Liquidation Bankruptcy Under the '78 Code

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LIQUIDATION BANKRUPTCY UNDER THE ’78 CODE

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Bankruptcies filed after October 1, 1979 will be governed by the Bankruptcy Reform Act of 1978. This Article is intended to guide attorneys through basic liquidation bankruptcy under the '78 Code. It will begin by inquiring into when bankruptcy is available, move to the estate and its distribution, and close by describing the bankruptcy discharge. To those who look at this and draw back because of its length, I will quote the late Professor Glenn: "But there is danger in excess of economy, even with words."

I. BACKGROUND

Two influential studies of bankruptcy led to the '78 Code. The Brookings Institution’s report on bankruptcy under the Bankruptcy Act of 1898 was published in 1971 and concluded, “So widespread and so ingrained are the shortcomings of the present system that radical rather than incremental change is necessary.” In 1970 Congress established the Commission on the Bankruptcy Laws of the United States and charged it to “recommend changes.” The Commission reported to Congress in mid-1973. Its conclusions about the present system paralleled the Brookings report. The '78 Code descends from the Commission’s recommendations and proposed code.

Why this outburst of discontent with the '98 Act? First, the '98 Act was a mess. Professor Countryman charitably described it as “combining, in an incredibly helter-skelter fashion, the substantive rules to be applied to, and the procedure to be followed in disposing of, the cases to which it applies.” Second, social change rendered many of its premises obsolete. Consumer bankruptcies strained a system designed for businesses. The adversary features necessary to gather and distribute assets proved otiose when the

bankrupts lacked assets. The policy of treating creditors equally waned when all took an equal zero; the policy of providing a fresh start for the bankrupt with its social welfare implications waxed in the developing social service state. Third, acceding to state laws and local practices created diversity in exemptions and the use of wage-earner plans when national uniformity seemed preferable. Fourth, every state but Louisiana adopted the Uniform Commercial Code (UCC). Article 9, dealing with security interests in personal property, is perhaps as important as the entire rest of the Code, and it effects much more of a basic change than the other important articles. Yet the bankruptcy system was keyed to pre-UCC personal property security.

Congress had passed a rules-enabling statute that allowed the Supreme Court through the usual network of committees to promulgate rules dealing with bankruptcy "practice and procedure." New rules took effect during the '70s, and under the enabling act's terms, these rules superseded huge portions of the Bankruptcy Act. No one knew which portions of the Act were "substantive" and still effective because the "repealed" language was not removed from the statute books.

The ambiguous status of the bankruptcy adjudicator also demanded attention. Originally, Congress perceived that the district judge would supervise bankruptcy and the referee would assist in administering cases. The role of the referee grew with the rise of assetless consumer bankruptcies; referees became, in effect, independent judges presiding over litigants having a theoretical but seldom exercised right to appeal. As the referee's adjudicatory role grew, creditors began to perceive that the referee's administrative involvement interfered with adjudicatory impartiality. The referee appointed the trustee, supervised estate administration, approved counsel, and later presided over adjudication. Parties ag-

12. D. Stanley & M. Girth, supra note 2, at 158.
grieved by the referee’s decisions could appeal, but the judge who appointed the referee heard the appeals. The Bankruptcy Rules changed the referee’s title to “Bankruptcy judge”; but that could not alter the stark reality of appointment for relatively short six-year terms and reappointments by district judges. While examining the ’78 Code, this Article will touch on how Congress dealt with the problems of the old Act.

II. Bankruptcy Under the ’78 Code

A. The Bankruptcy Court and Its Power

The ’78 Act creates a bankruptcy court for each federal judicial district that will be an “adjunct” to the district court. The President appoints the new bankruptcy judges to fourteen-year terms subject to confirmation by the Senate. The President must consider the candidates recommended by the Circuits’ Judicial Councils, and observers may expect Senators, Representatives, and the federal Attorney General to play a significant role in the process.

Bankruptcy judges will be more independent than in the past. Congress granted jurisdiction to district courts, but said that bankruptcy courts “shall exercise all of the jurisdiction conferred by this section on the district courts.” The ’78 Code is a compromise between life-tenured article III bankruptcy judges and something similar to the old system; like many compromises the new legislation is difficult to understand and satisfies no one. The Code enhances the stature of bankruptcy judges and removes them from positions subordinate to district judges. The federal bench did not conceal its dislike of this: Barnett McGurn, the Supreme

15. Id. §§ 152, 153.
16. Id. § 152.
17. The substantive parts of the ’78 Code became effective on Oct. 1, 1979 but the provisions establishing the bankruptcy courts will not become effective until April 1, 1984. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, §§ 402(a), (b), 92 Stat. 2682 (1978). This will allow for an orderly transition from the present system.
19. Id.
Court's press officer, said "It's considered one of the most drastic restructurings of the federal judiciary in the nearly two centuries of its existence." Before concluding that the bankruptcy court's "adjunct" status is more apparent than real, the observer should be reminded that the bankruptcy judge, although empowered to enjoin parties in another court, "may not enjoin another court," nor may the bankruptcy judge punish indirect contempts with imprisonment.

The '78 Code expands dramatically the bankruptcy court's jurisdiction. The transition bankruptcy courts exercise this jurisdiction until the new court goes into action in 1984. The old elusive distinction between summary and plenary jurisdiction hampered understanding, generated expensive, protracted litigation, and forced many bankruptcy cases into state courts with general jurisdiction or into federal district courts. The '78 Code grants the new bankruptcy court "original and exclusive jurisdiction of all cases under Title 11." The bankruptcy judge will hear most litigation in which the debtor or the estate might be interested. Moreover, filing bankruptcy stays bankruptcy-related litigation in other courts. To ameliorate injustices potentially created by this pervasive grant of jurisdiction, Congress also recognized that the bankruptcy court possesses discretion to abstain from exercising its jurisdiction when a nonbankruptcy forum could better handle a matter.

Expanded jurisdiction may create some hardship for defendants. The bankruptcy court has exclusive jurisdiction over all the bankrupt's property "wherever located," and process is anticipated to run nationwide. Provisions to transfer adversary proceedings may

22. 28 U.S.C.A. § 1481 (West Supp. 1979). Whether a bankruptcy judge may punish direct contempt with imprisonment is unclear.
mollify this hardship somewhat, but someone will have to travel.\textsuperscript{29} The benefit of pervasive jurisdiction outweighs the hardship it creates by eliminating drawn out, asset-consuming litigation over whether a court has jurisdiction. Contests over whether the bankruptcy court has "constructive possession" of property are too ephemeral to be entertaining.

The appellate structure is a novel compromise between appeals from the bankruptcy court to the court of appeals or to the district court.\textsuperscript{30} Appeals from final orders directly to the court of appeals will occur when all parties to the appeal agree.\textsuperscript{31} Parties may appeal of right final orders to the district court, and they may appeal interlocutory orders to the district court with that court's permission.\textsuperscript{32} The circuit council, however, may suspend the appeals to the district courts. The circuit's Chief Judge may choose panels composed of three bankruptcy judges for bankruptcy appeals. The panel hears appeals from final orders in bankruptcy court and may permit interlocutory appeals. Aggrieved parties may appeal from panels to courts of appeals.\textsuperscript{33}

B. Procedure

The Code leaves many things to procedural rules that have not been promulgated. Until new rules become effective, the existing rules from the '98 Act will, if consistent, be adopted for the '78 Code.\textsuperscript{34} The Committee on Rules of Practice and Procedure\textsuperscript{35} promulgated suggested interim rules and forms in August 1979 and bankruptcy judges may adopt these as local rules. This Article will refer to the existing rules and the interim rules from time to time, because most of bankruptcy is procedure. The statute calls the

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\textsuperscript{29} See 28 U.S.C.A. § 1475 (West Supp. 1979); R. BANKR. P 782. See also 28 U.S.C.A. §§ 1473(b), (d) (West Supp. 1979) (dealing with small claims actions where defendant resides and postpetition actions under regular venue rules).

\textsuperscript{30} Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, § 405(c), 92 Stat. 2685 (1978) (providing that the general procedure in this section will govern appeals during the transition).

\textsuperscript{31} 28 U.S.C.A. § 1293(b) (West Supp. 1979).

\textsuperscript{32} Id. §§ 1334(a), (b).

\textsuperscript{33} Id. §§ 160, 1293(a), 1482(a), (b).


\textsuperscript{35} Committee on Rules of Practice and Procedure of the Judicial Conference of the United States.
bankrupt person a “debtor,” seeking something less pejorative than “bankrupt.”

Herein, however, debtors will be called “debtors” before filing, but after filing, to avoid confusion, bankrupts will be “bankrupts.”

1. Voluntary Petitions

Who and what may file for the bankruptcy court’s liquidation relief? First, the filing party must possess a nexus with the United States through residence, domicile, place of business, or property. Next, it must be an individual, partnership, or corporation. Excluded from the benefits of liquidation bankruptcy are railroads, banks, insurance companies, homestead associations, credit unions, and savings and loan associations.

Petitions filed with the bankruptcy court are used to mitigate bankruptcy. Spouses may file a single petition. A voluntary petition constitutes an “order for relief.” It may be possible to get two for the price of one if husband and wife file together and pay a single filing fee for one case. Congress continued the Supreme Court’s cruel joke, United States v. Kras and some people may be too poor to go bankrupt because the in forma pauperis does not apply to the ’78 Code. Congress increased the filing fee to $60, but magnanimously continued to provide that bankrupts may pay in installments.

38. Id. §§ 101(8), 109. The code provides specially for stock and commodity brokers. Id. §§ 741-752, 761-766.
41. Id. § 302.
42. Id. § 301.
44. 409 U.S. 434 (1973) (holding that the statutory requirement of payment of a bankruptcy filing fee as a condition precedent to obtaining a discharge has a rational basis and does not deny indigents equal protection of the law).
46. Id. § 1930.
2. **Involuntary Bankruptcy**

The Code makes involuntary bankruptcy easier but protects the debtor more when the creditors' charges prove to be ill-founded. Creditors may file involuntary bankruptcy against persons and entities except farmers and charitable corporations. If the debtor has twelve or more creditors, three must join in an involuntary petition, but if he has fewer than twelve creditors, one petitioner suffices. In both instances, the petitioning creditor(s) must be owed $5,000 in unsecured, noncontingent debt.

The debtor may controvert the petition, whereupon the court will conduct a trial. The accepted learning about acts of bankruptcy as prerequisites for involuntary bankruptcy is substantially obsolete under the '78 Code. Also, the '78 Code substitutes equity insolvency for the balance sheet test. The normal basis for relief will be that “the debtor is generally not paying such debtor's debts as such debts become due.” Some involuntary bankruptcies will be triggered by the vestigal acts of bankruptcy, general assignments to benefit creditors and receiverships that occur within the 120 days before the petition is filed.

If the petitioning creditors prove their allegations or if the debtor fails to controvert the petition, the court enters an “order for relief.” Despite the existence of grounds for relief, the court may suspend or dismiss an involuntary bankruptcy when “the interests of the creditors and the debtor would be better served.” Bankruptcy judges may use this device to allow assignments and receiverships to liquidate debtors when bankruptcy administration will add nothing but expense.

Creditors generally use involuntary bankruptcy when they sus-

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49. This is not true out of bankruptcy. An act of bankruptcy will continue to trigger federal priority which does not apply in bankruptcy. 31 U.S.C.A. § 191 (West Supp. 1979). No one knows how acts of bankruptcy will be defined now that § 3 of the '98 Act has been repealed. Bankruptcy Act of 1898, § 3, 11 U.S.C. § 21 (1970) (repealed 1978).


51. Id. § 303(h)(2). See also id. § 101(10) (defining “custodian”).

52. Id. § 305(a)(1).
pect or know of double-dealing, preferences, or fraudulent convey-
ances and want to send businesses through the wringer. Proof of
acts of bankruptcy required under the old act delayed filing and
adjudication53 whereas the new liberal standard expedites involun-
tary bankruptcy If the creditors are wrong, the court, after dis-
missing a petition, may force hair-triggered or incorrectly petition-
ing creditors to pay the debtor's costs, attorney's fees, and
damages, and willful petitioners may be subjected to punitive dam-
ages.54 This may be preventive as well as remedial, for it may cause
creditors to think twice before filing a doubtful involuntary
bankruptcy

C. The Bankruptcy Process

Most bankruptcies begin when a debt-troubled client visits a
lawyer's office.55 To counsel consumer and small business debtors,
lawyers must be familiar with all the bankruptcy law; and the in-
formation gathering stage should summarize the entire process.
First, the lawyer should develop a list of all debts and assets. Un-
scheduled debts are not discharged.56 Concealing assets may lead
to a complete denial of discharge57 as well as possible criminal
prosecution.58 The schedules in present and interim forms 6, 7, and
8 provide an efficient legal vacuum cleaner to ferret out and clas-
sify assets. Debtors often forget about security deposits with utili-
ties and landlords, and accumulated tax refunds.

Second, the attorney should segregate secured debts. Cars,
houses, and furniture often are secured, and in most cases, the
creditor's security interest in the property survives bankruptcy 59
Unsecured debts to doctor, lawyer, merchant, paper carrier, and

53. COMMISSION REPORT, supra note 4, Part I, at 188.
55. See generally Wickham, Bankruptcy or Not? Advice for Attorneys Who Counsel
56. 11 U.S.C.A. § 523(a)(3) (West Supp. 1979). Section 523(b) allows discharge in the
second bankruptcy of debts left unscheduled in the first. Id. § 523(b).
57. Id. § 727(a)(2).
59. Under § 722, bankrupts may redeem consumer goods secured by dischargeable debts
by paying the creditors the amount of the claim secured. 11 U.S.C.A. § 722 (West Supp.
1979). Under § 522(f), the bankrupt may avoid certain liens on certain exempt property. Id.
§ 522(f).
credit card company must be reduced by debts not dischargeable. This class includes most taxes, family support obligations, and intentional tort judgments.\textsuperscript{60}

The attorney should consider ways to maximize exemptions. The '78 Code contains a federal exemption schedule but allows states to opt out, thereby limiting the debtor to exemptions available under state law.\textsuperscript{61} Virginia has so elected.\textsuperscript{62} Debtors with no assets available to creditors, all property exempt, and no garnishable wages should be advised not to waste their discharge; they may claim their exemptions, thumb their noses at creditors, and let the statute of limitations run. The lawyer should ask the debtor whether he will be coming into any money soon. If so, he should consider filing promptly to prevent his anticipated funds from being attached later.\textsuperscript{63} The debtor also should be asked whether new debts are likely; if so, he should be advised to wait and file only after these new debts become clear. Finally, debtors should not file bankruptcy if they have done anything that would bar discharge completely.\textsuperscript{64}

Many lawyers have a rule of thumb that: debtors should not file voluntary bankruptcy unless they will discharge debts equal to one-third of their yearly take-home pay. They should not waste their discharge on small amounts. People who would discharge less than one-third but are worried about garnishment or repossession or whose discharge may be barred in a liquidation bankruptcy should consider a plan for individuals with regular income.\textsuperscript{65}

If the debtor decides to file bankruptcy, the attorney should complete the petition and schedules.\textsuperscript{66} The suggested interim rules and forms resemble the old ones, except that married debtors now may file jointly.\textsuperscript{67} The bankrupt's attorney must disclose his or her compensation and source, and the bankruptcy judge may invali-

\textsuperscript{60} Id. § 523.
\textsuperscript{61} Id. §§ 522(b), (d).
\textsuperscript{64} Id. § 727(a).
\textsuperscript{65} Id. §§ 1301-1330. See generally Merrick, Chapter 13 of the Bankruptcy Reform Act of 1978, 50 DEN. L.J. 585 (1979).
\textsuperscript{66} INTERIM R. BANKR. P 1002; OFFICIAL BANKR. INTERIM FORMS 1, 6, 7, 8.
\textsuperscript{67} OFFICIAL BANKR. INTERIM FORM 2.
date unreasonable fees. The order for relief that occurs on filing determines the bankrupt's status as bankrupt and binds all interested parties.

1. Automatic Stay

The filing of the petition automatically stays creditors from most collection activities. Congress derived the automatic stay from earlier decisions enjoining secured creditors and from the several stays effective upon filing provided in the rules. The stay is intended to advance the two major policies of bankruptcy: to provide the debtor with a fresh start and to treat creditors equally.

Under the rubric that the petition constitutes an injunction, the stay becomes effective when the voluntary or involuntary petition is filed. Form orders mailed to all creditors listed in the bankrupt's schedules will assure that they receive notice to conform their conduct to the stay's structures. Courts will void creditors' actions that violate the stay utilizing orders to compensate or restore; if the creditors' conduct is outrageous, the court may impose a punitive contempt sanction.

The stay proscribes a broad spectrum of conduct, but the Code contains several exceptions and a procedure to seek relief. The stay forbids almost all formal or informal action against the bankruptcy estate's property or the bankrupt. Creditors are prohibited from employing or issuing process to commence or continue lawsuits based on claims that arose before bankruptcy, but the statute allows ongoing government litigation to continue prosecuting crimes.

70. 2 *Collier on Bankruptcy* ¶ 362.01-.03 (15th ed. 1979) [hereinafter cited as 2 *Collier*].
73. 11 U.S.C.A. § 101(4) (West Supp. 1979) defines "claim." "Action" includes one in the tax court. Id. § 362(a)(8). Section 546(b) allows postbankruptcy perfection of certain liens. Id. § 546(b); see id. § 362(b)(3).
or enforcing police-regulatory powers. Creditors are forbidden from enforcing prebankruptcy judgments by levying writs of execution against property of the estate or through personal enforcement in an interrogatory proceeding. The statute precludes judicial or private action seeking possession of estate property, for example, to repossess collateral or to oust a tenant, nor may creditors use judicial or nonjudicial tactics to create, perfect, or enforce liens against the property of the estate or of the bankrupt. Thus, creditors may not notify the bankrupt's account debtors, foreclose a warehouse lien, or move against property either abandoned by the trustee or acquired after filing. Family support and postbankruptcy creditors, however, may collect their debts from nonestate property Creditors may not collect by offsetting mutual debts. Finally, an omnibus clause interdicts "any act to collect, assess, or recover a [prebankruptcy] claim," which should stop personal and employer contacts as well as telephone campaigns.

