760 (Bankr. N.D. Ill. 1996).

In reviewing the second limitation, the Courts apply a totality of the circumstances test including consideration of (1) the income and expenses of both parties, (2) the nature of the debt, and (3) the former spouse's ability to pay the debt. *See Florio v. Florio (In re Florio)*, 187 B.R. 654 (Bankr. W.D. Mo. 1995); *Phillips v. Phillips (In re Phillips)*, 187 B.R. 363 (Bankr. M.D. Fla. 1995) (the court exercises its equitable powers to make a value judgment).

I.2.16. Condominium and Homeowners Association Fees

The Bankruptcy Reform Act of 1994 added Section 523(a)(16) which excepts from the discharge condominium and cooperative housing corporation fees and assessments which are due and payable after the order for relief. Section 523(a)(16) has two limitations. First, the exception does not affect the dischargeability of fees and assessments arising before the order for relief. Second, the exception applies only to fees and assessments payable during the period the debtor physically occupies the dwelling or the period during which the debtor rents the dwelling and receives rental payments. Section 523(a)(16) specifically references condominium associations and cooperative housing corporation fees and assessments. The legislative history of Section 523(a)(16) suggests that the exception is intended to affect "condominiums, cooperatives, or similar membership associations." H.R. Rep. No. 103-835, 103d Cong., 2d Sess. (1994). I haven't found any case law on this section.

I.2.17. Court Costs.

Section 523(a)(17) excepts from discharge a debt "for a fee imposed by a court for the filing of a case, motion, complaint, or appeal, or for other costs and expenses assessed with respect to such filing" regardless of an assertion of poverty by the debtor under 28 U.S.C. § 1915(b) or (f) or the debtor's status as a prisoner as defined in 28 U.S.C. § 1915(h). Section 523(a)(17) applies to all "fees . . . others costs and expenses" imposed or assessed by the court irrespective of the status of the debtor as a prisoner. Code § 523(a)(17) could also be read to render non-dischargeable fines and sanctions imposed in civil matters under Rule 11, Fed. R. Civ.P., Rule 9011, Fed. R. Bankr. P. or even the related state court sanction.

I.2.18. Support Enforceable Under the Social Security Act.

The "Personal Responsibility and Work Opportunity Reconciliation Act of 1996" added Section 523(a)(18). This Section excepts from discharge an obligation owed to a state or municipality that is in the nature of support and enforceable under Part D of title IV of the Social Security Act. The Act also amended the Social Security Act to provide that a debt owed under state law to the state or a municipality "that is in the nature of support and that is enforceable under this part is not released by a discharge in bankruptcy under title 11 of the United States Code." The amendments apply to bankruptcy cases filed only after August 22, 1996. P.L. 104-193, 110 Stat. 2105 (1996).

J. Set-Off

Section 553 recognizes a right to set-off established by nonbankruptcy law. Set-off is when the debtor debt is used to offset a creditor debt. Set-off is used as a tool for creditors to eliminate its debt to debtor and the debtor simultaneously eliminates its debt back to the creditor. However, certain set-offs may be avoided, such as if the right to set-off accrued within 90 days of filing the petition. Even if a creditor has a right of set-off , the set-off is stayed under 362(a)(7). The creditor must file for relief from the stay. The amount subject to the set-off is a secured claim pursuant to 506 and also may be used as cash collateral under 363. If a creditor is ordered to turnover the property under 542, the creditor may properly use set-off as a defense to the turnover action. Preference Rules under 547 do not apply to amounts subject to set-off.

Three requirements must be met in order to effect the right of set-off: (1) the party must make a decision to set off the debt (2) action must be taken; and (3) the set-off must be recorded. *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16 (1995). To protect its right to a set-off a creditor may temporarily withhold payment of a debt it owes to a debtor without violating the automatic stay. *Id.*

The mutuality requirement of set-off requires that each party pay its own claim, with the right to collect in its own name. *Matter of United Sciences of America, Inc.*, 893 F.2d 720 95th Cir. 1990).

K. Abandonment

Section 554(a) gives the Trustee the power (after notice and a hearing) to abandon burdensome property or property that is of inconsequential value/benefit to the estate. After the request of a party in interest (such as a creditor) and notice and hearing, the Court may order the Trustee to abandon burdensome or inconsequential property of the estate. Any property scheduled but not administered at the time of closing is abandoned to the debtor. If property is not abandoned to the debtor, it remains property of the estate. Abandoned property is not protected by the automatic stay. Sections 725 provides that a Trustee may dispose of any other property which an entity other than the estate has an interest, such as a lien, that has not been disposed of under another section of title 11. Section 1107 gives the debtor in possession the rights of the trustee, so that the debtor in possession has the right to abandon property.

VII. Problems for Secured Creditors in Bankruptcy

A. Use of Cash Collateral

Section 363(a) defines cash collateral as "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." It also includes the proceeds. The use of cash collateral usually arises in a Chapter 11 proceeding. In a Chapter 11 the Debtor in Possession both needs cash and could destroy the business with the misuse of such cash. The Code allows the Debtor in Possession free use of cash , not subject to a lien, so long that the cash is used "in the ordinary course of business." Encumbered cash (subject to a lien) is cash collateral. Cash collateral cannot be used without the permission of the bankruptcy court. Section 363 also governs the post petition use, lease and sale of estate property. Section 363(b) provides the Trustee with the ability to "use, sell or lease" estate property outside the ordinary course of the estate. To sell, lease or use property outside of the normal course of business, the Trustee give notice and have a proper hearing at the Bankruptcy Court. Section 363(c) provides the trustee with instances when the property can be sold, leased or used pursuant to the ordinary course of business. As long as its in the ordinary course of business, no notice or hearing is needed.

The priority extended to a cash collateral lender under section 363 is not affected by the dismissal of the bankruptcy case, and cash collateral lender's lien may prevail over suppliers who fail to secure bankruptcy court approval for their advances. *In re TNT Farms*, 226 B.R. 436 (Bankr. D. Idaho 1998).

B. Use Sale or Lease of Property

The use, sale and lease of estate property is governed by Section 363. It is related to cash collateral. Section 363(b) provides the Trustee with the ability to "use, sell or lease" estate property outside the ordinary course of the estate. To sell, lease or use property outside of the normal course of business, the Trustee give notice and have a proper hearing at the Bankruptcy Court. Section 363(c) provides the trustee with instances when the property can be sold, leased or used pursuant to the ordinary course of business. As long as its in the ordinary course of business, no notice or hearing is needed. While the Trustee can sell, lease, use estate property, it must do so pursuant to the automatic stay in Section 362. Section 363(f) states that in some instances the Trustee may even sell the property free and clear of certain liens. 363(e) however, gives parties the opportunity to demand "adequate protection" for their property if the property is to be leased or sold.

A two step test may be used to determine whether a postpetition transaction is in the debtor's ordinary course of business. The "horizontal dimension" test determines whether the transaction is of the sort commonly undertaken by companies in the debtor's industry. The "vertical dimension test" determines whether the transaction subjects the creditors to economic risk different from the risk they accpeted and could reasonably expect when they extended credit. *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1994).

C. Fraudulent Conveyances

Fraudulent conveyance law presents a unique blend of federal and state law. Statutes allowing for the avoidance or revocation of fraudulent transfers are found at 11 U.S.C. § 548 and, for South Carolina, S.C. Code Ann. § 27-23-10 et seq. The two collectively cover a multitude of situations and deceptive behavior. Much of the case law suggests that the fraudulent conveyance statutes are overlapping to the point of being redundant. A general review of the two statutes would seem to support this proposition. *In re Hoffman Associates, Inc.*, 194 B.R. 943 (Bankr. D.S.C. 1995) (analyzing South Carolina Fraudulent Conveyance Statute simultaneously with the Federal Fraudulent Conveyance Statute). However, there are subtle differences between the two that may prove to be useful, especially in light of the fact that a debtor is entitled to a jury trial on the state based claim, whereas, no such right exists as to the federal claim. *Granfinanciera, S.A. v. Nordberg*, 109 S. Ct. 2782, 492 U.S. 33, 106 L. Ed. 26 (1989).

Another major difference is the applicable statute of limitations. Under federal law, as is discussed later, the trustee is relegated to actions that took place within a year of the filing. An action under the Statute of Elizabeth is governed by the limitations period applicable to fraud actions. *Walter J. Klein Company, Inc. v. Kneece*, 239 S.C. 478, 123 S.E. 2d 870 (1962); *Tucker v. Weathersbee*, 98 S.C. 402, 82 S.E. 870 (1893). The applicable period is three years from the time the aggrieved creditor discovers facts that reveal the fraudulent conveyance. S.C. Code Ann. § 15-3-530(7) (Law. Co-op. Supp.). The mere recording of a deed or mortgage is insufficient to place creditors on notice of the fraudulent transfer for purposes of starting the limitations period. *Tucker v. Weathersbee, supra*.

Together, the two statutes provide a body of law that give the trustee or creditor a great deal of flexibility and allows him or her to reach a wide variety of activities. The following discussion is an analysis of each body of law, and it was drafted with the purpose of helping a trustee or creditor choose a line of attack that is most suitable to him or her.

C.1. Fraudulent Conveyance Law Under the Bankruptcy Code:

C.1.1. One Year Limit:

Section 548 of the Bankruptcy Code provides the federal rule available to trustees and debtors-in-possession. The section provides that a trustee may avoid any transfer of an interest of the debtor that was made or incurred on or within one year before the date of the filing of the petition, if procured through fraudulent means of the debtor. Bankruptcy Code § 548.

The timing of the transfer, therefore, becomes exceedingly important. Obviously, from the language found in the statute, the object of section 548 was to prevent prepetition transfers, not postpetition transfers. *See Consolidated Partners Inv. Co. v. Lake*, 152 B.R. 485 (N.D. Ohio 1993). Therefore, a transfer that occurs after the bankruptcy petition is filed is not covered under this statute. *Consolidated Partners Inc. Co. v. Lake*, 152 B.R. 485 (Bankr. N.D. Ohio 1993); Matter of Fisher, 80 B.R. 58 (Bankr. M.D.N.C. 1987); *In re Sattler's Inc.*, 73 B.R. 780 (Bankr. S.D.N.Y. 1987).

