

**THE IMPACT OF THE 2005 BANKRUPTCY REFORM
LEGISLATION ON SECURED LENDERS, DEBTORS, AND
DEBTORS' ATTORNEYS**

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I. INTRODUCTION

On March 10, 2005, the Senate passed S. 256, the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005". The banking credit card industry and the auto industry were two of the main proponents, while consumer groups and labor unions were two of the main opponents. After passing the House Judiciary Committee and the House, President Bush signed the bill into law on April 20, 2005. In his press release on April 20, 2005 President Bush addressed the purpose of S. 256 by saying:

Our bankruptcy laws are an important part of the safety net of America. They give those who cannot pay their debts a fresh start. Yet bankruptcy should always be a last resort in our legal system. If someone does not pay his or her debts, the rest of society ends up paying them. In recent years, too many people have abused the bankruptcy laws. They've walked away from debts even when they had the ability to repay them. This has made credit less affordable and less accessible, especially for low-income workers who already face financial obstacles.

The bill I sign today helps address this problem. Under the new law, Americans who have the ability to pay will be required to pay back at least a portion of their debts. Those who fall behind their state's median income will not be required to pay back their debts. This practical reform will help ensure that debtors make a good-faith effort to repay as much as they can afford. This new law will help make credit more affordable, because when bankruptcy is less common, credit can be extended to more people at better rates.

President George W. Bush, *President Signs Bankruptcy Abuse Prevention, Consumer Protection Act*, Press Release April 20, 2005.

This article addresses some of the major amendments which have been implemented by the new bankruptcy code; however, it does not address all amendments which have been passed. This article concerns the immediate effects the 2005 Bankruptcy Legislation will have on secured

lenders, as well as debtors and their attorneys. The New Bankruptcy Code went into effect on October 17, 2005. *Bankruptcy Abuse Prevention, Consumer Protection Act*, Senate Bill 256 Title XV Section 1501.

II. EVALUATING NON-BANKRUPTCY ALTERNATIVES FOR THE CREDITOR

A. PIERCING THE CORPORATE VEIL

In Fontana v. TLD Builders, Inc., the Appellate Court of Illinois, Second District, laid out the standard for piercing the corporate veil. *Fontana v. TLD Builders, Inc.* No. 02-05-0045 (Ill. App. 2d Dist, Dec. 2005). In Fontana, Plaintiffs filed a lawsuit naming TLD Builder, Inc, and Architect Stanley L. Glodeck as Defendants. *Fontana* at 1. The Plaintiffs then filed an Amended Complaint alleging that they owned a piece of real property in Clarendon Hills, Illinois on which TLD agreed and contracted to construct a single family residence for the sum of \$1,475,800.00. *Fontana* at 1-2. The allegations in the Amended Complaint stated that TLD breached the construction contract by failing to construct the home according to the contract and then abandoning all of the work on the home. *Fontana* at 2. The Complaint further alleged that Nicola DiCosola was the alter ego of TLD and was thereby liable for the damages sought. *Fontana* at 2. The Plaintiffs alleged that they incurred costs and expenses to correct the defects and that these costs and expenses exceed the fair market value of the home if it had been completed correctly in the first place; therefore, they asked for a Judgment in an amount in excess of \$2 million. *Fontana* at 2. The Plaintiffs also alleged that the architect breached the terms of the contract. *Fontana* at 2. The trial court held that TLD had materially breached the contract, failed to cure the breach, that it was appropriate to demolish the home and calculated the Plaintiff's damages at \$1,271,816.00. *Fontana* at 2. The trial court also held Mr. DiCosola

personally liable based on the facts that money had been loaned to the company which came from his personal account, that TLD had no employees, and that his wife Theresa was considered the sole-shareholder and director, but had no knowledge of any of the business matters she put her signature to, nor had she been paid a dividend. *Fontana* at 3-4.

Mr. DiCosola appealed and the Plaintiff's cross-appealed based on the "Piercing the Corporate Veil" count. *Fontana* at 6. The Appellate Court found that Mr. DiCosola was personally liable, thereby affirming the trial court's decision. *Fontana* at 15. In its decision, the Appellate Court laid out the elements that are necessary to pierce the corporate veil and hold an individual liable.

A corporation is formed in order to protect stockholders from unlimited liability. *Fontana* at 6. However, a Court may pierce the veil of limited liability when the corporation is merely the alter ego or business conduit of another person or entity. *Fontana* at 6. If a Court pierces the corporate veil, liability will be imposed on the individual or entity that is using the corporation merely as an instrumentality to conduct that person's or entity's business. *Fontana* at 6. Piercing the corporate veil is an equitable remedy which allows the imposition of liability on an underlying cause of action, but is not itself a cause of action. *Fontana* at 6.

In order for a Court to pierce the corporate veil, a two prong test must be met. The first prong is that there must be such unity of interest and ownership that the separate personalities of the corporation and individual no longer exist. *Fontana* at 6-7. The second prong of the test is that circumstances must exist that if the Court were to adhere to the fiction of a separate corporate existence it would sanction a fraud, promote injustice, or promote inequitable consequences. *Fontana* at 7.

Piercing the corporate veil is an important equitable remedy of which creditors need to be aware. It is important because a creditor may be able to use this remedy against a debtor in order to gain access to more resources for money damages. However, it is important that all corporations remain aware of the existence of this remedy and ensure that the appropriate procedures are currently in place in its own offices.

B. SUING THE PRINCIPALS DIRECTLY: DETERMINE WHICH ENTITY OR INDIVIDUAL FILED BANKRUPTCY

A creditor may need to review and possibly pursue other avenues, other than proceeding against the principal directly, in order to recover any monies owed. One possible option is to consider filing suit against the guarantor if they have not filed bankruptcy. A guarantor is liable in the capacity in which they signed, so a creditor must be aware of the procedures of notice under Article 3 of the Uniform Commercial Code pursuant to the various negotiable instruments that exist. For instance, if a guarantor signs in the capacity of a maker, it is not necessary for a creditor to proceed against a debtor first but can proceed directly against the guarantor without giving notice of dishonor. *Uniform Commercial Code* §3-419. It is important to understand in what capacity a person signed so that a creditor may proceed appropriately to recover against the guarantor, if the guarantor has not filed bankruptcy.

There are definite positives and negatives to the various avenues of collection. When a creditor proceeds against the principal, there is a definite advantage in that the principal has direct access to the principal's assets. The disadvantage to this avenue is that too much pressure on the principal may cause he/she to leave the business; therefore, the business would collapse along with the collateral, particularly soft collateral, such as accounts receivables. Once a business fails, it is often difficult for the Trustee or Receiver to collect the accounts receivable.

A creditor needs to carefully evaluate the available assets to determine which avenue to pursue. It is very important that once a creditor decides how it would like to proceed, it determine and follow the correct method to giving notice and obtaining liability against that party.

C. SUING THE APPRAISER BASED ON A NEGLIGENCE THEORY

In all too many cases, the Lender finds out after the fact that there was not enough collateral to support the loan. In Kelley v. Carbone, which was decided in the Appellate Court of Illinois, Second District, the Appellate Court reversed the Circuit Court of DuPage County in deciding that an appraiser was liable to a third party affected by the appraiser's actions. *Kelley v. Carbone*, No. 2-05-0097 (Ill.App.2d District, 2005).

The Plaintiffs, Ron and Lisa Kelley, Kelley Partners, Inc., Guy Mullen, and Mullen Enterprises, Inc. had filed a lawsuit in the Circuit Court of DuPage County against Michael J. Carbone and Michael J. Carbone and Associates, Inc. based on negligent misrepresentation. *Kelley* at 1. The facts were as follows, the Plaintiffs leased business properties from Triad Randall Lake, LLC: the Kelley's operated an Oil Works business and the Mullen's operated a car wash facility. *Kelley* at 1. The lease for the properties provided that after five years the lessees would have an option to purchase the property based on a set formula in the lease. *Kelley* at 1. The purchase price, at the end of the five years, was to be based on an appraisal performed by the Defendants. *Kelley* at 1.

The appraisal prepared by the Defendants stated that it was prepared for Todd Surta, President of Triad, and certified that it met the Uniform Standards of Professional Appraisal Practice (USPAP). *Kelley* at 1. The appraisal further stated that it was to "be used by the client to support possible future purchase agreements between the client and the current lessee of the

subject property." *Kelley* at 1. At the end of the five year period, the Plaintiffs exercised their option to purchase the property and paid a price based on the appraisal report which the Plaintiffs contend was much higher than they should have paid for the properties. *Kelley* at 1. The Plaintiffs sued the Defendants, the appraisers, for negligent misrepresentation alleging that the report did not conform to the USPAP and that there were numerous mistakes. *Kelley* at 1. The trial court dismissed the Complaint based on the Defendants' Motion to Dismiss on the theory that there was no privity of contract and, therefore, the Defendant owed no duty to the Plaintiffs. *Kelley* at 2.

The Appellate Court reversed the trial court's decision and stated that under the Illinois Supreme Court decision in Rozny v. Marnul, 43 Ill. 2d 54 (1969), the concept of privity of contract in actions for negligent misrepresentation had been abandoned. *Kelley* at 2. In Rozny, the Supreme Court went on to say that "tort liability is to be measured "by the scope of the duty owed rather than the artificial concepts of privity [of contract]."*Kelley* at 2 citing *Rozny*, 43 Ill. 2d at 62. However, a defendant may only be held liable against the person or group of persons for whose benefit and guidance the information was intended. *Kelley* at 2 citing *Rozny*, 43 Ill. 2d at 66-67.

The Plaintiffs maintained that their complaint properly stated a cause of action for negligent misrepresentation against the Defendants and that the Defendants owed them a duty despite the lack of contractual privity. *Kelley* at 2. In order to plead a cause of action for negligent misrepresentation against a provider of information employed by a third party, the Plaintiff must allege that the purpose and intent of the relationship was to benefit or influence the Plaintiff. *Kelley* at 2. The Plaintiffs alleged that the appraisal was intended to benefit or

influence them, as it was the appraisal that was used as the basis for the purchase of the property. *Kelley* at 2. The Defendants contended that they did not owe a duty to the Plaintiffs because the appraisal states that it was prepared exclusively for Todd Surta, Triad's President. *Kelley* at 3. The Appellate Court did not agree with this argument as it was based on the theory of lack of contractual privity. *Kelley* at 3. The Court found that the Defendants had an understanding that the appraisal would be used by others because of the statement that was contained in the appraisal stating that the appraisal was for the possible future purchase agreements between Triad and lessees. *Kelley* at 3. The Defendants, citing Rozny, also made the argument that they could not be held liable because the appraisal did not contain a guarantee of accuracy. *Kelley* at 3. However, the Court pointed out that the Defendants neglected to include the other five factors the court used to impose liability on the surveyor in that case, which were as follows:

1. The express, unrestricted and wholly voluntary "absolute guarantee for accuracy" appearing on the face of the inaccurate plat;
2. Defendant's knowledge that this plat would be used and relied on by others than the person ordering it, including Plaintiffs;
3. The fact that potential liability in this case is restricted to a comparatively small group, and that, ordinarily, only one member of that group will suffer loss;
4. The absence of proof that copies of the corrected plat were delivered to anyone;
5. The undesirability of requiring an innocent reliant party to carry the burden of a surveyor's professional mistakes; and
6. That recovery here by a reliant user whose ultimate use was foreseeable will promote cautionary techniques among surveyors.

