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Bankruptcy on the Blackboard

John Foster

BANKRUPTCY ON THE BLACKBOARD

A Collection of Graphic Illustrations Used in the Teaching of the Bankruptcy Course at the University of North Dakota School of Law

JOHN FOSTER*

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VII. STRONGARM POWER OF THE TRUSTEE: THE ABILITY OF THE BANKRUPTCY TRUSTEE TO AVOID TRANSFERS AND LIENS WHICH ARE NOT PROPERLY RECORDED OR PERFECTED IN THE SAME WAY AN INNOCENT PURCHASER OR LIEN CREDITOR COULD DO SO UNDER STATE LAW 278
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"A picture is worth a thousand words."[1]

UND School of Law Adjunct Faculty Member John Foster has taught various commercial law courses at the Law School since 1981, and one such course for second and third year law students is Bankruptcy. The class has historically met at 8 A.M. two days a week, and Professor Foster has a habit of arriving prior to 7 A.M. on those days to fill the blackboards and the whiteboards with his own graphic and "cartoon" interpretations of the theoretical and practical workings of the Bankruptcy Code. Professor Foster does his drawings "fresh" each class day, and varies the drawings from semester to semester. He does not like computer-generated images or other electronic graphics recall systems, because those, he says, take away from the immediacy of "hot on the board" drawings.

Professor Foster and his students have discovered there is considerable educational value in converting the overwhelming, massive, and mysterious federal legalese of Bankruptcy into pictures and illustrations which allow important points to be taught quickly and efficiently, and allow the students to brand into their brains memorable visual depictions of theories, concepts, and procedures, which the students can carry with them into practice.

It was the late and beloved Professor Randy Lee who suggested to the NORTH DAKOTA LAW REVIEW that a collection of Professor Foster's "cartoons and graphics" might provide education as well as entertainment to the bench, bar, and other readers of the North Dakota Law Review.

So, without further adieu, we present a collection of blackboard and whiteboard graphics from Professor Foster's bankruptcy course, with each drawing preceded by a short commentary, condensed from Professor Foster's lectures, explaining the graphics.[2]

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1. *See* www.napoleon.org/en/space/information_bulletin/Napoleon_bulletin_model.htm (positing that Napoleon Bonaparte spoke this famous quote possibly documented in EMMANUEL LAS CASES, MEMORIAL DE SAINTE-HELENE (La seuil, 1999) (1823).

2. Professor Foster's graphics depict the Bankruptcy Court as flying the "Jolly Roger Skull & Crossbones" flag. When asked about this, Professor Foster replies that the pirate ship death's head logo is intended to make a humorous comment on three aspects of Bankruptcy. First, the gnashing of teeth between the Federal Judiciary and Congress back in 1982, when the Supreme Court declared then-Bankruptcy Court pervasive jurisdiction unconstitutional as a violation of Article III, brought to mind that a lot of folks in the legal community viewed the powerful Bankruptcy Judges (ultimately declared too powerful) somewhat as "JURISDICTIONAL PIRATES." Second, debtors in bankruptcy generally suffer from EXTREME FINANCIAL MALNUTRITION (skull & bones). Third, creditors involved in a bankruptcy of a customer often feel their own BONES ARE BEING PICKED CLEAN by the process.

I. TYPES OF BANKRUPTCY AND THE ROLE OF THE TRUSTEE

There are two types of bankruptcy: liquidation and rehabilitation. In liquidation, a bankruptcy trustee sells off non-exempt assets and pays creditors with the sale proceeds. In rehabilitation, the debtor continues his work, or his business continues to operate and pays creditors with earned income.

Chapter 7 is the basic liquidation section. In liquidation, the debtor's purpose is to obtain a discharge (i.e., cancellation) of his debts and obtain a "fresh start." The debtor turns over all of his non-exempt property, and the Trustee gently "kicks" the debtor away from the bankruptcy estate and off into the sunset to make his fresh start *(see graphic next page)*. The Trustee, now in possession of the bankruptcy estate, sells off the former debtor property and converts it to cash, which he then distributes *pro rata* among unsecured creditors.

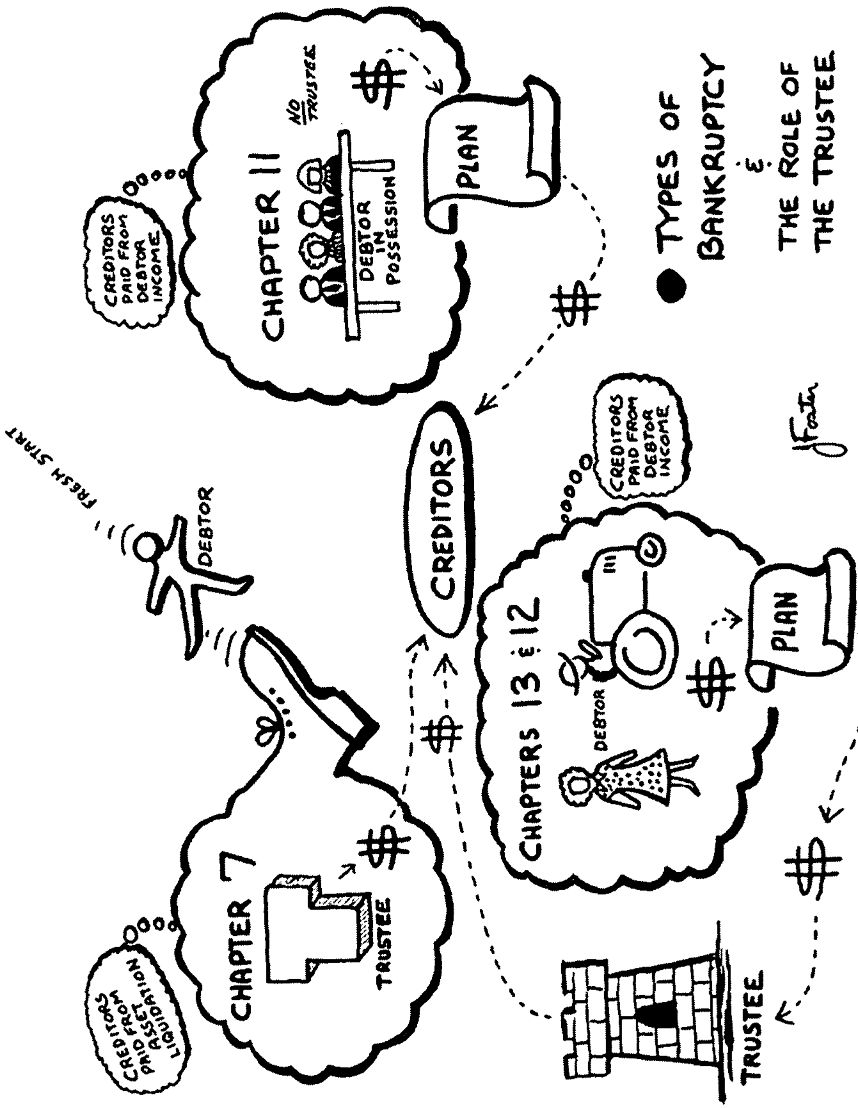
Chapter 11 Business Reorganization, Chapter 13 Individual Income Earner Debt Adjustment, and Chapter 12 Family Farmer Debt Adjustment are the Bankruptcy Code's primary rehabilitation sections. The debtor remains in possession of his property and continues to operate the business, work at his job, or farm the land. The debtor pays creditors using income generated by the business, the job, or the farm, and creditors are paid according to a written plan, confirmed by the court. The debtor ultimately receives a discharge of debts not paid by the plan when the debtor gets the plan confirmed *(Chapter 11)* or when the debtor completes payments under the plan *(Chapters 13 and 12)*.

In a Chapter 11, there is generally no Trustee appointed unless there has been fraud or gross mismanagement by the debtor. Usually, the debtor remains in control of the business as a "debtor-in-possession." The debtor files a plan of reorganization, the creditors vote whether to accept or reject the plan, the court confirms the plan, and the debtor goes forward operating the business and paying the creditors according to the dictates of the confirmed plan.

In Chapters 13[3] and 12 a Trustee is appointed, but the Trustee remains in somewhat of an "ivory tower" and does not take possession of the debtor's property, as the Trustee would in a Chapter 7. Instead, the debtor remains in possession of his property, continues to work his job or work the farm, and pays the Trustee a portion of the income earned at the job or on the farm according to the dictates of a confirmed plan of rehabilitation. The

3. In a Chapter 13, the debtor receives a broader discharge than is afforded by the other Chapters of bankruptcy. *See* 11 U.S.C. *§ 1328* (2000). The Bankruptcy Reform Act of 2005 will reduce this broad discharge considerably. *See* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

Trustee distributes the money received from the debtor to the creditors, according to the dictates of the plan.