In complex transactions, the specific date of the transfer could prove to be important. Generally, where a lien of some sort is granted as part of the transaction, the transfer is deemed to take place on the date the lien is perfected, provided it is done prior to the bankruptcy filing. *In re Tucker Oil Co., Inc.*, 55 B.R. 78, *appeal decided* 64 B.R. 183 (Bankr. W.D. Ark. 1985). At the same time, a granting of a security interest to a preexisting creditor during the one year period, without receiving new consideration, will alter the entire transfer or debt to the latest transaction date. *In re Kelley*, 7 B.R. 384 (Bankr. D.S.D. 1980). In deed questions, the operative date is when the deed is recorded. *In re Levy*, 185 B.R. 378 (Bankr. S.D. Fla. 1995). The obvious pattern is that the court will usually look to the date that actual title vests or the date on which the last significant part of the transfer took place. In other words, the transfer date is liberally construed to find coverage under the statute.

C.1.2. Elements required:

C.1.2.1. transfer

The term transfer, includes every method of disposing of or parting with property or possessions. *Hoecker v. United Bank of Boulder*, 476 F.2d 838 (10th Cir. 1973). The transfer does not have to be made directly by the debtor, as long as one can connect the transfer to the debtor, either directly or indirectly. *In re FBN Food Services, Inc.*, 185 B.R. 265, *affirmed and remanded* 82 F. 3d 1387, *rehearing denied* (N.D.Ill 1995); *Matter of Clover Donut of White Plains Corp.*, 14 B.R. 205 (Bankr. S.D.N.Y. 1981). Nevertheless, a transfer needs to be made. Therefore, a change in form or substance of the asset does not necessarily constitute a transfer. *E.g. In re Levine*, 139 B.R. 551 (Bankr. M.D. Fla. 1992) (Conversion of non-exempt property into exempt property did not constitute a transfer.).

a. Acts constituting transfers

(i) <u>Consignment of goods</u> -- *In re Factory Tire Distributors*, Inc., 64 B.R. 335 (W.D. Pa. 1986).

(ii) <u>Church contributions</u> -- *In re Young*, 82 F.3d 1407 (8th Cir. 1996) *rehearing and suggestion for rehearing en banc* denied 89 F. 3d 494.

(iii) <u>Judgments barring debtors from reasserting claims</u> -- *Matter of Besing*, 981 F. 2d 1488 (5th Cir. 1993) (Prejudicial dismissal was for debtor's discovery abuse.).

(iv) Transfers according to divorce decree, separation agreement, or marital property settlement -- *In re Lange*, 35 B.R. 579 (Bankr. E.D. Mo. 1983).

(v) Foreclosures -- *In re Littleton*, 888 F.2d 90 *rehearing denied* 890 F.2d 1167 (11 Cir. 1989).

(vi) Termination of lease -- see II,B,2,a,ii,(b) below.

(vii) Leveraged buyouts -- *In re Oxford Homes, Inc.*, 180 B.R. 1 (Bankr. D. Me. 1995).

(viii) Mortgage modifications -- *Matter of Venice Western Motel, Ltd.*, 67 B.R. 777 (Bankr. M.D. Fla. 1986) (transfer where net effect of modification increased principle amount of loan.).

(ix) Down payments on real property -- *In re McConnell*, 934 F.2d 662 (5th Cir. 1991); *but see Matter of Wey*, 854 F.2d 196 (7th Cir. 1988).

b. Acts not constituting transfers

(i) Conversion of non-exempt property into exempt property -- *In re Levine*, 139 B.R. 551 (Bankr. M.D. Fla. 1992); *but see In re Beckman*, 104 B.R. 866 (Bankr. S.D. Ohio 1989); *In re Breuer*, 68 B.R. 48 (Bankr. N.D. Iowa 1985); *In re O'Brien*, 67 B.R. 317 (N.D. Iowa).

(ii) Franchisor's termination of debtor's franchise-dealership contracts pursuant to terms of agreement -- *Matter of Jermoo's Inc.*, 38 B.R. 197 (Bankr. W.D. Wis. 1984); but see cases involving termination of lease by a lessor for breach of covenant contained therein, which is a transfer -- *In re Ferris*, 415 F. Supp. 33 (D.C. Okl. 1976); *In re Queen Ciry Grain, Inc.*, 51 B.R. 722 (Bankr. S.D. Ohio 1985).

C.1.2.2. Interest of the debtor in property, or any obligation incurred by the debtor

An essential element of an action under this section is that the debtor must have had an interest in the property transferred. *In re Jackson*, 105 B.R. 15 (Bankr. S.D. Ohio 1989). Because the interest of the debtor in the property is an undefined term in the bankruptcy code, the court will generally look to state law to help define its parameters. *In re Hulm*, 738 F.2d 323, (C.A.N.D. 1984), *cert. denied* 469 U.S. 990, 83 L. Ed. 2d 331, 105 S. Ct. 398, *on remand* 45 B.R. 523; *Matter of Simpson*, 36 F.3d 450 (5th Cir. 1994); *In re Dews*, 152 B.R. 982 (D. Colo. 1993); *In re Reynolds*, 151 B.R. 974 (Bankr. S.D. Fla. 1993); *In re Brajkovic*, 151 B.R. 402 (Bankr. W.D. Tex. 1993).

The battles are fought in two areas: (1) where the debtor owns legal title to a piece of property, and (2) where they do not possess legal title but some equitable interest. When the former is the case, it is often the debtor who must sustain the burden of proof that while legal title may be vested in his or her name, de facto or equitable title belongs to the alleged transferee. For example, in *In re Reynolds*, 151 B.R. 974 (Bankr. S.D. Fla. 1993), the debtor was the legal title holder to real estate. The court found however, that no fraudulent conveyance had taken place because the debtor did not have an interest in the property beyond the face of the document. The debtor successfully proved that he was the legal title holder of the property for the benefit of his son to allow him to obtain financing for the property, and that neither the debtor, nor the son, had ever considered the debtor to be the legal title holder.

Other times, the creditor is on the attack and is attempting to prove that the debtor had an equitable interest that was conveyed. Typically, a possessory interest in property is sufficient to trigger the provisions of § 548. *See e.g. In re Ocean Line of North Florida*, 137 B.R. 540 (Bankr. M.D. Fla. 1992).

C.1.2.3. *incurred within one year before the date of the filing --* [see supra].

C.1.2.4. *voluntarily or involuntarily*

Fraud, as a general rule, requires some type of intent on the part of the actor. The common law, however, does recognize constructive fraud. However, constructive fraud is just another way of proving intent, as mental intent is often very difficult to prove. The fact that involuntary actions can be grounds for a fraudulent act seems contrary to common sense and the common law. Nevertheless, Congress added this interesting twist to the types of activities that constitute fraudulent conveyances, and the question must be answered whether these words serve any purpose or modify in any way the listed actions that can constitute fraudulent behavior.

Courts have held that subjective intent to commit a fraud is not required under bankruptcy code § 548. *In re Nance*, 26 B.R. 105 (Bankr. S.D. Ohio 1982); *In re Checkmate Sterio and Electronics*, 9 B.R. 585, aff'd 21 B.R. 402 (Bankr. E.D.N.Y. 1981). In both of these cases, a trustee was applying the second method of proving fraudulent behavior. Bankruptcy Code § 548 is split into two sections. The first is discussed at i below; the second is discussed at ii. The second section of 548 is admittedly much more objective, and requires little testing of the debtor's motivations or mental state. Therefore, these cases do not answer the question of whether the involuntariness referred to in the primary paragraph of § 548 can be coupled with "actual intent," found in the first subparagraph, to create a much more relaxed standard of proof. The practical standard of proof in showing actual intent is discussed below.

C.1.2.4.1. actual intent to hinder, delay or defraud a creditor

Actual intent does not need to be proven by direct evidence or by an admission. *In re Sergio, Inc.*, 16 B.R. 898 (Bankr. D. Hawaii 1981). There exists common circumstantial indicia of a fraudulent intent that can be used to prove actual intent: (1) actual or threatened litigation against the debtor; (2) purported transfers of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and (5) retention by the debtor of property involved in putative transfer (i.e., reservation of benefits, control or dominion by the debtor -- *In re Warner*, 87

B.R. 199, *appeal dismissed* 94 B.R. 734 (M.D. Fla. 1988)). *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248 (1st Cir. 1991), on remand 149 B.R. 274. Other badges of fraud that have been noted in categorical form include:(1) absconding with the proceeds of the transfer immediately after their receipt; (2) absence of consideration when the transferor and transferee know that outstanding creditors will not be paid; (3) a huge disparity in value between the property transferred and the consideration received; and (4) the fact that the debtor was the officer, agent, or creditor of the transferor. *In re FNB Food Services, Inc.*, 185 B.R. 265 (N.D. Ill. 1995), *affirmed after remanded* 82 F.3d 1387, *rehearing denied*. Still other cases have sited additional badges of fraud: (1) the conveyance is concealed; (2) the transferee takes property in trust for the transferor and transferor remains in possession; and (3) debtor deals with property as his own. *In re Sergio, Inc.*, 16 B.R. 898 (Bankr. D. Hawaii 1981).

These badges of fraud and other suspicious behavior must be considered as a whole. A trustee does not have to prove any one of these factors with any degree of certainty. The facts, as taken together, only needs to lead to the conclusion that actual fraud existed. *In re Jeffry Bigelow Design Group, Inc.*, 956 F.2d 479 (4th Cir. 1992). The test requires a subjective determination of the debtor's motivation. Id. The standard is that fraudulent intent exists where the trustee shows that the transferor acted under circumstances precluding any reasonable conclusion other than that the purpose of the transfer was fraudulent as to his creditors. *Matter of Life Science Church of River Park*, 34 B.R. 529 (Bankr. N.D. Ind. 1983).