Kelley at 3-4 citing *Rozny*, 43 Ill. 2d at 67-68.

Based on the foregoing factors and the fact that the Defendants owed a duty to the Plaintiffs by virtue of their knowledge that the Plaintiffs would rely on their report, the Appellate Court reversed the trial court's decision. *Kelley* at 4-5. This decision is important for attorneys to keep in mind when dealing with debtors who end up having to pay a deficiency judgment

because the sale price did not meet the price the house was appraised or, possibly, banks who have mortgages on properties which may have been appraised at a higher value than the realistic potential purchase price.

III. OVERVIEW OF THE FUNCTION OF THE AUTOMATIC STAY

A. GENERAL FUNCTION OF AUTOMATIC STAY

Before discussing the new bankruptcy legislation, it would be helpful to review the concept of the automatic stay, which is one of the main reasons the debtor files for bankruptcy. The debtor's bankruptcy petition functions as the "automatic stay," notes Epstein, Nickles & White, authors of *Bankruptcy*, which is the article cited for the information in this section. David G. Epstein, Steve H. Nickles & James J. White, *Bankruptcy* 64 (West Group 1993) (1992). An automatic stay is given to the debtor when he or she files the bankruptcy petition, which gives the debtor several advantages. The stay stops all creditors' actions in order to allow the debtor to assess his or her financial situation. Thus, the automatic stay makes it easier to organize and sort the debtor's property, giving the debtor temporary freedom against persistent attempts at collection and foreclosure. Also, the stay gives the debtor the power to ease the burden or financial difficulties that resulted in bankruptcy. However, as Robert Fishman and Brian L. Shaw state, "the stay does not toll any applicable statutes of limitation for claims against the estate, except that action on claims for which the applicable statute of limitations had not expired upon the filing of the petition may be commenced within 30 days after notice of the termination of the stay." Robert Fishman & Brian L. Shaw, *Treatment of Secured Interests in Bankruptcy*, Secured Transactions 2001, Illinois Institute for Continuing Legal Education, Section 8, 8-6.

The consequences of the automatic stay are different for secured creditors and unsecured

creditors. With the automatic stay in effect, an unsecured creditor cannot maintain their claim against the debtor and the unsecured creditor is at a loss. On the other hand, the secured creditor still has the ability to advance their claims against the debtor, both while the bankruptcy case is pending and following the case. However, for the secured creditor, the loss of time can be a rather hefty price to pay for the creditor.

B. THE TERMINATION OF THE AUTOMATIC STAY

The automatic stay can be terminated in various ways, such as when the case is dismissed or when the debtor is discharged. In terms of time, the automatic stay can last from a few months to many years, depending on whether the debtor has filed a Chapter 7, 11 or 13. A stay regarding certain property may be terminated due to: 1) "cause, including the lack of adequate protection" or, 2) "lack of equity in the property" that is not needed for the debtor's reorganization process. 11 U.S.C. §362(d). Secured claimants can cite both reasons to lift the stay. The "lack of equity" argument is usually cited first and, if this argument does not win, then the creditor can cite the "cause" argument. Under the category of "cause," most creditors use the "lack of adequate protection" argument. Adequate protection is a fundamental element of bankruptcy because it serves to protect the value of a third-party's interest in property affected by the bankruptcy. Adequate protection also serves to keep the value of the lien intact when the stay is in effect. While the lien "is a property interest in the collateral," the lien's worth is described by the "amount of the secured debt." Moreover, the property's value is the "natural limit on the value of the lien." Thus, the stay will not serve to diminish the value of the lien. As a note to creditors, if the value of the collateral is decreased while the stay is in effect, the lien's value will decrease. However, if the lien's value does decrease, then "...the creditor is entitled either to adequate

protection against the risk or to relief from the stay so that she can dispose of the property before her lien is eroded." The creditor gets this privilege even if the collateral is a part of the debtor's reorganization plan. Common examples of allowing adequate protection to the creditor include providing insurance in the event that the lien's value is diminished by the decrease in value of the collateral. The stay on property is terminated by order from the court. The creditor can ask the court to lift the automatic stay. Individuals who will be affected by the stay's lifting, such as the debtor or the trustee, can make objections to the motion for relief from automatic stay. When an objection is made, the court will decide if the motion to lift the stay will be granted.

As a warning to creditors, it is important to note that a "willful" breach of the stay can result in the creditor being guilty of "contempt" and the possibility of having to pay damages. A breach of the stay is either "void or voidable" making the actions of the creditor meaningless. See 11 U.S.C. Sec. 362. However, creditors have the possibility to terminate or modify the stay if the creditors can show cause, including the lack of adequate protection. 11 U.S.C. §362(d)(1). "A debtor's use of delay tactics, especially to avoid an inevitable foreclosure proceeding or sale, is a common form of 'cause'." *Fishman* at 8-7. If the stay of an act is against property, the stay may be modified if the debtor does not have any equity in the property, and the property is not necessary to an effective reorganization. 11 U.S.C. §362(d)(2). All liens on the property should be taken into account when determining equity issues. *Fishman* at 8-7. Also, the addition of section 362(d)(4) in the new law may be extremely beneficial to creditors who hold a claim secured by an interest in real property. A stay of an act against the real property may be modified or terminated if the Court finds that the bankruptcy petition was filed as part of a scheme or plan to defraud creditors, and that it involved a transfer of all or part ownership of or another type of

interest in the property without the consent of the secured creditor or the Court, or if there were multiple bankruptcy filings affecting such real property. 11 U.S.C. §362(d)(4). Under these provisions, the secured creditor can find some hope for relief from the automatic stay.

C. RESTRICTION ON ASSESSING AUTOMATIC STAY VIOLATIONS AGAINST CREDITOR

An extremely important amendment for bankruptcy practitioners to understand is the amendment to the notice requirements. Previously, section 342(c) maintained the enforceability of the automatic stay even when the debtor failed to provide notice to the creditors. The newly amended section 342(g) has eliminated this fairly unrestrictive provision and replaced it with a provision that states that no monetary penalty may be imposed against a creditor for violating the stay if the creditor had not received proper notice as described under amended §342. 11 U.S.C. §342(a). This new amendment has the potential to cause great difficulties for debtors and debtor's attorneys. Of all the amended provisions of the bankruptcy code, this may be one of the most important of which to be aware; otherwise, a debtor could be left without any monetary recourse against a creditor who has violated the stay if notice was not properly given.

D. THE AUTOMATIC STAY AND THE APPLICATION OF THE ROOKER-FELDMAN DOCTRINE: A DEBTOR MAY WAIVE THE AUTOMATIC STAY THEREBY BRINGING THE DEBTOR OUT OF THE SCOPE OF PROTECTION GRANTED BY 11 U.S.C. §362

Author Steven P. Garmisa analyzed the Illinois Appellate Court decision in *In re Mid-City Parking*, 2005 WL 2857728 (Bankr. N.D. Ill., Oct. 31) regarding the automatic stay and the role of federal courts in an article for the Chicago Daily Law Bulletin entitled *Bankruptcy Judge Has Final Word on Automatic Stay, Request for Fees*. Steven P. Garmisa, *Bankruptcy Judge Has Final Word on Automatic Stay, Request for Fees*, Chicago Daily Law Bulletin, November

23, 2005. As Steven Garmisa notes, Bankruptcy Judge Jacqueline P. Cox rejected the request of Clark Polk, who had obtained a \$427,780 judgment against Mid-City in Cook County Circuit Court, to award the fees and costs incurred in getting a state court appeal dismissed. *Garmisa*. Once judgment was entered against Mid-City, Mid-City filed Chapter 11 which invoked the automatic stay under Section 362. *Garmisa*. Without seeking modification from the stay, Mid-City appealed the judgment at which time Clark Polk incurred fees and costs in order to have the appeal dismissed. *Garmisa*. Judge Cox stated in her opinion the following:

The general rule of the Rooker-Feldman doctrine states that after a state court with jurisdiction over a federal question enters a final order on that question, be it a statutory or constitutional ruling, a federal court with original jurisdiction under 28 U.S.C. sec. 1331, 1332 or 1334 in a subsequently filed action has no jurisdiction to review that state court ruling and all other matters inextricably intertwined with it; the federal question must be appealed to the state's highest court and then to the U.S. Supreme Court under 28 U.S.C. sec. 1257.

Federal Courts have nonetheless recognized specific statutory provisions that permit federal courts with original jurisdiction to entertain a collateral attack for certain federal questions litigated in state courts, most notable where the federal courts had exclusive jurisdiction over the federal question in the first place.

Bankruptcy is a particularly difficult area of law in which to determine whether a state court decision is subject to collateral attack in spite of the Rooker-Feldman doctrine. The federal district courts -- and by reference, the bankruptcy courts -- have "original and exclusive jurisdiction of all cases under Title 11" while also having "original but not exclusive jurisdiction of all civil proceedings arising under Title 11, or arising in or related to cases under Title 11." 28 U.S.C. sec 1334.

Judge Jacqueline Cox, *In re Mid-City Parking*, 2005 WL 2857728 (Bankr. N.D. Ill., Oct. 31, 2005). Judge Cox went on to determine that "federal courts must have the final word on the scope and applicability of the automatic stay with respect to a given course of conduct so as to prevent an inadvertent state-court modification of a federal injunction under section 362(d) -- an injunction intended to preserve a federal court's exclusive jurisdiction over the *in rem* proceeding

that is the bankruptcy 'case' under 28 U.S.C. sec1334(a)." *Mid-City Parking* 2005 WL 2857728.

Judge Cox notes the importance of this issue in Chapter 11 proceedings in which the debtor-in-possession acts in the capacity of a trustee under section 1107(a) having not been replaced by a trustee under section 1104(a). *Mid-City Parking* 2005 WL 2857728. "The issue in these cases is whether the debtor-in-possession must always seek modification of the stay to proceed with actions that are otherwise stayed automatically or, alternatively, whether the debtor-in-possession (acting as trustee) may proceed without a court order by simply waiving the protections of the automatic stay and taking action on behalf of the estate." *Mid-City Parking* 2005 WL 2857728.

Another issue raised in a Chapter 11 proceeding is the issue of waiver when it comes to the automatic stay. As Judge Cox states:

It goes without saying that once a trustee or debtor-in-possession unilaterally waives the protections of the automatic stay by proceeding with estate administration, he cannot contend that a creditor-appellee has violated the automatic stay by opposing the appeal he himself has initiated and prosecuted. If the trustee has waived the protections of the stay, it would logically no longer exist to restraining the creditor-appellee...