II. JURISDICTION UNDER THE BANKRUPTCY CODE: "TOO MUCH" AT FIRST UNDER THE 1978 CODE

When Congress enacted the Bankruptcy Code in 1978, effective in October 1979, it replaced the old bankruptcy referee system with a court system presided over by Bankruptcy Judges appointed by the President for fourteen-year terms.

Bankruptcy Judges were given pervasive jurisdictional authority under the 1978 Code. They had original and exclusive jurisdiction over bankruptcy cases—i.e., Chapter 7 Liquidation, Chapter 11 Business Reorganization, and Chapter 13 Individual Income Earner Rehabilitation (Chapter 12 was not enacted until the mid-1980's).

Bankruptcy Judges were also given original *and* exclusive jurisdiction over *all civil actions arising in or related to bankruptcy.* Such civil actions included anything of a financial nature affecting the debtor and his creditors. In short, just about *everything* was subject to bankruptcy court jurisdiction, including tort claims, divorce, breach of contract actions, antitrust cases, tax litigation, real estate boundary disputes, breach of warranty claims, debt collection cases, race discrimination and sexual harassment suits, foreclosure cases, product liability suits, will contests, etc. Whether a civil matter arising in or "related to" bankruptcy involved $10 or $10,000,000, it did not matter. Jurisdiction was all encompassing under the 1978 Code.

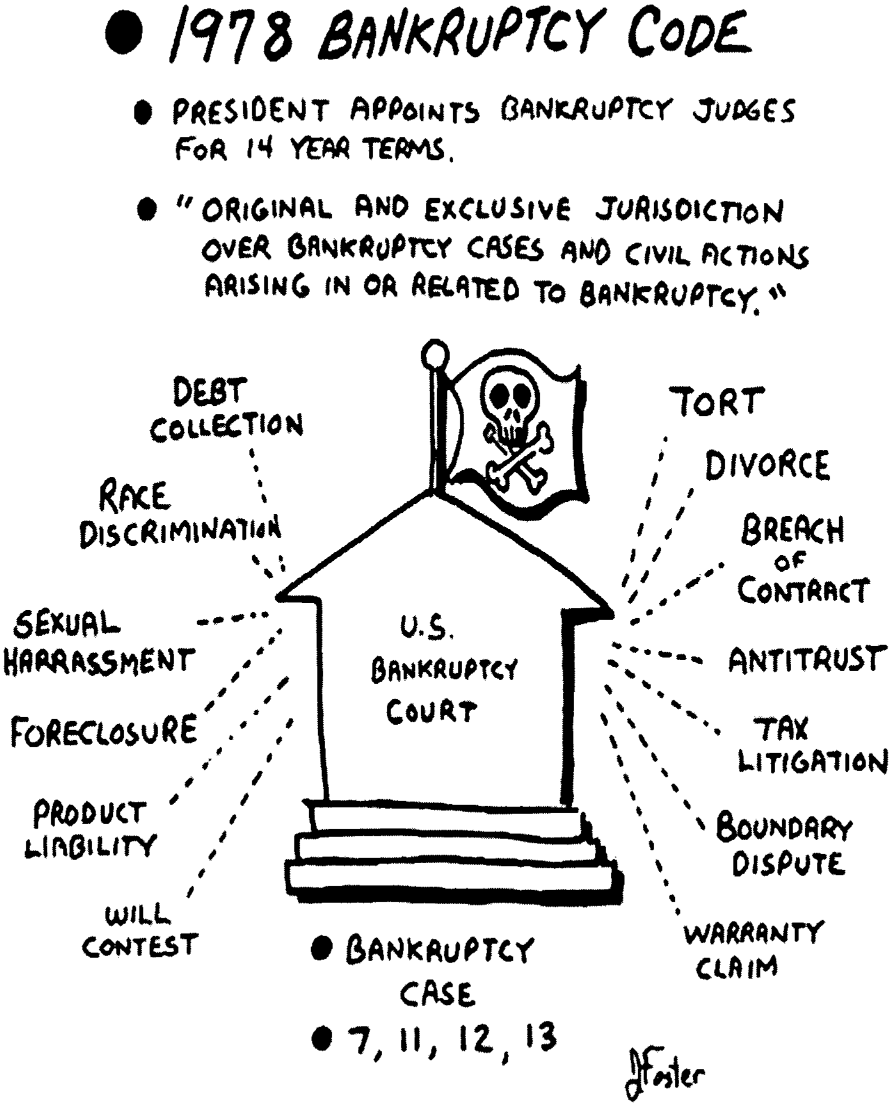
Note that the under the 1978 Code, Bankruptcy Judges, again appointed only for fourteen-year terms, had more jurisdiction then Federal District Judges, who are appointed for life under Article III of the Constitution. Unlike District Court Judges, Bankruptcy Judges were *not restricted* by any amount-in-controversy limits, federal question limits, and diversity of citizenship rules.

The Congressional concept of all-pervasive jurisdiction came to a "crash and burn" in 1982, in *Northern Pipeline Construction Company v. Marathon Pipeline Company*,[4] which in essence held that bankruptcy jurisdiction, as fashioned by Congress in 1978, violated Article III of the U.S. Constitution.[5]

As a result of *Northern Pipeline*, the Bankruptcy Courts operated under an "emergency order" for jurisdiction from 1982 forward, while Congress

4. 458 U.S. 50 (1982).
5. *N. Pipeline*, 458 U.S. at 87.

went back to the jurisdictional drawing board. Congress "fixed" the situation in the 1984 Bankruptcy Amendment and Federal Judgeship Act.[6]



6. Bankruptcy Amendments and Federal Judgeship Act, Pub. L. 98-353, 98 Stat. 336 (1984) (codified as 28 U.S.C. §§ 151, 157 (2000)); Pub. L. 98-598, 92 Stat. 2667 (1984) (codified as 28

III. BANKRUPTCY JURISDICTION TODAY: THE CONGRESSIONAL "FIX" CREATED AFTER *NORTHERN PIPELINE*

Under the 1984 Bankruptcy Amendments and Federal Judgeship Act, Congress made Bankruptcy Courts "units" of the Federal District Courts. No longer does the President appoint Bankruptcy Judges, but now the Circuit Courts of Appeal appoint Bankruptcy Judges for fourteen-year terms.

In the 1984 legislation,[7] which is law today, the Federal District Court has original and exclusive jurisdiction over all bankruptcy cases—i.e., Chapters 7, 11, 13 and 12—and also original *but not exclusive* jurisdiction over all civil proceedings arising in or related to cases under bankruptcy.

The Federal District Court is empowered to refer bankruptcy matters to the Bankruptcy Judge. Matters referred to a Bankruptcy Judge are divided between "core" matters and "non-core" matters. A core proceeding arises directly in connection with the purpose and concept of bankruptcy, and cannot stand on its own except in the context of a bankruptcy case. Examples of core proceedings include motions for relief from automatic stay, confirmation of a reorganization or rehabilitation plan, administration of the bankruptcy estate, trustee proceedings to avoid preferences, setoffs, fraudulent transfers, liens not timely or properly perfected, etc.