Which parties must be shown to have intent to defraud is unclear. Certainly, the debtor/transferor must have the requisite intent, but some courts hold that the transferee must have the intent as well. *Stratton v.*

Equitable Bank, 104 B.R. 713 (D. Md. 1989), *aff'd* 912 F.2d 464 (4th Cir. 1989); *Business Systems, Inc.*, 642 F.2d 200 (C.A. Tenn 1981) (Transferee does not have to return payments if transferee entered transaction in good faith without knowledge of intent to defraud creditors.); *Presbrey v. Noble*, 505 F.2d 170 (C.A. Utah 1974) (Transferee had bonafide purchaser status which trumped rights of trustee.). The apparent logic for this rule is simple. If a bona fide purchaser, without knowledge or intent to defraud, takes the property for a value, then he or she has paid what he or she believes to be fair consideration for the item, or, at the very least, the debtor has no hope of gaining a return on the transfer after the bankruptcy has passed. In these cases, the transferee must still show that the consideration paid was in an amount that he or she believed to be reasonable. *Id.* In truth, the rule appears to be that once the badges of fraud have been proven against the debtor, then the transferee is presumed to have a similar intent, and this intent can be overcome by showing that the transferee was a bona fide purchaser for value. If proven, then the transfer cannot be undone. The policy reasons for this rule are obvious, and an adoption of this rule would benefit public policy, particularly under economic efficiency arguments (the arguments are the same justifications for a bona fide purchaser rule under the Uniform Commercial Code).

There is, however, a middle ground between the two rules. Some cases have held that a transferee is protected from the fraudulent conveyance statute to the extent of the consideration given. Of course, which of the three positions taken will depend upon the party asserting the argument. *In re Mesa*, 48 B.R. 208 (Bankr. S.D. Fla. 1985). Under the presumption that the transferred item is always more valuable than the consideration paid, trustees will inevitably always argue that only the debtor's intent needs to be proven, as this test will grant the trustee the return of the entire item with no refund to the transferee; the transferee will always argue that both party's intent needs to be proven, because by keeping the property, the transferee retains his benefit of the bargain; and finally, the most logical remedy, the one in the middle, will go unargued, but will be the source of many judicial opinions, and has been termed the good faith rule. *See In re Maddalena*, 176 B.R. 551 (Bankr. C.D. Cal. 1995) (If transferee neither knew nor should have known of the fraudulent nature of the transfer, then transferee is entitled to retain the fraudulent transfer to the extent of the value given in the exchange; if transferee knowingly or recklessly participates in the fraudulent scheme, then he or she is not protected.); *Matter of Laughlin*, 18 B.R. 778 (Bankr. W.D. Mo. 1982). In cases where the transferee's "good faith" is an issue or the subject of discussion, courts generally look for earmarks of an arms-length transaction, or whether there are gross departures, to determine whether the transferee is entitled to any special treatment. *Bullard v. Aluminum Co. of America*, 468 F.2d 11 (C.A. Ind. 1972); *In re Browning Tufters, Inc.*, 3 B.R. 487 (Bankr. N.D. Ga. 1980).

This added twist on the law makes the adequacy of consideration all that much more important, and in some cases, a necessary factor in proving a fraudulent conveyance case. *See In re Pinto Trucking Service, Inc.*, 93 B.R. 379 (Bankr. E.D. Pa. 1988) (even where debtor did become insolvent as a result of transfer, court would not conclude fraudulent conveyance where debtor received adequate and fair compensation for sale.); *In re 18th Ave. Development Corp.*, 18 B.R. 904 (Bankr. S.D. Fla. 1982) (Evidence that transfer received a fair value was sufficient to show not a fraudulent conveyance.). However, in most cases, unequal consideration will not in itself prove a fraudulent conveyance case. *See e.g., In re Gutierrez*, 160 B.R. 788 (Bankr. W.D. Tex. 1993) (Purchase at 70% of value is insufficient, without other badges of fraud, to prove fraudulent conveyance.). And there are cases that hold that valuable consideration is not an affirmative defense to a fraudulent conveyance. *Matter of Beechwood*

Medicenter of Flint, 23 B.R. 939 (Bankr. E.D. Mich. 1982); *Matter of Montanino*, 15 B.R. 307 (Bankr. D.N.J. 1981) (Sale to parents living in same home was perceived to be effort to defraud creditors, and therefore, revocable, regardless of adequacy of consideration.). Upon review of the *Beechwood* case, the court had the facts of a preference case, and because of time limitations, it was trying to fit it into the fraudulent conveyance statute. The case does however stand for the proposition that, even if fair consideration is received, the transaction will be unwound where it is determined that the debtor was attempting to either prevent certain creditors for receiving what they would receive without the transfer, or the debtor was attempting to make the eventual receipt of those payments or property more difficult for one or more creditors. *Id.*

One of the highly litigated issues and one of the acts that angers trustees and creditors alike is where a debtor transfers non-exempt assets into exempt assets. While some courts hold that these internal transfers are not transfers at all, the majority of the courts do. *Supra.* Those courts that get past the initial question are inevitably faced with the question of whether the transfer to exempt property is a badge of fraud in and of itself. Creditors and trustees are often disappointed to find that the answer is no. The overwhelming number of cases state that the trustee must go one step further and prove that the transfer was made to prevent hinder or delay creditors from reaching the assets. *In re Holt*, 894 F.2d 1005 (8th Cir. 1990); *In re Breuer*, 68 B.R. 48 (Bankr. N.D. Iowa 1985); *In re O'Brien*, 67 B.R. 317 (N.D. Iowa 1986); *In re Levine*, 40 B.R. 76 (Bankr. S.D. Fla. 1984); *In re Oliver*, 38 B.R. 407 (Bankr. D. Mass. 1984). However, the additional proof necessary does to appear to minimal. *In re Barker*, 168 B.R. 773 (Bankr. M.D. Fla. 1994) (Even though placing funds into annuities was sound investment strategy, evidence appeared to show that transfer was made in attempt to hinder creditor's attempt to obtain the items.).

C.1.2.4.2. the Second Method of Proving Fraudulent Conveyance under § 548

C.1.2.4.2.1 received less than equal consideration; and

Obviously, in this phase of the test, the court is comparing what left the estate to what entered into the estate. *In re Southmark Corp.*, 138 B.R. 820 (Bankr. N.D. Tex. 1992). Generally, the litmus test in this case is -- as long as the unsecured creditors are no worse off because of the transfer, then the debtor received a reasonably equivalent value to that which left the estate because of the transfer. *In re Jeffrey Bigelow Design Group, Inc.*, 956 F.2d 479 (4th Cir. 1992). This does not mean that the debtor needs to receive a dollar for dollar exchange in order to have been paid a "reasonably equivalent value." *Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119 (5th Cir. 1993); *In re Southmark Corp.*, 138 B.R. 820 (Bankr. N.D. Tex. 1992). There is no magic percentage of fair market value that needs to be achieved in order to constitute reasonably equal consideration. *In re Fargo Biltmore Motor Hotel Corp.*, 49 B.R. 782 (Bankr. D.N.D. 1985) (Flat percentage basis approach is inappropriate, however, a good starting point with which to gauge a transfer's reasonableness.). However, one line of cases holds that anything less than 70% of the value is not reasonably equal. *Durrett v. Washington Nat'l Ins. Co.*, 621 F.2d 201 (5th Cir. 1980); *In re Thrifty Dutchman, Inc.*, 97 B.R. 101 (Bankr. S.D. Fla. 1988). In another case, *Misty Management Corp. v. Lockwood*, 539 F.2d 1205 (C.A. Nev. 1976), the court held that a transfer that was for over 70% of the collateral's value was unreasonable, where the difference amounted to $276,000. One court has stated that the relative percentage of fair market value[1] is but one factor to be compared along with good faith and the relative difference in amount paid compared to the fair market value. *In re Smith*, 24 B.R. 19 (Bankr. W.D.N.C. 1982). Other courts follow the 70% rule only in cases of private sales. *Madrid v. Lawyers Title Ins. Corp.*, 725 F.2d 1197 (9th Cir. 1984). A final line of cases holds that courts must determine reasonably equivalent value on a case by case basis. *First Federal Savings & Loan Assn. of Bismark v. Hulm*, 738 F.2d 323 (8th Cir.), *cert denied*, 469 U.S. 990 (1984).

While the court generally must look to the surrounding circumstances of the transaction to determine value, *Matter of Fairchild Aircraft Corp.*, 6 F.3d 1119 (5th Cir. 1993), it is improper for a court to consider sentimental value of the debtor or other similarly subjective criteria. *In re First Capital Holdings Corp.*, 179 B.R. 902 (Bankr. C.D. Cal. 1995). At the same time, a completely objective, mathematical standard does not apply either; a court must consider things such as whether indicia of an arms length transaction are present and other factors showing the actual fair market value of the property sold. *In re Morris Communications NC, Inc.*, 914 F.2d 458 (4th Cir. 1990) (appearing to side with the *First Federal v. Hulm*, *supra*, line of cases).

The operative date is the value of property and consideration as of the date of transfer. *In re Robinson*, 80 B.R. 455 (1987).

C.1.2.4.2.2. insolvent/small capital remaining/ debt incurred beyond ability to pay

Some courts hold that if the party attacking the transfer as being fraudulent meets the burden of proving that the consideration given was inadequate, the burden of the defense of the transferor's solvency, or the proof that one of the three subsections of § 548(a)(2)(B) exists, passes to the party seeking to uphold the transfer. *See*

[1] Note that fair market value is the standard barometer unless the property is transferred under a forced sale environment, in which case the value is liquidation value. In re Hollar, 184 B.R. 243 (Bankr. M.D.N.C. 1995).

e.g., *In re Joshua Sloam, Ltd.*, 103 B.R. 610 (Bankr. E.D. Pa. 1989). However, most cases place this burden on the trustee. *See e.g.*, *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989).

C.1.2.4.2.1. Insolvency

Courts look to see whether a debtor is either insolvent at the time of the transfer or rendered insolvent as a result of the transfer, and either one will be sufficient to pass this portion of the analysis. *In re Newtowne, Inc.*, 157 B.R. 374 (Bankr. S.D. Ohio 1993). To decide whether a debtor is insolvent, courts generally ask -- what would the buyer be willing to pay for the debtor's entire package of assets and liabilities? If the price is positive, the debtor is solvent; if the price is negative, the debtor is insolvent. *Covey v. Commercial National Bank of Peoria*, 960 F.2d 675 (7th Cir. 1992). Courts look to the debtors balance sheet. *Mellon Bank, N.A. v. Metro. Communications, Inc.*, 945 F.2d 635 (3d Cir. 1991), *cert. denied* 112 S. Ct. 1476, 117 L. Ed. 2d 620 (1992). However phrased, this method is a review of the assets and liabilities of the debtor, and a comparison between the two.