A Chapter 11 debtor-in-possession or case trustee may waive the protections afforded by section 362(a) when the actions that would otherwise violate the stay are in furtherance of his statutory duties of administering the bankruptcy estate, including appealing judgments against the debtor's estate in non-bankruptcy forums.

Until a debtor-in-possession or trustee takes affirmative action showing an intent to prosecute the appeal of a judgment claim, however, an appeal from a judgment against the debtor's estate is stayed pursuant to section 362(a)(1)."

Mid-City Parking, 2005 WL 2857728. Judge Cox determined that, in the case of *In re Mid-City Parking*, the Chapter 11 debtor-in-possession took affirmative action when it filed a notice of appeal in the Appellate Court of Illinois, and that such affirmative action waived the protections of the automatic stay; therefore, Clark Polk's costs and fees were incurred as a result of Mid-

City's willful violation of the automatic stay. *Mid-City Parking* 2005 WL 2857728.

As can be noted by Judge Cox's decision in *In re Mid-City Parking*, a debtor may violate and thereby waive the automatic stay bringing the debtor out of the scope of protection. This is important for creditors who hold a claim against the debtor, and all creditors should be aware of the details of Judge Cox's decision.

IV. THE NEW RESTRICTIONS ON APPLICATION OF THE AUTOMATIC STAY MAY SHORTEN THE TIME NECESSARY FOR A LENDER TO FORECLOSE ON ITS COLLATERAL

A. REFILING RESTRICTIONS WHICH RESTRICT APPLICATION OF THE AUTOMATIC STAY

Section 362 of the bankruptcy code has been amended to restrict application of the automatic stay and exclude certain situations from falling within the scope of the automatic stay provision. Honorable Eugene R. Wedoff, *Major Consumer Bankruptcy Effects of the 2005 Reform Legislation*, April 13, 2005. Section 362(c)(3) provides that if a debtor has filed a Chapter 7, 11 or 13 within one year of the dismissal of an earlier case, excluding a Chapter 11 or 13 which was filed after §707(b) dismissal (for a presumption of abuse), the automatic stay in the second bankruptcy terminates thirty days after the filing, unless it is otherwise demonstrated that the second case was filed in good faith in regard to the creditor which is sought to be stayed. *Wedoff* at 4. If the debtor files a second repeat case within the one year period, then the automatic stay will not go into effect, and the court is required to promptly enter an order to this effect. However, the debtor may file a motion to impose the automatic stay as to certain creditors by showing that the filing was made in good faith. *Wedoff* at 5. Second and third filings made within the one year period are presumptively made in bad faith and such presumption may only be rebutted by clear and convincing evidence that the filing was made in good faith. In our

experience under the new law, not many motions to impose or extend the automatic stay have been presented thus far. But, when a Motion has been presented, some Judges have held that Affidavits from the debtor(s) detailing the circumstances of the good faith filing must be attached to the Motion. A mere allegation in the Motion to extend or impose the automatic stay of a good faith filing without an Affidavit from the debtor(s) detailing facts that support a good faith filing is not sufficient. This places the burden on a debtor and/or his/her attorney, who is filing bankruptcy for the second time, to prove to the court that the case was filed in good faith; moreover, the amendment is an effort to prevent abuses of the bankruptcy code through multiple filings.

B. RESTRICTED APPLICATION OF THE AUTOMATIC STAY TO REAL ESTATE: THE COURT, UNDER CERTAIN CIRCUMSTANCES, HAS THE AUTHORITY TO LIFT THE STAY, EFFECTIVE FOR TWO YEARS, WHICH SHOULD EXPEDITE REAL ESTATE FORECLOSURE PROCEEDINGS

In its effort to prevent abuse of the bankruptcy code, the legislature has enacted other restrictions on the application of the automatic stay. For instance, under amended section 362(d)(4), in cases involving either "(A) transfers of real property collateral without the consent of the secured creditor or court approval or (B) multiple bankruptcy filings involving the same real property", where the Debtor has filed the case as a "part of a scheme to delay, hinder, and defraud creditors," the bankruptcy court may issue an order granting relief from the stay which is effective for two years from the date of entry against the owners of the property in all subsequent cases. 11 U.S.C. §362(d)(4). A debtor may be granted relief of such an order by demonstrating that the instant case was filed in good faith.

Also, section 362(b)(20) offers secured lenders some additional relief against those

debtors guilty of multiple filings. Section 362(b)(20) now provides that the automatic stay does not operate against "any act to enforce any lien against or security interest in real property following entry of the order under subsection (d)(4) as to such real property in any prior case under this title for a period of 2 years after the date of the entry of such an order, except that the debtor, in a subsequent case under this title, may move for relief from such order based upon changed circumstances or for other good cause shown, after notice and a hearing." This section provides secured lenders with more power when it comes to being able to enforce a lien against some sort of collateral. For instance, mortgage lenders who hold a lien against real property will be able to proceed in any manner to enforce that lien providing that an order was issued pursuant to 362(d)(4). If a secured lender is plagued by a debtor who has filed multiple times, this new section will allow this secured lender to enforce its lien against the real property and maintain the value of its collateral, instead of risking a substantial decrease in value and only receiving a fraction of the amount of the loan.

**C. RESTRICTED APPLICATION OF THE AUTOMATIC STAY TO
EVICITION PROCEEDINGS: THIS PROVISION WILL HELP THE
LANDLORD REPOSSESS REAL ESTATE IN A SHORTER TIME
PERIOD**

Beyond real property, debtors who lease property are faced with a very demanding automatic stay provision. Section 362 has been amended to allow any eviction proceedings to continue if a judgment for possession was obtained prior to the filing of the bankruptcy petition. 11 U.S.C. §362(b)(22). Also excepted from the automatic stay provision is any evictions based on endangerment of the property or illegal use of controlled substances on the property. 11 U.S.C. §362(b)(23). These types of evictions are excepted only if the eviction proceeding was commenced before the debtor filed bankruptcy or if the endangerment or illegal use occurred

within the 30 days preceding the bankruptcy filing. However, Section 362 does provide a way the automatic may remain in effect for thirty days. A debtor would be able to keep the stay in effect in various ways thereafter as set forth in 11 U.S.C. §§362(l) and (m). These new provisions of the automatic stay are important for debtors and bankruptcy practitioners to understand, as many multiple filers or lessees could be caught in a situation.

V. UNDERSTANDING THE IMPORTANCE OF ADEQUATE PROTECTION

Authors Robert Fishman and Brian L. Shaw emphasize the importance of understanding the concept of adequate protection in their article *Treatment of Secured Interests in Bankruptcy* included in the Illinois Institute for Continuing Legal Education's 2001 Handbook on Secured Transactions. "Adequate protection is not defined anywhere in the Bankruptcy Code, although it is of great and repeated importance in understanding both the use of cash collateral and the modification of the automatic stay." It is important to remember that granting priority status under 11 U.S.C. §503(b)(1) is not permissible as a form of adequate protection. *Fishman* at 8-5.

A. CASH COLLATERAL, REPLACEMENT LIENS AND THE "INDUBITABLE EQUIVALENT"

In circumstances where a creditor is faced with the possibility that the collateral may lose value because of wear and tear associated with normal usage, be of a finite quantity, or be consumed in the ordinary course of business, cash payments to cover depreciation, depletion, or consumption of the collateral may be necessary. *Fishman* at 8-4. Payment of current, post-petition, interest on the principal amount of the debt may be allowed only upon confirmation of a plan of reorganization. With respect to real estate collateral, payment of current real estate taxes may be considered. *Fishman* at 8-4.

Replacement liens are often necessary simply to maintain the status quo. Section 552(a)

of the Bankruptcy Code cuts off the typical after-acquired property clause found in many security agreements. *Fishman* at 8-4. Section 552(b) provides certain exceptions to that rule, including the protection and extension of security interests in proceeds, product, offspring, profits, and rents acquired post-petition, as well as fees, charges, accounts, and other payments for the use of hotel rooms and other public facilities, to the extent that the underlying collateral was subject to a valid pre-petition security interest that covered those same items. *Fishman* at 8-4. If the court is going to allow the debtor to consume assets that are subject to a security interest that is cut off by §552(a), then the secured creditor will want to obtain a court-approved replacement lien before the consumption occurs. Both the secured creditor and the court should be skeptical of replacement liens granted on assets of questionable or speculative value, such as future crop of the debtor. *Fishman* at 8-4 - 8-5.

The "indubitable equivalent" is the most nebulous of all. This concept had its genesis in Judge Learned Hand's opinion in In re Murel Holding Corp., 75 F.2d 941 (2d Cir. 1935). This concept is one that allows the court to fashion other forms of adequate protection as circumstances justify and allow. Remember, however, that the statute does not specifically state "indubitable equivalent" as an alternative. Further, the parties, subject to court approval in most instances, are free to fashion their own forms of adequate protection. *Fishman* at 8-5.

B. WHAT IS TO BE PROTECTED BY ADEQUATE PROTECTION AND THE BURDEN OF PROOF

The central theme of adequate protection is that the creditor is not to be unduly exposed to risk or loss without being provided with an appropriate form of protection. *Fishman* at 8-5. The creditor is to be protected from injury which is defined as a diminution of the value of its interest in the debtor's property. *Fishman* at 8-5.

Injury to a creditor's interest may be caused by any of the following: the automatic stay, the use sale or lease of property in which the creditor claims an interest under §363, or the granting of a lien under §364. *Fishman* at 8-5. Examples of injury to a creditor are: a decrease in the value of collateral through use or consumption, the accrual of post-petition interest, real estate taxes, or interest on a secured claim in the same property with a higher priority; the granting of relief to one party claiming an interest in collateral without granting the same relief to other parties claiming an interest and the sale of property subject to a security interest without the sale proceeds being devoted to the payment of appropriate secured indebtedness. *Fishman* at 8-5.

The burden of proof on the issues of adequate protection is on the party seeking to establish the existence of adequate protection, who is almost always the trustee or debtor in possession. *Fishman* at 8-6.

VI. ISSUES WHICH FREQUENTLY ARISE REGARDING THE USE OF CASH COLLATERAL

Section 363(a) defines cash collateral as cash, negotiable instruments, deposit accounts, and other cash equivalents, whenever acquired. *Fishman* at 8-8. More specifically, cash collateral is defined 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 and includes proceeds, products, offspring, rents, or profits of the property..." 11 U.S.C. §365(a). In most proceedings under Chapter 11 or Chapter 12 of the Bankruptcy Code, the debtor in possession or trustee will require the use of cash collateral in order to continue the business operations effectively. *Fishman* at 8-9. The secured creditor claiming an interest in the cash collateral will often oppose the use of cash collateral, believing that the debtor's business operation will lose money and the dissipation of the cash collateral will

ultimately prejudice the creditor's ability to be repaid in full. *Fishman* at 8-9. In order for a secured creditor to assert a security interest in cash collateral, it must have a perfected security interest in the cash collateral. The debtor, pursuant to 11 U.S.C. §1107, has the right to challenge the validity and/or scope of a secured creditor's claim to the cash collateral. The secured creditor has the burden of proof on the issue of validity and scope of its cash collateral.