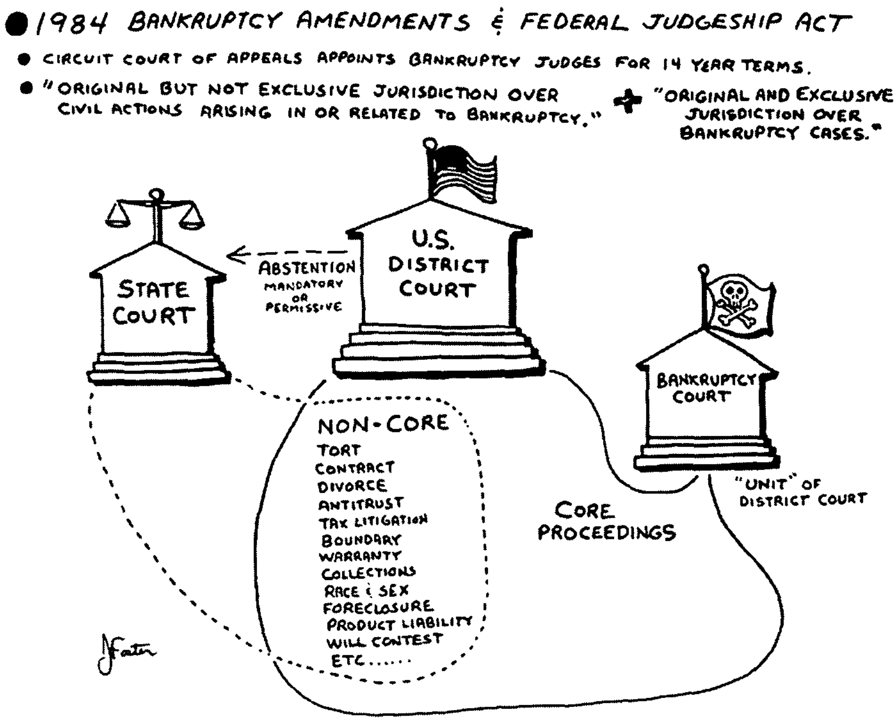
Non-core proceedings include matters not directly arising in or under the particular bankruptcy case, and which could stand as causes on their own in other courts. Examples are tort and breach of contract cases, divorce actions, anti-trust and tax litigation, boundary disputes, warranty claims, collection actions, race and sex discrimination and harassment suits, foreclosure, product liability actions, etc.

In a core proceeding, the Bankruptcy Judge makes final findings of fact, conclusions of law, and orders for judgment. In non-core proceedings, the Bankruptcy Judge may hear the matter but can only make *proposed* findings, conclusions, and orders, with the U.S. District Court making final versions.

The U.S. District Court and the Bankruptcy Court may, and in some instances must, abstain from a non-core matter, and send it back to State Court. Permissive abstention is allowed under 28 U.S.C. § 1334(c)(1) in the interests of justice or in the interests of respect for state law. Abstention is mandatory if a litigant timely files a motion for abstention and demonstrates criteria required in § 1334(c)(2).

U.S.C. § 1334 (2000)).

7. *See* 28 U.S.C. §§ 151, 157, 1334 (2000) (providing the 1984 language discussed in this section).


1984 BANKRUPTCY AMENDMENTS & FEDERAL JUDGESHIP ACT
CIRCUIT COURT OF APPEALS APPOINTS BANKRUPTCY JUDGES FOR 14 YEAR TERMS.
"ORIGINAL BUT NOT EXCLUSIVE JURISDICTION OVER CIVIL ACTIONS ARISING IN OR RELATED TO BANKRUPTCY."
+
"ORIGINAL AND EXCLUSIVE JURISDICTION OVER BANKRUPTCY CASES."
U.S. DISTRICT COURT
STATE COURT
ABSTENTION
MANDATORY OR PERMISSIVE
BANKRUPTCY COURT
"UNIT" OF DISTRICT COURT
CORE PROCEEDINGS
NON-CORE
TORT
CONTRACT
DIVORCE
ANTITRUST
TAX LITIGATION
BOUNDARY
WARRANTY
COLLECTIONS
RACE & SEX
FORECLOSURE
PRODUCT LIABILITY
WILL CONTEST
ETC......

IV. APPEALS FROM BANKRUPTCY COURT

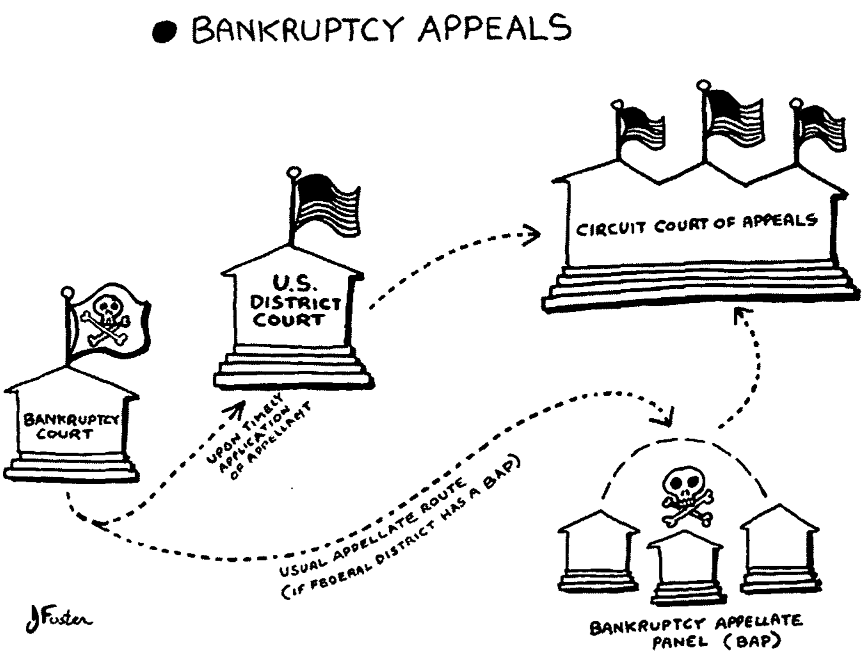
In 1994 Congress mandated that if a Federal Judicial District has sufficient resources, it must create a Bankruptcy Appellate Panel, consisting of three Bankruptcy Judges, to hear appeals from the Bankruptcy Court.[8]

In a federal jurisdiction which has created a Bankruptcy Appellate Panel *("BAP")*, appeals from the Bankruptcy Court are directed to the BAP, and if an appellant or appellee has grounds to disagree with the result at the BAP, then the matter may be appealed to the Circuit Court of Appeals.

If a party makes a timely election, the party may appeal from the Bankruptcy Court to the U.S. District Court, rather than to the BAP. If litigants have grounds to disagree with the result at the U.S. District Court, they can then appeal to the Circuit Court of Appeals.

In those jurisdictions which do not yet have a BAP, an appeal from Bankruptcy Court goes to U.S. District Court, and if further appeal is then needed, on to the Circuit Court of Appeals.

The United States Supreme Court has ultimate jurisdiction, of course, for appeals from the Circuit Court of Appeals.



8. *See* 28 U.S.C. § 158 (2000) (detailing Bankruptcy appellate jurisdiction).

V. THE AUTOMATIC STAY AND THE CO-DEBTOR STAY: AUTOMATIC STAY APPLICABLE IN ALL CHAPTERS OF BANKRUPTCY, CO-DEBTOR STAY AVAILABLE ONLY IN CHAPTERS 13 AND 12

Upon filing of a bankruptcy petition, the debtor and the debtor's property enjoy the protection of the Automatic Stay of *Bankruptcy Code § 362*.[9] Collection efforts by creditors, contact with the debtor, and lien perfection or recordation attempts are instantly restrained when the Stay goes into effect.

The Stay is broad in scope. Prohibited creditor activities include collection lawsuits at any stage, enforcement of judgments, enforcement or perfection of liens, Dunning letters, self-help repossession and other non-judicial remedies, setoffs, default notices, and any other attempts to disturb or take money or property from the debtor or the bankruptcy estate.

Exceptions to the Automatic Stay are criminal prosecutions, certain alimony and child support modification and enforcement activities, UCC perfection of purchase money security interests during the grace period, governmental regulatory and police actions, HUD foreclosures, tax notices, and paternity actions (but even these exceptions may be stayed under the equitable power of the court in *Bankruptcy Code § 105*[10]).

The Stay terminates when property of the bankruptcy estate is no longer such, when the bankruptcy case is closed, dismissed, or the debtor is denied or granted discharge, or upon request of a creditor seeking relief from the Stay.

Relief from the Stay requires the creditor to show either "cause," such as lack of adequate protection of the creditor's lien, or that the debtor has no equity in the property and the property sought to be relieved from the Stay is not necessary to an effective reorganization or rehabilitation.

In Chapters 13 and 12, non-bankrupt persons are protected by the special Co-Debtor Stay imposed by *Bankruptcy Code §§ 1301* and *1201*, in addition to the Automatic Stay applicable to the bankrupt debtor and the debtor's property.[11] Non-bankrupt co-debtors include guarantors, co-signers, co-makers, joint obligors, sureties, partners, etc. The Co-Debtor Stay applies only to *consumer debts* (and not commercial or agricultural business debts).