When looking at assets, the court must assign to those assets that are readily susceptible to liquidation, *In re Joshua Sloam*, 103 B.R. 610 (Bankr. E.D. Pa. 1987), their fair market value. In re Davis, 169 B.R. 285 (E.D.N.Y. 1994); *In re Pioneer Home Builders, Inc.*, 147 B.R. 889 (Bankr. W.D. Tex. 1992) (Fair market value price at time of transfer is most equitable standard.). Therefore, assets are best valued by determining what price they would bring on the open market. An open market value has been further defined as that value that a prudent business person could obtain from the sale of an asset when there is a willing buyer and a willing seller. *See Pioneer*, *supra*. Under this approach it is inappropriate to add costs and expenses associated with the sale of the assets. *Id.* The method of market price valuation focuses on what a willing buyer would pay, not necessarily what a willing seller would ultimately receive. *Id.* However, the value can be reduced by factors regarding the difficulty of the sale of the asset, but only if they affect the market price and do not relate to the costs of sale. *Id.* The value may be further adjusted by the net costs of making the asset marketable. *Id.* The court cannot take into consideration the debtor's subjective sentimental value placed upon the item. *Id.* The court can value doubtful or contingent claims at less than face value. *In re Join-In Inern. (USA) Ltd.*, 56 B.R. 555 (Bankr. S.D.N.Y. 1986). If a debtor is a guarantor on a liability, courts will generally multiply the total debt by the percent chance that the guarantee will be exercised to determine the liability to be included in the balance sheet. *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992) (cited in 26 Collier Bankr. Cas.2d 1046). Goodwill can be considered an asset, and can be determined by average high earnings over a period of years, valuable customer lists, and/or by trade names. *In re Roco Corp.*, 701 F.2d 978 (2d Cir. 1983).

The assets are to be reduced by liabilities. Courts can refer to 11 U.S.C. § 101(4) to determine what is a liability. *See In re: Joshua Slocum, Ltd.*, 103 B.R. 610 (Bankr. E.D. Pa. 1989) (finding that shareholders stock redemptions were not liabilities under Bankruptcy Code § 101(4).

At least one court has allowed the use of the retrojection method to prove insolvency. *In re R. Purbeck & Assocs., Ltd.* 27 B.R. 953 (Bankr. D. Conn. 1983) (analyzing insolvency in a preference action). Since insolvency at a given point in time is often difficult to demonstrate by direct proof, courts permit the trustee to show that the debtor was insolvent at one point in time and then prove that the same condition existed at the time of the subject transfer. "This method ... applies equally to situations in which the trustee starts at a point in time prior to the transfer....[to use this method, the trustee must] show the absence of any substantive or radical charges in the assets or liabilities of the bankruptcy between the retrojection dates. Possibly another burden would be to show that the evidence relating to solvency at the time of the transfer was scant." *Id.* (Evidence was scant.)

C.1.2.4.2.2. Unreasonably small capital remaining

The Bankruptcy Code does not define unreasonably small capital. However, most courts hold that the definition indicates a financial condition short of insolvency. *E.g., Murphy v. Meriton Sav. Bank* (*In Re: O'Day Corp.*), 126 B.R. 370, 407 (Bankr. D. Mass. 1991). However, the condition must be severe enough that it soon turns to, or severely threatens, insolvency; otherwise, the statute is overly broad. In re *Badnais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989). Some cases have confused unreasonably small capital remaining with the third subsection, dealing with ability to pay expenses as they become due. *See Pioneer Home Builders, Inc.*, 147 B.R. 889 (Bankr. W.D. Tex. 1972). While it is one method of reviewing capital, the method renders this provision meaningless, in light of its cousin, § 548(a)(2)(13)(iii). However, determining whether enough capital exists to continue the business would not be inappropriate or redundant. *In re Joshua Slocum, Ltd.*, 103 B.R. 60 (Bankr. E.D. Pa. 1989); *In re Vadnais Lumber Supply, Inc.*, 100 B.R. 127 (Bankr. D. Mass. 1989). *In Vadnais*, the Court held that the analysis must somehow be tied to insolvency. Since the standard is something less than insolvency, then it must somehow be tied to causing or inevitably leading to insolvency. *Id.*. Delving into the courts logic, one is faced with the conclusion that subparts ii and iii are strikingly similar.

C.1.2.4.2.3. Incurred debt beyond ability to pay

There is scant authority specifically referring to 548(a)(2)(B)(iii). The language of this provision requires that the debtor intended to incur, or believe he would incur, debts that would be beyond his ability to pay. Bankruptcy Code § 548(a)(2)(B)(iii). Therefore, a fundamental issue is whether this provision applies at all in cases where the transfer is involuntary, especially when the debtor is admittedly solvent. All cases that do discuss the provision examine the intent of the debtor when the transfer was made. The provision requires an affirmative act by the debtor. The court in *In Re Hall*, 131 B.R. 213 (Bankr. N.D. Fla. 1991), has held that involuntary transfers were not contemplated by 548(a)(2)(B)(iii). *Id.* (Reconciling with general "involuntary" language of 548).

C.1.3. Who may bring claim:

The statute grants the federal fraudulent conveyance cause of action to trustees and debtors-in-possession, and therefore, a creditor generally does not have standing to prosecute an action for fraudulent conveyance. *In re Auxano, Inc.*, 87 B.R. 72 (Bankr. W.D. Mo. 1988); *In re Grell*, 83 B.R. 652 (Bankr. W.D. Mo. 1988); *In re Hess*, 21 B.R. 465 (Bankr. W.D. Va. 1982). However, courts hold that an individual creditor can bring an action for recovery of an alleged fraudulent transfer provided they can show that the trustee or creditor's committee failed to zealously prosecute the action on behalf of estate. *In re Gibson Group, Inc.*, 66 F.3d 1436 (6th Cir. 1995); *In re v. Savings Oil & Heating Co., Inc.*, 91 B.R. 655 (Bankr. E.D.N.Y. 1988); *In re Conley*, 159 B.R. 323 (Bankr. D. Idaho 1993).

In one case, *Glinka v. Abraham and Rose Co, Ltd.*, 199 B.R. 484 (D. Vt. 1996), the court allowed a creditor and the trustee to jointly pursue a fraudulent conveyance action. The court found that by itself, the estate lacked the funds to pursue the claim, and that allowing the creditor to join the trustee imposed no net financial burden on the bankruptcy estate.

C.2. South Carolina Fraudulent Conveyances/Statute of Elizabeth.

South Carolina Code § 27-23-10 et seq, known as the Statute of Elizabeth, states, essentially, that "any transaction which may be had or made to or for any intent or purpose to delay, hinder or defraud creditors and others of their just and lawful rights to that property shall be deemed and taken to be clearly and utterly void, frustrate and of no effect." This is qualified by § 27-23-40, which states:

> Nothing contained in § 27-23-10 to 27-23-30 shall extend or be construed to impeach, defeat, make void or fraustrate any [transfer] made upon or for good consideration and bonafide to any person or body politic or corporate.

Although the statute of Elizabeth's protection extends to any and all parties who are defrauded in connection with the conveyance of property, *Mathis v. Barton*, 460 S.E. 2d 406 (S.C. App. 1995) (citing *Lebovitz v. Mudd*, 2293 S.C. 49, 358 S.E.2d 698 (1987), when a creditor actually becomes a creditor can prove to be important. South Carolina case law makes a distinction between existing creditors and subsequent creditors. The applicable date of reference is the date of the challenged transfer. A creditor whose claim straddles the transfer date shall be treated according to when the majority of the claim accrued. *Id*.

Creditors who were creditors at the time the transfer took place -- i.e., existing creditors -- can set aside a fraudulent conveyance upon a showing that:

(a) where the transfer was made for valuable consideration --

(1) the transfer was made by the grantor with actual intent of defrauding his creditors;

(2) the grantor was indebted at the time of the transfer; and

(3) the grantor's intent is imputed to the grantee; or

(b) where the transfer is made without valuable consideration --

(1) the grantor was indebted to the creditor at the time of the transfer;

(2) the conveyance was voluntary; and

(3) the grantor failed to retain sufficient property to pay the indebtedness to the plaintiff in full, not merely at the time of the transfer, but in the final analysis when the creditor seeks to collect his debt.

Id.[structure of text altered for clarification].

Subsequent creditors, those creditors where at least fifty percent of the claim accrued after the allegedly fraudulent transfer, may set aside a transfer if they show (1) the conveyance was without consideration and (2) it was made with a view to future indebtedness or with actual fraudulent intent on the part of the grantor to defraud creditors. The obvious difference between the two is that an existing creditor can choose between proving lack of consideration and actual fraud whereas a subsequent creditor must always prove lack of consideration, and some type of intent. *Id.* With the exception of the elements requiring a creditor to prove that the debtor was indebted to him at the time of the transfer, all of the aforementioned elements are discussed below in order. As for proof that the grantor was indebted to the creditor at the time of the transfer, it has never been flushed out, but it would seem fairly obvious that if one is able to prove that he is an existing creditor -- fifty percent of debt owed prior to transfer -- then these elements are self actualizing, provided a creditor remembers that part of his proof is to show when the debt occurred and the amount.

C.2.1 Valuable consideration.

Obviously, for an existing creditor, the first question that must be answered is whether or not the transfer was for valuable consideration. Valuable consideration means something more than nominal. *Matthews v. Matthews*, 35 S.E. 2d 157, 207 S.C. 170 (S.C. 1945). Generally, in South Carolina, a contract need only mention consideration for it to be considered a bonafide exchange for value. However, under fraudulent conveyance law, the standard is higher, and courts will look past the four corners of the document to discern whether the exchange amounted to an arms length transaction. *See First Citizens Bank and Trust Co. of South Carolina v. Scofield*, 335 S.E. 2D 248, 286 S.C. 520 (S.C. app. 1985) (for $5.00 and "Love and Affection" insufficient language to circumvent Statute of Elizabeth). Valuable consideration is the fair equivalent of the property conveyed. Additionally, any value given must inure to the benefit of the debtor in order to be considered. *Dufresne v. Regency Realty, Inc.of Hilton Head Island*, 366 S.E. 2d 256, 295 S.C. (S.C. App. 1987) (Value given to someone other than the debtor does not county as consideration for fraudulent conveyance purposes.).