Stays against estate property continue until the property is sold, abandoned, or exempted; stays of other actions persist until the case is closed or dismissed, or the bankrupt is discharged. In the meantime, creditors may seek relief from the stay. The Code anticipates prompt hearings and decisions. The judge may terminate, modify or condition the stay for cause, "including the lack of adequate protection of an interest in property . . . ."

74. Id. §§ 362(b)(1), (4).
75. Id. Section 541 defines the property of the estate. See text accompanying notes 145-210 infra.
77. Id. § 362(a)(3).
78. Id. § 362(a)(4). But see id. § 546(b) (which allows lien perfection under some circumstances). Section 362(b)(7) allows foreclosure of certain mortgages, and § 362(b)(8) grants the government the right to issue notice of a tax deficiency. Id. §§ 362(b)(7), (8).
79. Id. § 362(a)(5).
80. Id. § 362(b)(2).
81. Id. § 362(a)(7). See also id. § 553.
82. Id. § 362(a)(6).
83. Id. § 362(c). Professor Kennedy points out that the Code nowhere specifies when the property ceases to belong to the estate. Kennedy, supra note 69, at 37-38.
A creditor or any person may be uncertain whether the stay is correct under the circumstances, whether action will violate a part of the automatic stay, or whether a course of action is excepted from the stay's operation. The wise step is to move to be relieved from the stay. The unseemly alternative is to act and later defend contempt by arguing that the stay did not govern. Creditors should not appoint themselves judges in their own cases; disrespect for the judicial process may have the unintended consequence of contempt citations issued for violations of erroneous injunctions.86

2. **Interim Trustee**

Shortly after the order for relief, the judge must appoint an interim trustee to maintain continuity and protect the estate.87 The judge will appoint a member of the panel of private trustees as interim trustee.88 The interim trustee will serve until a permanent trustee qualifies.89 In most consumer bankruptcies, if the estate lacks assets for creditors, then the interim trustee will become the permanent trustee.90

Under the '98 Act, many felt that bankruptcy was operated by and for attorneys.91 As an alternative, Congress created a five-year pilot system of United States Trustees in several districts, including Virginia's eastern.92 The United States Trustee works autonomously under an Assistant Attorney General for Bankruptcy. She will select panels of private trustees,93 appoint trustees to specific bankruptcies, and monitor the performance of those trustees. This will relieve judges from administrative functions and free them to adjudicate. The United States Trustee will designate an interim

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87. 11 U.S.C.A. §§ 303(g), 701(a) (West Supp. 1979). The interim trustee replaces the receiver under R. BANKR. P 201. Receivers will no longer be appointed. Id. § 105(b).
90. Id. § 702(d).
trustee from the panel when a liquidation bankruptcy is filed. After five years, the Attorney will report on the progress of the United States Trustee system and Congress will consider whether to expand the system to all the districts.

Interim trustees perform a number of administrative tasks that should be done promptly. They must inform banks, custodians of estate property, and the bankrupt’s creditors not to transfer. The petition should be recorded in all other counties in which the bankrupt owns realty. The bankrupt will tell the trustee of assets that should reduce problems about postpetition transactions. The interim trustee also may dispose of perishable estate property, seek appropriate injunctions, and investigate when necessary.

3. Creditor’s Meeting

After a bankrupt files a voluntary petition or the judge enters an order for relief on an involuntary petition, creditors receive notice of the creditors’ meeting. The ’78 Code changes the cast of characters at the creditors’ meeting. Traditionally, the judge presided at the first meetings of creditors, but this system was attacked because it potentially allowed the judge to learn sensitive information before a dispute solidified. The ’78 Code departs significantly and bars the judge from even attending the meeting. The new statute leaves the nature, place, and time of creditors’ meetings to the rules.

The present rule is not adapted to the creditors’ meeting under the ’78 Code because it anticipates that the judge will preside. The creditors’ meeting probably will be set between two and three weeks after the order for relief. In eastern Virginia, this usually

96. Id. § 542(c).
97. Id. § 549(c); R. BANKR. P 602.
101. R. BANKR. P 205.
102. Id. 203(a), 204.
has been approximately thirty days. Because the judge does not preside, the meeting need not be held in the courtroom, although scheduling convenience and custom may lead to courtroom meetings. Congress anticipated that either the United States Trustee or the interim trustee would preside at the creditors’ meeting; in eastern Virginia, the interim trustee usually presides. The suggested interim rule has the clerk presiding. The creditors’ meeting agenda is to examine the debtor as well as to elect a trustee and perhaps a creditors’ committee.

The new rules or Congress must deal with a judgeless meeting at which judicial functions may be needed. The bankrupt must be compelled to attend, be sworn, and testify. The bankrupt and third parties must produce books and records. The creditors or perhaps the trustee may question the debtor. The parties in interest may subpoena third parties to testify and produce material. The suggested local rules provide that the meeting will be taped.

Perhaps, civil deposition procedure would be more appropriate. A court reporter could administer oaths. As with civil depositions, if someone objected, the answer could be taken with the objection. But if a witness claimed a privilege and refused to answer, someone would have to rule that the claim was well taken or order the witness to answer.

The examination’s scope is broad. Questioners may elicit whether the bankrupt has failed to schedule interests or property or committed avoidable transfers; defenses against claims, whether the estate has causes of action, and whether bankrupt is entitled to be discharged. Examination into the debtor’s conduct, property, and affairs is limited by applicable evidentiary privileges and rele-

103. INTERIM R. BANKR. P 2003(b)(1). This is inappropriate because the clerk may lack legal training and authority.
105. Id. §§ 521(3), 542(e).
106. Id. § 343.
107. INTERIM R. BANKR. P 2003. 11 U.S.C.A. § 344 (West Supp. 1979) allows the court to grant “use and derivative use” immunity to witnesses who claim the privilege against self-incrimination.
108. FED. R. CIV. P 30.
109. Id. 30(c).
110. Id. 26(c), 30(d).
vance;\textsuperscript{111} creditors may not ask about the debtor's love life unless it is relevant, as for example, if it leads to a nondischargeable judgment for alienating someone's affections.\textsuperscript{112} The bankrupt apparently may bring an attorney to lodge objections and to ask rehabilitatory questions. If necessary, the meeting will have to be interrupted to ask the judge to rule on evidentiary questions.\textsuperscript{113} After several adjournments to adjudicate a privilege claimed by the bankrupt, the creditors' meeting may be adjourned and a turnover proceeding scheduled before a district judge with power to imprison to coerce testimony. The district judge may grant use immunity and compel the bankrupt to answer. If the bankrupt fails to appear at the creditors' meeting or disdains to cooperate, the bankruptcy court may coerce him with contempt\textsuperscript{114} or deny him a discharge.\textsuperscript{115}

4. \textit{ELECTING A TRUSTEE}

At the creditors' meeting, creditors may elect a trustee upon request.\textsuperscript{116} If no trustee is elected, the interim trustee, selected after the order for relief, serves as trustee.\textsuperscript{117} Creditors with "allowable, undisputed, fixed, liquidated, unsecured," nonpriority claims may vote for trustee;\textsuperscript{118} creditors with interests materially adverse to other creditors, such as insiders,\textsuperscript{119} may not.\textsuperscript{120} The trustee is elected if creditors with twenty percent of the amount of debt vote

\begin{footnotes}
\textsuperscript{111} R. \textit{BANKR. P} 917 applies the Federal Evidence Rules to bankruptcy.


\textsuperscript{113} 2 \textit{COLLIER}, supra note 70, ¶ 343.10. \textit{But see H.R. REP. No. 595, supra note 27, at 331, reprinted in Ad. News, supra note 27, at 6287} (judge not involved on questions where he may learn information which later may be involved in a dispute).

\textsuperscript{114} Maggio v. Zeitz, 333 U.S. 56 (1948).

\textsuperscript{115} 11 U.S.C.A. § 727(a)(6) (West Supp. 1979). The bankrupt will be denied discharge only when he refuses to testify after being granted immunity.

\textsuperscript{116} \textit{Id.} § 702. \textit{See also id.} § 321 (eligibility to serve as trustee).

\textsuperscript{117} \textit{Id.} § 702(d).

\textsuperscript{118} \textit{Id.} § 702(a)(1) and R. \textit{BANKR. P} 207 procedure governs in deciding whether a creditor may vote. \textit{See H.R. REP. No. 595, supra note 27, at 378, reprinted in Ad. News, supra note 27, at 6334; S. REP. No. 989, supra note 20, at 92-93, reprinted in Ad. News, supra note 20, at 5878-79.}


\textsuperscript{120} \textit{Id.} §§ 702(a)(2), (3).
\end{footnotes}
and if the winner receives a majority of the votes cast.121 The judge may disapprove the elected trustee.122 The trustee then qualifies by posting an adequate bond.123

The trustee represents the estate, in particular, unsecured creditors.124 She must realize everything from the estate that is possible and distribute the proceeds to the creditors. Her duties are as follows. She must assemble the estate, collect the bankrupt’s accounts and debts, suing if necessary.125 She must file notice in land records offices and notify banks. An investigation of the bankrupt’s affairs is in order to reveal misconduct and mismanagement and to uncover causes of action. She also must ask the judge to compel the bankrupt and others to deliver property. Claims may be arbitrated or compromised.126 She should scrutinize the debtor’s transactions with attorneys.127 The trustee must upset improper transfers, fraudulent conveyances, preferences, and defective liens.128 In seeking to maximize the estate, she may abandon assets129 and must adopt or reject the bankrupt’s executory contracts and leases.130 The trustee may use, sell, or lease the estate’s property.131 She may employ attorneys, accountants, and other professionals.132 She must keep accurate, detailed records and accounts from which verified reports may be drafted.133

The trustee must examine creditors’ proofs of claim and object to improper claims.134 In determining whether a creditor’s claim is invalid, the trustee is entitled to interpose the bankrupt’s personal defenses to prevent the allowance of unjust claims.135 If a party

121. Id. § 702(c).
122. R. BANKR. P 209(a).
124. Id. § 323(a).
125. See generally id. § 704.
126. Id. § 323(b); R. BANKR. P 610.
128. Id. §§ 544(b), 547(b), (d), 548, 549, 550.
129. Id. § 554.
130. Id. § 365.
131. Id. § 363.
132. Id. § 328.
133. Id. §§ 704(2), (7); R. BANKR. P 218.
134. 11 U.S.C.A. § 704(4) (West Supp. 1979). Section 521 tells the bankrupt to assist the trustee. Id. § 521.
135. Id. § 541(e).
with a pecuniary interest requests information the trustee must furnish it. The trustee may oppose the bankrupt's discharge. Finally, the trustee will draft a final report stating property received and disbursed and expenditures. She will file the verified report with the judge or, in pilot program districts, the United States Trustee. The trustee is an officer of the court and must discharge her duties with reasonable diligence; if she fails to perform or performs negligently the judge may hold her personally liable. The creditors receive the final report and dividend checks. If the report is approved, the trustee will be discharged. "[N]otice and a hearing" procedure is important throughout the administration of the bankruptcy estate. In many situations, when the '98 Act mandated judicial approval, the '78 Code requires notice and a hearing. For example, notice and hearing must be held before the trustee is allowed to collect administrative expenses or to use, sell, or lease estate property. The Code's policy is to separate administrative and judicial functions, to allow the trustee discretion, and to free the judge from administrative matters to adjudicate disputes. To advance this goal the Code, in many instances, tells the trustee to give notice to all creditors and assumes that if a creditor wants to be heard it will ask. Notice only generates an opportunity to be heard; the trustee may proceed if no opponent comes forward in a timely fashion. The current rule allows ten days notice to perform comparable acts and a new rule will provide for a similar time.

136. Id. § 704(6). See also id. § 107.
137. Id. § 704(5).
138. Id. § 704(8); H.R. REP. No. 595, supra note 27, at 379, reprinted in Ad. News, supra note 27, at 6335.
139. 4 COLLIER ON BANKRUPTCY ¶ 704.04 (15th ed. 1979) [hereinafter cited as 4 COLLIER]. See also 11 U.S.C.A. § 324 (West Supp. 1979) (dealing with removing trustees).
140. 4 COLLIER, supra note 139, ¶ 704.12. 11 U.S.C.A. § 330 (West Supp. 1979) tells how the trustee is compensated and reimbursed. Congress should increase the grossly inadequate compensation to assure satisfactory service to the creditors and the court.
142. Id. § 363(b).
143. Id. § 102(1).
144. R. BANKR. P 203(a).
D. The Estate

When a bankruptcy case begins, the '78 Code creates an estate. Congress' overarching policy is to include in the estate all the debtor's property interests. This represents a significant departure from the estate under the '98 Act. Congress changed the concepts intending to simplify the law.

First, nonbankruptcy law, generally state law, determines whether the bankrupt owns something or owes someone and how much. The '98 Act went beyond that and provided that property would be included in the estate only if the bankrupt could have transferred it or if the bankrupt's creditors could have subjected it to collection process. This additional layer of legalism caused complications unrelated to the underlying interests, and court decisions exacerbated the difficulty by interpreting "transfer" in light of federal law and the fresh start policy. The '78 Code eliminates that inquiry. It provides that when a bankruptcy case begins, an estate is created composed of all the bankrupt's legal or equitable interests in property at the time the case commences. State law defines legal or equitable interests, but the issue of what is the property of the estate is a federal one, decided without referring to leviability or transferability.

Second, following nineteenth century conceptual analysis, the '98 Act "vested" the bankrupt's "title" in the trustee. More functional modern analysis downgrades vesting and title concepts as creating hard cases and bad jokes. The '78 Code dissolves the bankrupt's interest and transfers it to the estate to liquidate and distribute to creditors by creating an estate and allowing the trust-
tee to represent the estate and deal with the estate's property.\textsuperscript{152}

Third, the '98 Act left the bankrupt's exempt property out of the estate.\textsuperscript{153} This fragmented the administration of the estate and created potential hardship for the bankrupt.\textsuperscript{154} Under the '78 Code "all" the debtor's property interests, including exempt property, enter the estate.\textsuperscript{155} The bankrupt carves exempt property out of the estate.\textsuperscript{156} This unifies the administration of the debtor's property and results in more uniform treatment.

Several other aspects of the estate's property under the new Code are worth examining. The usual date of cleavage will be the date the petition is filed. Even though the estate gets the property the bankrupt owns at the time of filing, to provide incentive and a fresh start, the bankrupt keeps what comes afterward.\textsuperscript{157} The estate, however, includes "proceeds, product, offspring, rents, and profits" of the estate's property.\textsuperscript{158} Thus the estate gets colts, apples, stock dividends, and trade-in vehicles from the mares, trees, securities, and automobile inventory the bankrupt owned when bankruptcy was filed.\textsuperscript{159}

Also, several types of property enter the estate even if they are acquired after filing.\textsuperscript{160} The estate receives wages earned but unpaid including, when appropriate, a proportion of the bankrupt's tax refund.\textsuperscript{161} Most trustees in Virginia, however, ignore the pro rata share of tax refunds for the current year as well as accrued vacation pay. Bankrupts should tell ancestors, relatives, and benefactors to change wills or make new wills and to change insurance beneficiaries because the estate takes life insurance proceeds.

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\textsuperscript{154} Kennedy, Limitation of Exemptions in Bankruptcy, 45 Iowa L. Rev. 445 (1960).
\textsuperscript{156} Id. § 522; see text accompanying notes 502-42 infra.
\textsuperscript{157} But cf. In re Cohen, 276 F. Supp. 889 (N.D. Cal. 1967) (teacher must turn over earned but unpaid salary).
death benefits, bequests, devises, and inheritances realized within the 180 days following filing. Also, bankrupts should suspend marital discord because the estate receives property acquired within that period from property settlements and divorce decrees. A current rule requires the bankrupt to inform the trustee of property received during the appropriate period and the new rules probably will retain the same rule.

Some interests that the estate takes include the following: all real property interests such as life estates and other future interests, equities of redemption, leases, and the debtor's interest in property as defined under local law. In Virginia, under the '98 Act, neither spouse disposed of an individual interest in tenancy by the entireties property because state law immunized the property from all but joint creditors and therefore was either exempt from or outside the bankruptcy estate of either spouse. Only if both spouses were bankrupt and their estates were jointly administered, would entireties property be available to joint creditors. Under the Code, the result is similar but the moves are different. The estate takes the bankrupt spouse's interest in property the bankrupt holds as a tenant by the entireties, but Virginia bankrupts exempt their interests under state law. If the tenants file a joint bankruptcy, entireties property becomes an estate asset available to all creditors.