A debtor in possession, as required pursuant to 11 U.S.C. §363(c)(4), must keep cash collateral segregated and must account for it to the secured creditor claiming an interest in it. *Fishman* at 8-9. Cash collateral may be used only under limited circumstances. Its use requires either consent of the applicable secured creditor(s) or, after notice and a hearing, a court order authorizing its use in accordance with the provisions of §363. *Fishman* at 8-9. The debtor in possession, however, is free to use non-cash collateral in the ordinary course of business unless otherwise limited by court order. *Fishman* at 8-10.

In order for the debtor in possession to use cash collateral over the objection of a party with an interest in that cash collateral, the court must find the interested party is adequately protected. *Fishman* at 8-10. Temporary use may be granted if the court preliminarily determines there is a reasonable likelihood the secured creditor can be adequately protected. *Fishman* at 8-10. The burden of demonstrating adequate protection exists and no further protection is required is on the debtor in possession or trustee. *Fishman* at 8-10. If the debtor makes a request to use cash collateral and a creditor with an interest in the cash collateral neither objects nor requests that it be provided with adequate protection, then the court may authorize the use without ordering that the creditor be provided adequate protection. *Fishman* at 8-10. If the creditor later requests protection, it will be too late with respect to any use that has already been authorized and

that has already occurred. *Fishman* at 8-10.

VII. THE EFFECT OF THE NEW BANKRUPTCY CODE ON THE USE, SALE OR LEASE OF PROPERTY: THE REWORKING OF LEASE ASSUMPTIONS RESTRICTS THE DEBTOR'S AND THE LENDER'S OPTIONS ON MAINTAINING OR RELOCATING COLLATERAL

Although the lease termination sections may not directly impact a bank, it can indirectly affect a bank's client if the bank has less time to move the borrower's product, equipment, business, and customer flow from one location to another. The amendments to Section 365 may have a significant impact on lessors especially concerning the assumption or rejection of leases. Section 365(d)(1) and (2) have remained unchanged and provide that, in a Chapter 7 bankruptcy, the debtor has sixty days from the order of relief to assume or reject any executory contracts or unexpired leases for residential real property or personal property, and, in a Chapter 13 bankruptcy, the debtor may assume or reject an executory contract or unexpired lease any time prior to confirmation of a plan, but upon request of any party the Court may order the trustee to determine, within a certain period of time, whether to assume or reject the contract or lease. 11 U.S.C. §365(d)(1) and (2).

The most significant change has occurred in Section 365(d)(4). This section has been amended to extend the initial time for a debtor to assume or reject a contract or lease for nonresidential real property to 120 days. If the debtor can show cause for an extension of time, this time frame may be extended for another 90 days. Bruce C. Scalabrino, *Bankruptcy Reform for Non-Bankruptcy Lawyers*. Illinois Bar Journal Vol. 93, October 2005, 521. Once the 90 day extension is granted, there can be no more extensions without the written consent of the lessor. *Scalabrino* at 521. Under the old Bankruptcy Code the debtor or lessee was allowed 60 days

after the date of the order for relief, or within additional time granted by the Court for cause, to assume or reject an executory contract or unexpired lease. If the debtor did not take such action, the trustee was required to immediately surrender the property to the lessor. The new provision gives the lessee/debtor much more time, however, it may give secured lenders an unrealized benefit. This benefit may be realized in the sense that this gives a lessee more time to determine what he or she may wish to do and, in that time, he or she may decide to relocate, refinance or restructure a business. This could benefit a secured lender who holds equipment as collateral because it may help to protect the value of that collateral and the loan itself. Fluctuating valuations of a Bank's collateral may occur, meaning the optimum time to sell collateral varies depending on seasonal fluctuations; therefore, a creditor should plan the timing of its recoveries and/or commercially reasonable sale with these fluctuations in mind. See *Advanced Chapter 11 Bankruptcy Practice* § 2.25, Legal Publishing January 1990 Vol I, 2-17. Furthermore, reasonable companies may expose the creditor to an "improvement in position" claim. *Advanced Chapter 11 Bankruptcy Practice* at 2-17.

Also, a provision which has been left unchanged by the amendments to the Bankruptcy Code is section 365(c)(2), which prohibits a trustee from using, selling or leasing cash collateral unless all the entities which have an interest in the cash collateral consent or the court authorizes the use, sale or lease upon notice and hearing. 11 U.S.C. §365(c)(2). As stated above, cash collateral is defined 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 and includes proceeds, products, offspring, rents, or profits of the property..." 11 U.S.C. §365(a). This section helps to protect secured lenders as it is likely that

these lenders will have some sort of negotiable instrument or document of title. This provision helps to protect their interest and allows the secured party to have a voice in how the collateral is used or sold. This will be very important to a secured lender who wishes to protect the value of the collateral.

VIII. NEW RESTRICTIONS AS TO THE SCOPE OF THE DEBTOR'S DISCHARGE WILL GIVE THE BANK LEVERAGE IN NEGOTIATING A HIGHER PAYMENT ON ITS CLAIM

A. FRAUDULENT FINANCIAL STATEMENTS AND THE EXCEPTION OF FRAUD COMPLAINTS FROM DISCHARGE PURSUANT TO §523(a)(2)

Under section 523(a)(2) money, property, services or an extension, renewal or refinancing of credit is nondischargeable to the extent that it was obtained through

- (A) false pretenses, a false representation, or actual fraud, other than a statement respecting the debtor's or an insider's financial condition;
- (B) use of a statement in writing
 - (i) that is materially false;
 - (ii) respecting the debtor's or an insider's financial condition;
 - (iii) on which the creditor to whom the debtor is liable for such money, property, services, or credit reasonably relied; and
 - (iv) that the debtor caused to be made or published with intent to deceive;

11 U.S.C. §523(a)(2). This provision has not been changed by the Bankruptcy Abuse Prevention and Consumer Protection Act. However, it is important that all parties be aware of this section as this means that any debt obtained under a false representation or false financial statement would not be dischargeable in a Chapter 13 unless the Plan provided for full payment of the claim.

An amendment of great importance and effect to lenders, debtors and bankruptcy practitioners is the reduction of the so-called Chapter 13 "super-discharge" of Section 1328. In short, the "super-discharge" is no longer so super. "Debts for trust fund taxes, taxes for which returns were never filed or filed late (within two years of the petition date), taxes for which the

debtor made a fraudulent return or evaded taxes; fraud and false statements under §523(a)(2), unsecured debt under §523(a)(3), defalcation by a fiduciary under §523(a)(4), domestic support payments, student loans, drunk driving injuries, criminal restitution and fines and civil restitutions or damages rewarded for willful or malicious personal actions causing personal injury or death are now excepted from discharge." *ABI* at 5. There are a few debts which are still dischargeable under the amended "super-discharge". These include "debts for willful and malicious injury to property (§523(a)(6)), debts incurred to pay nondischargeable tax obligations (§523(a)(14)), and debts arising from property settlements in divorce or separation proceedings (§523(a)(15))." *Wedoff* at 19.

B. LUXURY GOODS OR SERVICES AND STUDENT LOANS

The new bankruptcy legislation has made some minor changes to provisions relating to the dischargeability of credit card debts and student loans; however, such minor changes may have a large impact on debtors. First, pursuant to §523(a)(2)(C), the presumption of nondischargeability for fraud has been expanded by reducing the amounts a debtor must charge for "luxury goods" from \$1,225 to \$500 and the amount for cash advances reduced from \$1,225 to \$750. 11 U.S.C. §523(a)(2)(C). Another potential trap the debtor may have to overcome is the fact that the time period of when these charges are to be made for the presumption to be invoked has been increased from 60 to 90 days for luxury goods and 60 to 70 days for cash advances.

Another somewhat minor amendment in wording is one that may have a substantial impact on debtors: the amendment to the dischargeability of student loans. Section 523(a)(8) has been amended to make student loans nondischargeable, in the absence of undue hardship,

regardless of the nature of the lender, thus covering loans from non-governmental and profit-making organizations. This means that loans which have been extended from profit and non-governmental agencies are no longer dischargeable under the bankruptcy code. *ABI* at 6.

However, private lenders are still left at the mercy of the "undue hardship" test which may permit a debtor to discharge any and all educational loans. 11 U.S.C. 523(a)(8). Creditors must be aware of the fact that the "undue hardship" test is not simply measured by the hardship placed on the debtor but also the hardship placed on the debtor's dependents. *ABI* at 6. However, such hardship discharges of student loans are very rare.

C. NEW RESTRICTIONS ON OBTAINING A CHAPTER 13 DISCHARGE OF DEBT WHEN THE DEBTOR HAS PREVIOUSLY FILED A CHAPTER 7

An amendment which will have a definite impact on debtors' choices of filing Chapter 7 or Chapter 13 bankruptcies is the amendment to Sections 727(a)(8) and 1328. Under amended §727(a)(8), a debtor is now subject to a denial of a discharge if the debtor received a Chapter 7 or 11 discharge in a case filed within eight years of the filing of the current case. *ABI* at 1. Under new section 1328(f), "a Chapter 13 debtor will be denied a discharge if the debtor received a discharge (1) 'in a case filed under Chapter 7, 11, or 12 ... during the 4-year period preceding the date of the order for relief' in the pending case, or (2) in a case filed under Chapter 13...during the 2-year period preceding the date of such order." These new amendments to the Chapter 7 and Chapter 13 provisions will change the strategic practices of many debtors and practitioners. This will eliminate some of the advantages of filing a Chapter 7 and then a Chapter 13, a so-called "Chapter 20". However, in many cases, Chapter 20's will still be a viable entity. Even though a Debtor may not receive a discharge under their Chapter 13 after receiving a Chapter 7 discharge, it is often the case that the Chapter 13 proposes a full repayment of all debts left over from the

Chapter 7. Thus, although the Debtor will not receive a discharge in his/her Chapter 13, they will receive something similar by proposing to pay the debt in full.

IX. THE REDUCED POWERS OF THE TRUSTEE TO AVOID PREFERENTIAL TRANSFERS: CREDITORS, INCLUDING LENDERS, NOW HAVE ADDITIONAL DEFENSES

A. THE CHANGES IN SECTION 547 GIVE ADDITIONAL DEFENSES TO THE TRANSFEREES

The Bankruptcy Abuse Prevention and Consumer Protection Act has amended section 547(c)(2) to read as follows:

The trustee may not avoid under this section a transfer—

- (2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—
 - (A) made in the ordinary course of business or financial affairs of the debtor and the transferee; or
 - (B) made according to ordinary business terms

11 U.S.C. §547(c)(2). The amendment of changing the "and" to an "or" broadens the scope of defenses for a transferee. Now, the transferee can defend a preferential transfer complaint if the transfer meets the qualifications of either (A) or (B). This new changes is a benefit to creditors as if a debtor decides to make a payment, the risk of it being avoided as a preferential transfer is much less as now such transfer must only be made according to ordinary business terms or in the ordinary course of business or financial affairs of the debtor in order to fall out of the scope of the trustee's avoidance powers. This provision essentially helps to protect payments made to creditors.