A creditor may seek relief from the Co-Debtor Stay if the debtor's Chapter 13 or Chapter 12 Plan does not intend to fully repay the debt, the

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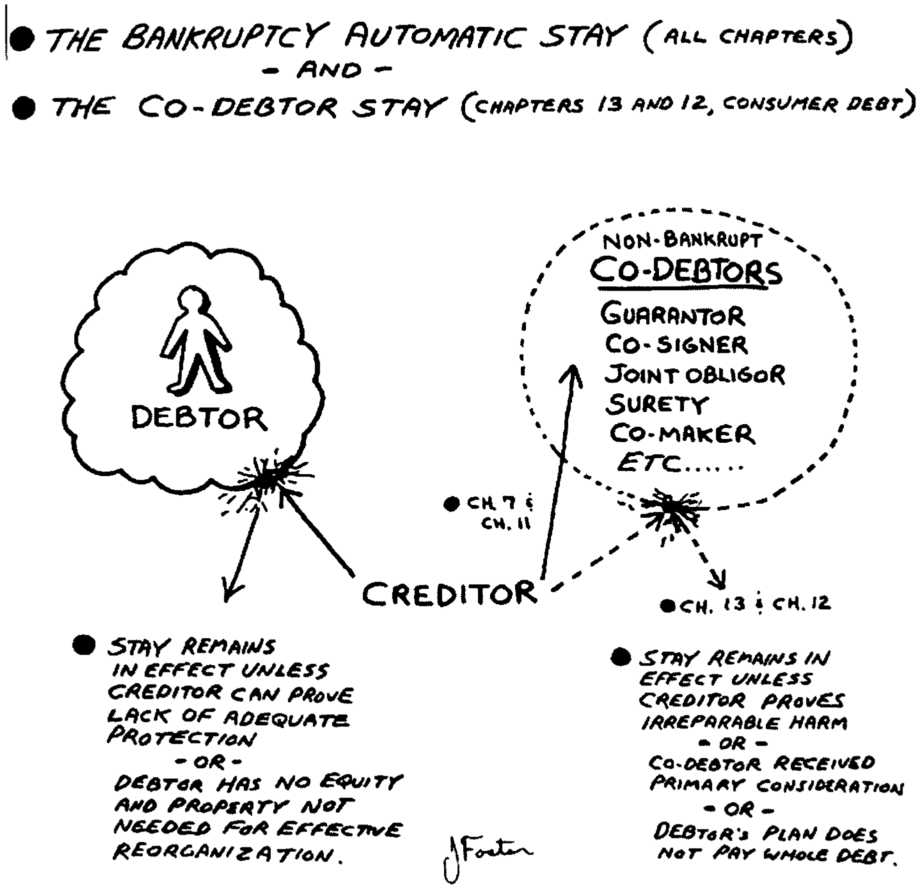
9. 11 U.S.C. § 362 (2000).
10. 11 U.S.C. § 105 (2000).
11. 11 U.S.C. §§ 1201, 1301 (2000).

non-bankrupt co-debtor (and not the debtor) actually received the consideration for the debt, or that the Stay will "irreparably harm" the creditor's interest.



VI. AVOIDABLE PREFERENCES

The bankruptcy Trustee has the ability to undo and take back from a creditor any money, property, lien, or anything else of value which the creditor obtained during the ninety day "eve of bankruptcy" and which resulted in the creditor receiving preferential treatment over other creditors.[12]

The graphic on the next page illustrates the elements needed by the Trustee to prove an avoidable preference. In the graphic, a $10,000 loan made in January is repaid in full in August, and then the debtor files bankruptcy in October. The Trustee determines that an unsecured creditor should receive only *ten cents* on the dollar on his claim. In order to establish the avoidable preference and recover against the creditor, the Trustee must show the following five elements:

1. That there has been a *transfer to or for the benefit of a creditor* of money, property, a lien, or anything of value. The transfer can be voluntarily made by the debtor, or involuntarily extracted from the debtor by zealous creditor action or through state judicial process such as a sheriff's execution. In the graphic on the next page, the transfer occurs in August when the debtor parts with (voluntarily or involuntarily) $10,000 worth of money, property, lien, or other value and it gets into the hands of the creditor.

2. That the transfer is made *on account of antecedent debt* (i.e., a debt which arose prior to the time of the transfer). In the graphic, the debt arose back in January when the debtor signed the promissory note and obtained the loan proceeds.

3. That the transfer is made *within ninety days of bankruptcy*, which is colloquially known as the "eve of bankruptcy." If the transfer is made to an insider, such as a relative or business associate, the Trustee can reach back *an entire year,* rather than just ninety days, prior to the bankruptcy to undo the transaction.

4. That the transfer is made *while the debtor is insolvent* (the debtor is presumed insolvent during the ninety days prior to bankruptcy).

5. And that the transfer enables the creditor to receive more than the creditor would have received in a liquidation bankruptcy, had the transfer not occurred. In the graphic, the Trustee has determined that unsecured creditors should receive only *ten cents* on the dollar. The creditor in the graphic, on the other hand, received at the time of the transfer in August full repayment of the $10,000 loan. The Trustee would take the position that he

12. *See* 11 U.S.C. § 547 (2000).

should have received only $1,000 (i.e., 10%). Therefore, the Trustee can attack the creditor for having received a $9,000 preference.

VII. STRONGARM POWER OF THE TRUSTEE: THE ABILITY OF THE BANKRUPTCY TRUSTEE TO AVOID TRANSFERS AND LIENS WHICH ARE NOT PROPERLY RECORDED OR PERFECTED IN THE SAME WAY AN INNOCENT PURCHASER OR LIEN CREDITOR COULD DO SO UNDER STATE LAW

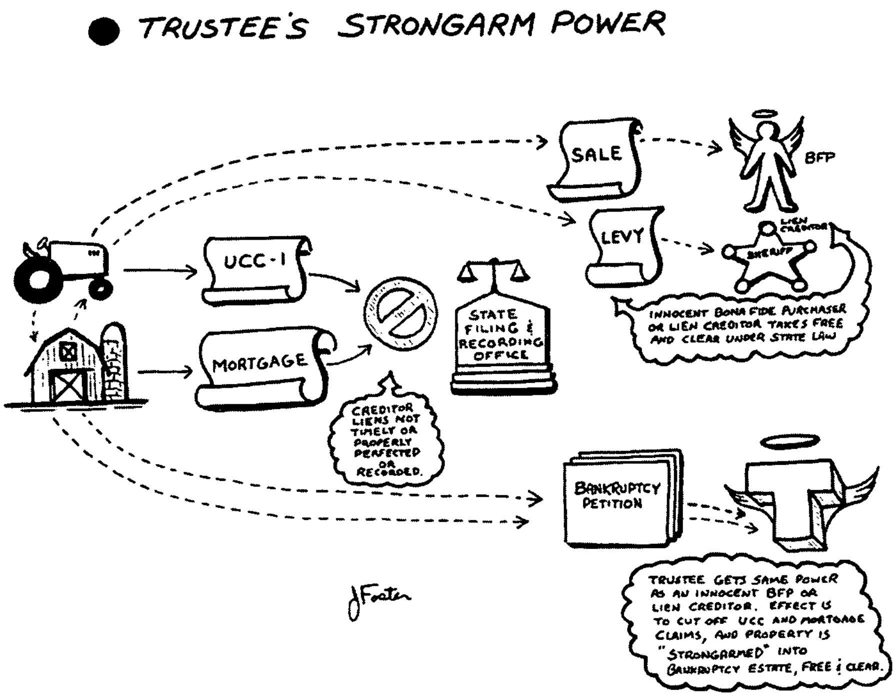
Bankruptcy Code § 544(a)[13] gives the Trustee, as of the date of the bankruptcy filing, all of the same rights as would have been available to a "hypothetical bona fide purchaser" or "hypothetical lien creditor" of the debtor's property under State Law. If a lien upon or transfer of the debtor's property would have been avoidable by such a purchaser or lien creditor under State Law, the Trustee can avoid it under Bankruptcy Law.

In the graphic on the next page, the owner of the farm and the tractor grants to a bank a real estate mortgage on the farm and a UCC security interest in the tractor. The bank *fails to record the mortgage* or records it with an erroneous legal description. Also the bank *fails to file a UCC Financing Statement* or files it in the wrong place.

Under State Law, an innocent bona fide purchaser of the farm or the tractor would be able to buy those items from the owner free and clear of the mortgage lien and the security interest of the bank, because a lien search would reveal nothing in the public record. Similarly, under State Law, an innocent lien creditor, such as a sheriff with an execution levy or a lawsuit creditor with a judgment lien, would take a first lien position on the property, because again nothing appears in the public record indicating the existence of a superior lien.