C.2.2. Fraudulent Intent

If valuable consideration was given, the creditor is forced to prove fraudulent intent. In usual circumstances,

> fraudulent intent . . . can be shown only by a consideration of the attendant facts and circumstances, a resort to which must usually be had in order to distinguish between transactions which are bona fide, and those which are not. The Courts frequently must resort to evidence or circumstances which are not properly explained, when such circumstances lead to the belief that a fraudulent intent was present. . . . For fraud is not to be expected to seek the glare of day, or the presence of witnesses for its consummation. It is usually effected in secret, and it is only from circumstances [that it may be presumed].
>
> Certain circumstances so frequently attend conveyances to defraud creditors that they are recognized and referred to as "badges of fraud." These badges tend to excite suspicions as to the bona fides of a challenged conveyance. Unexplained, they may warrant an inference of fraud. Whether the inference is warranted depends in large measure on whether a satisfactory explanation is presented.
>
> . . . Among the generally recognized badges of fraud are:
> [1] insolvency or indebtedness of the transferor;
> [2] lack of consideration for the conveyance;

[3] relationship between the transferor and the transferee;
[4] the pendency or threat of litigation;
[5] secrecy or concealment;
[6] departure from the usual method of business;
[7] the transfer of the debtor's entire state;
[8] the reservation of benefit to the transferor;
[9] retention by the debtor of possession of the property.

> Although it has been said that a single badge of fraud may stamp a transaction as fraudulent, it is more generally held that one circumstance recognized as a badge of fraud may not alone prove fraud; where there is a concurrence of several such badges of fraud an inference of fraud may be warranted.

Coleman v. Daniel, 199 S.E.2d 74, 261, S.C. 198 (S.C. 1973).

C.2.3. Knowledge of Grantee.

In order to set aside a fraudulent conveyance made where value is given, the creditor must show that the fraudulent intent of the debtor is imputable to the grantee. *Sumner v. Janicare, Inc.*, 366 S.E. 2D 20, 294 S.C. 483 (S.C. App. 1988). This requires that the transferee have knowledge or participate in the scheme, which can be proven by circumstantial evidence. *SCNB v. Halter*, 359 S.E. 2D. 74, 293 S.C. 121 (S.C. App. 1987). Actual knowledge of, or participation in, the debtor's fraudulent intention on the part of the transferee need not be established in order to justify a conclusion that the transaction was fraudulent. The transaction is subject to attack if at the time of the transfer the transferee had notice of circumstances which would arouse the suspicion of any ordinary prudent man and cause him to make inquiry as to the purpose for which the transfer was being made, which would disclose the fraudulent intent of the maker. *Coleman v. Daniel*, 199 S.E. 2D 74, 261 S.C. 198 (S.C. 1973). Knowledge on the part of a purchaser that the seller is indebted or insolvent has frequently been held sufficient to place a purchaser on notice and to require him to investigate. *Id.* The purchaser need not know of the specific debt that the creditor asserts is being hindered or prejudiced as a result of the transfer. *Id.* Perhaps the most ambiguous element is the requirement that an existing creditor must prove that a transfer without consideration was voluntary. A voluntary conveyance is a transfer made without consideration or for a mere nominal consideration. *Durham v. Blanchard*, 438 S.E. 2D 259 (S.C. App. 1993). Where nominal or some amount of consideration is paid, the transfer is considered voluntary to the extent the value of the property is more than the consideration paid. *Kirby v. Horne Motor Co.*, 366 S.E. 2D 259 (S.C. App. 1988).

C.2.4. Voluntariness of transfer

A voluntary conveyance is a transfer made in good faith without consideration or for a mere nominal consideration. *Durham v. Blackard*, 438 S.E. 2d 259 (S.C. App. 1993). "A voluntary conveyance which violates the statute [of Elizabeth] will be set aside to the extent of the value of the property transferred less any consideration received in exchange therefore." Id. at 263.

C.2.5. Insolvency

When an existing creditor is showing that the grantor failed to retain sufficient property to pay the indebtedness to the plaintiff in full, they are in essence attempting to prove insolvency. The court in *Gardner v. Kirven*, 191 S.E. 814, 816 (1937) seems to suggest that the plaintiff needs to show that "[i]f in the final event the property of the debtor is not sufficient to pay his debts existing at the time of this voluntary conveyance, then such conveyance is null and void as to such debts." *Id.* Clearly, the *Garvin* holding suggest that a creditor may show insolvency at the time the debt is sought to be collected. *Garvin* supports the position that in conveying property, debtor's must retain sufficient property to satisfy their debts when they become due. The amount of property that must be retained "means a sufficient amount of property not merely at the time of the transfer, but an amount from which in the final analysis the creditors are able to collect their indebtedness in full." *Id.* at 816.

No South Carolina Court has held that this element is presumed or abandoned when the debtor/grantor has filed bankruptcy. Nevertheless, it would seem that a creditor's or trustee's duties in proving this element go beyond simple proof that the debtor filed bankruptcy. The creditor or the trustee must show that the debtor is infact insolvent. The mere filing of a petition is insufficient because one can file bankruptcy for one of two reasons -- (1) the inability to pay ones debts as they become due, and (2) not having enough assets to pay ones debts. According to *Durham v. Blackard,* 438 S.E. 2d 259 (S.C. App. 1993), a creditor may have to prove that the debtor has insufficient assets to pay the debt, after the transfer. *See Durham*, 438 S.E. 2d at 263 ("McMillan failed to retain sufficient property to pay his debt to Blackard."). Additionally, in *Dufresne v. Regency, Inc*., 366 S.E. 2d 256 (S.C. App. 1987), the court focused on the assets of the debtor versus the liabilities, further evidencing that the a creditor must prove insolvency. *See also, Garvin v. Kirven*, 191 S.E. 814 (1937) (The grantor must reserve a sufficient amount of property to pay his creditors.). A debtor may have filed for bankruptcy using only the first condition. However, it seems almost tautological to state that if the debtor has enough assets to pay his debts without the necessity of recovering the fraudulent conveyance, the trustee would be hard pressed to justify the suit. Therefore, while the burden to show insolvence is more than showing that a petition was filed, the burden is met once the Trustee establishes that without the recovery of the fraudulent conveyance, the estate will not distribute a 100% payout to creditors.

C.2.6. Was made with a view to future indebtedness

It appears that the court in *Matthews v. Burton*, and in *Parker Peanut Co. v. Felder*, 20 S.E. 2D 716 (S.C. 1942), was referring to some proof that the debtor knew of the impending indebtedness at the time of the transfer. Although the court in *Gentry v. Lanneau*, 32 S.E. 523 (1899) was even more relaxed and suggested that the creditor need only prove that the transfer was made in anticipation of some future indebtedness.

C.3. South Carolina Uniform Commercial Code Bulk Sales Act Fraudulent Conveyance Statute.

Under the South Carolina version of the Uniform Commercial Code, the legislature has implanted a fraudulent conveyance statute to help protect creditors. The Bulk Transfer Act, found at South Carolina Code § 36-6-100 et seq., seeks to protect creditors from two possible events: from an enterprise that may sell its stock to an insider for less than what it is worth and from an enterprise that sells its stock only to distribute the proceeds to an individual who disappears. The act seeks to accomplish this purpose solely by providing notice to the creditors of the selling enterprise. See Official Comment 4 to S.C. Code Ann. § 36-6-101 (S.C. Code Ann.). The provision that gives the Bulk Transfers act its teeth is S.C. Code §§ 36-6-104 and 105, which essentially states that transfers in bulk of all or a major part of a business's inventory is not effective against existing creditors of that business unless the transferee gives notice to the creditor at least ten days before the transferee takes possession of or pays for the goods, whichever is first. S.C. Code § 36-6-104. If the creditors are not given the statutory notice neither good faith nor fair consideration are defenses for the transferee. *See In re Pritchard*, 8 B.R. 88 (Bankr. Cal. 1981) (good faith is immaterial); *Darby v. Ewing's Home Furnishings*, 278 F. Supp. 917 (D.C. Ok. 1967) (fair consideration is no defense).

D. Preferences

D.1. Elements of a Preference Cause of Action

Pursuant to section 547(b) of the United States Bankruptcy Code, a trustee may avoid any transfer of an interest of the debtor in property:

(1) to or for the benefit of the creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtors was insolvent;

(4) made --

(a) on or within 90 days before the date of the filing of the petition; or

(b) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if --

(a) the case were 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.

11 U.S.C. § 547(b). It is the trustee's burden to prove each and every one of these elements. *Id.* at § 547(f); *Danning v. Bozek*, 836 F.2d 1214 (9th Cir. 1988). Failure to meet this burden on any one element precludes a finding that a transfer is a preference. *In re Hood*, 118 B.R. 417 (Bkrtcy. D.S.C. 1990); *In re Cockreham*, 84 B.R. 757 (D.Wyo. 1988). Further, because the elements above are objective, the intent of the debtor is irrelevant.

Marathon Oil Co. v. Flatau, 785 F.2d 1563 (11th Cir. 1986). Accordingly, it is the *effect* of the transfer which is controlling. *Barash v. Public Fin. Corp.*, 658 F.2d 504 (7th Cir. 1981).

D.2. Transfer of an Interest of the Debtor in Property

Section 101 of the Bankruptcy Code defines a "transfer" as "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 and foreclosure of a debtor's equity of redemption." 11 U.S.C. § 101(54). This definition is exceptionally broad, and therefore includes virtually every conceivable transfer, including the creation or fixing of judicial liens.[2] Precisely because this definition is so broad, the true test is not whether a transfer occurred, but whether the debtor had an actual or constructive ownership interest in the transferred property. *In re Hood*, 118 B.R. 417 (Bkrtcy.D.S.C. 1990); *In re Flooring Concepts, Inc.*, 37 B.R. 957 (9th Cir. 1984).[3] In this regard, ownership is determined by the debtor's ability to control the disposition of the property. *Id*.

For example, in *In re Cybermech, Inc.*, 13 F.3d 818 (4th Cir. 1994), the Fourth Circuit Court of Appeals addressed the question of whether a debtor corporation's return of another corporation's down payment on the purchase of office machines constituted an avoidable preference. In the court held that the debtor did have an interest in the payment funds because the debtor, upon receipt of the funds, could deposit it, commingle it with other funds, withdraw from it, transfer it or otherwise use the payment funds in anyway it so desired. *Id.* at 820.