Another minor change that has been made is Section 547(3)(B) which extends the perfection period for property from 20 to 30 days after the debtor receives possession of the property. This allows a creditor more time to perfect its security interest so that the transfer will

not be avoided as preferential. Obviously a minor change, but one that may be very important to creditors who hold security interests in a debtor's property to help protect their interests in the property.

B. AFFIRMATIVE DEFENSES TO AVOIDANCE ACTIONS UNDER SECTION 547

Attorney Edward S. Margolis has written an excellent article entitled "Advantage to Creditor: Understanding Preference Actions and Available Defenses" in the Illinois Bar Journal Volume 93, November 2005 edition. In this article, Attorney Margolis states that there are three most common affirmative defenses to a preference action, of which one has been made more favorable to creditors by the Bankruptcy Abuse Prevention and Consumer Protection Act. Edward S. Margolis, *Advantage to Creditor: Understanding Preference Actions and Available Defenses*. Illinois Bar Journal Vol. 93, November 2005, 591. The first defense, payments in the ordinary course of business, is a defense based on the rationale that normal financial relations should be left undisturbed because avoiding these types of transfers does not fit into the policy of Section 547, which is to discourage unusual action by either debtors or creditors on the slide into bankruptcy. To fit into the boundaries of this defense the creditor must prove three elements: "(1) the debt underlying the payment was incurred in the ordinary course of business between the debtor and the creditor and (2) the payment was made in the ordinary course of business of the debtor and the creditor or (3) according to ordinary business terms." *Margolis* at 591. Generally speaking, the creditor will have to show that the questioned transaction was usual between the parties and the time interval between the rendering of the services or providing the goods and payment was also usual. *Margolis* at 591. The Court, in determining whether the defense applies, will look at factors such as the prior course of dealings between the parties and the

amount, timing, and circumstances of the payments. *Margolis* at 591. The changes to this affirmative defense will be beneficial to creditors, as prior to the amendment creditors also had to establish that the ordinary course of dealings was common between the creditor and debtor.

Margolis at 591. Now, the creditor must only prove that the payments were in the ordinary course of business between the parties or in the ordinary course of business within the industry, but the creditor does not have to show both. *Margolis* at 591.

Our seventh circuit court of appeals has ruled that "ordinary business terms" refers to the range of terms that encompasses the practices in which firms similar in some general way to the creditor in question engage. The BAPCPA puts the creditor on a level playing field with the trustee by providing that "only dealings so idiosyncratic as to fall outside the broad range should be deemed extraordinary and therefore outside of the scope of subsection [B]." A creditor will now, within its own records, be able to establish whether the payments were in the ordinary course of business.

Margolis at 591-592.

The second most common defense, according to Edward Margolis, is payments that represent the simultaneous exchange of new value. *Margolis* at 592.

A transfer may not be avoided if the alleged preferential payments were given in exchange for a simultaneous or near simultaneous rendering of services or delivery of goods, the most common of which would be the COD purchase. Such simultaneous exchanges would also apply to prepayments for merchandise released upon receipt of payment. The theory here is that there was no antecedent debt and that the estate received an equivalent exchange of value for the alleged preferential payment.

Margolis at 592.

The third affirmative defense is that the creditor provided subsequent new value after receiving the payment that is alleged to be preferential. *Margolis* at 592. In order to use this defense, the creditor must be able to show that it rendered services or delivered merchandise after receiving the payment that is alleged to be preferential, and that it has not received payment for those goods and services. *Margolis* at 592. The creditor cannot prove this defense by merely

presenting the client's ledger of unpaid invoices rendered during the 90 days prior to the filing of bankruptcy, but must show the invoices were delivered to the debtor after the creditor received each of the payments the trustee is alleging to be preferential. *Margolis* at 592.

These revised affirmative defenses provide a creditor with the opportunity to defend against preference actions and hold onto payments which may have been made by the debtor on an open account. This is obviously beneficial to creditors in that there is more opportunity for creditors to receive payment without worrying that these payments will be avoided as a preference.

X. THE REPERCUSSIONS OF THE BANKRUPTCY ABUSE PREVENTION AND CONSUMER PROTECTION ACT OF 2005: POTENTIAL ATTORNEY LIABILITY, NEW DUTIES AND LIABILITIES IMPOSED ON DEBTOR'S COUNSEL, NEW DISCLOSURE REQUIREMENTS AND RECORD-KEEPING REQUIREMENTS

A. LIABILITY FOR DEBTORS' ATTORNEYS

The new Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 has several repercussions for debtor's attorneys in cases involving consumer bankruptcies. Helen Gunnarsson, author of the article, "The Bankruptcy Abuse Reduction Fiasco," notes that the Act is causing a stir among attorneys practicing bankruptcy law. Lawyers are referring to the Act as the "Bankruptcy Abuse Reduction Fiasco." *Illinois Bar Journal*, June 2005, Vol. 93.

Gunnarsson notes that under the Act, lawyers who are representatives for debtors will be required to "certify their clients' schedules and reaffirmation agreement."

Bankruptcy practitioners must be aware of the new duties and liabilities they face when representing a bankruptcy debtor. Section 707(b) has been amended to put a heavier burden on debtor's counsel. Honorable Eugene R. Wedoff, *Major Consumer Bankruptcy Effects of the 2005*

Reform Legislation. April 13, 2005, 13. These amendments include subparagraph (4)(A) which states that a trustee who successfully pursues a motion under 707(b) may be awarded costs and fees payable by debtor's counsel, if the trustee finds that the Chapter 7 filing violated Fed. R. Bankr. P. 9011. 11 U.S.C. §707(b)(4)(A). Apparently, there is no limit on fees. Additionally, there is no statutory formula for determining the amount of the fees. Accordingly, this leaves the Chapter 7 trustee with a large amount of discretion, though it seems likely that judges will enforce a reasonableness standard. Subparagraph (4)(B) states that a civil penalty may be awarded against the debtor's attorney if the court finds any violation of Rule 9011 by the debtor's attorney; however this provision is only applicable to Chapter 7. Such civil penalty shall be payable to the trustee, U.S. Trustee, or bankruptcy administrator. Under subparagraphs (4)(C) and (D), the debtor's attorney's signature equals a certification that "the attorney has "performed a reasonable investigation", such an investigation has led the attorney to determine that the signed documents are well grounded in fact, that the Chapter 7 petition is not considered an abuse under §707(b), and that "the attorney has no knowledge after an inquiry that the information in the schedules filed with [the] petition is incorrect". *Wedoff* at 13-14. However, this provision does not provide for any type of sanctions if the information is incorrect. *Wedoff* at 14.

Section 707(b)(4)C of the Bankruptcy Code notes that the signature an attorney affixed on a court document is held under a new standard. For example, "the signature of an attorney on a petition, pleading, or a written motion shall constitute a certification that the attorney has (I) performed a reasonable investigation into the circumstances that gave rise to the petition, pleading, or written motion; and (ii) determine that the petition, pleading, or written motion- (I) is well grounded in face; and (II) is warranted by existing law or good faith argument for the

extension, modification, or reversal of existing law and does not constitute an abuse under paragraph (1) [which provides for dismissal or conversion of any case found to be an abuse of the Bankruptcy Code].” Illinois Bar Journal, June 2005, Vol. 93.

The question then becomes, "what must a debtors' attorney do to protect his or herself?" In the article, "Bankruptcy Practice after Bankruptcy Reform", Illinois Bar Journal, January 2006, Vol. 94, the author conducts a survey of various bankruptcy attorneys in the state of Illinois. From the survey, it appears more attorneys are conducting additional work as a result of the provisions of Section 707. *Id.* Among these additional actions, some attorneys use commercial asset locator services to search public records on each client before filing a bankruptcy petition. *Id.* In addition, other attorneys use free, online public records searches available from some circuit courts or recorder of deeds offices. *Id.* In addition, the U.S. Trustee's Office is required to audit a certain percentage of bankruptcy filings for compliance with Section 707. *Id.* As a result, an attorney can not be too safe. It seems fairly clear that an attorney need not go to a debtor's residence to physically review all property the debtor owns, but some level of research is required.

Although this section lists several provisions that an attorney must follow, Gunnarsson notes that existing rules of bankruptcy such as Rule 9011 of the Federal Rules of Bankruptcy Procedure and the Federal Rules of Civil Procedure Rule 11, have always required such procedures as Section 707(b)(4)C. Illinois Bar Journal, June 2005, Vol. 93. The American Bar Association notes that “Rule 9011 doesn’t require an attorney to sign the bankruptcy schedules that list the debtor’s financial information.”

The penalty for disregarding the provisions of Rule 9011 of the Federal Rules of

Bankruptcy can result in the attorney having to pay “the trustee’s costs and attorney’s fees as well as a civil penalty if the violation results in dismissal or conversion of the case on motion of the trustee.”

B. NOTICE REQUIREMENTS TO DEBTORS

Moreover, Section 524(k) mandates that attorneys provide a “disclosure statement to be made in connection with any reaffirmation agreement.” Like Section 707(b)(4)C, section 524(k) notes that it must have “...a signed certification by the debtor’s attorney that (1) the agreement is fully informed and voluntary on the debtor’s part, (2) the agreement does not impose an undue hardship upon the debtor or any of the debtor’s dependent, and (3) the attorney has fully advised the debtor of the legal effect and consequences of the reaffirmation agreement and any default under the agreement.” The language of “reasonable investigation” found in Section 707(b)(4)C may imply that “...debtor’s attorneys to hire private investigators and appraisers to ensure that their clients’ schedules are correct,” suggests the American Bar Association.

Another change lawyers should be ready for is that lawyers who are handling bankruptcy cases for debtors will be required to report themselves “as debt relief agencies.” Section 526 - 528 mandate the “restrictions on attorneys and other debt relief agencies.” Specifically, Section 528 notes that “any debt relief agency” should include a statement similar to this: “We are a debt relief agency. We help people file for bankruptcy relief under the Bankruptcy Code.” In addition, section 526(a)(4) notes those lawyers who declare themselves to be “debt relief agencies” are now allowed to “...advise an assisted person or prospective assisted person [i.e. a client]... to pay an attorney or bankruptcy petition preparer fee or charge for services performed as part of preparing for or representing a debtor in a case under this title.” Furthermore, if a “debt

relief agency” does not comply with Sections 526-528, then the attorney will be required to pay his client “...for the amount of its fee, as well as for actual damages and attorney’s fees and costs.” In addition, Section 527 mandates that “debt relief agencies” issues a statement to clients with the following statement in all capital letters: “THE LAW REQUIRES [at sec. 528(a)] AN ATTORNEY OR BANKRUPTCY PETITION PREPARER TO GIVE YOU A WRITTEN CONTRACT SPECIFYING WHAT THE ATTORNEY OR BANKRUPTCY PETITION PREPARER WILL DO FOR YOU AND HOW MUCH IT WILL COST.”