All the debtor's interests in personal property when the case is

162. 11 U.S.C.A. §§ 541(a)(5)(A), (C) (West Supp. 1979). To anticipate this problem: "To my son William , provided that should I die within the 180 days after he becomes bankrupt, then on that condition I leave to the William and Mary Law School Fund."
163. Id. § 541(a)(5)(B).
165. Excluded from the estate are the bankrupt's interest in personal property which the bankrupt may exercise for the benefit of another entity. 11 U.S.C.A. § 541(b) (West Supp. 1979); cf. Bankruptcy Act of 1898, § 70a(3), 11 U.S.C. § 110a(3) (1970) (repealed 1978) (treatment by the old act). Property in which the bankrupt holds only legal title becomes part of the estate, but any equitable interest not held by the debtor is excluded. 11 U.S.C.A. § 541(d) (West Supp. 1979). This is intended to confirm the status of secondary mortgage market transactions. S. Rep. No. 989, supra note 20, at 83-84, reprinted in Am. News, supra note 20, at 5869-70.
166. In re Bishop, 482 F.2d 381 (4th Cir. 1973).
commenced become property of the estate. Every lawyer who counseled debtors under the old law knows that the question of whether bankrupts kept their pension rights was a mess under the transferability-leviability standard.\(^{170}\) Under the Code, pensions are estate property, but many may be carved out as exempt.\(^{171}\) Similarly, the bankrupt insurance agents' renewal commissions enter the estate.\(^{172}\) Public licenses and franchises are estate property and the trustee is required to conform to rules and regulations, including obtaining permission before transferring.\(^{173}\) The Code invalidates clauses that restrict transfer of property or forfeit an interest in bankruptcy.\(^{174}\) Clauses in debts or security agreements that provide that bankruptcy triggers default probably survive but the effects of the default now are determined under bankruptcy law; the issue in such cases will be adequate protection.\(^{175}\)

The bankrupt's causes of action are included in the estate. Courts under the '98 Act allowed the trustee to pursue bankrupts' truth-in-lending actions,\(^{176}\) but personal injury claims were more difficult.\(^{177}\) Under the '78 Code all rights of action, personal injury, contract, libel, conversion, or alienation of affections pass to the

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\(^{170}\) See, e.g., Short v. Grand, 507 F.2d 425 (8th Cir. 1974) (amount credited to bankrupt in state retirement fund passes to trustee); In re Prestien, 427 F. Supp. 1003 (S.D. Fla. 1977) (disability benefits previously paid to bankrupt enter estate); In re Howe, 381 F. Supp. 1025 (N.D. Fla. 1974) (military retirement adjustment pay was contingent, not vested, remains property of debtor); Annot., 93 A.L.R.3d 711 (1979); 34 A.L.R. Fed. 316 (1977).


\(^{173}\) E.g., Barutha v. Prentice, 189 F.2d 29 (7th Cir.), cert. denied, 342 U.S. 841 (1951) (motor carrier license); In re Quaker Room, 90 F. Supp. 758 (S.D. Cal. 1950) (liquor license).


\(^{175}\) Id. § 361; U.C.C. § 9-311.


\(^{177}\) In re Kanter, 505 F.2d 228 (9th Cir. 1974) (state statute denying trustee right to personal injury action violates supremacy clause); Carmona v. Robinson, 336 F.2d 518 (9th Cir. 1964) (personal injury suit filed before petition is "subject to judicial process" and, therefore, passes to the trustee); In re Buda, 323 F.2d 748 (7th Cir. 1963) (under Wisconsin law, an action for personal injury, not subject to judicial process, did not vest in the trustee); In re McCog, 373 F. Supp. 870 (W.D. Tex. 1974) (possible recovery from wrongful death action not exempt).
The trustee may abandon the bankrupt's cause of action, particularly if it is burdensome because of a valid defense. Causes of action or personal injury proceeds also may be exempted under the federal schedule.

Trust property may create some analytical difficulties. If the bankrupt is a trustee under a valid trust, then the estate takes that interest on the terms the bankrupt held it, subject to the beneficiaries' interest. The estate may continue to act as trustee and to earn fees or the interest may be abandoned because of low value. This also would be true of an interest held by the bankrupt as constructive or resulting trustee. If, for example, the bankrupt has medical bills reimbursed by an insurance company and files for bankruptcy after receiving the insurance check but before paying the bill, the bankrupt would be a resulting trustee for the person who provided the medical service. If the bankrupt is beneficiary of a trust, the estate succeeds to the bankrupt's debtor's interest. Proving, however, that class legislation sometimes benefits even the rich, Congress ignored the Commission's recommendation and excepted the bankrupt's entire interest in income from a spendthrift trust that is otherwise valid under state law.

The estate also includes the bankrupt's property recovered by the trustee. Custodians, most often prepetition liquidators such as a receiver or an assignee for creditors, must turn the bankrupt's property or its proceeds over to the trustee. The trustee may recover property or its value from most transferees of avoided transfers. Interests in property preserved for the benefit of the

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179. Id. § 554.
180. Id. § 522(d)(11). But see Va. Code § 34-3.1 (Cum. Supp. 1979) (Virginia bankrupts may not elect § 522(d)).
182. 11 U.S.C.A. § 541(c)(2) (West Supp. 1979); COMMISSION REPORT, supra note 4, Part I, at 197. The Washington Post reported that the creditors of Mr. L. DuPont Copeland Jr., bankrupt, will receive 20 cents on the dollar while the bankrupt lives in a house worth $500,000 off the income from more than 75 spendthrift trusts worth millions of dollars. Jones, Copeland Files Payoff Plan, Wash. Post, May 18, 1974, § C, at 9, col. 2.
184. Id. § 543.
185. Id. § 550.
estate or transferred to the estate are included in the estate.\footnote{\textmd{Id.} \S\S 541(a)(4), 551.} Finally, property interests that the estate acquires after the case begins, such as benefits from contracts entered into after the petition is filed, are included in the estate.\footnote{\textmd{Id.} \S 541(a)(7).}

Prebankruptcy custodians must turn estate property over to the trustee.\footnote{\textmd{Id.} \S 544.} Custodians include receivers, assignees for the benefit of creditors, and secured creditors' agents for lien enforcement.\footnote{\textmd{Id.} \S 543.} Custodians who know of the bankruptcy are forbidden from administering or disbursing the estate's property except to preserve it and they must account for management; the court may compensate or surcharge the custodian as the case compels.\footnote{\textmd{Id.} \S 101(10).} Finally, if all interests are better served, the bankruptcy court may allow the custodian to continue to administer the property.\footnote{\textmd{11 U.S.C.A.} \S 543(c) (West Supp. 1979).}

After the bankrupt files a petition, the '78 Code tells entities who possess or control estate property other than custodians to deliver it to the trustee.\footnote{\textmd{Id.} \S 544.} This furthers the broad definitions of the estate's property and the court's jurisdiction\footnote{\textmd{Id.} \S 541; 28 U.S.C.A. \S 1471 (West Supp. 1979).} and allows the bankrupt to claim exemptions;\footnote{\textmd{Id.} \S 363(b).} moreover, the trustee may use the property to maximize the chances of rehabilitation or dividends to creditors.\footnote{\textmd{Id.} \S 363(c).} Creditors who possess estate property may ask that their interest be adequately protected before they turn the property over.\footnote{\textmd{Id.} \S 542(e).} Subject to evidentiary privileges but not attorney's liens, persons who possess the bankrupt's books or documents must turn them over to the trustee.\footnote{\textmd{Id.} \S 542(f).}

Assume the bankrupt files with $100 in a checking account and

\begin{itemize}
\item \textmd{Id.} \S 541; 28 U.S.C.A. \S 1471 (West Supp. 1979).
\item \textmd{Id.} \S 363(b).
\item \textmd{Id.} \S 363(c).
\item \textmd{Id.} \S 542(e).
\end{itemize}
owes no debts to the bank. The Code compels the bank to honor a postbankruptcy check for $100 drawn by the trustee.\textsuperscript{198} If the bankrupt owes the bank $100 and has defaulted, the bank may offset the account against the debt and ignore the trustee's demand.\textsuperscript{199} If the bank already has honored a $100 check drawn by the bankrupt the day before bankruptcy and presented by the payee two days after the petition was filed, must the bank also honor the trustee's check? The '78 Code adopts the \textit{Bank of Marin v. England}\textsuperscript{200} result, which holds that if, after bankruptcy, the bank honors the bankrupt's prebankruptcy check in good faith without actual knowledge that the petition has been filed, it need not pay a second time to the estate.\textsuperscript{201}

The bank's right to honor a check drawn before, but presented after, the petition is filed emphasizes the need to give prompt notice to the bankrupt's creditors and debtors. Actual notice sufficient to destroy the bank's ability to honor the check may come informally by phone or letter. The '78 Code provides only that the clerk will send "such notice as is appropriate," leaving provision of the details to the rulemakers.\textsuperscript{202} The legislative history tells us that creditors, equity security holders, and governmental regulators should receive notice, and that published notice may be appropriate.\textsuperscript{203} Many inveterate creditors receive legal newspapers that list bankruptcy. The formal notice includes the automatic stay of collection.\textsuperscript{204}

Bankrupts remain economically sentient after petitions are filed. The court may authorize transactions, that then will be protected.\textsuperscript{205} The trustee, however, may avoid unauthorized postpetition transfers, with some exceptions.\textsuperscript{206} Assume \textit{B}, who owns real property in Norfolk and Giles County, files a petition in Norfolk.

\textsuperscript{198} \textit{Id.} § 542(b).
\textsuperscript{199} \textit{Id.}, see §§ 362(a)(7), 363(c), 553.
\textsuperscript{200} 385 U.S. 99 (1966).
\textsuperscript{201} 385 U.S. at 101-03; 11 U.S.C.A. § 542(c) (West Supp. 1979).
\textsuperscript{204} 11 U.S.C.A. § 362 (West Supp. 1979); see \textit{Official Bankr. Form} 12.
\textsuperscript{206} \textit{Id.} § 549.
The next day X records a deed from B for the Norfolk property and Y records one for the Giles County farm. Both X and Y are bona fide purchasers (BFPs) who paid consideration without knowledge of the bankruptcy. The '78 code protects Y but not X because the trustee may avoid the bankrupt's transfers of real property in the county where the petition is filed unless the transferee records before the petition is filed. Title searchers in counties with a resident bankruptcy court beware. Deeds recorded after bankruptcy in counties other than those where the petition is filed defeat the trustee unless the bankruptcy petition is indexed in the land records where the property is located.207

Postpetition transferees of personal property receive less protection. The trustee may avoid transactions before the order for relief in involuntary cases and transfers by an entity that lacks knowledge of the petition. Congress intended to protect only the transferror. In our example, if the bank, after honoring the prebankruptcy check, is exonerated, then the trustee may recover the estate property, $100, from the payee-transferee.208 Typical transferees of personal property lose that property and are consoled with an unsecured claim against the estate.209

Congress excepted one type of transaction from this harsh rule. After an involuntary petition is filed, but before an order for relief is entered, transactions between the debtor and third persons are protected if the third person gives fair equivalent value.210 If, however, the debtor sells for fifty percent of fair value or if the third person exchanges a prepetition debt for the property, then the trustee may recover the estate property. This is designed to allow businesses to continue legitimate operation after creditors file involuntary bankruptcy

1. Abandonment-Assumption-Rejection

Assets and liabilities easily can be distinguished. In the abstract,

207. Id. § 549(c).
208. Id. §§ 303(b), 542(c), 549(a); H.R. Rep. No. 595, supra note 27, at 375, reprinted in Ad. News, supra note 27, at 6331; S. Rep. No. 989, supra note 20, at 90, reprinted in Ad. News, supra note 20, at 5876. The payee is subject to § 549(a) unless immune under § 549(c).
210. Id. §§ 549(a)(2)(A), (b).
a bankrupt’s assets pass to the estate to be divided among his creditors, after which his liabilities are discharged. The practical world, however, taxes these facile categories. Some “assets” lack value to the estate. Executory contracts and leases may be either assets or liabilities. An onerous contract or lease may be the reason for bankruptcy and a profitable contract may have considerable value to the estate. The ’78 Code gives the trustee power and discretion to sort these with an eye to maximizing the estate for the benefit of bankrupt’s creditors.

(a) Abandonment

The trustee’s goal in administering the estate is to secure funds for the creditors. To further this goal, the trustee may abandon burdensome property or property without value to the estate. For example, if the bankrupt’s nonexempt pleasure boat is worth $2400 but stands as security for a $2300 debt, the trustee may conclude that it will yield nothing to the estate. The trustee or other interested parties may apply to the court for an order abandoning property. The court must give notice; if no one objects, then the court may order the boat abandoned without a hearing, but if someone lodges an objection the court will hold a hearing. Moreover, property scheduled but not administered will be abandoned to the bankrupt by operation of law.

Abandonment means that the property is no longer part of the estate and thus is beyond the trustee’s control. Except for property scheduled but not administered, which returns to the bank-

211. The difference between an asset and an executory contract is important because the trustee has 60 days to assume a contract. Id. § 365(d).
212. Id. § 554. Prior law was nonstatutory. See Brown v. O’Keefe, 300 U.S. 598 (1937). In 1973, R. BANKR. P 608 enacted the better practice.
214. Id. § 554(c). Unscheduled property apparently remains the estate’s and if it is valuable the estate may be reopened. Id. § 554(d). Subsection 554(d) contains two errors; it should read “property of the estate that is not scheduled and not abandoned under this section remains property of the estate unless the court orders otherwise” instead of reading “property of the estate that is not abandoned and that is not administered in the case remains property of the estate.”
215. Under the former practice, it was held that upon abandonment the trustee’s title to the abandoned asset irrevocably revested in the bankrupt effective as of the time of filing. Brown v. O’Keefe, 300 U.S. 598 (1937). The ’78 Code abandons these analogies and title fictions.
rupt, the abandoned property may go to anyone with a right to possess it. The trustee cannot reclaim abandoned property. If property secured for $80,000 and abandoned because it is worth only $60,000 later doubles in value because of a new highway, then the bankrupt or perhaps the mortgagee keeps the property. The '78 Code does not specify a time to abandon; prior law allowed a "reasonable" time and particularly in a fluctuating market, the trustee will lose nothing by waiting.

It is hoped that requiring the judge to approve abandonment of scheduled property will end the unseemly practice under the '98 Act of "abandonment for consideration." As outlined by Professor Shuchman, this practice allowed the trustee to determine the bankrupt's equity in an automobile or secured appliances or the value of children's toys and pets, claim the property, and then demand consideration to abandon. One Saint Bernard owner, revealing that he valued his dog more than a discharge, fled, which may have been a mistake because the trustee probably only wanted to "sell" the beast back. Different and better compensation for trustees, less parsimonious exemptions to bankrupts, and judicial supervision should extirpate this shabby practice.

(b) Rejection and Assumption

Rejecting uncompleted contracts resembles abandoning valueless or burdensome property. Assumption of a bankrupt's contracts flows from the idea that things of value pass to the estate. The '78 Code changes the way the bankrupt's estate treats executory contracts and leases.
First, the statute is silent as to what is an executory contract or lease for bankruptcy purpose. All contracts are executory in the sense that something remains to be done. When both sides have performed a contract fully, it ceases to be a contract. Not all contracts executory under contract law, however, are executory for the purposes of bankruptcy. A contract executory for bankruptcy must be defined in light of the trustee's power to assume or reject, the nonbankrupt party's claim against the estate, and the assets of the estate.  

Consider employment contracts. Does the trustee have an option to assume or reject the bankrupt's employment contract? Many employment contracts are from paycheck to paycheck and are not assets of the estate or subject to assumption and assignment. Furthermore, bankruptcy will not prevent an employee from performing. This means two things: the employee keeps postfiling earnings for his fresh start, and the employer has no claim against the employee's estate.

If the bankrupt has an employment contract for a full year may the trustee assume that contract and assign it to someone else for consideration to allow the assignee to earn the salary due the bankrupt? "Personal" contracts are not subject to assumption. At state law, the trustee cannot force the nonbankrupt party to accept substituted performance by the trustee or an assignee. The duties are nondelegable in that the nonbankrupt party, the employer, expects the bankrupt to fulfill the contract; the court cannot compel the nonbankrupt to accept a substitute. Thus, the trustee cannot assume contracts to purchase on credit or brew beer.

Professor Countryman observes that

[t]he doctrine would doubtless apply to the employment contract of an actress, a musician, a professional football player or even a law professor, [but not to] the contract of a ditch-digger, a streetcleaner, or a dishwasher. This comes very close to saying that the trustee of the employee only takes title to an executory contract of employment in cases where [s]he would not want to

222. Countryman, 57 Minn. L. Rev., supra note 221, at 450.
223. Countryman, 58 Minn. L. Rev., supra note 221, at 480.
224. 11 U.S.C.A. § 365(c)(1)(A) (West Supp. 1979); Countryman, 58 Minn. L. Rev., supra note 221, at 482; Countryman, supra note 6, at 463-66.
assume it and where the employer would not be damaged by [her] rejection. 225

If, however, the bankrupt has performed the employment contract fully, the bankrupt’s right to receive the money passes to the estate. For example, if the bankrupt, a law teacher who is paid over twelve months for teaching ten, files bankruptcy in the spring with two months’ salary to receive, he must turn over those two checks to the trustee. 226

Other contracts are nonexecutory in bankruptcy. Consider a contract between the bankrupt and a seller, the latter to sell a carload of corn to the bankrupt. When the petition is filed, the seller has performed fully by shipping the corn, but the bankrupt has not performed by paying for the corn. The trustee cannot assume or reject. The estate has benefited fully from the nonbankrupt’s performance and the corn has become an asset of the estate. The seller is left with a claim against the estate for the purchase price. 227

Alternately, assume the bankrupt has paid the seller for the corn but the seller has not delivered it. When the bankrupt has performed fully and the nonbankrupt has not yet performed, the bankrupt has a claim to the nonbankrupt’s performance that, as a cause of action, passes to the estate. 228 If the trustee assumes the bankrupt’s contract with the seller, nothing will be gained in the trustee’s cause of action against the seller for damages. 229

For bankruptcy purposes, an executory contract is one in which some performance remains due on both sides. Professor Countryman says, more precisely than the examples given above, that the trustee may assume or reject “a contract under which the obligation of both the bankrupt and the other party to the contract are

225. Countryman, 58 MINN. L. REV., supra note 221, at 483. See also H.R. REP. No. 595, supra note 27, at 347, reprinted in AD. NEWS, supra note 27, at 6303-04; S. REP. No. 989, supra note 20, at 58, reprinted in AD. NEWS, supra note 20, at 5844.

226. Florance v. Kresge, 93 F.2d 784 (4th Cir. 1938); In re Cohen, 276 F Supp. 889 (N.D. Cal. 1967).

227. Countryman, 57 MINN. L. REV., supra note 221, at 451-52.


so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.” All unexpired leases fit this definition. Many simple contracts, however, are executory under nonbankruptcy law but nonexecutory under the trustee’s power to assume or reject. The trustee’s options with an executory contract are as follows: to reject the contract, which will reduce the nonbankrupt’s claim against the estate by forcing it to avoid consequences; to assume the contract with all its burdens and render performance to benefit the estate; or to assume the contract and assign it for money to enlarge the estate.