Under Bankruptcy Law, the Trustee gets the same ability to ignore the bank's mortgage and security interest as the innocent buyer and the innocent lien creditor would have under State Law. Under Bankruptcy Law, the date of the bankruptcy filing is deemed to be the equivalent of the State Law date of sale to an innocent bona fide purchaser, or the date of the attachment of an execution or judgment lien imposed by a lien creditor. The Trustee, wearing the hat of the innocent buyer or lien creditor, checks the public record, the same as a buyer or lien creditor would do under State Law when purchasing or liening up a piece of property, and, finding no recorded or perfected interest in the public record, the Trustee gets to "strongarm" the property into the bankruptcy estate, free and clear of the bank's mortgage lien and security interest. *The bank is rendered an "unsecured" creditor.*

13. 11 U.S.C. § 544(a) (2000).


TRUSTEE'S STRONGARM POWER
SALE
BFP
LEVY
LIEN CREDITOR
SHERIFF
INNOCENT BONA FIDE PURCHASER OR LIEN CREDITOR TAKES FREE AND CLEAR UNDER STATE LAW
UCC-1
MORTGAGE
STATE FILING & RECORDING OFFICE
CREDITOR LIENS NOT TIMELY OR PROPERLY PERFECTED OR RECORDED.
BANKRUPTCY PETITION
TRUSTEE GETS SAME POWER AS AN INNOCENT BFP OR LIEN CREDITOR. EFFECT IS TO CUT OFF UCC AND MORTGAGE CLAIMS, AND PROPERTY IS "STRONGARMED" INTO BANKRUPTCY ESTATE, FREE & CLEAR.
J Foster

VIII. TRUSTEE'S SETOFF AVOIDANCE

A classic setoff occurs when a borrower owes the bank money on a defaulted loan, and the bank owes the borrower money because the borrower has a checking or savings account with funds deposited at the bank. The bank reaches into the deposit account and pulls out money to pay down the defaulted loan.

A bankruptcy Trustee may undo a setoff by a bank against a debtor's deposit checking or savings account, if the setoff occurred within the ninety day "eve of bankruptcy" and if the bank "improves its position" from ninety days before bankruptcy to the date of the setoff.[14]

To determine whether a bank has "improved its position," the Trustee through discovery finds out exactly how much money was in the debtor's deposit *checking or savings account exactly ninety days prior* to the bankruptcy filing, and also finds out exactly how much was owed on the *debtor's loan to the bank exactly ninety days prior* to the bankruptcy filing.

Leading up to the day the bank performed the setoff, if the bank during that timeframe *"improves its position" in the debtor's checking or savings account,* such as by accepting additional deposits, and if the bank *"improves its position" on the debtor's loan,* such as by accepting from the debtor voluntary payments lowering the balance owed, the Trustee adds the two "improvements" in position together to arrive at the amount he can demand that the bank disgorge to the bankruptcy estate.

In the graphic on the next page, ninety days before the debtor files bankruptcy he has only $10,000 in his checking account, and he owes $50,000 to the bank on his loan. Leading up to the day of the setoff on the eve of bankruptcy when the bank ultimately takes $30,000 out of the checking account and sets it off against the defaulted loan, the debtor's bank account gets fattened, presumably with additional deposits, and the *account balance goes up to $30,000* by the day of the setoff. In addition, the loan gets reduced, presumably through regular payments, *down to a loan balance of $40,000* by the day of the setoff.

In short, from ninety days before bankruptcy to the day of setoff the bank improves its position by $20,000 in the bank account *(starting with a balance of $10,000 and accepting additional deposits for a total available of $30,000 on setoff day),* and the bank improves its position by $10,000 on the loan *(starting with an exposure of $50,000, reduced by regular payments to $40,000 on setoff day).*

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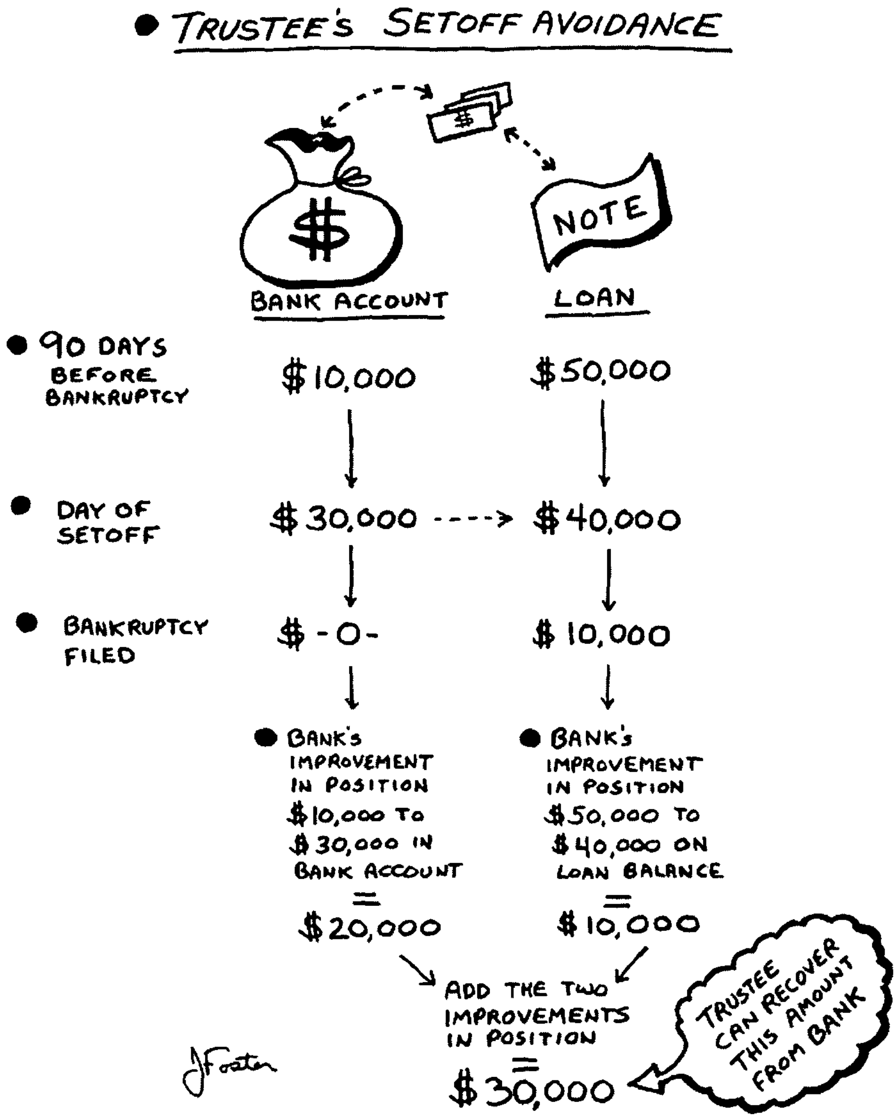
14. 11 U.S.C. § 553 (2000).

Adding the two "improvements" in position together—$20,000 worth of deposits plus $10,000 worth of loan payments—the Trustee determines he can demand that the bank remit to the bankruptcy estate a total of $30,000. He can sue the bank if it doesn't.


TRUSTEE'S SETOFF AVOIDANCE
$
$
NOTE
BANK ACCOUNT
LOAN
90 DAYS BEFORE BANKRUPTCY
$10,000
$50,000
DAY OF SETOFF
$30,000
$40,000
BANKRUPTCY FILED
$ -0-
$10,000
BANK'S IMPROVEMENT IN POSITION $10,000 TO $30,000 IN BANK ACCOUNT
=
$20,000
BANK'S IMPROVEMENT IN POSITION $50,000 TO $40,000 ON LOAN BALANCE
=
$10,000
ADD THE TWO IMPROVEMENTS IN POSITION
=
$30,000
TRUSTEE CAN RECOVER THIS AMOUNT FROM BANK
JFoster

IX. TARDY PERFECTION AVOIDANCE: THE TRUSTEE'S ABILITY TO CHANGE REALITY BY "DEEMING" CERTAIN LIENS THAT ARE TARDILY PERFECTED TO HAVE ARISEN ON THE PERFECTION DATES

A most unusual avoiding power the Trustee has in a bankruptcy case is the ability to avoid a lien that was "tardily" perfected, even though it was perfected properly under state law. *Bankruptcy Code § 547(e)*[15] permits the Trustee to invalidate a lien, which, although perfected by the time bankruptcy is filed, was nevertheless perfected "tardily" after the actual transaction occurred. The Trustee "deems" the lien as not having been granted on the date it actually was given by the debtor, but rather on the later day of perfection. If the perfection then happens to have occurred during the ninety days prior to bankruptcy, the Trustee can use *§ 547(a)*[16] avoidable preference powers to invalidate the lien.