---

[2] *See* 4 COLLIER ON BANKRUPTCY § 547.03 (15th Ed. 1991) ("Any judicial proceeding that creates or fixes a lien upon the debtor's property will constitute a preference."). In South Carolina, a lien is created when the judgment is enrolled. S.C. Code Ann. § 15-35-810 (1976).

[3] In determining whether a debtor has an interest in property, state law governs.

Therefore, the debtor's "ability to exercise complete 'dominion and control over the funds' was sufficient to 'demonstrate an interest in property' under the preferential transfer provision . . . the [money] transferred . . . was a transfer of an 'interest of the debtor in property.'" *Id.* at 821 (quoting *In re Smith*, 966 F.2d 1527 (7th Cir. 1992)).

Another illustrative case is *In re Hood*, 118 B.R. 417 (Bkrtcy.D.S.C. 1990). There, the debtor was facing an imminent sheriff's levy when a friend of the debtor's intervened by offering to personally pay the debtor's debts. The debtor's creditors, however, refused to accept her checks. The debtor then took his friend's personal checks to the bank where they were exchanged for cashier checks and used to pay off the creditors. After finding that the transfer satisfied the other elements of a preference, the court turned to the ultimate question of whether or not the debtor possessed an interest in the transferred funds. Accordingly, the court held that the debtor did not have an interest in the funds because the debtor did not and could not control the disposition of the funds. In so holding, the court adopted and applied the "earmark" doctrine. This doctrine essentially states that funds loaned to a debtor by a third party that are "earmarked" for a particular creditor do not belong to the debtor. Its application requires:

(1) The existence of an agreement between the new lender and the debtor that the new funds will be used to pay a specified antecedent debt. Where the payment is made directly by the third party to the creditor, this requirement is inapplicable;

(2) Performance of that agreement according to its terms; and

(3) Transaction, when viewed as a whole, including the transfer of new funds out to the old creditor, does not result in the diminution of the estate.

Id. at 420 (citing *In re Bohlen Enter.*, 859 F.2d 561 (8th Cir. 1988)). Applying the doctrine, the court found that (1) the debtor and his friend entered an agreement that earmarked the funds for the payment of the debtor's creditors; (2) the debtor's friend directly paid the creditors; (3) the agreement was performed according to its terms;

(4) the funds transferred were never property of the debtor nor did they become property of the debtor; and (5) the transfer did not diminish the debtor's bankruptcy estAte. *Id.* Therefore, the court concluded that the transfer was not an interest of the debtor in property simply because the debtor did not and could not control the disposition of the property. *Id.* at 421.

D.3. To or For the Benefit of a Creditor . . .

Section 101 of the Bankruptcy Code defines a "creditor," in relevant part, as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 U.S.C. § 101(10)(A). Further, a "claim" means:

> (A) right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
>
> (B) right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.

11 U.S.C. § 101(5)(A)(B). In construing these terms, the United States Supreme Court stated in *Ohio v. Kovacs*, 469 U.S. 274, 105 S.Ct. 705, 83 L.Ed.2d 649 (1985) that Congress intended for them to be used in their broadest possible sense. The courts have obliged by finding creditors in even the most contingent and remote cases. *See*, *e.g., In re Cybermech*, 13 F.3d 818 (4th Cir. 1994) (buyer was a creditor of the seller because the buyer had paid for the goods, and therefore had a claim against the seller for a right to payment or a right to an equitable remedy for breach of performance); *In re Gold Coast Seed Co.*, 751 F.2d 1118 (9th Cir. 1985) (holding that a seller acquired a claim against the buyer at the time the buyer received and accepted the goods).

The transfer, however, must also benefit the creditor. Accordingly, this benefit can either be direct, *see, e.g., In re Cardon Realty Co.*, 146 B.R. 72 (Bkrtcy.W.D.N.Y. 1992) (holding that debtor's payment to creditor/assignee of loan obligation benefitted the creditor/assignee, regardless of what she did with the money after she received it, because it paid off an antecedent debt), or indirect, *see, e.g., In re Conrad Corp.*, 806 F.2d 610 (5th Cir. 1987) (holding that the debtors' transfer of restaurants in exchange for a simultaneous assumption of their debt by a third party benefitted the creditor, and therefore, constituted a voidable indirect transfer to the creditor).

D.4. Ninety Day Reachback Period; "Insider" Extension of the Preference Period

Subsection (b)(4) of section 547 provides that a transfer can only be avoided where it was made on or within ninety days before the filing of the petition. 11 U.S.C. § 547(b)(4)(A). While this is generally an absolute rule, subsection (b)(4)(B) immediately follows and provides that where the transfer was made to an "insider," the time limit for avoidance is extended to one year pre-petition. An "insider," in the conventional sense, is simply someone who stands in a close relationship with the debtor and who possesses the ability to control the debtor's actions. *In re Pineview Care Center, Inc.*, 152 B.R. 703 (D.N.J. 1993).[4] The most common examples include a relative or general partner of the debtor in the cases where the debtor is an individual or a partnership, and the director(s) or officers of the debtor in the cases where the debtor is a corporation. 11 U.S.C. § 101(31).

One of the more interesting situations where these two elements play a featured role occurs where the trustee attempts to recover a transfer to an outside creditor that benefits an insider creditor. The most common example of this scenario exists where the insider creditor guarantees a loan and then directs its payment to the creditor

[4] A more exact definition of the term appears in 11 U.S.C. § 101(31).

advancing the loan. In *Levit v. IngersollRand Fin. Corp.*, 874 F.2d 1186 (7th Cir. 1989), the court examined such a situation and set forth the "Deprizio" doctrine. This doctrine essentially allows the trustee to recover from non-insider transferees for payments made during the extended preference period which benefits insider creditors or guarantors. While many courts have adopted the "Deprizio" doctrine, *see, e.g.,Ray v. City Bank & Trust Co.*, 899 F.2d 1490 (6th Cir. 1990), other courts have vehemently refused to apply its reasoning. For example, in *In re Midwestern Co., Inc.*, 102 B.R. 169 (W.D.Mo. 1989), the court opposed the *Levit* decision because it felt that section 547 unambiguously set forth two distinct time limits for each type of creditor. In this regard, the *Midwestern* court held that an outside creditor is only liable for a transfer made within the ninety day limitation while an insider creditor is only liable for a transfer made within the extended preference period of one year. While the *Midwestern* court was attempting to give "full meaning" to section 547, the court in *In re Mercon Indus., Inc.*, 37 B.R. 549 (Bkrtcy.E.D.Pa. 1984), reached an identical result by concluding that a debtor's payment to an outside creditor for the benefit of an insider creditor constituted two distinct and separate transfers -- one to the primary creditor (outsider) and one to the guarantor (insider).

While this dispute was eventually settled with the passing of the 1994 Bankruptcy Reform Act disposing of the Deprizio doctrine, it is still relevant to any pre-1994 actions. More importantly, South Carolina bankruptcy courts follow the Deprizio doctrine. *See In re Hoffman Assoc.*, 179 B.R. 797 (Bkrtcy.D.S.C. 1995).

D.5. For or on Account of an Antecedent Debt . . .

An antecedent debt is simply a debt that the debtor incurs before he makes the alleged preferential transfer. 4 COLLIER ON BANKRUPTCY § 547.05 (15th Ed. 1991). This element is present to promote the central concept governing the existence of a preference action -- the preservation of the debtor's assets. Accordingly, any transfer to a creditor that occurs during the preference period on account of an antecedent debt serves only to deplete the debtor's bankruptcy estate, and therefore is in derogation of this policy of preservation.

While the term "antecedent" is easy enough to grasp, the existence of a "debt" depends upon the existence of a claim. In *In re Cybermech*, the creditor, Royal Cake Co, Inc. (hereinafter "Royal") entered a sales agreement with the debtor, Cybermech, Inc. (hereinafter "Cybermech") whereby Royal paid Cybermech a substantial down payment for various equipment. Due to financial troubles, however, Cybermech soon informed Royal that it would be unable to perform the contract and returned the down payment. Three weeks later, Cybermech filed a voluntary Chapter Seven petition. The trustee quickly moved to have the returned down payment set aside as a preference. Royal, however, challenged the trustee and alleged, among other things, that the returned payment was not an antecedent debt because (1) Cybermech never owed a debt to Royal; and (2) even if Cybermech did, the debt was not antecedent to the transfer. The court disagreed and held that because Royal possessed a claim against Cybermech for performance under the contract, Royal was a creditor, and Cybermech owed Royal the debt of

performance.[5] In so holding, the court stated that the terms "claim" and "debt" were coextensive; where one exists then so does the other:

> The Code defines "debt" as "liability on a claim." 11 U.S.C. § 101(12). By making "claim" the operative term in the definition of debt, "Congress gave debt the same broad meaning it gave claim." [Citation omitted]. Indeed, it is clear that "the terms 'debt' and 'claim' are coextensive: a creditor has a 'claim' against the debtor; the debtor owes a 'debt' to the creditor." [Citations omitted]. By defining debt as "liability on a claim," Congress did not impose an additional element, namely that legal liability be established through litigation. "[W]hen a claim exists, so does a debt." [Citation omitted]. They are but different windows in the same room.

---

[5] For a discussion of how the *Cybermech* court determined that Royal was a creditor, and thus possessed a claim, *see supra*. Section II(B).

Id. at 822. Therefore, Cybermech did owe a debt to Royal and said debt was antecedent to the transfer because Cybermech contracted the debt well before it returned the money.

D.6. Made While the Debtor was Insolvent . . .

A debtor is essentially insolvent when his liabilities exceed his assets. 4 COLLIER ON BANKRUPTCY § 547.06 (15th Ed. 1991).[6] In this regard, there is a presumption of insolvency during the ninety day reachback period. *Id*. In *Transit Homes, Inc. v. South Carolina Nat'l Bank*, 57 B.R. 40 (Bkrtcy.D.S.C. 1985), however, the court held that the presumption of insolvency can be rebutted by the introduction of the debtor's filed schedules.

D.7. That Enables the Creditor to Receive More Than Such Creditor Would Have Received in a Hypothetical Chapter 7 Case.