The ’78 Code grants the trustee the general power to assume or reject unexpired leases and executory contracts subject to procedural protections and qualifications. The Code sets no standards to guide the trustee’s action; apparently, the trustee will be instructed by “business judgment.” The trustee must exercise this power carefully. The expenses of performance are administrative expenses paid ahead of prebankruptcy creditors and if the trustee assumes a losing contract, then the cost could exhaust the estate. In a liquidating bankruptcy, the Code allows the trustee sixty days after the order for relief to assume or reject an executory contract, unless that time is extended for good cause. Rejection constitutes a breach deemed to occur just before the petition is filed. The nonbankrupt party becomes a general creditor for damages caused by the breach and may seek to have that claim allowed.

The ’78 Code departs significantly from prior law in dealing with bankruptcy clauses in contracts and follows the better reasoned precedent by expressly prohibiting the nonbankrupt party from enforcing a clause that allows a party to terminate on the other’s

230. Countryman, 57 Minn. L. Rev., supra note 221, at 460.
232. 2 Collier, supra note 70, ¶ 365.03. Courts may qualify this in reorganization cases where the trustee asks to reject a labor contract; the court must consider the issue and can be expected to balance the equities of the debtors and the employees. Id.
234. Id. § 365(g).
235. Id. § 502(g).
insolvency or bankruptcy. But preventing the nonbankrupt party to a contract from hampering efforts to rehabilitate the bankrupt requires a flexible and sensitive approach to that nonbankruptcy party. If the bankrupt has defaulted other than by breaching a bankruptcy clause, the trustee must cure the defect within sixty days or adequately assure cure, compensation, or future performance. From the nonbankruptcy's perspective, if promises could pay no bankruptcy would have occurred; substituting adequate assurance for performance will generate some hard questions.

Perhaps the most radical changes occur in the landlord-tenant area in which specific termination clauses previously have been effective and common. When the bankrupt is a tenant, the estate will be liable for the reasonable value of occupying the premises until the trustee assumes or rejects. If the bankrupt tenant has defaulted, then the cure-compensation-performance assurances mentioned in the previous paragraph apply. Moreover, the trustee cannot assume an unexpired lease in a shopping center without more specific assurances.

If the landlord files bankruptcy, different problems ensue. The trustee may administer the rental property as an asset of the estate or may reject it. Leases both convey realty for a term and create obligations to perform in the future. Rejection by the lessor's trustee cancels the bankrupt's obligation to perform in the future without divesting the lessee of the possessory estate. After the trustee rejects, the tenant may stay on but the trustee has no obligation to provide heat or haul out the trash. The Code allows the tenant to

239. 11 U.S.C.A. § 365(b) (West Supp. 1979). Section 108(b) allows a 60-day grace period; § 105(a) allows the grace period to be extended. See id. §§ 105(a), 108(b).
242. 11 U.S.C.A. § 365(b)(3) (West Supp. 1979). The trustee must assure the source of rent and other consideration, that she will not breach shopping center covenants relating to radius, location, use or exclusivity, and that the shopping center's tenant mix will not be disturbed.
offset against future rent all damages arising from the rejection and limits this offset 1) to the rent, forbidding a claim for damages over and above the rent, and 2) to damages caused by the trustee's lack of performance after rejection.  

Once a contract or lease has been assumed, the trustee may assign it for consideration to enhance the estate. The Code invalidates clauses that permit the nonbankrupt party to terminate when a lease or contract is assigned. Having required the trustee to cure defaults and adequately assure future performance, the Code relieves the estate from liability for breaches after assignment. The obligation then binds the assignee.

The '78 Code treats separately installment contracts for the sale of realty. These contracts are executory because the vendor has not conveyed title and the vendee must pay money. If the vendor files bankruptcy, rejection of the vendee's contract may create injustice to the vendee. Absent a provision to the contrary, if the trustee rejects, the estate would retain the amount the vendee paid, receive the property back, and reduce the vendee to a general creditor. Rejection, in short, results in a windfall to the vendor. The Code ameliorates the vendee's plight. If the vendor's trustee rejects, it allows the vendee two options. The vendee may treat the contract as terminated and claim a lien on the property measured by the amount previously paid. Alternatively, the vendee may remain in possession, offset postrejection damages against payments, complete paying, and demand a title from the trustee. Thus, the Code treats the installment contract as the functional equivalent of a purchase money mortgage, makes the purchaser into an owner-borrower, and reduces the purchaser's uncertainty about the seller's bankruptcy, an event he could not control.

243. Id. § 365(h); see In re Johns, 1 COLLIER BANKR. CAS. 2d 174, 178 (D. Nev. 1979).
245. Id. § 365(f)(3).
246. Id. § 365(k).
249. Id. He is therefore a secured creditor.
250. Id. § 365(i).
III. THE TRUSTEE'S POWER TO AVOID

Bankruptcy is a process that spreads the cost of failure among various entities and individuals. In a variety of ways, Congress has resolved the question of who should bear the loss. This brings us to the unsung and unheard class war between general and secured creditors. The '78 Code follows its predecessor in giving the trustee power to avoid the bankrupt's prebankruptcy transfers and transactions. A creditor may consider itself fully secured or repaid and it may anticipate recovering fully from its collateral. The trustee may wield one of the avoidance powers and convert that creditor into a general creditor who receives only a small percentage, if anything. She will upset a security interest or transfer which, for one reason or another, the Code does not recognize; that creditor, instead of recovering fully, falls into the great unwashed mass of general creditors along with doctor, lawyer, paper-carrier, and credit card company. This increases the fund available to the general and priority creditors who thereby receive a larger proportion of their claims.

Federal bankruptcy law interacts with the state law of mortgages and secured transactions. All the states but one now govern personal property security with article 9 of the UCC, which simplifies secured transactions tremendously. Article 9 also signaled a significant political victory for secured creditors. Under article 9, creditors become secured more easily and secured creditors defeat general creditors more often than previously. In many ways, the '78 Code completes the secured creditors’ victory, which began with the drafting and adoption of article 9; the revision attempts to accommodate bankruptcy to UCC commercial financing.

The class war between general and secured creditors, however, continues on other fronts. Professor Kennedy notes that the UCC’s advantages for secured creditors and the accompanying qualifica-

251. See comments to Va. Code §§ 8.9-102, 8.9-403 (Cum. Supp. 1979) for a brief look at how senselessly complex Virginia’s pre-UCC secured transaction law was.
252. In regard to formation and perfection of security interests, see U.C.C. §§ 9-203, -204, -402; in regard to the protection of secured creditors, see U.C.C. § 9-301.
tion of the policy of treating creditors equally may have played a part in developing the automatic stay, which delays the secured creditor’s right to enforce but enhances the bankrupt’s opportunity to rehabilitate.\textsuperscript{254} Before proceeding to the specific avoidance powers, the reader should be reminded of the immortal words of Sam Ervin, formerly Senator from North Carolina: “I will admit if you start reading all of the sections of the bankruptcy act that you reach a state of great intellectual confusion.”\textsuperscript{255}

A. \textit{Section 544 Avoidance Powers}

State recording statutes allow certain transferees, purchasers, and creditors to invalidate the debtor-transferor’s unrecorded security interests and other transfers.\textsuperscript{256} An early decision under the '98 Act held that bankruptcy was not “equivalent to a judgment, allotment or other specific lien.”\textsuperscript{257} Therefore, a trustee could not upset a creditor’s security in an unfiled conditional sale to the bankrupt because the state recording statutes protected only creditors who had levied and none had in that case. Congress responded with the predecessor to section 544, which granted the trustee a judicial lien creditor’s power to avoid unfiled liens.\textsuperscript{258}

The section combats “the evil of secret liens” by encouraging creditors to record security interests so that the debtor’s appearance plus the filing system will fairly represent to others how the debtor stands. Debtors should own what they appear to own; the amendment discourages debtors from appearing to be good credit risks on secretly mortgaged property. Giving the trustee the lien avoidance power of a bankrupt’s date of bankruptcy judicial lienor allows the trustee to invalidate the bankrupt’s creditors’ unfiled security interests. She may prevent the creditor’s unrecorded liens from being effective in bankruptcy just as a levying creditor could at state law.\textsuperscript{259}

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{254} Kennedy, \textit{supra} note 69, at 62-63.
\item \textsuperscript{255} \textit{Hearings on S. 976 and S. 1912 Before the Senate Comm. on Finance}, 89th Cong., 1st Sess. 23 (1965).
\item \textsuperscript{256} See, \textit{e.g.}, Va. \textit{Code} § 55-96 (Cum. Supp. 1979); U.C.C. § 9-301.
\item \textsuperscript{257} York Mfg. Co. v. Cassell, 201 U.S. 344, 352 (1906).
\item \textsuperscript{258} Bankruptcy Act of 1898, § 70c, 11 U.S.C. § 110(c) (1970) (repealed 1978).
\item \textsuperscript{259} H.R. \textit{Rep. No. 511}, 61st Cong., 2d Sess. 6-7 (1910); S. \textit{Rep. No. 691}, 61st Cong., 2d Sess. 6-7 (1910).
\end{itemize}
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Section 544(a) gives the trustee two powers to set aside or avoid transfers and encumbrances. First, section 544(a) contains the present strong-arm clause.260 District Judge Holmes said of section 544(a)'s predecessor that it conferred upon the trustee the status of "the ideal creditor, irreproachable and without notice, armed cap-a-pie with every right and power which is conferred by the law of the state upon its most favored creditor who has acquired a lien by legal or equitable proceedings."261

The trustee may avoid any of the bankrupt's prebankruptcy transfers that are vulnerable under the appropriate state law to a creditor on the day of bankruptcy. The trustee is a hypothetical lien creditor possessing this status "whether or not such a creditor exists."262 If the creditor's lien is unrecorded or unperfected on the date of bankruptcy, the trustee may use the state's recording statutes to avoid the creditor's lien status. The property subject to the avoided lien goes into the estate and the creditor becomes a general creditor. This discourages secret liens, encourages creditors to record, and allows those who deal with a debtor to protect themselves by checking the record.

Section 544(b) allows the trustee to exercise the avoidance rights of an actual unsecured creditor. It is derived from the former act's section 70e.263 If the bankrupt's transfers or obligations may have been avoided under applicable state law before bankruptcy by an actual unsecured creditor, the trustee inherits that creditor's power and may avoid the transfer or obligation. If no actual creditors exist that could have acted, the trustee is powerless under section 544(b). This Article will return to section 544(b) after examining section 544(a).

State real estate recording statutes provide that unrecorded transfers by deed or mortgage are vulnerable to later purchasers


261. In re Waynesboro Motor Co., 60 F.2d 668, 669 (S.D. Miss. 1932).


from and creditors of the transferor. Under Virginia law, the owner's unrecorded conveyance is void as to a purchaser without notice and a judgment lien creditor regardless of notice. Section 544(a)(1) allows the trustee to avoid any transfer avoidable by a day of bankruptcy judicial-judgment lienor. Thus, as under the prior bankruptcy act, the bankruptcy trustee, the bankrupt's judgment lien creditor, takes the bankrupt's realty free from unrecorded interests created by mortgage or deed.

Section 544 also gives the trustee the avoidance power of a day of bankruptcy BFP of realty. This will be more useful in states where the real estate recording statute fails to protect judgment creditors. It does affect security interests in fixtures under UCC section 9-313. If the creditor fails to fixture-file nonpurchase money interests in fixtures before the debtor goes bankrupt the trustee uses her BFP power to avoid the security interest that the creditor could have perfected against a BFP from the debtor. If, however, the creditor has fixture-filed before bankruptcy, the trustee cannot avoid the security interest, even though the interest of another part owner's BFP would defeat the fixture security interest. The fixture security prevails because the creditor cannot perfect it against such a BFP.

The trustee may use section 544(a) and UCC section 9-301 to avoid unfiled security interests on personalty. A series of examples will illustrate this. Assume that on January 1 Creditor and Debtor

268. Iowa Code Ann. § 558.41 (West 1950). Judgment creditors are not treated as purchasers for value under recording acts which do not mention them. Giving the trustee the BFP's power to avoid allows the trustee to acquire the status of a purchaser who has paid value and to defeat unrecorded transfers. In states where the recording statutes fail to mention judgment creditors, 11 U.S.C.A. § 544(a)(3) (West Supp. 1979) gives the bankruptcy trustee powers equal to those of a trustee in Virginia, where judgment liens are protected.

"An unrecorded real estate transfer that is not valid as against a bona fide purchaser, but is good against a judicial lien creditor, will now be invalid against the [grantor's] trustee in bankruptcy." Levin, supra note 262, at 174-75.
270. I am grateful to Professors Frank Kennedy and Al Clovis for helping me with this problem.
create a security interest valid between the two; Creditor loans Debtor $1,000 and takes a security interest on the player piano in Debtor’s saloon.\textsuperscript{271} Creditor fails to file a financing statement. On March 1 Debtor files bankruptcy and on March 2 Creditor perfects its security interest by filing for record.\textsuperscript{272} Under section 544(a)(2), the trustee assumes the power to avoid liens of a date of bankruptcy execution lienor. Under UCC section 9-301, a creditor with an unperfected security interest loses to a judicial or execution lienor. The trustee as a hypothetical lienor under the federal act uses the state recording act to avoid Creditor’s security interest. Creditor joins the general creditors and the piano goes into the estate for general creditors.\textsuperscript{273}

Change the facts so that they occur in this sequence: January 1, security agreement; February 28, financing statement filed to perfect; March 1, Debtor files bankruptcy. The trustee may not assume that the ’78 Code’s day of bankruptcy execution lienor status is based on money loaned in the gap while the security interest is unperfected. She cannot use section 544(a)(2)’s hypothetical lienor status to avoid a security interest perfected at bankruptcy. If an actual creditor could have avoided the security, however, the trustee may use section 544(b) to succeed to that actual creditor’s avoidance power. Liens unperfected for a time which no actual creditor could have avoided, but perfected at bankruptcy, escape the trustee’s powers under section 544.\textsuperscript{274}

Consider another variation: on January 1 Creditor loans Debtor $1,000 on the piano and they enter into a security agreement. The Beer Company sells Debtor ten kegs of beer on credit during January. On February 1, Creditor perfects its security interest by filing a financing statement. Debtor goes under the suds on March 1. The trustee cannot use section 544(a) to avoid Creditor’s security interest, for Creditor perfected it before bankruptcy. Nor may she

\textsuperscript{271} The collateral piano is “equipment.” U.C.C. § 9-109(2).
\textsuperscript{272} Id. § 9-401(3).
\textsuperscript{273} Under the original U.C.C. § 9-301, the creditor must be ignorant of the unfiled interest to avoid it but Virginia adopted the 1972 amendments which abolish the ignorance prerequisites. In those states without the 1972 amendments, 11 U.S.C.A. § 544(a) (West Supp. 1979) draws a veil across the trustee’s eyes.
use section 544(b), which is available only when an actual unsecured creditor could have avoided the security. Creditor's security interest is not vulnerable under UCC section 9-301 to a general or unsecured creditor who loans or extends credit while the security is off record. Under section 9-301, Creditor's unperfected security interest is vulnerable only to a lien creditor, that is, a creditor by attachment, levy, an assignee to benefit creditors, or a receiver.\(^{275}\)

The '78 Code further adapts bankruptcy to UCC financing. Assume that on February 1, Debtor buys the player piano from Dealer who delivers it to the saloon but retains a purchase money security interest.\(^{276}\) On February 2 Debtor files bankruptcy and on February 6 Dealer perfects the security interest.\(^{277}\) May the Debtor's trustee use section 544(a) to upset Dealer's security? The UCC allows a creditor who has extended purchase money a ten-day grace period to perfect by filing.\(^{278}\) Professor Gilmore has argued that the late-filed security interest should be effective if accomplished before the grace period ends, even though the debtor filed bankruptcy before the creditor put the security interest on record.\(^{279}\) Moreover, the UCC arguably deprives the trustee of a state avoidance power to assume. The counterargument is that the trustee should be able to avoid the security interest unfiled on the date of bankruptcy to prevent secret security and to encourage creditors to record promptly.

The '78 Code settles the argument in favor of Dealer. The trustee's lien avoidance power is subject to state law, such as article 9 of the UCC, which allows perfection after bankruptcy to relate back to the period before bankruptcy.\(^{280}\) Thus, the Dealer filing within the UCC's ten-day bankruptcy causes perfection to relate back to defeat the trustee's intervening power to avoid liens.

\(^{275}\) U.C.C. § 9-301(3).
\(^{276}\) Id. § 9-107.
\(^{277}\) Security interest in equipment is perfected by filing. Id. §§ 9-109(2), -302(1).
\(^{278}\) Id. § 9-301(2).
\(^{279}\) 2 G. Gilmore, Security Interests in Personal Property § 45.3.2, at 1297 (1965).
1. *The Decline of Moore v. Bay*

The '78 Code affects the doctrine of *Moore v. Bay*\(^{281}\) significantly. A simplified history of the career of that often-execrated\(^{282}\) decision based on an example will aid our understanding. Assume that Bankrupt has four creditors who extend credit and file as follows: Prior Creditor loans $3,000 on February 1; Secured Creditor loans $6,000 on February 2, taking security good against the debtor; on February 4 Gap Creditor extends $3,000 of credit; on February 6 Secured Creditor files to perfect its security; on February 8 Post Creditor delivers $6,000 of goods on open account; and the Debtor buckles under the strain, filing bankruptcy on March 1. The collateral for Secured Creditor’s loan is the estate’s only asset, worth $12,000. The debts total $18,000. How does Secured Creditor’s security fare?