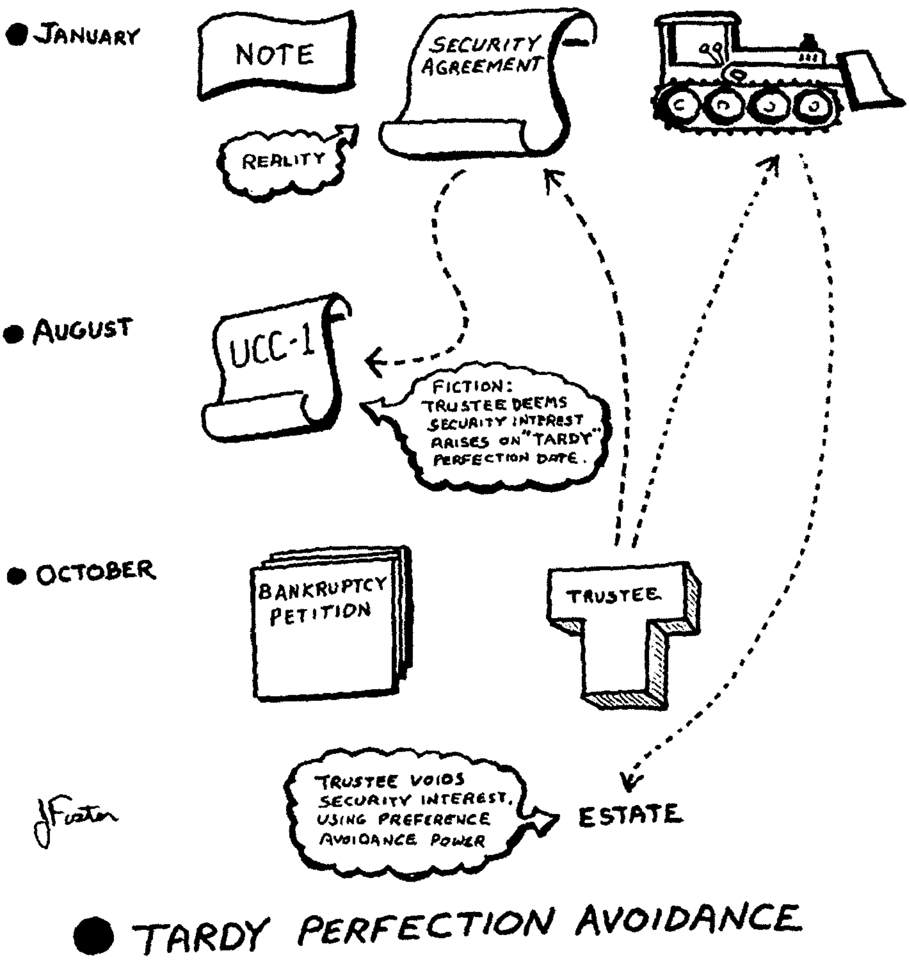
In the graphic on the next page, debtor borrows money from the bank in *January,* and to secure the loan grants to the bank a security interest in his bulldozer. *The bank, however, neglects to file a UCC Financial Statement at this time.* In *August* the bank realizes that it had earlier failed to perfect with a UCC-1 filing. The bank hurriedly runs a UCC-1 to the courthouse. The bank thinks *"Whew!"*

In *October* debtor files bankruptcy and the Trustee determines that it is a "no asset" bankruptcy and unsecured creditors would receive zero payments. The Trustee is able to avoid the security interest on the bulldozer, thereby rendering the bank an unsecured creditor, by "deeming" the security interest on the dozer to have been given not on the day it was actually given in January, but rather on the day the bank perfected the security interest in August. That is, the Trustee, through this fiction, creates a new reality, which results in an *unsecured loan* having been made in January, and a security interest having been given in August to convert an unsecured loan to a secured one.

So what? Bankruptcy was not filed until October, and the bank was perfected by then, albeit tardily, right? True, but by deeming the lien to have arisen in August, within ninety days of bankruptcy, while the loan was made back in January and is now deemed to be on an unsecured basis, the Trustee may now void the lien as an *avoidable preference.* The now "unsecured" loan is an *antecedent debt,* the "tardy" security interest is a *transfer to a creditor,* which is deemed to have occurred *within ninety days*

15. 11 U.S.C. § 547(e) (2000).
16. *Id.* § 547(a).

of bankruptcy while the debtor was presumed insolvent, and having determined that unsecured creditors will receive no money in this bankruptcy, the Trustee uses the preference to avoid the lien because *the creditor is deemed to have received more by taking a lien on the bulldozer than he would have received as an unsecured creditor in a Chapter 7 Liquidation.*[17]



17. *Good Grief! Can this be right?* Yes it is, unfortunately for the bank. The folks in Congress were deadly serious when they made this up as part of the Bankruptcy Code.

X. PROVING CREDITOR CLAIMS IN BANKRUPTCY

In order for a creditor to share in any distribution by the Trustee from a bankruptcy estate, the creditor must file a Proof of Claim.[18] (A Proof of Claim is not required in Chapter 11, however, if the debtor has properly scheduled the creditor claim in the bankruptcy petition, *§ 1111*.) Often times, in typical consumer Chapter 7 cases, the Clerk of Bankruptcy Court notifies creditors, at the time of notification of the first meeting of creditors, that no Proofs of Claim should be filed because the case appears to be a *"no asset"* case where no distribution will be forthcoming. If the Clerk, Trustee, or the Court locates assets later, however, creditors are notified to then file their Proofs.

Where there is a net estate, if all creditors do not file their Proofs of Claim, the ones who do receive a greater pro rata share of the estate. This often happens in bankruptcy cases, where many creditors either neglect or otherwise fail to file their Proofs of Claim (believing that in the end they either won't get anything or it will be a paltry pennies-on-the-dollar recovery). Those who do file, however, then get a windfall benefit from the neglect or failure of the others.

In the graphic on the next page, there are 100 creditors holding claims totaling $100,000 against a bankruptcy estate, which only has a net $10,000 to distribute. If all of the creditors would file their Proofs of Claim, each creditor would receive 10% of its claim, or *"Ten Cents on the Dollar."*

Assume, however, that only 3 creditors file their Proofs of Claim, and the other 97 fail to do so.

Creditor A has a filed Proof of Claim for $3,000, Creditor B has a filed Proof for $2,000, and Creditor C has a filed Proof for $1,000. Out of the net estate, the trustee can pay creditors A, B, and C the total amount of their claims (i.e., 100 Cents on the Dollar), and the Trustee still has $4,000 left out of the original $10,000 net distributable estate.

Where does the $4,000 surplus go? To the debtor.[19] If the other 97 creditors find out about this, there might be some gnashing of teeth.