Subsection (b)(5) is merely a codification of the United States Supreme Court holding in *Palmer Clay Products Co. v. Brown*, 297 U.S. 227, 56 S.Ct. 450, 80 L.Ed. 655 (1936). There, the court held that whether a transfer is preferential should be determined "not by what the situation would have been if the debtor's assets had been liquidated and distributed among his creditors at the time the alleged preferential payment was made, *but by the actual effect of the payment as determined when bankruptcy results*." [Emphasis added]. In this regard, the court in *Elliot v. Frontier Prop./LP*, 778 F.2d 1416, 1421 (9th Cir. 1985) stated:

> This analysis requires that in determining the amount that the transfer "enables the creditor to receive," 11 U.S.C. § 547(b)(5) (1982), such creditor must be charged with the value of what was transferred *plus* any additional amount that he would be entitled to receive from a Chapter 7 liquidation. The net result is that, as long as the distribution in bankruptcy is less than one-hundred percent, *any* payment " on

[6] For a more extensive definition, *see* 11 U.S.C. § 101(32).

> account" to an unsecured creditor during the preference period will enable the creditor to receive more than he would have received in liquidation had the payment not been made. [Emphasis theirs].[7]

This section is also applicable to secured creditors. In *Smith v. Creative Fin. Management, Inc.*, 954 F.2d 193, 199 (4th Cir. 1992), the court stated:

> While the bankruptcy code recognizes and respects the preeminent status given to the secured creditor by state commercial codes, a creditor is "secured" under the code only to the extent of the value of his interest in the property of the estate . . . Section 547(b)(5) does not, as Creative seems to argue, add any special protections for the secured creditor. Indeed, the term "secured creditor" is not even included in that section . . . As the plain language of [section] 547(b)(5) convey, the court must focus, not on whether a creditor may have recovered all of the monies owed by the debtor *from any source whatsoever*, but instead upon whether the creditor would have received less than a 100% payout in a Chapter 7 liquidation.

See also 4 COLLIER ON BANKRUPTCY § 547.08 (15th Ed. 1991) ("The analysis [for unsecured creditors] is similar for secured creditors . . . .").

D.8. Primary Defense -- The Ordinary Course of Business Exception

While section 547(c) sets forth a number of instances where a trustee cannot avoid a preference transfer, the most important of these "defenses" is the ordinary course of business exception. This exception is embodied in the text of subsection (c)(2) which provides that a trustee cannot avoid a transfer:

---

[7] The Supreme Court demonstrated this principle in *Palmer* with the following example:

> [W]here the creditor's claim is $10,000, the payment on account of $1,000, and the distribution in bankruptcy is 50%, the creditor to whom the payment on account is made receives $5,500, while another creditor to whom the same amount was owing and no payment on account was made will receive only $5,000.

Palmer, 297 U.S. at 229, 56 S.Ct. at 451, 80 L.Ed. at 656.

(A) in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee;

(B) made in the ordinary course of business or financial affairs of the debtor or the transferee; and

(C) made according to ordinary business terms.

The essential purpose of this exception is "to leave undisturbed normal financial relations because it does not detract from the general policy of the section to discourage unusual action by either the debtor or its creditors during the debtor's slide into bankruptcy." *Morrison v. Champion Credit Corp.*, 952 F.2d 795, 801 (4th Cir. 1991). In this regard, the creditor who claims the exception also possesses the burden of proof. *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044, 1047 (4th Cir. 1995). Further, the creditor must satisfy its burden by a preponderance of the evidence. *Id*.

In *In re Jeffrey Bigelow Design Group*, 956 F.2d 479 (4th Cir. 1992), the Fourth Circuit Court of Appeals held that subsection (c)(2)(A) and (B) are analyzed pursuant to a subjective test. There, the court stated that the "'focus of [the] inquiry must be directed to an analysis of the business practices which were unique to the particular parties under consideration.'" *Id.* at 486 (quoting *Waldschmidt v. Ranier*, 872 F.2d 739, 743 (6th Cir. 1989). This inquiry is "'peculiarly factual, . . .'" *Id.* (quoting *In re First Software Corp.*, 81 B.R. 211, 213 (Bkrtcy.D.Mass. 1988), and "[a]ttention should be drawn to the reality of the situation and not the formal structure." *Id.* at 488. In this regard, the court emphasized that "form must not be elevated above substance." *Id*.

The Fourth Circuit utilized a different approach, however, in examining subsection (c)(2)(C). In *Advo-System, Inc. v. Maxway Corp.*, 37 F.3d 1044 (4th Cir. 1995), the creditor was a direct mail advertising firm that required its customers to prepay for its services. One of these customers was the debtor. In the ninety-day period preceding the debtor's bankruptcy petition, the debtor made twelve payments to the creditor. Two of the payments were prepayments while the remaining ten payments were for services previously rendered. The creditor had waived the last ten payments and had allowed the debtor to pay when able. Shortly after the debtor filed for Chapter 11 protection, the trustee moved to avoid the latter ten payments as preferences. The creditor countered that said payments fell within the ordinary course of business exception, and therefore, were unavoidable.

The court began its analysis by refusing to apply subsection (c)(2)(A) and (B)' s subjective test for subsection (C). *Id.* at 1048 ("[b]ecause subsection B and C are written in the conjunctive, the use of subsection B's subjective approach under subsection C would render subsection C superfluous . . . [w]e refuse to say that Congress wrote a separate subsection for no reason at all."). The court then held that subsection (C) should be analyzed under an objective test whereby a court looks to the industry norms for the determination of "ordinary business terms." *Id*. The court then explained the application of this test:

> [T]he extent to which a preference payment's credit terms can stray from the industry norm yet still satisfy [section] 547(c)(2)(C) depends on *the duration of the debtor-creditor relationship*. "[T]he more cemented (as measured by its duration) the pre-insolvency relationship between the debtor and the creditor, the more the creditor will be allowed to vary its credit terms from the industry norm yet remain in the safe harbor of [section] 547(c)(2)(C)." *Id*. at 225. A "sliding-scale window" is thus placed around the industry norm. On the one end of the spectrum, "[w]hen the relationship between the parties is of recent origin, or formed only after or shortly before the debtor sailed into financially troubled seas, the credit terms will have to endure a rigorous comparison to credit terms used generally in a relevant industry." *Id.* In such a case, only those "departures from [the] relevant industry's norms which are not so flagrant as to be 'unusual' remain within subsection C's protection." *Id.* at 226.
>
> On the other end of the spectrum, "when the parties have had an enduring, steady relationship, one whose terms have not significantly changed during the pre-petition insolvency period, the creditor will be able to depart substantially from the range of

> terms established under the objective industry standard inquiry and still find a haven in subsection C." *Id.*

Id. at 1049 (quoting *Fiber Lite Corp. v. Molded Acoustical Products, Inc.*, 18 F.3d 217 (3d Cir. 1994)). In so holding, the court also emphasized that "subsection C never tolerates a gross departure from the industry norm, not even when the parties have had an established and steady relationship." *Id.* at 1050.

Applying their "newly adopted" sliding scale approach to subsection (c)(2)(C), the court found that the creditor had failed to meet its burden of satisfying subsection (c)(2)(C). Because the creditor's normal business practice was to require prepayment, their waiving of the requirement for the debtor constituted a gross departure from their industry norm. Therefore, and despite their longstanding relationship with the debtor, the creditor was held liable for the preference payment.

D.9. Defense -- The New Value Exception

Another defense worthy of mention is the new value exception. It is embodied in section 547(c)(1)(A)(B) which provides:

> (c) The trustee may not avoid under this section a transfer --
>
> (1) to the extent that such transfer was --
>
> (A) intended by the debtor and the creditor to or for whose benefit such transfer was made to be a contemporaneous exchange for new value given to the debtor; and
>
> (B) in fact a substantially contemporaneous exchange.

The exception's existence and purpose is to protect transactions that do not diminish the bankruptcy estate. *In re Martin*, 188 B.R. 689 (M.D.Ala. 1995). In this regard, it is the intent of the parties which constitutes the most critical element. *See In re Hersman*, 20 B.R. 569 (Bkrtcy.N.D.Ohio 1982) ("The key inquiry, therefore, is whether the parties at the outset intended the exchange to be contemporaneous.”). Legislative history reveals the type of transaction that this exception was designed to cover:

> However, for the purposes of this paragraph, a transfer involving a check is considered to be “intended to be contemporaneous,” and if the check is presented for payment in the normal course of affairs . . . that will amount to a transfer that is “in fact substantially contemporaneous.

H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 373 (1977), U.S. Code Cong. & Admin. News, p. 5787 (1978). A check, then, is the classic example. *See In re Davis*, 22 B.R. 644 (Bkrtcy.M.D.Ga. 1982) (holding that the only type of credit transaction which would result in a transfer under the new value exception is a check transaction, which is for all practical intents and purposes really a cash transaction). Conversely, a credit card transaction is the classic bad example. In *In re Hersman*, the court explained:

> Where goods are paid for by a check, the payor had funds in the banking institution upon which the check is drawn when he makes the check payable to the person furnishing the goods. The payee need only present the check for payment . . . When using a credit card to pay for goods, a consumer is generally seeking that which its name implies -- the extension and receipt of credit. By using a credit card, the credit card consumer does not intend a contemporaneous exchange for value. Instead, what is generally intended is the receipt of goods or services presently and time to pay for the same in the future . . . .

In re Hersman, 20 B.R. at 573.

A transaction, however, need not only be contemporaneous, but it must create new value as well. While the question of new value is always a question of fact, *In re Spada*, 903 F.2d 971 (3d Cir. 1990), its form can be virtually anything. *See In re Prescott*, 805 F.2d 719 (7th Cir. 1986) (stating that new value includes new credit, goods, services and property). In *In re Townsend-Robertson Lumber Co.*, 144 B.R. 407 (Bkrtcy.E.D.Ark. 1992), the court found new value in the retention of fees for the storing of a Chapter 7 debtor’s lumber. In *In re Mantelli*, 149 B.R. 154 (9th Cir.BAP Cal. 1993), however, the court held that a debtor's payment to his wife of a civil contempt sanction did not create new value because the payment was not made for goods or services, but in lieu of a five day jail sentence.