The district court in *Moore* gave the state recording act the same effect in bankruptcy as state law: Secured Creditor lost to claims that would beat it, that is, Prior Creditor and Gap Creditor, but it was effective against Post Creditor. Thus Prior Creditor, Gap Creditor, and Secured Creditor recovered in full while Post Creditor received nothing. The issue before the Supreme Court was whether the trustee on behalf of Post Creditor could upset Secured Creditor’s security. The Supreme Court’s cryptic opinion held yes. Thus all four creditors became general creditors and received two-thirds of their claims. Under section 70e of the '98 Act the trustee assumed Gap Creditor’s power to avoid liens and Gap Creditor could upset Secured Creditor’s security under the applicable state recording act. Section 70e elevated the trustee above any actual creditor. The Court held that once the trustee has one creditor’s power to avoid, a security interest defective to that one creditor fails as to all creditors.

Thus, state recording acts that allow a general creditor to avoid unperfected security create a miserable state of affairs for secured creditors. To illustrate: Debtor and Creditor enter into a security agreement creating a security interest in $10,000 collateral; Debtor charges shoes for $40 on his credit card. Creditor perfects the se-

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\(^{281}\) 284 U.S. 4 (1931).

security by filing and Debtor goes bankrupt. Debtor's trustee uses section 70e to assume the credit card creditor's power under state law and avoids Creditor's security in all the collateral, reducing Creditor to a general claim for $10,000.283

Several changes have been made to ameliorate the secured creditor's agony. The UCC altered state law; instead of allowing a general creditor to defeat off-record security, it requires a judicial lien creditor.284 This reduces the number of people who can avoid security interests unperfected at bankruptcy. Professor Hawkland concluded that Moore v. Bay "is substantially dead"285 as a result of the UCC because that grim reaper had operated almost exclusively under state recording statutes that protected general creditors.286 Thus, in a UCC jurisdiction like Virginia, Secured Creditor's security interest would be valid against the trustee. The estate would be divided as follows: Secured Creditor $6,000 or one hundred percent; Prior Creditor, Gap Creditor and Post Creditor each taking fifty percent, or $1,500, $1,500, and $3,000 respectively.

The Bankruptcy Commission sought to dilute Moore v. Bay in another way. It proposed that the secured creditor who perfects late, but before bankruptcy, should lose security in the collateral only in the amount lost under state law.287 Assuming, as we must under section 9-301 of the UCC, that Gap Creditor and the credit card creditor levied on the collateral, the secured creditors would lose security in the collateral of $3,000 and $40 and remain secured for the balance. Given the change in state recording acts, this was the district court's result in Moore v. Bay. Congress, however, deleted the language that avoided the security interest only to the extent of the actual creditor's claim.288

Section 544(b) takes another route to attack Moore v. Bay. Section 70e of the '98 Act allowed the trustee to assume any actual

283. See, e.g., Mercantile Trust Co. v. Kahn, 203 F.2d 449 (8th Cir. 1953).
284. U.C.C. §§ 9-301(1)(b), (3); see text accompanying note 278 supra.
287. COMMISSION REPORT, supra note 4, Part II, at 160.
288. 11 U.S.C.A. § 550(a) (West Supp. 1979) seems to adopt the Moore v. Bay rule on this point.
creditor's power, but section 544(b) limits the trustee to "creditors holding an unsecured claim." Unsecured creditors lack power under the UCC's recording requirement to avoid unperfected security interests.\textsuperscript{289} The trustee cannot use section 544(b) to attack belatedly filed security interests in a UCC jurisdiction. The UCC limited the trustee under section 70e to actual lien creditors; Congress cooperated by eliminating from section 544(b) all cases in which attack on security is open only to lien creditors. The trustee only may assume an unsecured creditor's avoidance power, but unsecured creditors cannot avoid belatedly filed security.\textsuperscript{290} Creditors' incentive to perfect security is provided by section 544(a), which avoids security interests that are unperfected when the debtor files bankruptcy. Thus, in our examples, even if the Gap Creditor and the credit card creditor levied execution, the trustee cannot use section 544(b) to avoid the security.\textsuperscript{291}

Congress intended section 544(b) to follow the result of Moore v. Bay.\textsuperscript{292} What remains? The trustee may use state fraudulent conveyance doctrine under section 544(b) when the '78 Code's fraudulent conveyance section is insufficient.\textsuperscript{293} Also, the trustee under section 544(b) may ascend to an actual creditor's power to avoid a

\textsuperscript{289} U.C.C. § 9-301.

\textsuperscript{290} To reject the idea that the trustee may assume a secured creditor's rights, reversing several cases which allowed that, one could argue that 11 U.S.C.A. § 544(b) (West Supp. 1979) gives the trustee unsecured creditor status. See, e.g., Electric Constructors, Inc. v. Azar, 406 F.2d 475 (6th Cir. 1968); Abramson v. Boedeker, 379 F.2d 741 (5th Cir.), cert. denied, 389 U.S. 1006 (1967). This is consistent with one reading of the legislative history but unfortunately not the statute. H.R. REP. No. 595, supra note 27, at 370, reprinted in Ad. News, supra note 27, at 6326; S. REP. No. 989, supra note 20, at 85, reprinted in Ad. News, supra note 20, at 5871. If Congress had wanted the trustee to avoid security filed late but perfected at bankruptcy, it should have given the trustee a judicial lien.

\textsuperscript{291} The trustee may avoid the levying creditor's execution lien as a preference or fraudulent conveyance, 11 U.S.C.A. §§ 547(b), 548 (West Supp. 1979), and preserve it for the benefit of the estate, id. § 551, achieving the same result as the Commission's proposal. Also, a late filed consensual security interest may be either a preference or a fraudulent conveyance. See In re Farm & Home Co., 84 F.2d 933 (6th Cir. 1936) (late filed security interest as a fraudulent conveyance).


defective or improperly noticed bulk sale of business assets.\textsuperscript{294} Moore v. Bay still provides that if the trustee does avoid under section 544(b), she will avoid completely instead of being limited to the amount of the actual creditor’s claim. Also, when the trustee recovers, the proceeds will be divided under bankruptcy, instead of nonbankruptcy law. Although Congress and the state legislatures have eliminated almost all the instances in which the Moore v. Bay rule will operate, Congress has retained the effect of Moore for the rare event when it will apply\textsuperscript{295}

B. Statutory Liens

A statutory lien arises automatically because of “a statute or specified circumstances or conditions” including common law landlord’s liens.\textsuperscript{296} Examples provided by the legislative history are warehouse liens,\textsuperscript{297} mechanics liens,\textsuperscript{298} and tax liens.\textsuperscript{299} To be distinguished from statutory liens are consensual security interests\textsuperscript{300} and judicial liens from judgment or levy of execution.\textsuperscript{301} Congress felt that because people holding perfected material and mechanics’ liens had furnished valuable consideration that enhanced the estates in an amount equal to the lien, they should retain their security, even though this preferred them over other creditors. On the other hand, statutory liens could be disguised state priorities that merely reflect influence in state legislatures. Priorities arise when an insolvent debtor’s estate is distributed. Congress set out to strike down this class of statutory liens to preserve the integrity

\textsuperscript{294} See U.C.C. § 6-104 (bulk transfer ineffective against creditors of the transferor for noncompliance with the information requirements of this section).

\textsuperscript{295} Moore v. Bay will operate probably only in cases of fraud or defective bulk sale.


\textsuperscript{297} U.C.C. § 7-209. See also U.C.C. § 2-702 (establishing a lien upon buyer’s insolvency).


\textsuperscript{300} 11 U.S.C.A. § 101(37) (West Supp. 1979). If a tenant signs a security agreement giving the landlord a security in the tenant’s property to assure that the tenant will pay the rent, this is a consensual security interest, not a landlord’s lien. “Only Chuck Berry would be inclined to call a security interest obtained by Mabel [a] ‘Mabelline.’” D. Epstein, DEBTOR-CREDITOR LAW IN A NUTSHELL 223 (2d ed. 1980).

of bankruptcy priorities.302 Previously, Congress expressed this policy imperfectly303 but in the Code it asserts federal supremacy and maintains uniformity by preventing states from frustrating the bankruptcy distribution system by calling a priority a lien.

The new statutory lien provision attempts to distinguish valid statutory liens from disguised priorities. Valid liens fit the definition of a statutory lien304 but are not voided under either the special305 or general invalidation sections.306 If the creditor must record or comply with other prerequisites for a perfected statutory lien the Code allows it to perfect within the period allowed by the statute even after bankruptcy 307 Valid statutory liens cannot be avoided as preferences even though the lienor perfected within the critical period.308

Invalid statutory liens are those that fit the Code definition309 but come within one of the invalidating provisions. All liens for rent or of distress for rent are invalidated.310 Congress expresses a policy against disguised priorities by avoiding statutory liens triggered by financial embarrassment.311 Generally, the trustee may avoid liens that arise from insolvency proceedings, when the debtor falls below a specified financial standard, or upon levy of execution.312 Creditors who cannot perfect a statutory lien in property against a hypothetical day of bankruptcy BFP of that property

302. Id. § 507.

305. Id. § 545.
306. See, e.g., Va. Code § 8.01-66.2 to .11 (Cum. Supp. 1979). Section 544(a) of the '78 Code narrows the scope of § 545 by invalidating liens vulnerable to a levy of writ of execution on the day of bankruptcy. Id. §§ 544(a), 545. Section 545(2) adds a BFP's avoidance power for "property" to § 544(a)(3)'s BFP avoidance power. Id. §§ 544(a)(3), 545(2).
307. Id. § 546(b).
308. Id. § 547(c)(6).
309. Id. § 101(38).
from the debtor also lose to the trustee.\textsuperscript{313}

The new statute, however, failed to settle clearly the major conflict under the prior act, the validity of the vendor's privilege. The issue, which was litigated in Louisiana and Puerto Rico with different results, concerned a statutory seller's security interest that loses to a BFP from the buyer when the BFP takes possession. The Louisiana court refused to assume that the hypothetical BFP from the buyer took possession and upheld the seller's interest.\textsuperscript{314} The Puerto Rican court assumed a "full blooded" hypothetical BFP who took possession and struck down the vendor's privilege as an invalid statutory lien.\textsuperscript{315}

Congress takes no specific stand in the '78 Code on whether the hypothetical BFP is presumed to take possession. Because the Code allows the vendor to perfect against an intervening interest, it probably will adopt the Louisiana result. The vendor may defeat the vendee's nonpossessing BFP by seizing the property. If the vendee has the property on the day of bankruptcy, then the creditor may seize constructively by filing notice with the bankruptcy court; this will perfect the security interest against the trustee's hypothetical BFP status.\textsuperscript{316}

The federal tax lien must be treated separately. It arises when an assessment is made and attaches to all the taxpayer's property.\textsuperscript{317} Unfiled tax liens lose to many BFPs from the taxpayer, creditors with perfected security, mechanics lienors who file, and judgment creditors.\textsuperscript{318} Unfiled tax liens are statutory liens, which lose to either a day of bankruptcy BFP or a levying creditor; in the debtor's bankruptcy, they are invalid against the trustee who as-

\textsuperscript{313} 11 U.S.C.A. § 545(2) (West Supp. 1979). Mechanics who might perfect mechanic's liens by the statutory method or by notice to the trustee within a certain time, however, are protected even when the final act of perfection occurs after bankruptcy if the final act of perfection relates back to the prebankruptcy \textit{Id.} § 546(b). See \textit{In re Chesterfield Developers, Inc.}, 285 F Supp. 689 (S.D.N.Y. 1968). The automatic stay should not stay the steps necessary to perfect a statutory lien. Levin, \textit{supra} note 262, at 179.


\textsuperscript{315} \textit{In re J.R. Nieves & Co.}, 446 F.2d 188 (1st Cir. 1971).


\textsuperscript{317} I.R.C. § 6321.

\textsuperscript{318} \textit{Id.} § 6323.
sumes hypothetical BFP status against statutory liens and execution lienor status against all unfiled security interests. Some filed tax liens lose to BFPs from the taxpayer. The 1966 Tax Lien Act protects several groups of people who deal with the taxpayer after the government files the tax lien; purchasers of securities, vehicles, retail inventory, and household goods defeat a filed tax lien if they buy during the first forty-five days after filing. The trustee may assume the status of these potential BFPs and, despite filing of the tax lien before bankruptcy, invalidate the tax lien as a statutory lien on personal property that a BFP could have taken free of the tax lien on the date of bankruptcy.

Finally, the Code subordinates those tax liens the trustee cannot avoid. The former act subordinated tax liens on personal property unaccompanied by possession to administrative and wage claims, resulting sometimes in circular priority. The subordinated federal lien often beat another lien, which in turn came before administrative and wage claims; a 1966 amendment to obtain uniformity created only confusion. The '78 Code subordinates all tax liens on real and personal property and remedies the circularity and distribution problems by arranging the creditors in a line. Instead of treating a tax lien claim as secured, it subordinates the tax creditor to between the fifth and sixth priority. This leaves unsecured creditors, lienors senior to the tax lien, and junior lienholders undisturbed.

320. Id. § 544(a).
324. Marsh, supra note 303, at 710.
326. Id. § 507(a).
C. Preferences

The bankrupt's trustee may avoid both fraudulent and secret conveyances. Although creditors may use the recording acts and fraudulent conveyance doctrine at state law, bankruptcy law goes beyond state law. When a firm or individual is failing, creditors naturally seek advantage over other creditors and scramble for the debtor's assets. The debtor may pay or secure one especially deserving or zealous creditor to the detriment of others. Another favored device is to grant a creditor security but keep the security off the record to retain credit. The common law does not condemn a preference but allows a debtor to prefer one creditor over another. Preference doctrine in a bankruptcy context is intended to advance the policy of treating the insolvent's creditors equally. By allowing the trustee to recover preferences, bankruptcy law prevents prebankruptcy transfers from disturbing equality among creditors, weakens creditors' incentives to dismember debtors, and thereby, as Professor MacLachlan wrote, "promotes sound credit practices."

A preference occurs when an insolvent transfers property in the ninety days preceding bankruptcy to or for the benefit of a creditor to pay an antecedent debt if that transfer allows that creditor to receive a greater percentage than similar creditors. Comparing fraudulent conveyances and preferences will aid in the understanding of this abstract definition. Preferences are not voidable as fraudulent conveyances because the debtor pays adequate consideration for an antecedent debt to the preferee. Anyone may receive a fraudulent conveyance, but a preference flows only to a creditor; a fraudulently conveying debtor often transfers property benefiting himself or others closely related while a preferring debtor provides money for a creditor. Moreover, a fraudulent conveyance is usually a volitional act. On the other hand, the Code does not require any intent to prefer; a preference may be an involuntary appropriation

331. 11 U.S.C.A. § 547(b) (West Supp. 1979). The Code shortens the critical period from four months to 90 days.
by a creditor from a passive debtor, such as the judicial lien.

1. **Legal Liens as Easy Preferences**

A legal lien is a lien by legal process, attachment, judgment, execution, or garnishment. Prebankruptcy legal liens offend the bankruptcy policy of distributing assets equally to all creditors. The '78 Code continues the policy of staying lien enforcement when the petition is filed and ending the race of diligence at a period prior to filing by upsetting prebankruptcy legal liens.

The '98 Act contained a special section for the trustee to avoid legal liens. A legal lien is conceptually a preference, but the '98 Act required the preferee to know or have reasonable cause to believe that the debtor was insolvent as a prerequisite to recovering the preference. The '78 Code deleted both the special section for avoiding legal liens and the requirement of knowledge for recovering a preference.

Legal liens are voidable as preferences and the new preference law simplifies this doctrine considerably. Under the former practice, the legal lien creditor might complete the legal process by sale before bankruptcy was filed; the creditor could argue that no legal lien remained and that the transfer had to be analyzed as a preference that included showing the creditor had reasonable cause to believe the debtor was insolvent. Under the '78 Code, the transfer is still a preference even though the property is sold and the lien gone. Moreover, a purchaser of property subject to a lien with notice that the bankrupt is insolvent buys subject to the trustee's right to recover the property. A BFP, however, is protected.

Before proceeding to more complex negotiated transactions, a review of the elements of a preference with a judgment lien example will be useful. Assume a judgment creditor docket a judgment in York County on January 2. Docketing creates a judgment lien on the judgment debtor's York County farm. The judgment debtor

332. Id. § 101(27).
334. Id. § 60b, 11 U.S.C. § 96b.
335. 11 U.S.C.A. § 547 (West Supp. 1979); see text accompanying notes 362-63 infra.
files bankruptcy on March 31. Is this a preference that the debtor's bankruptcy trustee may avoid? Answering this question requires an examination of each of the six elements of a preference.

The first element is that there must be a transfer.\textsuperscript{339} The Code defines transfer as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing or of parting with property or with an interest in property\textsuperscript{340} This broad phraseology is satisfied because the judgment debtor has involuntarily parted with an interest in property If the judgment creditor has caused the sheriff to levy execution on the judgment debtor's personal property, the execution lien also would be a transfer.

The second element is that the transfer must be "to or for the benefit of a creditor.\textsuperscript{341} A creditor is an entity with a claim against the debtor; a claim is a "right to payment whether or not such right is reduced to judgment."\textsuperscript{342} A judgment or execution creditor fixing a lien on the debtor's property and carving out a priority over other creditors is a transfer because the lien constitutes a transfer of that interest to that creditor. "[E]very conceivable type of transfer of the debtor's property to virtually every kind of creditor may be avoided as a preference if the other requirements are met.\textsuperscript{343}

The trustee may avoid a transfer to a creditor as a preference only if the transfer is "for or on account of an antecedent debt owed by the debtor before such transfer was made.\textsuperscript{344} The Code interdicts preferences to advance equality and to prevent favoritism. Preferences occur only when debtors pay debts owed before the transfer. Conversely, transfers for present exchanges of consideration of equal value are not preferences. But perfecting a security interest for a debt previously unsecured results in a priority in the collateral, diminishes the estate available to general creditors, and constitutes a transfer for an antecedent debt. Therefore, converting a general debt embodied in a judgment into a judgment

\textsuperscript{339} 11 U.S.C.A. § 547(b) (West Supp. 1979).
\textsuperscript{340} Id. § 101(40).
\textsuperscript{341} Id. § 547(b)(1).
\textsuperscript{342} Id. §§ 101(4), (9).
\textsuperscript{343} 4 COLLIER, supra note 139, ¶ 547.17.
lien in particular property is a transfer for an antecedent debt.