In addition to this aforementioned statement, the attorney must also give the disclaimer that before the bankruptcy is filed, it should be analyzed whether or not the client is able to secure a “...different forms of debt relief under the Bankruptcy Code and which form of relief is most likely to be beneficial...” for your client. However, as stated above, it is likely that the vast majority of debtors who own real estate in the Chicago and collar counties area are not "assisted persons" under the Bankruptcy Code as most real estate in this area is worth more than \$150,000.00. Accordingly, in those cases, the debtor's attorney will not be a "debt relief agency" under the Code.

For those attorneys who represent paying debtors, they must consider Sections 527 and 528, in that they are treated as a "debt relief agency" under the new code. Under new §526, debtors' counsel are subject to loss of fees, damages, injunctive remedies, and imposition of costs for any failure to meet new disclosure and record-keeping requirements imposed on 'debt relief agencies' in new §527 and § 528. "Debt relief agency" is defined in new §101(12A) as "any person who provides any bankruptcy assistance to an assisted person in return for payment of money or other valuable consideration." 11 U.S.C. § 101(12A). "Assisted person" is defined in

new §101(3) as "any person whose debts consist primarily of consumer debts and the value of whose nonexempt property is less than \$150,000." 11 U.S.C. § 101(3). It is, therefore, likely that the vast majority of debtors who own real estate in the Chicago and collar counties area are not "assisted persons" under the Bankruptcy Code as most real estate in this area is worth more than \$150,000.00. Accordingly, in those cases, the debtor's attorney will not be a "debt relief agency" under the Code. Among the new requirements for bankruptcy attorneys meeting the definition of "debt relief agencies" is to: (1) retain a copy of each of several notices which is required to be given to an "assisted person" for two years, (2) disclose in advertising the statement "we help people file for relief under the Bankruptcy Code," (3) cannot advise a debtor to incur more debt, (4) must disclose all costs, (5) enter into a written contract, and (6) disclose that an attorney is not necessary to file bankruptcy. *Wedoff* at 14 and *ABI* at 5.

Obviously, it is important that bankruptcy attorneys stay alert to the new disclosure requirements and to the potential of sanctions and fees which may be brought against them for failure to adhere to the requirements. This opens up a new door of attorney liabilities for which many bankruptcy attorneys may not be prepared. Many small firms that only do occasional Chapter 7 bankruptcies will probably stop filing bankruptcies.

XI. NEW DOCUMENT PRODUCTION REQUIREMENTS FOR INDIVIDUAL CHAPTER 7 DEBTORS WHOSE DEBTS ARE PRIMARILY CONSUMER DEBTS

_____ Section 521 sets forth new requirements for debtors. *Wedoff*, at 1-2. First, debtors are required to file certain documents with their schedules. Debtors must file a certificate from an attorney or petition preparer showing that the debtor was given notice of the types of bankruptcies, etc., as required by Section 342(b). If the debtor is a *pro se* debtor, then a

certificate of the debtor must be filed in which the debtor states that the debtor has read the notice. Also, the debtor and his/her spouse, whether or not the case is a joint case, is required to provide "copies of all payment advices or other evidence of payment received within 60 days before the filing of the petition, by the debtor from any employer of the debtor" and "a statement of the amount of monthly net income, itemized to show how the amount is calculated". *Wedoff* at 2. Local Rules enacted in the Northern District of Illinois require the "payment advices" to be provided to the Trustee 7 days prior to the first Meeting of Creditors. In addition, the debtor must also give a statement which shows "any reasonably anticipated increase in income or expenditures over the 12-month period following the date of the filing of the petition." *Wedoff* at 2. The term "monthly net income" is not defined in the Code as amended by S. 256, but requires that the debtor issue a statement of "current monthly income." The "current monthly income" is a term, which is defined by the new § 707(b) means test and for the amended "disposable income test" of § 1325(b), with the total amount of appropriate deductions for support expenses and secured debts. *Wedoff* at 2. However, it is important to note that this requirement is only for individual debtor(s) whose debts are primarily consumer debts. Accordingly, a corporation, not being an individual, and individuals whose debts are primarily non-consumer debts need not provide payment advices or statement of monthly net income

Secondly, Section 251 states every debtor must give to the trustee and any creditor making a timely request a copy of the federal income tax return or transcript of the return (at the debtor's option) for the period for which the return was most recently due for which the debtor filed a return. The particular provision may apply to individual debtors in Chapter 7 and Chapter 13 cases, because § 521(e)(1), which is the requirement that the court give "copies of certain

filings to creditors" has limited scope. *Wedoff* at 2.

Third, each individual debtor who filed a Chapter 7, 11 or 13 case should also file copies of federal income tax return or a transcript of the return, with the court and with the IRS. These copies of the federal income tax return should consist of copies for the tax year ending while the case is pending and also for a tax year that ended three years before the case was filed, as well as copies (or transcripts) of any amendments filed to those returns. The returns that are filed or transcripts that were submitted, must be available to those parties who are interested and with the debtor's privacy protected by regulations to be adopted by the Director of Administrative Office. *Wedoff* at 2. Again, the Bankruptcy Court for the Northern District of Illinois has passed local rules requiring the tax returns to be provided to the trustee and not filed with clerk. This has the effect of preventing a debtor who has not filed his/her last four year's worth of income tax returns from filing a case under the bankruptcy code.

XII. THE NEW MEANS TEST APPLICABLE TO POTENTIAL CHAPTER 7 DEBTORS: THE LENDER'S ENHANCED POWERS WHICH UNDER CERTAIN CIRCUMSTANCES CAN COMPEL THE DEBTOR TO CONVERT THE CASE TO A CHAPTER 13 WHEREBY THE CREDITOR WILL AT LEAST RECEIVE A PARTIAL PAYMENT

Potential Chapter 7 debtors are faced with a new hurdle under the 2005 Bankruptcy Reform Legislation. Section 707(b) of the Bankruptcy Code has been amended to state that, upon a finding of abuse by an individual debtor with primarily consumer debts, a Chapter 7 bankruptcy may be dismissed or converted to a Chapter 13. Under the new amendment, there are two ways in which abuse may be determined: (1) an un rebutted presumption of abuse, which arises under the application of the new means test and (2) generally on grounds of bad faith which is determined by the totality of the circumstances. Honorable Eugene R. Wedoff, *Major*

Consumer Bankruptcy Effects of the 2005 Reform Legislation. April 13, 2005, 9.

The biggest potential hurdle for the Chapter 7 debtor is the new means test. This test provides that in order to be eligible to file a Chapter 7 bankruptcy, without the threat of dismissal or conversion, a debtor must have income which is less than the state median income.

Otherwise, a presumption of abuse of the bankruptcy code arises which may lead to the trustee or any creditor bringing a Motion to Dismiss. American Bankruptcy Institute, *25 Changes to Personal Bankruptcy Law*, 1.

The means test has three elements: "(a) a definition of 'current monthly income,' measuring the total income a debtor is presumed to have available; (b) a list of allowed deductions from current monthly income, for purposes of support and repayment of higher priority debt; and (c) defined 'trigger points,' at which the income remaining after the allowed deductions would result in the presumption of abuse." *Wedoff* at 11. Current monthly income is defined in new section 101(10A) as that income received, within a defined six-month period, by the debtor, and if filing jointly, that income received by the debtor's spouse, and regular contributions to household expenses made by other persons. 11 U.S.C. § 101(10A). However, Social Security benefits and certain victim payments are excluded. 11 U.S.C. §101(10A)(B). The six month period for determining income ends the last day of the calendar month preceding the filing if the debtor filed schedules with the bankruptcy petition. 11 U.S.C. §101(10A)(A).

After determining the debtor's annualized monthly income based on the six month period prior to the filing of the case, one must look at whether the income is in excess of the state median income of the state of residency. In Illinois, the median income breaks down as follows:

1 Family Member	\$41,602
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2 Family Member	\$51,572
3 Family Member	\$62,178
4 Family Member	\$70,357
Each Additional Member	\$6,300 per person

Household size is determined by the number of working individuals in the household. If the debtor and his/her spouse's income is excess of the median income for the state of residency, one must look at the expenses (deductions) to determine whether the presumption of abuse will arise.

The deductions which are allowed under the means test are laid out in new §707(b)(2)(A)(ii)-(iv). These deductions can be found in ten categories: (1) living expenses which have been specified under the standards of the Internal Revenue Service; (2) actual expenses to which the IRS has recognized, but has not specified a specific allowance; (3) expenses incurred for the protection from family violence; (4) contributions which are made for the care of nondependent family members; (5) actual expenses involved in administering a Chapter 13 plan; (6) up to \$1500 annually per minor child for grade and high school; (7) additional home energy costs; (8) 1/60th of all secured debt which will be due in the five years subsequent to filing; (9) 1/60th of all priority debt; and (10) up to 15% of gross income for continued contributions to tax-exempt charities. *Wedoff* at 11-12.

Also applicable to the new means test are the two triggering points for the presumption of abuse which are set out in §707(b)(2)(A)(I): "(1) if the debtor has at least \$166.67 in current monthly income available after the allowed deductions (\$10,000 for five years), abuse is presumed regardless of the amount of the debtor's general unsecured debt, and (2) if the debtor has at least \$100 of such income (\$6000 for five years), abuse is presumed if the income is

sufficient to pay at least 25% of the debtor's general unsecured debt over five years." *Wedoff* at 12. Stated more simplistically, "Abuse is presumed if the debtor's currently [sic] monthly income (as determined by an average of the previous 6 months) less secured payments divided by 60, less priority debts divided by 60, less the allowed expenses permitted by the IRS, less certain other allowed expenses, is greater than \$100 per month of a Chapter 13 plan. Debtors who meet this new standard would be shifted to 5 year repayment plan in Chapter 13." *ABI* at 1. In order to rebut the presumption of abuse applied by the trigger points, a debtor must swear to and document "special circumstances" which would either decrease income or increase expenses so that the debtor's income falls below the applicable trigger points. *Wedoff* at 13; citing 11 U.S.C. §707(b)(2)(B).

In a Chapter 7, if a debtor's household income is greater than the median income for the household, the means test must be taken further to determine whether the debtor's current monthly income is enough to raise the presumption of abuse. In most cases, the presumption of abuse will arise because the IRS Standard for expenses is static. This means that most cases must then be filed as a Chapter 13 or documentation must be provided to rebut the presumption of abuse. In a Chapter 13, if a debtor's household income is greater than the median income for the household, a plan commitment of five years is required.