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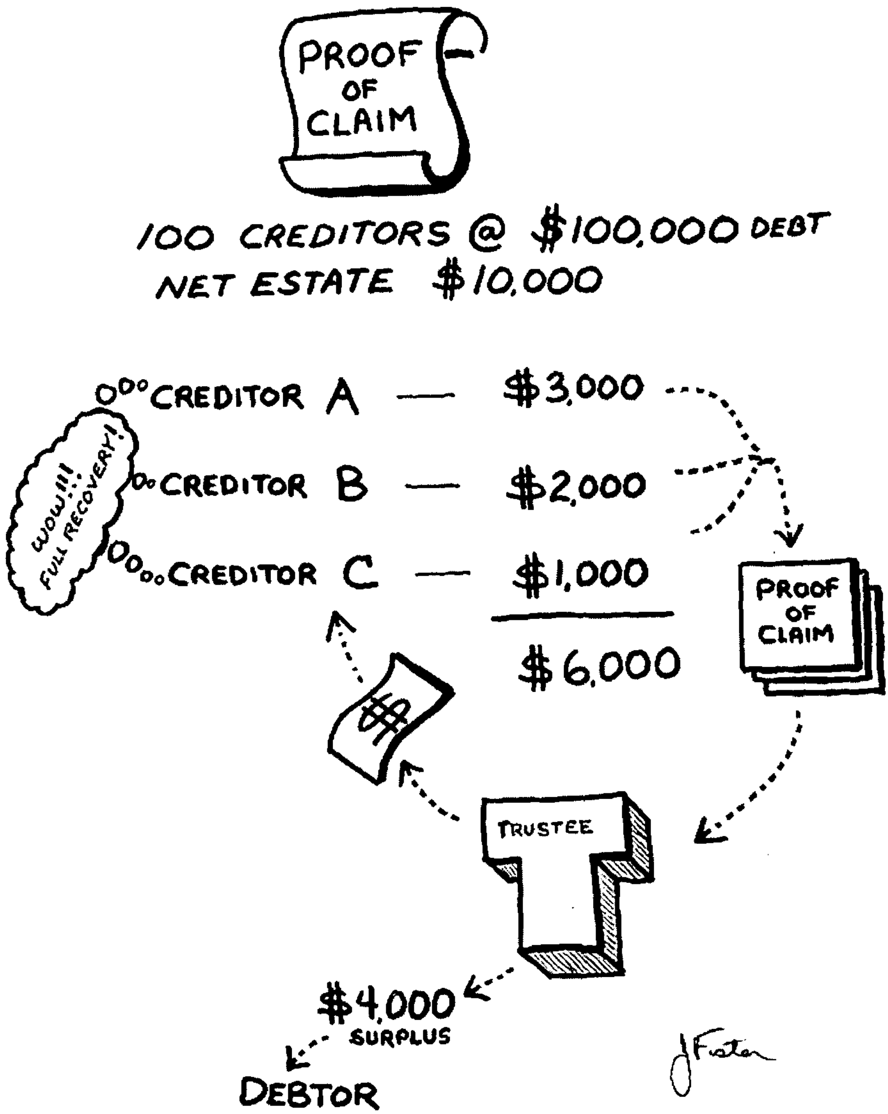
18. 11 U.S.C. § 501 (2000).
19. 11 U.S.C. § 726 (2000).


PROOF OF CLAIM
100 CREDITORS @ $100,000 DEBT
NET ESTATE $10,000
CREDITOR A — $3,000
CREDITOR B — $2,000
CREDITOR C — $1,000
$6,000
WOW!!! FULL RECOVERY!
PROOF OF CLAIM
TRUSTEE
$4,000 SURPLUS
DEBTOR
J Foster

XI. OBTAINING LOANS AND CREDIT WHILE IN BANKRUPTCY

In rehabilitation bankruptcy cases such as Chapters 11, 12, and 13, it is often necessary for the Debtor-In-Possession or the Trustee to obtain loans or other financial credit to carry on the business. Naturally existing creditors who are owed money might be reluctant to lend more money or give any new credit to the Debtor or the Trustee. An outside lender would obviously be hesitant to deal with a bankrupt entity. Recognizing this reluctance, *Bankruptcy Code § 364*[20] provides some inducements and incentives for either existing creditors or new lenders to provide loans or credit to a bankrupt entity. These inducements and incentives are summarized in the graphic on the next page.

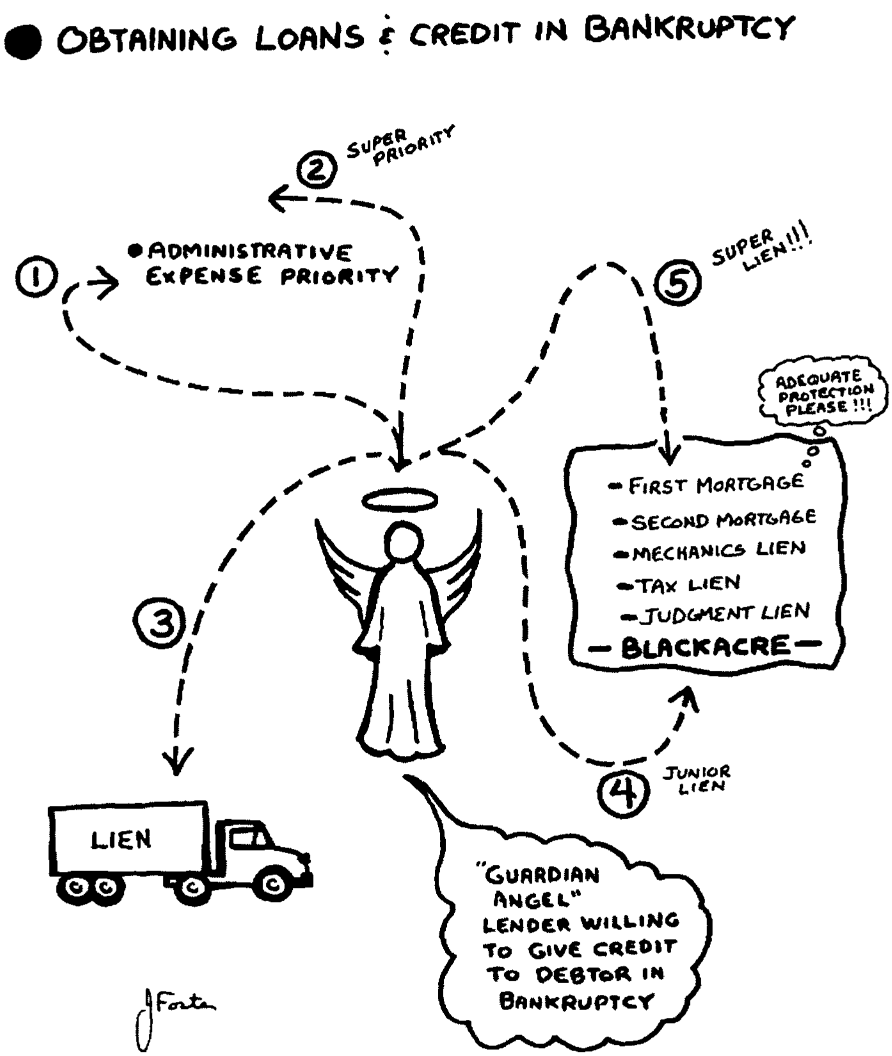
The Bankruptcy Court is authorized to grant to lenders willing to deal with the bankrupt entity an administrative expense priority for the repayment of any credit *(No. 1 on the graphic)*. Or, the Court can even grant a super-administrative expense priority, ahead of all other administrative expense priorities *(No. 2 on the graphic)*.

Another alternative is for the Court to grant the new lender a lien on property of the bankruptcy estate not already subject to a lien (*No. 3 on the graphic*), or, the Court can grant a junior lien on property already subject to liens held by other creditors (*No. 4 on the graphic*).

Finally if all else fails and the new lender is reluctant to grant credit even after the foregoing inducements, the Court, after notice and hearing, may authorize a lien to be granted to the new lender which is superior to existing liens (*No. 5 on the graphic*). This has the effect of "squeezing down" the priorities of the existing liens, and naturally those existing creditors are going to want adequate protection for their liens (at this point, perhaps the Bankruptcy Court will grant these existing creditors administrative expense priorities or liens on other properties as adequate protection for their having lost their initial priority positions by reason of the new lender's super lien).

Heard in the corridors outside the Bankruptcy Court after existing lienholders were pushed into an inferior position by a super lien granted to a new lender: *"If the adequate protection we got was so darned adequate, why didn't the other guy take it?"*

20. 11 U.S.C. § 364 (2000).


OBTAINING LOANS & CREDIT IN BANKRUPTCY
① ADMINISTRATIVE EXPENSE PRIORITY
② SUPER PRIORITY
③
④ JUNIOR LIEN
⑤ SUPER LIEN!!!
ADEQUATE PROTECTION PLEASE!!!
- FIRST MORTGAGE
- SECOND MORTGAGE
- MECHANICS LIEN
- TAX LIEN
- JUDGMENT LIEN
- BLACKACRE -
LIEN
"GUARDIAN ANGEL" LENDER WILLING TO GIVE CREDIT TO DEBTOR IN BANKRUPTCY

XII. USE OF COLLATERAL BY A CHAPTER 11 DEBTOR

A business filing Chapter 11 reorganization wants to continue doing business, so naturally it needs to use its equipment, sell its product, pay its employees, and do everything associated with the running of a business. If assets depreciate while they are in use, or cash proceeds of collateral are used to pay employees and other operating expenses, any secured creditors with liens on those assets have a right to demand adequate protection and need to be heard on that issue. *Bankruptcy Code § 363*[21] sets forth the rules as to when notice and a hearing are required for creditors to have their say.[22]

In the graphic on the next page, Fly by Night Air has filed Chapter 11. Various financial institutions have perfected security interests in the airline's equipment including jet planes, in accounts including cash receipts and credit card receipts for ticket sales to the flying public, and in the resulting cash in the airline's deposit accounts used to pay employees and the operating the expenses of the business.