The fourth element the trustee must show is that the transfer occurred while the debtor was insolvent. The Code uses a balance sheet test of insolvency; insolvency exists if the debtor's liabilities exceed assets when the alleged preference occurs. Debtors unable to pay debts as they mature are not, for that reason alone, insolvent for preference purposes. Property fraudulently conveyed is not counted as an asset in determining insolvency but courts apparently consider property transferred to satisfy an antecedent debt as part of the debtor's assets. The trustee carries the burden of proof of all elements of a preference, but the Code facilitates proving insolvency by creating a presumption that the debtor was insolvent during the ninety-day period preceding the petition. The legislative history states that this presumption requires the bankrupt to produce some rebutting evidence but leaves the ultimate burden of proof on the trustee. We cannot determine whether our hypothetical judgment debtor was insolvent when the judgment creditor docketed, but assuming that the debtor introduces no proof, the presumption of insolvency prevails and the trustee wins.

To be voidable as a preference, a transfer must occur "on or within 90 days" before filing the petition. Transfers of realty occur when the interest of the transferee, here the judgment creditor, is perfected sufficiently to defeat a BFP from the debtor. The date the creditor acquires the lien depends on the state law of judgment and execution liens. In Virginia, when a judgment lien is docketed, the lienor's interest defeats unrecorded interests and

345. Id. § 547(b)(3).
346. Id. § 101(26)(A).
347. See generally 2 J. Bonbright, The Valuation of Property 751-89 (1937) (discussing the equity and the assets-liabilities tests of insolvency).
351. 11 U.S.C.A. § 547(b)(4) (West Supp. 1979). R. Bankr. P 906(a) tells us to use Fed. R. Civ. P 6(a) to compute time which excludes the first day, the day of transfer, and includes the last day, the day the petition is filed.
later purchasers from the debtor. Thus, when docketing creates the judgment lien the transfer occurs within the critical period. Judgment liens perfected by docketing outside the ninety days preceding bankruptcy are unaffected by bankruptcy.

The sixth and final element of a preference is that the transfer enables the recipient to receive more than it would have recovered if, absent the transfer, the debtor’s estate had been liquidated in bankruptcy and the recipient had been paid as in the liquidation. The judge compares what the recipient received with what it would have received in a hypothetical bankruptcy liquidation on the date of the transfer if the transfer had not occurred. The judgment creditor would receive more by realizing on the farm than it would as an unsecured creditor in bankruptcy.

Thus, the trustee may invoke the preference section to avoid a judgment lien perfected within the ninety days preceding bankruptcy. The preferred judgment creditor’s lien dissolves but the debt lingers on; the creditor may assert it as a general claim and the debt will be discharged.

2. Preferences Refined

For a preference to exist, the debtor must transfer his property. Property includes exempt property. If the insolvent debtor pays a creditor within the critical period but the money comes from the debtor’s spouse, there will be no preference. Similarly, the creditor who receives payment from a person who endorsed the bankrupt’s note will not be preferred. Paying debts with another’s money does not diminish the debtor’s estate; in fact, it improves his financial posture by reducing claims. If the debtor returns converted property to the owner, this is not a preference because the property never belonged to the debtor. Finally, exchanging property of equal value or granting security for new value is not a pref-
ference because the debtor's estate remains in the asset-liability balance.

The Code does not require the debtor to treat all creditors equally; rather, it seeks to assure equality for similarly situated creditors. Thus, the debtor may pay a fully secured creditor without creating a preference. That is Animal Farm equality: all creditors are equal but some are more equal than others. Under the '98 Act, courts classified creditors according to distribution category The '78 Code sets up an artificial comparison by requiring the court to consider all creditors and ask whether the alleged preferee received more with the transfer than it would have under a hypothetical liquidation bankruptcy distribution absent the allegedly preferential transfer; the distribution is hypothetical because no administrative expenses are calculated. If the preferee would have received more, then the transfer is a preference. The judge must consider the way the estate would have been distributed among all creditors in addition to the group to which the creditor belongs. If the debtor transfers to reduce a creditor's claim that would not be allowable, the creditor would have received nothing and the transfer is a preference.361

The '98 Act had two defects: to recover the preference, the trustee had to prove that the debtor was insolvent when he transferred, and that the recipient had "reasonable cause to believe the debtor was insolvent at the time of transfer." Whether the creditor knew of the debtor's embarrassed state should have been irrelevant to equal distribution of the estate among other creditors who, perhaps, were also ignorant. These prerequisites put difficult burdens on the trustee and prevented many worthwhile recoveries. The '78 Code remedied these defects by eliminating "reasonable cause to believe" and creating a presumption that the debtor was

360. See, e.g., Swarts v. Fourth Nat'l Bank, 117 F. 1, 6-7 (8th Cir. 1902).
insolvent during the ninety days before bankruptcy. With a few exceptions, discussed below, the trustee will be able to recover payments of unsecured debts that occur within the ninety days before bankruptcy.

Several exceptions accommodate preference doctrine to modern commercial reality. Parties intend many transactions that include short extensions of credit to be cash sales. Thus, the trustee may not recover an otherwise preferential transfer. The parties "intended to be a contemporaneous exchange" which is "in fact a substantially contemporaneous exchange." The legislative history states that checks that involve credit are "intended to be contemporaneous;" if the payee presents the check promptly the transfer will be "substantially contemporaneous" and not recoverable. The '78 Code also prevents the trustee from recovering payments made by a buyer to a seller within a normal forty-five day billing cycle between receipt of the goods by the buyer and receipt by the seller of the money. This provision also allows the power company to keep the money a consumer paid for electricity burned the month before. Power company haters may be consoled by knowing that the same rule protected the innocent paper-carrier.

Moreover, the trustee may not recover when the bankrupt and a creditor intend to enter into a secured loan but execute the documents after a delay of ten days. These are typically purchase money loans when the loan enables the debtor to buy the collateral. If the creditor and the bankrupt had more than one transaction, the '78 Code refuses to treat as preferential the fresh, un-

363. 11 U.S.C.A. § 547(f) (West Supp. 1979). Section 547(b)(4)(B) provides that the trustee may recover as preferences payments to an "insider" creditor with reasonable cause to believe the debtor was insolvent made after 90 days but within one year of bankruptcy. Id. § 547(b)(4)(B). Section 101(25) defines "insider." Id. § 101(25).
364. Id. § 547(c)(1); U.C.C. § 3-503(2)(a) (30 days). See Engstrom v. Wiley, 191 F.2d 684, 686-87 (9th Cir. 1951).
368. 11 U.S.C.A. § 547(c)(3) (West Supp. 1979); see U.C.C. § 9-301(2).
secured value "returned" by the creditor.370 This codifies the net result rule developed under the '98 Act.371 The creditor who receives a preference and then extends credit has restored value to the estate; the net result rule in effect reduces the preference by the amount of the later credit.

Delayed perfection of transfers may constitute preferences.372 A transfer of security to a creditor for an antecedent debt depletes the debtor's estate that would be available to other creditors, and if all the elements of a preference are satisfied the transfer will be a preference. Assume in the earlier example that Debtor gives Secured Creditor a security interest in Debtor's property but, to avoid hampering other financing, they agree not to record it. When Secured Creditor learns of Debtor's imminent collapse, it records to achieve first claim to the collateral as well as priority over the trustee and other creditors. Transfers, the Code provides, are made when perfected. This means two things. First, if the security agreement is entered into more than ninety days before bankruptcy, but is filed during that critical period, the transfer "occurs" when it is recorded and the period begins to run on the date of perfection. Second, a debtor giving security to a creditor for a prior debt transfers the collateral for an antecedent debt when the creditor perfects the security.373 If the other elements of a preference are satisfied, the late filed security will constitute a preference.

Transfers occur generally when they are effective between the parties and are perfected usually when they are recorded. The '78 Code, however, allows a ten-day grace period to perfect a security interest or transfer.374 Other transfers are made when perfected, except that those left unperfected "occur" the day before bankruptcy is commenced.375 Realty transfers are perfected when the BFP from the debtor cannot defeat the transferee; transfers of other property are perfected when the transferor's execution lienor

373. Id. § 101(40).
374. This reduces the period from 21 days. See id. §§ 546(b), 547(c)(3); U.C.C. § 9-301(2).
cannot upset the transferee’s interest.\textsuperscript{376} Invalidating secret liens makes sense because the debtor’s other creditors may have been misled into extending credit or not collecting diligently. The trustee may invalidate security unperfected on bankruptcy under section 547(e).\textsuperscript{377} If, moreover, the parties delay recording with an intent to mislead other creditors, the trustee may upset a late filed security agreement as a fraudulent conveyance.\textsuperscript{378} Preference doctrine completes the general creditors’ protection.

3. Inventory on Accounts Financing: The Floating Lien in Bankruptcy

The common law did not allow creditors to take security interests in the property the debtor acquired after the security agreement because the debtor could not transfer property he did not yet own.\textsuperscript{379} Inventory and accounts receivable financing were invalid as floating liens on shifting stock because the debtor retained too much control over the collateral.\textsuperscript{380} As a practical matter, these rules intended to prevent the debtor from overextending himself while leaving the debtor and other creditors a cushion of assets.\textsuperscript{381}

The early arguments lost the political battle when state legislatures passed the UCC which embraced inventory and accounts receivable financing.\textsuperscript{382} Article 9 changed the earlier approach by allowing notice filing to create continuous perfection, approving after-acquired property clauses in security agreements, covering proceeds of collateral as collateral, and allowing the debtor to reinvest proceeds.\textsuperscript{383} This form of financing is often called a floating lien because the lien “floats over” from the inventory collateral the debtor has to the accounts and proceeds received from their sale.

\textsuperscript{376} Id. § 547(e)(1); U.C.C. § 9-301.
\textsuperscript{377} 11 U.S.C.A. § 547(e)(1) (West Supp. 1979); U.C.C. § 9-301.
\textsuperscript{381} King, supra note 379.
\textsuperscript{382} U.C.C. §§ 9-204, 9-205.
\textsuperscript{383} U.C.C. §§ 9-203(2), 9-204, 9-205, 9-306, 9-402.
as well as to other after-acquired inventory. If the debtor stumbles, the creditor may realize on the new collateral:

Through seas that are bleakest and winterest
On floats the floating security interest.\(^{384}\)

Inventory and accounts receivable financing are common practices in Virginia.

One important problem remains: does the UCC’s floating lien comport with the policy of fairness and equality for creditors expressed in the preference section of the ’78 Code? Stated differently, does fixing a floating lien on property a bankrupt acquires in the critical period before bankruptcy transfer collateral for an antecedent debt under the perfection clause and prefer the floating lienor? If the creditor’s security interest is perfected continuously, the debtor has not transferred collateral to the creditor for an antecedent debt. This result has led to a debate about the validity of the floating lien. A summary of this debate is warranted before analyzing the ’78 Code’s impact.

Assume Debtor borrows $100,000 from Creditor and grants Creditor a security interest in accounts receivable. In the critical period within which transfers are vulnerable as preferences begins, the Debtor accumulates $50,000 in accounts receivable and Debtor files bankruptcy. Is allowing Creditor’s security agreement to create a security interest floating down over the accounts a preference? The trustee argues that Creditor has no lien until Debtor acquires the accounts and that when Creditor’s lien floats over the accounts a security interest is created in the collateral to secure the earlier debt. Several elegant theories were developed to insulate Creditor’s security interest in the accounts from the trustee’s preference attack.

First, a section of article 9 “deems” that Creditor’s security interest in Debtor’s accounts is for new value.\(^{385}\) Thus, the accounts are not security for an antecedent debt because a constructive loan

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384. Skilton, Security Interests in After-Acquired Property Under the Uniform Commercial Code, 1974 Wis. L. Rev. 925, 929. The author rejects the aquatic metaphor for floating, concluding that the security interest floats in a more ethereal sense. If a physical metaphor is necessary, he prefers a gaseous one.

occurs. Deeming one thing to be another or to occur at another time is one of the worst techniques in the drafter's art.\textsuperscript{386} Deeming new value recognizes that a security interest cannot attach to the debtor's collateral until the debtor acquires it and moves the debt forward. This fictional definition of antecedent debt, if accepted, would simply eliminate that element from the preference section.\textsuperscript{387} Courts disavow reliance on this section,\textsuperscript{388} possibly because it brazenly interferes with the Supremacy Clause of the Constitution.\textsuperscript{389}

Second, a leading decision held that Debtor transferred the accounts collateral to Creditor when Creditor filed the financing statement.\textsuperscript{390} Because Creditor could defeat the debtor's lien creditor when it filed, the transfer was outside the critical period for determining preferences.\textsuperscript{391} If Creditor perfects a security agreement with an after-acquired clause, all additional collateral is protected from attack under preference doctrine because Debtor transfers security to Creditor when the security interest is perfected. The doctrine that filing a financing statement constitutes the transfer applies to transfers when Creditor delays perfection.

Observers cannot understand why it governs when Creditor perfected before Debtor acquired the collateral.\textsuperscript{392} The real reason Debtor's lien creditor cannot reach the accounts immediately after Creditor perfected is that the accounts did not exist then. This theory says simply that the account was transferred before it existed and before Debtor acquired it; the previous theory moved the debt forward while this theory moved the creation of the security interest back.\textsuperscript{393}

Another theory to move the debt back is the "Mississippi River" or floating mass theory\textsuperscript{394} The secured property is a unit continuously in existence. The elements change but the mass is the same

\textsuperscript{386} Marsh, supra note 303, at 726.
\textsuperscript{387} 1A U.C.C. Serv. § 11.07[1] (MATTHEW BENDER 1963).
\textsuperscript{388} See, e.g., DuBay v. Williams, 417 F.2d 1277, 1289 n.15 (9th Cir. 1969).
\textsuperscript{389} Countryman, supra note 385, at 275-80.
\textsuperscript{390} DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969).
\textsuperscript{391} Id.
\textsuperscript{392} Countryman, supra note 385, at 275.
\textsuperscript{393} U.C.C. §§ 9-203(1)(c), -303; Countryman, supra note 385, at 277.
in this stable reality with changing constituents. The Greek philosopher Heraclitus postulated that one could not step into the same river twice, but the proponents of this theory argue that although the water may be different, it is still the Mississippi. Therefore, the transfer occurs when Creditor creates a security interest in the entity; thus, the transfer is outside the critical period to avoid preferences. The Mississippi River cannot apply to our hypothetical because the river is dry; there is no collateral until the critical prebankruptcy period.

A variation on the Mississippi River theory is the relaxed substitution theory. Under the idea that Debtor may substitute new collateral for old, this theory substitutes accounts for inventory and proceeds for accounts in the retail inventory-accounts-money-inventory cycle. The debtor must substitute collateral contemporaneously and the new collateral must be worth no more than the old. Our hypothetical comprehends collateral acquired when none existed before. Substituting an account for inventory normally increases value because a merchant marks up inventory to include labor, rent, wages, and profit in addition to cost of goods sold. Moreover, the debtor acquires new accounts daily but the old are paid in monthly installments; therefore, in addition to the markup, the value of accounts fluctuates. Courts approved the floating lien. One court, in its zeal to protect the floating lien from the trustee's preference attack, relaxed "strict timing and value rules" as "no longer appropriate."395

A floating lien based on a financing statement filed outside the critical period for determining preferences prevailed over the trustee's preference argument. This was felt not to conflict with preference's policy to stop secret liens and eve of bankruptcy transfers because the creditor's security interest was filed before bankruptcy and gave notice to the world.396 If the collateral was worth $10,000 the day before the critical period began and is worth $90,000 on the date bankruptcy occurs, the creditor may apply $90,000 to the $100,000 debt. This allows the secured creditor to contract in advance for an unfair share of the debtor's assets. What if the debtor, instead of meeting his payroll, uses all available cash to buy inven-

395. Id.
396. DuBay v. Williams, 417 F.2d 1277 (9th Cir. 1969).
Moreover, a financing statement is little warning to other creditors and the creditor’s lien in after-acquired property may be nearly secret. Finally, some creditors, such as the doctor, lawyer, credit card company, and employee are inveterate general creditors who may be prejudiced by engorged security interests.

The ’78 Code’s preference section cuts through the UCC’s fictions. A debtor does not transfer collateral to a secured creditor until the debtor acquires rights in the collateral. Thus, all the collateral that floats in under the previously perfected security agreement in the critical prebankruptcy period is preferential. But the preference section creates an exception for a creditor with a security interest in accounts receivable and inventory. That exception is limited; the creditor cannot improve its position during the critical prebankruptcy period. It applies only to undersecured creditors. The judge must compare the creditor’s position on the date of bankruptcy with that ninety days before bankruptcy and focus on the actual advantage the creditor gained during the critical period. If, in the example above the comparison showed that the undersecured creditor’s deficiency decreased then the creditor is preferred in the amount of the decrease. Thus, if the debt is $100,000 and the collateral equals $65,000 on January 1 but $90,000 on April 1, then the creditor is preferred for the $25,000 improvement in its position. But if, during that period, the creditor advanced an additional $25,000 increasing the debt to $125,000, the deficiency remains the same and the creditor is not preferred.