Generally, abuse may be found through the totality of the circumstances test. Under §707(b)(3) when the presumption of abuse either does not apply or has been rebutted, abuse may be proved through a showing that the debtor filed the petition in bad faith or through the totality of the debtor's financial circumstances. *Wedoff* at 13. The procedure for determining an abuse under either one of these applications starts with the requirement that debtors file a statement of

calculations under the means test as part of the schedule of current income and expenditures. Section 704(b) requires that the U.S. Trustee or bankruptcy administrator review the debtor's material and, within ten days of the first meeting of creditors, file with the court a statement of whether the presumption arises. If the presumption arises, then a motion under §707(b) must be filed or a statement explaining why a motion is not being filed must be filed. All creditors must be notified within ten days of the filing of the petition if a presumption arises.

XIII. CHANGES AFFECTING CHAPTER 13 DEBTORS AND CHAPTER 13 SECURED CLAIMHOLDERS

A. CRAMDOWN FOR CERTAIN SECURED LOANS IS NO LONGER PERMITTED UNDER CHAPTER 13; NEW RESTRICTIONS ON CRAMMING DOWN A CAR LOAN

The 2005 Bankruptcy Reform Legislation has amended §1325(a) to limit the power to strip down secured claims to the value of the collateral. *Wedoff* at 17. Stripdowns will no longer be allowed for purchase money security interest in motor vehicles that have been purchased within 910 days (approximately two and a half years) of the filing of the petition or for all other secured debts which have been incurred within one year of the bankruptcy. As to stripdowns, new §506(a)(2) affects the value of a stripped down secured claim. *Wedoff* at 18. Section 506(a)(2) provides that the value of a stripped down secured claim should be based on the cost to the debtor of replacing the collateral. However, if the collateral was for personal, family or household purposes, then the replacement cost is equal to the retail price for property of a similar age and condition. Also, it is important to note that section 1325(a)(5)(B)(i) provides that a creditor must be allowed to retain any lien even after payment of the stripped down secured claim has been made.

The 2005 Bankruptcy Reform Legislation further provides for adequate assurance

payments to creditors prior to plan confirmation. Sections 1325 and 1326 have been amended to provide for two new conditions. Section 1325(a)(5)(B) has added subparagraph (iii) which requires that the Chapter 13 plan provide for the payment of secured claims in equal installments which are, at least, sufficient to provide adequate protection. Section 1326(a)(1) has two new subparagraphs (B) and (C) which state that the debtor must make adequate protection payments directly to the secured creditor prior to the confirmation of the plan for a lease of personal property (subsection B) or to secured claim on personal property for which the portion of the obligations become due after the filing of the case. 11 U.S.C. §§1326(a)(1)(B) and (C). These payments are then deducted from the pre-confirmation plan payments made to the trustee.

Further, section 1325(a) has been amended to limit the time during which the debtor could modify the rights of secured creditors. James J. Haller and William A. Mueller, *The New Bankruptcy Law: A Consumer Lawyer's Guide*. Illinois Bar Journal Vol. 93, September 2005, 456. Section 1325(a)(9) provides that a debtor may only cram down the value of a claim of a creditor holding a purchase money security interest in a motor vehicle acquired for personal use without the agreement of the creditor, if the debt was incurred more than 910 days prior to filing. *Haller* at 456. For other purchase money security interests in property other than motor vehicles, the restriction is only applicable if the debt was incurred within 365 days prior to filing the bankruptcy petition. 11 U.S.C. §1325(a)(9). This may help to protect secured creditors from modifications of their rights because the old code did not place a time limit on such activity, so secured creditors were constantly vulnerable to modification. However, if the creditor agrees to the cramdown, the statutes do not apply.

B. THE DEBTOR'S CONTRIBUTION OF DISPOSIBLE INCOME TO THE CHAPTER 13 PLAN

The new provisions of the amended bankruptcy code state that a Chapter 13 plan must provide for payment of unsecured claims in full with interest or, in the alternative, provide for all of the debtor's disposable income to be contributed to the plan for its minimum term. *Haller* at 456 citing 11 U.S.C. 1325(b). The minimum term has been amended under section 1325(b) to a five year term unless the debtor(s) income is less than the median income for the state.

C. **THE DEBTOR NOW HAS THE BURDEN OF PRODUCING FINANCIAL STATEMENTS AND INCOME TAX RETURNS IN A CHAPTER 13 CASE**

Debtors and attorneys representing the debtor must contend with new filing requirements under the 2005 Bankruptcy Reform Legislation. Upon request of the judge or a party of interest, the debtor must file a financial statement annually which provides for the income and expenditures of the debtor during the tax year. *Wedoff* at 20. It is not enough for the debtor to simply provide the information because the new §521(f)(4) states that the statement must demonstrate how the numbers were calculated, and under §521(g)(1), it must also disclose the amount and sources of income, identities of persons responsible with the debtor for the support of a dependent and those persons who contributed to the household and the amount contributed.

Beyond financial statements, the debtor is also required under §521(f) to file copies or transcripts of certain federal income tax returns and, under §1308(a), the debtor is required to file with the appropriate taxing body, no later than the day preceding the 341 meeting, any "tax return under applicable nonbankruptcy law' that was required to be filed for a taxable period ending within four years of the filing of the bankruptcy case." If the debtor fails to provide these documents, the trustee, under 1308(b), is permitted to continue the 341 meeting for a maximum of 120 days unless longer extensions are permitted under applicable nonbankruptcy law. Upon expiration of the 120 days, an extension may only be granted by the court upon showing of

circumstances which were beyond the control of the debtor. This has the effect of denying anyone who has not filed tax returns for the last four years and who were required to do so under applicable law the ability to file a bankruptcy case.

XIV THE NEW REQUIREMENT TO PRODUCE TAX RETURNS AND OTHER DOCUMENTS OR FACE DISMISSAL WITH OR WITHOUT PREJUDICE

Section 521 as discussed under the principles of a Chapter 13 apply across the board for other bankruptcy filings; therefore, a debtor will be required to provide federal income tax returns to the court, trustee or any creditor making a timely request. *Wedoff* at 2. A debtor is further required under amended section 521 to provide: (1) a statement of monthly net income which has been itemized to show how it was calculated; (2) a statement of any anticipated increase income or expense subsequent to the filing; (3) evidence of any payment received from an employer of the debtor within sixty days before filing; (4) a certificate of an attorney or the petition preparer stating that the debtor was provide an informational notice which is required under amended §342(b) or if the debtor is pro se, a certificate which states that the debtor has received and read such notice; (5) a certificate of credit counseling; and (6) a photo ID. *Wedoff* at 2 and *ABI* at 3-4.

It is important for debtors or attorneys representing the debtor to make a checklist of these documents to ensure that all documents are filed or, where applicable, provided to the trustee; otherwise, if such documents are not provided within a forty-five day period after the filing of the petition, the case can be dismissed with or without prejudice. *ABI* at 4.

XV. DEBTORS ARE NOW FACED WITH MANDATORY CREDIT COUNSELING AND DEBTOR EDUCATION

A major change which has occurred through the amendment of Title 11 is the new

requirement that debtors must attend credit counseling in order to be eligible to file bankruptcy. Under the new bankruptcy code section 109(h), an individual may not be a debtor under Title 11, unless within the preceding 180 days of filing, the individual has received credit counseling from an "approved nonprofit budget and credit counseling agency." *ABI* at 1. The approval of the counseling agency shall come from the United States Trustee or bankruptcy administrator under standards which have been set forth in §111, one of which is the agency must provide services without regard to the debtor's ability to pay. *Wedoff* at 3. Advice shall be provided to the debtor in either an individual or group briefing, which may take place over the telephone or internet, and must outline opportunities for credit counseling and assist in performing a related budget analysis. *Wedoff* at 3 and *ABI* at 1. The debtor may be able to circumvent this requirement under three exceptions which are: (1) debtors who are located in a district where the United States Trustee or bankruptcy administrator has determined adequate services are not available; (2) debtors who submit to the court certification which describes exigent circumstances which require immediate bankruptcy filing; however, it is further required under this exception that the debtor was unable to obtain counseling at least five days prior to the filing; and (3) debtors who are incapacitated, disabled or on active military duty are exempt. *Wedoff* at 3-4.

To date, there has been one case decided which sets forth the requirements of requesting that a Court, pursuant to §109(h)(3), temporarily waive the requirement contained in § 109(h)(1) that the debtor receive credit counseling in order to be eligible to file a petition under the new Bankruptcy Code. *In re Bertha Mae Gee*, Bankr.W.D. Missouri, Case No. 05-71886. In that case, the Debtor filed her case with a "a Certification of Exigent Circumstance to Waive Debt Counseling Prior to Filing". *Id.* The court reviewed the certification and "and issued an order

rejecting it, denying the implied motion for waiver, on the grounds that the certification failed to address and therefore comply with the requirement of § 109(h)(3)(A)(ii) that the Debtor had requested counseling services prior to filing, but was unable to obtain them within a period of five days subsequent to the request." *Id.* Because the debtor had failed to file a certificate stating that the debtor had not obtained or requested credit counseling, the Court dismissed the case. *Id.* The debtor filed a motion to vacate the dismissal alleging further facts to support her failure to file the certificate. The motion alleged other difficulties the debtor had, but, "on the subject of credit counseling, the motion states only that a particular credit counseling service, Consumer Credit Counseling of Springfield, Missouri, does not do counseling on the first day on which it is contacted and that on October 24, 2005 (four days after filing), Debtor contacted Consumer Credit Counseling of Springfield which advised that it would send her the necessary paperwork to complete the counseling." *Id.* The Court denied the motion to vacate the dismissal stating:

What the motion to vacate does not say is what it must say in order to warrant this Court's granting a waiver of the credit counseling requirement which is that **prior** to the filing of the petition, the Debtor requested credit counseling services and was unable to get them within a period of five days. The original certification and the motion to vacate essentially concede that the Debtor did not obtain or request credit counseling services prior to the filing of the petition. Without a waiver, Debtor is clearly ineligible to be a debtor under § 109(h)(1) because she did not obtain the required credit counseling services within 180 days prior to the filing of the petition. The Debtor can be eligible for a waiver under § 109(h)(3) only if each of the following three requirements is met: (1) the certification describes exigent circumstances that merit a waiver; (2) it states that the debtor requested credit counseling services from an approved agency, but was unable to obtain the services during the five-day period beginning on the date on which the debtor made the request; and (3) the certification is satisfactory to the Court. These requirements are stated in the conjunctive, meaning that each of the three requirements must be met.

Id.

Beyond the counseling requirement which must be completed prior to the filing of the

bankruptcy, a debtor will not be granted a discharge unless the debtor completes mandatory debtor education. *ABI* at 1. The mandatory education requirement involves the debtor completing a course in personal financial management which has been approved by the U.S. Trustee. If the debtor fails to complete the education requirement, the debtor can be denied a discharge under §§727 and 1328. It is important for bankruptcy practitioners to inform potential bankruptcy clients of these educational requirements, as the majority of debtors will be unaware of the new requirements.