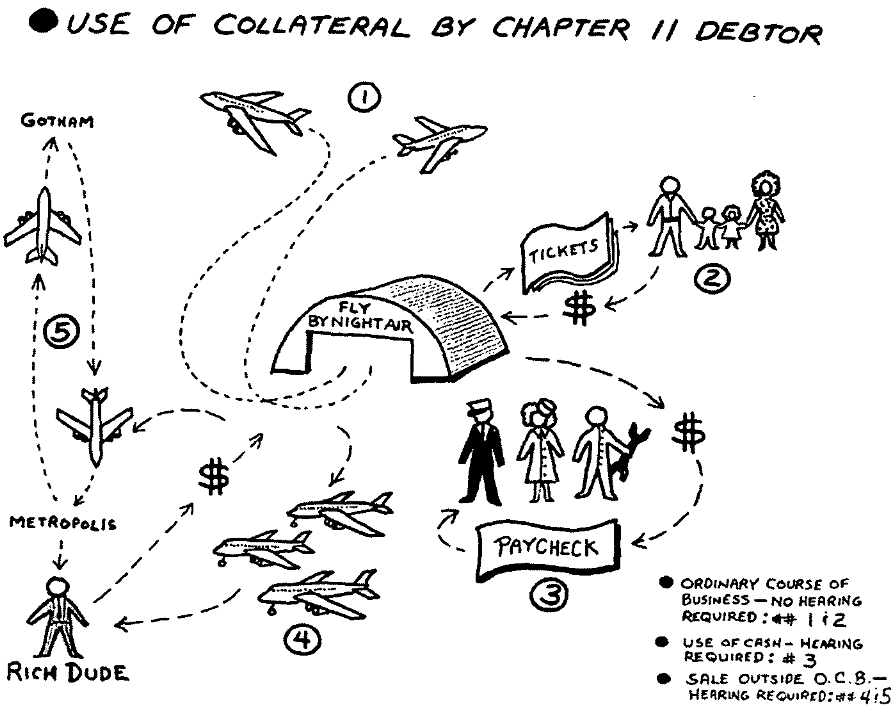
Use of collateral in a Chapter 11 debtor's *ordinary course of business does not require notice and hearing* to the creditors. What does an airline do in the ordinary course of business? It flies people and cargo around the world. So, regular flights, takeoffs, and landings are permitted without a hearing.[23] *(No. 1 on the graphic.)* Also, in the ordinary course of an airline's business, it sells tickets to the flying public and takes in credit card and cash receipts in exchange for those tickets. Because that is the ordinary course of business, no hearing is required and the airline may dispense tickets and *collect* money (but *not* spend it) without consent of the creditors.[24] *(No. 2 on the graphic.)*

Fly By Night Air of course needs to pay its pilots, flight attendants, and mechanics, but that requires cash to issue paychecks. The use of *cash collateral*, if it is subject to a secured party's lien, is *not permitted* unless there is notice and a hearing allowing the cash lienholders to have their say and argue about adequate protection. So while paying employees might be in the ordinary course of business, nevertheless the use of cash requires a hearing.[25]

In order to raise a bundle of quick cash, and get leaner and meaner in its reorganization, Fly By Night decides to sell off to Rich Dude a part of its

21. 11 U.S.C. § 363 (2000).
22. *Id.* § 363(c)(1).
23. *Id.*
24. *Id.*
25. *Id.* § 363(c)(2).

jet plane fleet and its profitable shuttle service air route between Gotham City and Metropolis. Since an airline is *not* ordinarily in the business of *selling* planes or air routes (rather it is in the business of *flying* planes *on* air routes), such a sale would *not be in the ordinary course of business*, and therefore notice and a hearing are required before the sale may be consummated.[26] If the bankruptcy court approves the sale, secured creditor liens will of course attach to the proceeds of the sale of the planes and shuttle route to Rich Dude. *(Nos. 4 and 5 on the graphic.)*



26. *Id.* § 363(b).

XIII. EFFECT OF DISCHARGE: DEBTS DIE, BUT LIENS LIVE

A debtor's discharge in bankruptcy voids any *personal* obligation of the debtor to pay the discharged debt.[27]

But otherwise *unavoided liens,*[28] which pre-date the bankruptcy, are *not canceled* along with discharge of the personal obligation to pay the debt.[29] In other words, a judgment lien on farm real estate, a mortgage lien on a house, a security interest in a tractor, a mechanic's lien on a construction project, etc., all will survive bankruptcy, and after the bankruptcy discharge, the secured creditor is entitled to foreclose the lien or repossess the property (although the creditor is no longer allowed to pursue the debtor personally for the obligation).

Debtor's counsel must be careful to advise debtor clients that unless they reaffirm debts secured by a lien on their property, the debtors will lose their property through foreclosure or repossession after the bankruptcy discharge, even though the debtors have discharged their personal obligation to pay the debts from their own resources. The property will still be vulnerable and available to the creditor's grasp.

In North Dakota, a State Clerk of District Court may accept a certified copy of a Federal Bankruptcy Discharge for filing at the courthouse, and that has the effect of preventing the lien of a judgment from attaching to property acquired after the debtor's bankruptcy, and also has the effect of removing any judgment lien as a cloud on the debtor's homestead.[30] *Note, however, that pre-bankruptcy judgment liens remain in full force and effect on land in existence prior to the debtor's bankruptcy.*

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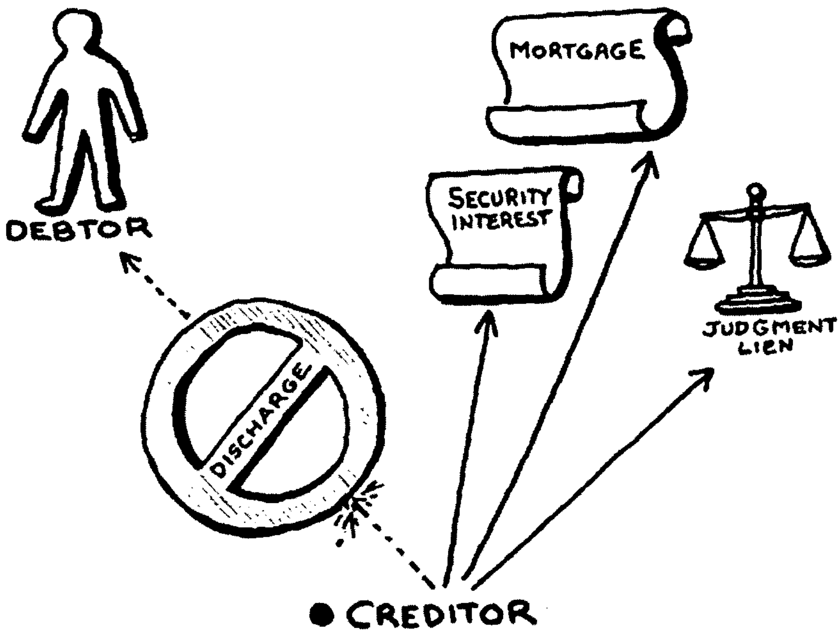
27. 11 U.S.C. § 524 (2000).

28. *Certain liens do not survive bankruptcy* if they are properly avoided and cancelled by the debtor or the trustee. By motion, the debtor in a "fresh start lien avoidance" may cancel non-purchase money security interests and judicial liens on property, which the debtor would otherwise be able to exempt. 11 U.S.C. § 522(f) (2000). The trustee is able to cancel liens, which were granted to or obtained by a creditor on a preferential basis during the ninety days prior to bankruptcy under the unavoidable preference rule of *Bankruptcy Code § 547. See* 11 U.S.C. § 547 (2000). The trustee can avoid liens that meet the criteria of being a fraudulent transfer under *Bankruptcy Code § 548. See* 11 U.S.C. § 548. Additionally, under the "strong arm clause" of *Bankruptcy Code § 544(a),* the trustee can avoid liens that are not timely or properly recorded or perfected. *See* 11 U.S.C. § 544(a) (2000). Additional lien avoidance powers are found in *11 U.S.C. §§ 547 (e), 548 (d), and 545.*

29. 11 U.S.C. § 524.

30. N.D. CENT. CODE § 28-20-30 (2004).

• DEBTS DIE. LIENS LIVE.



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