E. Turnover Orders

Section 542(a) generally provides that a third party noncustodian that has custody or control over property of the estate that either the Trustee may use, sell or lease or that the debtor may exempt must turn that property over to the Trustee, unless the property is of inconsequential value or benefit to the estate. Section (b) provides that an individual that owes a matured debt shall pay that debt to the order of the trustee, unless the debt is being set-off under Section 553. Subsections 542(c) and (d) provides specific instances where the third party does not have to turn the property over to the Trustee. Specifically, if the party does not know of the commencement of the case, or if the third party is transferring life insurance benefits. 542(e) also requires the turnover of books and records from individuals such as attorneys and accountants to the Trustee. Note that Section 542(e) does not waive or constitute any exception to the attorney-client privilege.

The court will exceed its equitable power if it orders turnover of property held by a creditor without first providing adequate protection for that property. *In re Empire for Him, Inc.*, 1 F.3d 1156 (11^{th} Cir. 1993).

F. Exemptions

Exempted property is property that the debtor may keep. If a debtor owns too expensive or too much property for a particular section, the debtor must surrender the excess to the estate or sell the property and keep the cash equivalent of the exempted property. Property that is fully liened is not subject to an exemption. Many of South Carolina's Exemptions are located at S.C. Code Ann. 15-41-30:

1. Up to 5,000.00 in a residence or burial plot owned by a debtor or a dependent of the debtor.

2. Up to 1,200.00 in a motor vehicle (Ex. a debtor has a 6,000 car. The debtor can sell the car for 6,000 and keep 1,200 in cash.)

3. Up to 2,500.00 in household goods, wearing apparel, furnishings, appliances, books, animals, crops or musical instruments held primarily for personal, family or household use.

4. Up to 500.00 in jewelry

5. Up to 1,000.00 in liquid assets (cash, drafts, securities, notes etc) This exemption is only available if the debtor does not take a homestead exemption.

6. Up to 750.00 in professional implements, tools of the trade and books

7. Any interest that the debtor has in an unmatured life insurance contract, but not a credit life insurance contract.

8. Up to 4,000.00 in dividend, interest or loan value of any lie insurance contract.

9. Any professionally prescribed health aids for the debtor or a dependent of a debtor.

10. The debtors right to receive: a social security benefit, a veteran's benefit, a disability benefit, alimony, support or separate maintenance and a payment of a stock, bonus, pension, sharing, annuity or similar plan on account of age, disability, death or length of service.

11. The debtor may also receive any property traceable to: an award under a crime victim reparation law, a payment on account of bodily injury of the debtor or of the wrongful death or bodily injury of another individual of whom the debtor was or is a dependent, a payment under a life insurance contract that insured a person to whom the debtor was s dependent on the date of the insured's death.

12. Any interest or right in an individual retirement account.

13. The debtor's interest in an ERISA qualified employee pension plan.

14. South Carolina has other exemptions:

    a. Fraternal benefit association

b. Right to annuity or retirement allowance from the S.C. Retirement System, the Retirement System for Judges and Solicitors, the Retirement System for the General Assembly, the police Officers retirement System or any private municipality retirement system.

c. Any pension fund held before or after the Fireman's pension funds held by any municipality.

d. 50,000 in cash surrender value or proceeds from an individual life insurance policy for the benefits of the debtors, spouse, children or other dependents.

e. 50,000 in cash surrender value or proceeds from a group life insurance policy for the benefits of the debtors, spouse, children or other dependents.

f. Workers Compensation pursuant to S.C. Code Ann. 42-9-360

g. Public Aid and Assistance pursuant to S.C. Code Ann. 43-5-190

h. Crime Victim's Compensation pursuant to S.C Code Ann. 16-3-1300

i. Partnership Property pursuant to S.C. Code Ann. 33-41-720.

15. Other Federal Exemptions include:

a. Social Security paid or payable 42 U.S.C. 407

b. Veteran's benefits 38 U.S.C. 3101

c. Disability or death compensation for government employees 5 U.S.C. 1830

d. Civil Service retirement annuity 5 U.S.C. 8346

e. Armed Services retirement or retainer pay annuity 10 U.S.C. 1440

f. Military survivor annuity, 10 U.S.C. 1450

g. Foreign service retirement and disability 22 U.S.C. 4060

h. Annuities for survivors of judicial officials 28 U.S.C. 376

i. Longshoremen's and harbor workers compensation and benefits, 33 U.S.C. 916

j. Benefits from Servicemen's or veteran's Group Life Insurance 38 U.S.C. 770(g)

k. War risk hazard compensation benefits 42 U.S.C. 352(e)

l. Railroad retirement annuity for supplemental annuity 45 U.S.C. 231(m)

m. Railroad workers unemployment compensation 45 U.S.C. 352 (e)

n. The Clothing of seamen 46 U.S.C. 1110

o. CIA retirement 50 U.S.C. 403

G. Valuation of Security Interest

Section 506 determines the actual amount of a secured claim, but does not govern if the claim itself is specifically allowed. A creditor is secured if it has a lien on the property or if the property is subject to setoff pursuant to Section 553. The creditor is secured to the value of the creditor's interest in the property or the extent of the amount of setoff. If the amount of the collateral is less than the claim, then the creditor is unsecured for the remainder of the claim. 506(b) states that if the value of the collateral exceeds the amount of the creditor's claim, then the creditor's claim can be increased by expenses and interest incurred by the creditor. 506(c) requires that the Trustee charge the secured creditors for certain necessary expenses to preserve the property, 506(d) summarily voids liens secured by claims that are not properly allowed claims.

A debtor's Chapter 13 property is valued according to the cost a debtor would incur in obtaining a like asset for the same use. This is also known as replacement value. Determining the replacement value requires deductions for certain costs including warranties, storage and reconditioning. *Associates Commercial Corp v. Rash,* 520 U.S. 953 (1997).

Replacement value for a vehicle may be calculated by averaging wholesale values in the "blue book" and then by adjusting the value according to other evidence introduced by the parties. *In re Getz*, 242 B.R. 916 (B.A.P. 6th Cir. 2000).

Valuation of collateral securing a creditor's claim is flexible and is not limited to a single point in time for purposes of determining whether a creditor is entitled to accrue interest under 506(b). *In re T-H New Orleans Ltd. Partnership*, 116 F.3d 790 (5th Cir. 1987).

Under 506(b) no recovery exists for postpetition interest on an oversecured claim, but recovery of reasonable fees and costs are permitted. *United States v. Ron Pair Enterp. Inc*., 489 U.S. 235 (1989).

The Chapter 11 debtor in possession may not surcharge an oversecured bank's collateral to pay debtor's attorneys of the services are not necessary and do not confer a benefit to the banks. *In re Compton Impressions, Ltd.*, 217 F.3d 1256 (9th Cir. 2000).

H. Treatment of Secured Claims in Chapter 11 Plans

In Chapter 11 Bankruptcy, The debtor usually files the plan pursuant to Section 1121. The plan must place creditors into substantially similar classes pursuant to 1122. Secured Creditors usually have their own class. Section 1123 provides that the plan may impair or leave unimpaired any class of secured or unsecured claims, (1123(b)(1) but if the plan leaves a class unimpaired, then the plan must specifically state it. (1123(a)(2).) Section 1124 defines an unimpaired class as a class that is completely protected under the plan. Unimpaired classes are deemed to have protected the plan, as those creditors will receive the full amount of their security interest. Section 1129(a)(8).

For a plan to be confirmed each class must have accepted the plan under 1129(a)(7) or the class must be crammed down under 1129(b). A class has accepted the plan if at least 2/3 in amount and more than ½ in number of the creditors in the class have accepted the plan. 1126(c). The court may also "knock out"creditors whose acceptance or rejection of the plan was not in good faith. 1126(e). So as a class of secured creditors, the plan can either leave them unimpaired so that the secured creditors get the total amount of their lien and are deemed to have accepted the plan. The secured creditors can accept the plan, or they can reject the plan and the debtor can try to "cram" the plan down on them, forcing them to accept the plan. Section 1129(b)(2) provides the mechanism to "cram down" around a secured creditor. The plan must be fair and equitable and provide that the holders retain the liens securing the claims, that each holder receive deferred cash payments totaling at least the allowed amount of such claim (or for the sale and proceeds of the liened items) or the realization by the holders of the indubitable equivalent of such claims. Thus, it is very hard to "cram down" on a secured creditor, unless the creditor is getting what they would have gotten outside of bankruptcy. Thus, it is smart for most Chapter 11 plans to go ahead and set the secured creditors up as an unimpaired class, deemed to have accepted the plan.

Claims may be classified separately if the claims are not substantially similar, if there are good business reasons for doing so, or if in the claimants have sufficiently different interests under the plan. Claims may not be classified separately solely in order to gerrymander an affirmative vote on reorganization. *Matter of Wabash Valley Power Assoc.*, 72 F.3d 1035 (7th Cir. 1995) *cert denied*, 519 U.S. 965 (1996).

In determining whether a classification is reasonable, the court should look to purposes that classification serves: (1) voting to determine whether a plan can be confirmed; and (2) treatment of claims under the plan. Each class must represent a voting interest that is sufficiently distinct to merit and separate voice. John Hancock Mutual Life Ins. Co. v. Route 37 Bus. Park. Assocs., 987 F.2d 154 (3d Cir. 1993).

Any alteration of rights constitutes an impairment, even if the value of the rights is enhanced. *Matter of Wabash Valley Power Assoc.*, 72 F.3d 1035 (7th Cir. 1995) *cert denied,* 519 U.S. 965 (1996). A claim is impaired unless the plan does not alter the legal, equitable, and contractual rights to which a claim or interest entitles the holder. *In re Windsor on the River Assoc. Ltd.*, 7 F.3d 127 (8th Cir. 1993).

The purchase of claims for the purpose of securing the approval or rejection of a plan is not per se bad faith. *In re 255 Park Plaza Assocs. L.P.,* 100 F.3d 1214 (6th Cir. 1996).

A postpetition secured lender is not entitled to vote on a plan of reorganization. *In re Kliegl Bros. Univ. Elec. Lighting Co.*, 149 B.R. 306 (E.D.N.Y. 1992).

When all requirements for a confirmation of a reorganization plan are met except for 1129(a)(8), the bankruptcy court must confirm the plan despite the objection of an impaired class or classes so long as the plan does not discriminate unfairly and is fair and equitable with respect to the impaired classes. *In re Bonner Mall Partnership,* 2 F.3d 889 (9th Cir. 1993).