Congress approved UCC commercial financing by protecting previously perfected security interests in accounts and inventory from preference attack, but it rejected the most extravagant and unfair versions in the interest of fairness to general creditors. Avoiding the increment of improved collateral position that the creditor obtains in the ninety days preceding bankruptcy serves the policies of

397. U.C.C. §§ 9-204, Comment 5, 9-204(3). U.C.C. § 9-208 gives the later creditor no rights against the secured party.

398. Countryman, supra note 385, at 280.


treated all creditors equally and preventing dismemberment. Congress could have gone farther in the general creditors' direction and measured secured creditors valid security by the lowest value of collateral during the critical period. 401 This would have approved the policy of the floating lien but lowered the dam just a little.

4. Proceeds

The UCC secures the lender who finances inventory and accounts. The '78 Code prevents the collateral from declining by attaching the creditor's security interest to inventory and accounts that the debtor acquires to restock his shelves. Buyers of inventory ordinarily take free of the sellers' security interests. 402 But the UCC evens the valleys in the secured creditor's collateral by securing the debtor's proceeds. When the debtor sells inventory the buyer hands over cash or a check; if the debtor sells on credit, he receives a claim against the buyer. Buyers may trade in old vehicles as part of the price of new ones and the debtor may sell these to other buyers. The debtor deposits cash and checks in a bank account and typically writes checks to purchase new inventory. Article 9 grants the secured creditor a security interest in the proceeds the debtor receives in exchange for secured collateral. 403

Failing debtors often neglect to replenish inventory. The UCC has a special subsection to deal with the creditor's security interest in proceeds when the debtor becomes involved in insolvency proceedings. 404 It grants the creditor a perfected security interest in several types of proceeds: identifiable noncash proceeds, for example, items traded in; collateral accounts containing only proceeds; identifiable money, neither commingled nor deposited; undeposited checks and the like; and finally, commingled cash and deposit accounts not to exceed "any cash proceeds received by the debtor within" the ten days before the insolvency proceedings be-

403. Id. §§ 9-203(3), -306.
404. Id. § 9-306(4).
The inventory financer expects the debtor to use proceeds of collateral to either reduce the debt or purchase new inventory. Its lien floats over the proceeds of collateral to maintain collateral at a steady value.

Given the elegance of the problem as well as the high quality and large quantity of law review literature, the observer must be surprised to find that the '78 Code fails to resolve whether a proceeds security interest is valid in bankruptcy. Assume tragically undersecured Creditor who files a financing statement on January 1, commences to finance Debtor's inventory under a standard commercial security agreement. Debtor, a player piano retail and repair operation, files bankruptcy on July 1 with two categories of proceeds. Identifiable proceeds include a traded-in player piano, $100 in an envelope, and a $100 check. Commingled "proceeds" consists of $5,000 in a bank account that Debtor deposited the day before bankruptcy; the deposit includes $500 from the only piano Debtor sold in the ten days before bankruptcy. Creditor claims a security interest in all identifiable proceeds and the entire bank account.

What is the ambit of Creditor's perfected security interest under state law? Its security interest in the identifiable proceeds, that is, the piano, the $100, and the check as substituted collateral is one possibility. The key to whether Creditor has a perfected security interest in the account is an insolvency proceeding plus commingling; these requirements are satisfied by bankruptcy and Debtor's prebankruptcy deposit. The amount of the security interest is subject to dispute. It cannot exceed "any cash proceeds" the debtor received during the prebankruptcy ten days. If "any cash proceeds" refers to money from any source, so long as some comes from inventory, Creditor's security interest in the account is $5,000. If "any cash proceeds" is limited to money Debtor received from selling Creditor's secured collateral, Creditor has a se-

405. Several qualifications on the last category are omitted.
406. U.C.C. §§ 9-306(4)(a), (b), (c).
407. Id. § 9-306(4)(d). Whether the debtor must commingle in the ten days preceding bankruptcy is not discussed.
408. Id. § 9-306(4)(d)(ii).
409. In re Gibson Products, 543 F.2d 652 (9th Cir. 1976), cert. denied, 430 U.S. 946 (1977). This would be more persuasive if the statute said simply "any cash."
The trustee first will attack the security interest as a preference. For the purpose of the proceeds provision, Debtor transfers the security interest in the proceeds collateral when Debtor actually acquired an interest in those proceeds. Following this analysis, Creditor's security in proceeds is a specialized form of after-acquired property. The buyers' cash, checks, and trade-in are exchanged for Debtor's inventory. To create a continuously perfected security interest, the Debtor must substitute the new collateral at the same time or before releasing the old and the new collateral may not be worth more than the old. If the selling price exceeds the cost of the inventory, perhaps the excess will be a preference. The identifiable proceeds more likely are to be treated as substituted collateral. An amount in a deposit account that represents money exchanged for collateral may be treated as substituted collateral but this may be preferential to the extent the retail price exceeds the cost of the goods. If, however, Creditor's security interest in proceeds includes the entire commingled bank account, so long as some of the deposits are proceeds courts are likely to hold it preferential as a grant of security in additional collateral and preferential to the extent it exceeds the amount buyers exchanged for inventory.

Second, the trustee may argue that Creditor's perfected security interest in proceeds that begins on insolvency conflicts with the federal priority scheme. Although the UCC labels the security interest in commingled proceeds a security interest, the trustee

412. 11 U.S.C.A. § 547 (West Supp. 1979); see Countryman, supra note 385, at 271.
414. Sawyer v. Turpin, 91 U.S. 114 (1875); Countryman, supra note 385, at 271.
416. This is the same result as Gibson under the '98 Act but without the fantastic logic. See Note, Tex. L. Rev., supra note 411.
will argue that it is really a disguised state priority and invalid as a state attempt to interfere with the federal distribution scheme.\textsuperscript{420} A 1955 decision upheld the Uniform Trust Receipts Act (UTRA), which gave the secured creditor priority out of the debtor's assets up to the amount collected in the ten days before bankruptcy.\textsuperscript{421} The UTRA labeled the creditor's security interest a priority; but UTRA operated on demand outside of bankruptcy and was valid despite the debtor's transfer.\textsuperscript{422} The Uniform Commercial Code calls its provision a security interest; but, because it operates only when the debtor is insolvent,\textsuperscript{423} it seems more vulnerable as a priority.

The third question is whether the Creditor's security interest in proceeds, which perfects automatically on insolvency, is an invalid statutory lien.\textsuperscript{424} Insolvency proceedings, state or federal,\textsuperscript{425} cause the lien to become effective.\textsuperscript{426} The trustee may avoid statutory liens that are triggered by bankruptcy or other insolvency proceedings.\textsuperscript{427} Creditor will argue that the interest was acquired by contract, not statute. Because Debtor consented, the interest is not a statutory lien which must arise "solely" by operation of law.\textsuperscript{428} Collier's treatise states, "If the lien arises by force of statute, without any prior consent between the parties it will be deemed a statutory lien."\textsuperscript{429} Moreover, the legislative history asserts that all UCC security interests are security agreements.\textsuperscript{430} The observer can be far from certain that the interest in proceeds is a statutory lien, but if

\textsuperscript{420} Elliot v. Bumb, 356 F.2d 749 (9th Cir.), \textit{cert. denied}, 385 U.S. 829 (1966); N.W Day Supply Co. v. Valenti, 343 F.2d 756 (1st Cir. 1965); \textit{In re} Crosstown Motors, Inc., 272 F.2d 224 (7th Cir. 1969), \textit{cert. denied}, 363 U.S. 811 (1960).
\textsuperscript{421} \textit{In re} Harpeth Motors, 135 F Supp. 863 (M.D. Tenn. 1955).
\textsuperscript{422} \textit{Id.} at 866-68.
\textsuperscript{423} U.C.C. § 9-306(4).
\textsuperscript{424} 11 U.S.C.A. § 545 (West Supp. 1979); Countryman, \textit{supra} note 385, at 269, 272, 274.
\textsuperscript{425} U.C.C. § 1-201(22).
\textsuperscript{426} \textit{Id.} § 9-306(2), which creates the security interest in proceeds, fails to perfect it. Section 9-306(3) perfects the creditor's nonsolvency security interest in proceeds. Section 9-306(4) perfects the proceeds security interest upon insolvency. \textit{See id.} § 9-306(4).
\textsuperscript{428} \textit{Id.} § 101(38). Further, Gilmore argues that the creditor's interest in commingled proceeds limits the creditor's common law right to trace and avoids the "expense and nuisance" of tracing. 2 G. Gilmore, \textit{supra} note 279, at 1336, 1339-40.
\textsuperscript{429} 2 \textsc{Collier}, \textit{supra} note 70, ¶ 101.38.
it is a statutory lien, it almost certainly is invalid.

The trustee has another statutory lien argument about the traded-in piano. The piano is a proceed because it was exchanged for collateral. 431 Creditor’s perfected security interest in the piano occurs upon Debtor’s insolvency 432 An ordinary buyer of the piano from Debtor defeats any existing security interest in it. 433 A statutory lien that loses to a BFP from Debtor fails. The ’78 Code gives the trustee the statutory lien avoidance power of a day of bankruptcy BFP 434 The trustee becomes a BFP at the same time the creditor’s security interest attaches. Do the trustee’s and Creditor’s interests take equal rank? 435 Does federal supremacy raise the trustee’s interest above Creditor’s?

Returning to consensual lien avoidance, the Creditor’s security interest in proceeds perfects when an insolvency proceeding begins. 436 The trustee at the date of bankruptcy acquires the power to avoid unperfected consensual liens of a judicial lienor or a BFP of realty 437 The arguments for the power to avoid security interests liens resemble the BFP power against statutory liens. Does the trustee’s execution lienor status defeat or become equal to the Creditor’s simultaneously perfecting security interest in proceeds? 438

Commercial law generally has failed to keep pace with commercial practice; people in business justifiably criticize lawyers, judges, and legislatures for obsolete law. Omitting important problems is even more reprehensible than failing to keep up. Congress has left open the problem of proceeds in bankruptcy that doubtless will cause uncertainty and perhaps injustice.

D. Fraudulent Conveyances

In addition to the power to avoid preferences, the trustee has the

431. U.C.C. § 9-306(1).
432. Id. § 9-306(4)(a).
433. Id. §§ 9-109(4), -307(1).
435. Countryman, supra note 385, at 272.
436. U.C.C. § 9-306(4); see text accompanying note 426 supra.
438. Countryman, supra note 385, at 274-75.
power to upset fraudulent conveyances. The '78 Code's fraudulent conveyance section is a streamlined version of the Uniform Fraudulent Conveyance Act.

It specifies four types of voidable transactions. First, if the debtor transfers property or incurs an obligation actually intending to defraud, hinder, or delay existing or future creditors, then the trustee may avoid the transaction. If a defendant in a civil action for battery, intending to prevent collection of a judgment, gives all his nonexempt property to his mother in trust for his children, that is an intentional fraudulent conveyance. Prebankruptcy “gifts” of boats, refrigerators, and money also fit in this category. What the bankrupt intended is a question of fact and, while the debtor's solvency-insolvency and fair-inadequate consideration are immaterial, they bear on the question of intent. Trustees usually will find scant direct proof of fraudulent intent, but judges use circumstantial evidence to infer fraud. Examples of circumstantial evidence include unrecorded security instruments, reserved rights in the transferred property, and a close relationship with the transferee.

The Code defines three other types of constructively fraudulent transfers, which must have been made for less than reasonably equivalent value. Avoidable transfers are those made when the debtor was insolvent or became so as a result of the transaction; was in business and the transfer left him with an unreasonably small capital to carry on; and intended to incur debts beyond his ability to pay after transferring. When the debtor transferred for full consideration, for example, to pay an antecedent debt to his mother-in-law, the trustee cannot use these fraudulent conveyance sections to avoid the transaction, even though the debtor knew that paying one creditor meant not paying others. Transferees who fail to balance the debtor's transfer with fair considera-

440. Id. § 548(a)(1).
442. 4 Collier, supra note 139, ¶ 548.02.
tion, however, deplete the assets available to be distributed to the transferor's creditors. Thus, less than reasonably equivalent value, coupled with insolvency or resulting insolvency, unreasonably small remaining capital, or intent to incur excessive debts, equals an avoidable transfer. The Code only protects a good faith transferee who gives value and only to the extent of that value.\textsuperscript{446}

The trustee may upset any fraudulent conveyance that occurs within the year preceding bankruptcy\textsuperscript{446} She may reach earlier transactions under the notion that a transfer occurs only when a subsequent BFP from the debtor cannot defeat the transferee.\textsuperscript{447} Thus, in 1976 Achilles deeds Troyacre to Whizbang Shield Company, but Whizbang does not record the deed. Achilles has a chariot accident and the injured victim sues him. Whizbang records the deed in July 1979 during the trial. The jury returns a large verdict for the victim. Achilles files bankruptcy and lists the judgment to be discharged. The trustee of Achilles' estate may recover Troyacre from Whizbang as a fraudulent conveyance. An unfair conveyance by a debtor facing debts is fraudulent.\textsuperscript{448} This conveyance occurs when Whizbang records the deed, perfecting it against a purchaser from Achilles.\textsuperscript{448} Thus, the Code exorcises transfers when they become known or reasonably discoverable and prevents secret fraud from becoming invulnerable fraud.

E. The Borderland of Preference and Fraudulent Conveyance

Fraudulent conveyance and preference doctrines are subtle and slippery to students, teachers, lawyers, and judges. The bankruptcy trustee may recover either fraudulent conveyances or preferences in federal bankruptcy court, but creditors in state court may recover only fraudulent conveyances.\textsuperscript{450} Fraudulent conveyance doctrine tolerates preferences, paying one of several creditors before

\begin{itemize}
  \item \textsuperscript{445} Id. § 548(c).
  \item \textsuperscript{446} Id. § 548(a).
  \item \textsuperscript{447} Id. § 548(d)(1).
  \item \textsuperscript{448} Id. § 548(a)(2)(B)(iii).
  \item \textsuperscript{449} Id. § 548(d)(1). The example is based on Kindom Uranium Co. v. Vance, 269 F.2d 104 (10th Cir. 1959). The solution in the text assumes that Whizbang gave no consideration and that it is fair to judge Achilles's intent when Whizbang recorded. As to the latter, see 4 COLLIER, supra note 139, ¶¶ 542.08, 548.87.
  \item \textsuperscript{450} VA. CODE §§ 55-80, -81 (Repl. Vol. 1974).
\end{itemize}
the others; a transfer to a creditor to satisfy an antecedent debt is for value and therefore not a fraudulent conveyance.451

Preferences offend the policy against distributing an insolvent's property equally among his creditors. To avoid the unequal effect of a preference, a collective proceeding like bankruptcy must avoid the preference and divide the assets among all creditors.452 A fraudulent conveyance depletes the debtor's estate that is available to all creditors.453 Individual creditors may sue under state law to recover fraudulently conveyed property. The debtor ought to pay the creditors instead of depleting the available assets to benefit himself or someone unrelated to his prior dealings. "A debtor ought to be just before he is generous" is the adage advanced by the fraudulent conveyance doctrine;454 but the debtor who has preferred one creditor already has been just. Society accordingly considers fraudulent conveyances to be more serious and to involve moral turpitude; fraudulent conveyers may be denied a bankruptcy discharge455 and may have committed a crime.456

A reader of the Southeastern Reporter is reminded occasionally of the following dialogue from the motion picture Casablanca:

"What brought you to Casablanca, Rick?"
"My health. I came for the waters."
"What waters? We're in the desert."
"I was misinformed."

Similarly misinformed, Virginia lawyers file fraudulent conveyance actions in state court to avoid preferences.457 Consider the following example: an officer who has cosigned the firm's note to Bank builds up the firm's account with Bank allowing Bank to offset just

453. 1 G. Glenn, Fraudulent Conveyances and Preferences § 195 (rev. ed. 1940).
454. J. MacLachlan, supra note 282, § 221.
456. 18 id. § 152 (West Supp. 1979).
before the firm goes down the drain.\textsuperscript{458} In bankruptcy, the setoff probably is avoidable and this also appears to be an indirect preference to the officer.\textsuperscript{459} Under proper analysis, this transaction, however, is not a fraudulent conveyance.\textsuperscript{460} Professor Ulrich's cogent and readable article\textsuperscript{461} tells how the state courts, sharing the lawyers' confusion, have relieved them of their errors by calling a preference a fraudulent conveyance. To make sense of these decisions is impossible because the "court has so obviously strained to fit a square peg [preference] into a round hole [fraudulent conveyance]."\textsuperscript{462} Because of the inconsistent precedent no one can predict how the Virginia courts would decide the preceding hypothetical.

The creditor's proper course of action when a debtor transfers questionably is to file an involuntary bankruptcy proceeding\textsuperscript{463} and place the issue before a bankruptcy judge with, if not always the ability to tell the difference,\textsuperscript{464} at least the power to avoid both fraudulent conveyances and preferences.\textsuperscript{465} The estates of debtors who have committed preferences should be liquidated and distributed in a collective proceeding like bankruptcy to prevent an aggressive nonpreferee from using the fraudulent conveyance doctrine to substitute one preference for another.

\section*{F Preference Enabling Transactions}

People in debt often borrow from Peter to pay Paul. When bankruptcy follows, Debtor's payment to Paul may be a preference. What if Debtor gives Peter a security interest? If Peter takes security in exchange for money which makes Debtor liquid enough

\footnotesize{458. See Jospeh F Hughes \& Co. v. Machen, 164 F.2d 983 (4th Cir. 1947), cert. denied, 333 U.S. 881 (1948).

459. Union Trust Co. v. Peck, 16 F.2d 986 (4th Cir.), cert. denied, 273 U.S. 767 (1927) ('98 Act); 11 U.S.C.A. § 553(b) (West Supp. 1979). The '78 Code eliminated the preferee's knowledge of insolvency as a prerequisite to recovery. It also developed the concept of an insider preference, which includes the knowledge prerequisite but lengthens the statute of limitations. Id. § 547(b)(4)(B) (West Supp. 1979).


462. Ulrich, supra note 452, at 69.


464. See the litigation summarized in Aulick v. Largent, 295 F.2d 41 (4th Cir. 1961).

to prefer Paul, then may the trustee avoid Debtor's transfer of security to Peter?