XVI. THE NEW RESIDENCY REQUIREMENT FOR STATE OR LOCAL EXEMPTIONS AND LIMITS PLACED ON HOMESTEAD EXEMPTIONS

A. THE NEW RESIDENCY REQUIREMENT FOR STATE OR LOCAL EXEMPTIONS

Under the amended bankruptcy code, a debtor may only take advantage of the state or local law governing the debtor's exemptions if the law of the state the debtor wishes to apply has been the debtor's domicile for 730 days prior to filing. *ABI* at 1 citing 11 U.S.C. §522(b)(3). If the debtor has not maintained a domicile in the state for the required 730 days (approximately two years), the governing exemptions are those of the place of the debtor's domicile for the majority of the 180 days preceding the 730 day period. If, through application of the new residency requirement, the debtor is excluded from asserting an exemption of the local or state law then the debtor is permitted to choose the federal exemptions. *ABI* at 6-7. This new amendment places a two year residency requirement on a debtor which in many cases may drastically change the exemptions which are allowed or chosen. The intended result would be that debtors would not travel to states with unlimited exemptions, such as Florida and Texas, to "hide" their money in a residence.

B. LIMITS ON THE HOMESTEAD EXEMPTION

In the context of the state or local law residency requirement, a debtor may be precluded from asserting the homestead exemption of the state in which they reside. This is obviously another effort on the part of the legislature to prevent abuse of the bankruptcy code by debtors moving to a more homestead friendly state. Even in the friendliest of homestead exemption states, the amended bankruptcy code has provided limits on these homestead exemptions. Under amended §522(o), a debtor's homestead value may be reduced "to the extent of any addition to the value of the homestead on account of a disposition of nonexempt property made by the debtor - made with intent to hinder, delay, or defraud creditors - during the 10 years prior to the bankruptcy filing." *ABI* at 7. Also, under new §522(p), any value in excess of \$125,000 which is added to the homestead during the 1215 days (approximately three years and two months) preceding the bankruptcy filing may not be included in the state homestead exemption. This section applies without regard to the debtor's intent. The only exception under this provision is if the property was transferred from another homestead within the same state or it is the principal residence of a family farmer.

An absolute \$125,000 cap may be applied under amended §522(q) if either "(a) the court determines that the debtor has been convicted of a felony demonstrating that the filing of the case was an abuse of the provision of the Bankruptcy Code, or (b) the debtor owes a debt arising from a violation of federal or state securities law, fiduciary fraud, racketeering, or crimes or intentional torts that caused serious bodily injury or death 'in the preceding five years.'" Also, if the homestead is reasonably necessary to the support of the debtor and any dependent of the debtor then the limitation is inapplicable.

The Bankruptcy Reform Legislation is taking the restrictions of the homestead exemption very seriously as can be seen under the new §522(q)(1). This new section allows for a delay of a discharge in Chapter 7, 11 or 13 if the debtor may be subject to a limitation of the homestead exemption. This could prolong a debtor's bankruptcy, especially for those debtors who have recently transferred to a friendlier homestead exemption state.

XVII. MORE INFORMATION AVAILABLE ON THE INTERNET

For individuals considering filing for bankruptcy or for attorneys with questions about the new bankruptcy code, there are several online resources available for research. The Web site hosted by the American Bankruptcy Institute (www.abiworld.org) and the National Association of Consumer Bankruptcy Attorneys (www.nacba.com) provide valuable information on the new bankruptcy code. In addition, there are various discussion groups available regarding the new bankruptcy code, which can be found by performing a simple google.com search online.

XVIII. PRACTICE POINTERS FOR LENDERS FACED WITH A DEBTOR WHO HAS FILED BANKRUPTCY OR MAY BE ON THE VERGE OF FILING BANKRUPTCY

When you receive a bankruptcy notice on a loan customer, take the following action:

1. Determine which loan officer/employee is responsible for monitoring the file and deciding which action needs to be taken.
2. Immediately consult a bankruptcy attorney and determine the scope of the representation and the duties which are being assigned. e.g. Is the law firm going to file the proof of claim or will it be done in-house?
3. Determine which entity or individual filed. The automatic stay only applies to the entity or individual which filed, unless the co-debtor stay

applies pursuant to 11 U.S.C. §1301. A business trade name is not usually the correct legal entity.

4. Record and/or tickle all appropriate deadlines.
5. Determine the scope and value of the Lender's collateral. (a) Is the Lender's claim perfected? (b) Is all of the collateral subject to the automatic stay or just a portion of it? (c) Is the Lender's cash collateral protected? Does the Lender have cash collateral? (d) Do any orders need to be entered to protect the Bank's cash collateral? See Sec. 363 for the definition of cash collateral and Bankruptcy Rule 4001 for the implementation of cash collateral orders. Typical examples of cash collateral are accounts receivables or inventory sale proceeds. (e) Are there any other Lenders that have a competing claim to your collateral? (f) Do you need to obtain the approval of the Guarantor(s) before you enter into a Cash Collateral Agreement?
6. In many cases, file a Proof of Claim. Prepare a Proof of Claim that includes the principal, interest, attorney's fees and other charges relating to the debt. See 11 U.S.C. §501.
7. Discuss with your bankruptcy attorney if any bankruptcy court orders need to be entered to protect, clarify or evaluate the Bank's collateral.
8. Stop sending notices to the customer because it probably violates the automatic stay. You should deal only with the debtor's bankruptcy attorney. See 11 U.S.C. §362.

9. It is usually a good idea to file a Proof of Claim in order to receive payment on your claim for money's loaned. A lender will need to attach the note and security documents to the Proof of Claim. See Sec. 501 and 502.
10. Be careful of the late payment syndrome. Pursuant to 11 U.S.C. §547 a lender, if it is not fully secured, could be compelled to disgorge certain funds to a Chapter 7 trustee or Chapter 13 debtor if the funds were received within 90 days of the bankruptcy filing.
11. For Chapter 7 Cases Only. Determine if the debtor will sign a reaffirmation agreement. Reaffirmation Agreement is an agreement in which the debtor agrees to continue making scheduled payments in exchange for being able to retain possession of the collateral. 11 U.S.C. §524(c) as an agreement between a holder of a claim and the debtor for which the consideration, in whole or in part, is based on a dischargeable debt. The agreement must be made before granting of a discharge under section 727, 1141, 1228 or 1328. 11 U.S.C. §524(c)(1). The debtor must receive proper disclosures as described in 11 U.S.C. §524(k). The agreement must be filed with the court and if applicable must be accompanied by a declaration or affidavit of the attorney representing the debtor during the negotiation. 11 U.S.C. §524(c)(3) Also, the debtor must not have rescinded the agreement at any time prior to discharge or within 60 days after the agreement is filed with the court

whichever is later, by giving notice to the holder of the claim. 11 U.S.C. §524(c)(4).

12. Notify the guarantor that the Debtor has filed bankruptcy. Consider accelerating the surety and declaring the loan immediately due and payable as the guarantor, but check the terms of the loan documents first.
13. Be aware of the procedural and factual specifics of motions, as a Motion to Extend the Automatic Stay filed by a debtor was recently denied because of four major reasons:
 - (a) no factual evidence of change of circumstances;
 - (b) no affidavit verifying any factual allegations;
 - (c) did not give at least five business days notice to all creditors; and
 - (d) it was not filed immediately after the case.

See 11 U.S.C. §362 for the statutory requirements.

14. Determine if the Debtor has given the Lender a fraudulent financial statement or engaged in some other type of fraudulent activity. If so and if the Lender can prove it, the individual Debtor may have to pay the Lender 100% of the claim, even if the claim is unsecured. See 11 U.S.C. §523.

XIX. RECENT BANKRUPTCY CASE LAW

A. THE *ROOKER-FELDMAN* DOCTRINE IS NOT A DEFENSE AGAINST A BANKRUPTCY DEBTOR WHO IS ATTEMPTING TO RESCIND THE MORTGAGE.

In the case of *In re Hodges*, Bankr.N.D.Illinois, Case No. 05-62676 the court determined that a judgment of foreclosure did not bar a federal bankruptcy adversary proceeding under the

Rooker-Feldman doctrine. In *Hodges*, the debtor refinanced his home and later defaulted on the mortgage. The court entered a default order of foreclosure after the foreclosure complaint went unanswered. After the judgment, but before the actual sale of the home, the debtor filed Chapter 13 and later asserted certain statutory and common law claims against the creditor. *Hodges* at 5. The creditor asserted the defense of *Rooker-Feldman* which would have barred any review by the federal court. The *Rooker-Feldman* doctrine is reviewed by Bankruptcy Judge Goldgar and then ruled inapplicable to the mortgage rescission case. Judge Goldgar stated:

"The *Rooker-Feldman* doctrine takes its name from two Supreme Court decisions: *Rooker v. Fidelity Trust Co.*, 263 U.S. 413 (1928), and *District of Columbia Court of Appeals v. Feldman*, 460 U.S. 362 (1983). In each, the losing party in a state court case filed a federal action asserting that the state judgment was invalid. In each the court held that the District Court lacked jurisdiction over the action. The reason, the court explained in *Rooker*, is that hearing the action 'would be an exercise of appellate jurisdiction,' and 'no court of the United States other than this court' has appellate jurisdiction over state court decisions. *Feldman* endorsed this view, holding that no federal court but the Supreme Court can hear 'challenges to state court decision in particular cases.' The *Rooker-Feldman* doctrine thus stands for the fundamental proposition that lower federal courts do not have subject-matter jurisdiction over claims seeking review of state court judgments." See Garmisa, Steven P. *Bankruptcy Judge Takes a Fresh Look at Judgment of Foreclosure*, Chicago Daily Law Bulletin, December 7, 2006 quoting Judge Goldgar.

The *Hodges* court in denying the motion asserting the *Rooker-Feldman* defense reasoned that pursuant to a recent U.S. Supreme decision of *Exxon Mobile v. Saudi Basic Indus.*, 544 U.S. 280,

161 L.E.2d 454 (2005) the *Rooker-Feldman* doctrine is limited to those cases where the losing party was involved in a state court proceeding which had ended, and the losing party then decides to file a complaint in federal court complaining of an injury caused in the state court proceeding. *See Hodges* at 11. In an Illinois mortgage foreclosure proceeding the Bankruptcy court reasoned, the entry of judgment does not end the case and therefore the judgment only represents a partial final order. *Hodges* at 15-16. A foreclosure proceeding ends only upon court order confirming sale. *Hodges* at 17-18. As a result, the court in *Hedges* determined that the creditor could not assert a *Rooker-Feldman* defense.

XX. CONCLUSION

Although the new bankruptcy code is an extensive piece of legislation, it is important for secured lenders and bankruptcy practitioners to stay aware of the many changes which will be enacted. It is obvious that lenders need to be aware of these changes in order to protect the Bank's collateral.

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