In *Dean v. Davis*, the Supreme Court allowed the trustee to upset the security interest that then allowed the debtor to prefer a creditor as a fraudulent conveyance.\(^{466}\) *Dean* included additional features: Jones, the debtor, needed the cash to pay Paul, a bank, to prevent a forgery prosecution; Jones granted a security interest in all his property to Dean, his brother-in-law; Jones's note to Dean was overdue when Dean recorded the documents so neither intended for Jones to continue in business. Involuntary bankruptcy followed promptly.

Despite the unfair nature of the transaction, the Court's reasoning was strained. Jones did not prefer Dean because Jones transferred security to Dean for contemporaneous consideration, not an antecedent debt. If anyone was preferred, it was the bank which received a greater percentage.\(^{467}\) Dean, moreover, loaned Jones an amount roughly equal to the value of the property and because the security equaled the debt, the consideration between Dean and Jones was adequate. Jones intended to use the money to pay the bank, not to hinder other creditors. Jones' transfer to the bank was not a fraudulent conveyance; it strains logic to say that a transaction between Jones and Dean that made Jones sufficiently liquid to pay the bank is a fraudulent conveyance. Why should Dean's assistance to Jones have been fraudulent when the bank's act of receiving the money was not? The debtor substituted a secured creditor for an unsecured creditor, and this reduced the amount of money available to other general creditors in the debtor's later bankruptcy.

Congress made two attempts at codifying *Dean v. Davis*.\(^ {468}\) The legislation embodied the rule imperfectly.\(^ {469}\) The decision hinged on Jones's desire to escape criminal prosecution coupled with his

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467. Id.
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apparent indifference to liquidation, but the legislation failed to make clear that if the parties thought the loan would rehabilitate the borrower the trustee could not upset the transaction. The Commission Report recommended and Congress agreed to delete the attempt to codify Dean because it hindered rehabilitation by deterring creditors and buyers from dealing with embarrassed businesses.470

What are the trustee's options if a Dean v. Davis fact pattern should reoccur?471 First, Collier's hints that because the decision held the transaction to be an intended fraudulent conveyance, the present fraudulent conveyance statute will suffice.472 If courts find that a lender who exchanges money for security to allow a borrower to pay another creditor commits a fraudulent conveyance, the law is back where it was before Congress deleted the codification of Dean. Lenders who take security to help the borrower rehabilitate himself by paying an importuning creditor should be entitled to retain the security against the trustee to the extent the lender gives value, even though the importuning creditor receives a preference.473 If, however, the lender lacks good faith in that it knows or believes the debtor soon will be bankrupt and takes security to protect itself while allowing the debtor to prefer another creditor, then the trustee may be able to upset the security interest as an intended fraudulent conveyance.474

Second, the trustee may use the preference section. The '78 Code removes a prerequisite to recovery provided in the '98 Act. She need not prove that the preferee had reasonable cause to believe that the debtor was insolvent.475 Although to believe that the bank in Dean did not know that Jones was hopelessly defunct de-

472. 11 U.S.C.A. § 548(a)(1) (West Supp. 1979); 4 COLLIER, supra note 139, ¶ 548.01[a], at 548-12 to 13 n.17; ¶ 548.07, at 548-73 n.46.
474. 4 COLLIER, supra note 139, ¶ 548.07[3], at 548-73. See also Note, HOFSTRA L. REV., supra note 461, at 549, 555-57. Whether a court would allow the fraudulent conveyee to subrogate to the trustee's action against the preferee remains to be seen. Alternatively, the conveyee may subrogate to the preferee's claim against the estate, but this merely duplicates the conveyee's claim.
475. See text accompany notes 331-35 supra.
fies common sense, this requirement proves to be an unnecessary barrier that prevents trustees from upsetting other preferences. Removing it will ease the trustee’s path against the recipient of the consideration.

The '78 Code’s preference section adds an additional arrow for the trustee’s quiver. Formerly, preferences more than four months old were immune, but the '78 Code allows the trustee to recover insider preferences that occurred in the year preceding bankruptcy. Thus, the statutes of limitations for fraudulent conveyances and insider preferences are the same. Congress removed one reason to use the fraudulent conveyance section rather than the preference section when an insider received the preference. May the trustee substitute the insider preference doctrine for the previous codification of Dean v. Davis? Congress defined insiders to be those so closely related to the debtor that courts should scrutinize their relations carefully. The trustee may recover preferences that occurred in the first three-quarters of the year preceding bankruptcy from insiders who had reasonable cause to believe the debtor insolvent. Whether the roughly equal value that flowed between Dean and Jones would have prevented a court from holding their transaction to be a preference remains to be seen.

G. Setoff

The concept of setoff began in Rome and first was recognized in Virginia as early as 1645. Under nonbankruptcy law, creditors may apply a mature debt against a mutual debt and pay only the balance. Today banks are the most frequent offsetters; they apply deposit accounts to the amount a depositor owes the bank. Like

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477. Id. § 548(a).
478. Id. § 101(25).
479. Id. § 547(b)(4)(B).
480. But see 4 Collier, supra note 139, ¶ 547.29, at 547-103 n.1 (“Dean v. Davis considered certain insider preferences to be fraudulent transfers.”).
482. R. Brown, The Law of Personal Property § 13.12 (3d ed. 1975). The UCC does not apply to bank set-off, U.C.C. § 9-104(i), but a creditor may take a security interest in a deposit account, id. § 9-302(f). The right to offset may be a lien under an expansive definition of lien like 11 U.S.C.A. § 101(28) (West Supp. 1979), but the Code refers to a setoff
the '98 Act, the '78 Code provides for setoff.483 Under the '98 Act, setoff was recognized as an exception to the preference doctrine; the trustee, however, could recover a setoff as a preference if she could show that the bankrupt deposited intentionally to grant a preference.484 This proved to be too narrow and it prejudiced other creditors as well as the principle of equal distribution. The '78 Code is drawn more carefully. Setoff is not subject to preference analysis,485 instead the setoff section is itself a mini-preference section, as the following analysis demonstrates.

The creditor or bank may offset only mutual debts. The debt and the claim need not arise from the same transaction, nor must they be of the same character; one may be tort and the other may be contract.486 The debts merely must be owed, valid, and enforceable on both sides.487 Banks cannot offset against the bankrupt's trust funds or against the bankruptcy trustee's debt to the bank because the debts lack mutuality.488 On the same principle, the bank may not offset the bankrupt's separate debt against a joint account.

The creditor or bank may offset before bankruptcy under nonbankruptcy law by adjusting its books and giving appropriate notice, but the filing of a bankruptcy petition automatically stays setoff.489 In a liquidation bankruptcy, the court should relieve the creditor from the stay and allow setoff.490 The creditor also may


484. New York County Nat'l Bank v. Massey, 192 U.S. 138 (1904); Jensen v. State Bank, 518 F.2d 1, 4 (8th Cir. 1975) (allowing setoff where bankrupt's checking account was long-standing and had not been built up in order to permit the bank to obtain a preference).


490. Ahart, Bank Setoff Under the Bankruptcy Reform Act of 1978, 53 AM. BANKR. L.J. 205, 208 (1979). Conversely, setoff may frustrate efforts to rehabilitate and in a nonliquidating bankruptcy, the judge may continue the stay if the debtor adequately assures him that
assert setoff to defend against the trustee’s preference or fraudulent conveyance action. The creditor somehow must claim setoff; if the creditor files proof of claim or accepts a dividend, the judge may hold that it has waived the right to offset.491 Perhaps the safest course of action for the creditor-bank is to seek relief from the automatic stay, subtract the amount of the bankrupt’s deposit from the debt, and file a claim for the balance of the debt.492

The ’78 Code prohibits creditors from offsetting when the offset resembles a preference. First, a creditor may not offset claims against the bankrupt that the creditor obtained from third parties after bankruptcy or in the ninety days before bankruptcy while the debtor was insolvent.493 For example, the creditor discounts the debtor’s note to the bank and renews it several times. When the bank demands collateral, the creditor buys the note back from the bank and offsets it against the debtor’s open account.494 The offset is invalid in bankruptcy. Second, the Code prohibits setoff when the creditor, instead of acquiring a claim, incurs a debt to the future bankrupt within the critical period intending to enhance the creditor’s right to offset.495 For example, assume President has cosigned Company’s note at the Bank and in the ninety days before filing bankruptcy, he deposits all available cash in an account at the Bank, understanding that Bank will offset the account against the cosigned note.496 The trustee may recover the setoff.

Third, the ’78 Code, limits prepetition setoff with the intention of deterring banks from devastating troubled debtors with massive offsets.497 The trustee may recover prepetition setoffs to the extent

the bank’s interest will be protected. Id. at 212. See also 11 U.S.C.A. § 363 (West Supp. 1979).

491. 4 COLIER, supra note 139, ¶ 553.07.
493. Id. §§ 553(a)(2)(A), (B). Like the preference section, the setoff section presumes insolvency during the critical 90 days. Id. § 553(c).
the setoff improves the offsetting creditor’s position.\textsuperscript{498} The improvement in position test resembles the preference test for inventory and accounts creditors. Both are intended to prevent a creditor from building up the amount of the debtor’s assets subject to its exclusive dominion. But, as the following example shows, the two tests are not identical. Assume Debtor owes Bank $15,000. On the first day of the critical prebankruptcy ninety days, his deposit is $10,000 but when Bank offsets sixty days later, the account contains $15,000. The Code allows Bank to offset $10,000 but it tells Bank to return the $5,000 improvement of its position.\textsuperscript{499} Under a preference analysis, the entire $15,000 could be avoided by the trustee. Congress intended this provision to encourage nonbankruptcy rehabilitation by deterring offsets that will trigger bankruptcy;\textsuperscript{500} it does not apply to postbankruptcy setoffs.\textsuperscript{501}

IV. Exemptions

Insolvency schemes that do not contemplate the debtor leaving the courtroom in a barrel provide exemptions for certain assets. The '78 Code changes the bankruptcy approach to exemptions by first requiring that all the bankrupt’s property pass to the estate.\textsuperscript{502} In claiming exemptions, the bankrupt seeks the return of exempt property from the estate.\textsuperscript{503} Under the '98 Act, the bankrupt would withhold exempt property so that it never would become part of the bankruptcy estate.\textsuperscript{504} The change is significant. The Code creates a single administration, one estate in one court. This should result in more prompt administration and prevent double recovery. Also, the bankrupt’s fresh start is advanced by having the process

499. 4 COLLIER, supra note 139, ¶ 553.08[3].
adjudicated by a sympathetic and knowledgeable court.

The attorney should obtain a list of property from each individual bankrupt. The debtor may convert nonexempt property into exempt property without committing a fraudulent conveyance. The attorney should apply the appropriate exemption schedule and file a list of exempt property. Generally, creditors may not collect unsecured debts from exempt property, but tax and family support creditors may collect their nondischarged debts from exempt property. Unless a party, generally a creditor, or the trustee objects, "the property claimed as exempt on such list is exempt." The bankrupt may waive an exemption by omitting to claim it, but dependents may file exemptions if the bankrupt fails to do so. The exemption section applies separately to both spouses who file joint bankruptcies. Each spouse is entitled to claim a complete set of exemptions. Also, the present rule allows the bankrupt who has not maximized exemptions to amend the exemption schedule. These provisions advance the policy of the exemption statutes to cushion bankrupts and their families against the debilitation of financial difficulty.

The '78 Code provides the bankrupt a choice of exemption schemes but allows the states a veto. The bankrupt may choose between (1) the applicable state's exemptions, including whatever jointly owned and entireties property the state exempts plus

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507. Id. §§ 522(b), (e). In an apparent excess of caution, Virginia bankrupts continue to file homestead deeds in state circuit courts under Va. Code §§ 34-6, -13, -17 (Repl. Vol. 1976). This is probably unnecessary. 11 U.S.C.A. §§ 522(b), 541(a) anticipate that all the bankrupt's property will enter the estate and that the bankrupt will claim property as exempt on the schedules as filed and amended. These sections refer to the property specified as exempt in the state code not to the technical procedural prerequisites. White v. Stump, 266 U.S. 310 (1924) and In re Swift, 96 F Supp. 44 (W.D. Va. 1950) are overruled. This issue probably will not be litigated until a bankrupt "forgets" the homestead deeds.
508. Id. § 522(c).
509. Id. § 522(l).
510. 3 COLLIER ON BANKRUPTCY ¶ 522.07 (15th ed. 1979) [hereinafter cited as 3 COLLIER].
512. Id. §§ 302, 522(m).
513. R. BANKR. P 110.
514. 11 U.S.C.A. § 522(b) (West Supp. 1979). The court applies the law of the state where
nonbankruptcy federal exemptions; and (2) a federal exemption schedule.\textsuperscript{515} The state may veto the second choice. The Code provides that a bankrupt may not elect the federal schedule plus state jointly owned realty if that state "specifically does not so authorize."\textsuperscript{516} According to Representative Butler of Virginia, states only may veto by an affirmative, specific prohibition.\textsuperscript{517} Virginia's General Assembly vetoed the Virginia bankrupt's option to elect the federal schedule.\textsuperscript{518} Thus, Chapter 34 of the Virginia Code and nonbankruptcy federal exemptions govern Virginia bankruptcy exemptions.\textsuperscript{519}

This Virginia legislation is unfortunate. Allowing the states to opt out of the federal schedule was a late legislative compromise between those in Congress who advocated uniform federal exemptions and those who favored continued reliance on state exemptions. Allowing states to veto the federal option is "one of the most peculiar federal-state arrangements on record."\textsuperscript{520} Creditor advocates argue that state exemptions work well because they reflect different standards of living and are relied upon in extending credit. This argument is unpersuasive.\textsuperscript{521} The federal exemption schedule takes a large stride toward enacting the constitutional mandate of a "Uniform Law of Bankruptcy."\textsuperscript{522} Allowing the bankrupt to take advantage of more liberal state exemptions\textsuperscript{523} qualifies that uniformity, but does so in aid of the bankrupt's fresh start.\textsuperscript{524}

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515. \textit{Id.} § 522(b). Section 522(d) includes most of the nonbankruptcy federal exemptions; it does not appear to supercede the others. \textit{Id.} § 522(d).

516. \textit{Id.} § 522(b)(1).


519. Nonbankruptcy federal exemptions include: Foreign service retirement and disability; social security; civil service retirement benefits; admiralty death and disability benefits; railroad retirement benefits; veterans benefits; and others. \textit{See} 3 COLLIER, supra note 510, ¶ 522.02, at 522-10.


The federal exemptions are used as a floor, a low figure. The Virginia General Assembly acted in the closing days of the session and without informing itself fully. The legislation throws Virginia bankrupts back to the archaic, rural-oriented patchwork disparaged so deservingly elsewhere in this issue.\footnote{525}

The federal bankruptcy exemptions are not generous. Bankrupts may exempt 1) residential property real or personal not to exceed \$7,500; 2) an automobile up to \$1,200 in equity or value; 3) a variety of personal or household items, individually not worth more than \$200; 4) \$500 worth of jewelry; 5) implements, professional books, and tools of the trade up to \$750; 6) any unmatured life insurance contract and up to \$4,000 in loan or surrender value; 7) \$400 that that can be applied to any of the above if their value exceeds the dollar limit; 8) any unused amount of the residential property exemption to claim in personal property; 9) professionally prescribed health aids; 10) social security, unemployment compensation, veterans' disability, illness or unemployment benefit; 11) family support payments, benefits under a life insurance contract, wrongful death awards, compensation for loss of future earnings, and most employee pensions to the extent the bankrupt needs them for personal or family purposes; 12) crime victim's reparation; and 13) no more than \$7,500 of a personal injury award for actual bodily injury, excluding compensation for pain, suffering, and actual pecuniary loss.\footnote{526} The federal exemption schedule closely parallels the property of the estate. The estate includes property such as personal injury claims and pension rights that arguably were nonleviable under the '98 Act; the federal exemption section saves an interest in the claim for the bankrupt. Coupling the new federal estate with unreconstructed state exemption statutes creates a potential for massive injustice.

\footnote{522} The choice between § 522(d), the Federal bankruptcy exemption schedule, and state exemptions creates incentive to file bankruptcy if in a state with less liberal exemptions than § 522(d). The National Conference of Commissioners promulgated the Uniform Exemptions Act hoping that states would pass it and eliminate the gap by bringing state exemptions up to § 522(d). The author prefers the Uniform Act and allowing the option to elect 522(d). The state veto without changing the state statutes completely frustrates uniformity, modernism and fairness.

\footnote{525} See Note, The Failure of the Virginia Exemption Plan, infra this issue.

Several provisions in the new exemption section change earlier law without allowing the states to opt out. Virginia allows debtors to waive the homestead exemption for any debt. Form notes universally contain waiver clauses, and flint-hearted creditors with waiver notes often used the bankrupt's schedules of exempt property to direct the sheriff to property upon which to levy. This no longer is possible under the '78 Code. Waivers in favor of general creditors are unenforceable in bankruptcy. The property will be exempt, protected from levy by the automatic stay during the proceeding, and by the discharge injunction after the bankruptcy ends.

The Code preserves valid liens, even those on exempt property. Thus, prudent creditors will obtain security interests instead of notes with waiver clauses. The trustee may invalidate liens for a variety of reasons. After the trustee avoids liens, the debtor may claim the unsecured property as exempt. If the bankrupt is guilty of misconduct concerning exempt property, he may not exempt it after the trustee restores it to the estate. The bankrupt, for example, may not convey property fraudulently before bankruptcy and, after the trustee recovers it, claim it as exempt.

Despite waivers of exemption, the bankrupt may avoid certain liens that impair an exemption. The bankrupt may avoid two types of liens: judicial liens, such as execution and judgment liens obtained by legal process or proceeding, and nonpossessor, non-purchase money security interests in health aids, property used to earn a living, and personal, household, or family property. Even

530. Id. §§ 362(c), 524(a).
531. Id. § 522(e)(2).
532. Id. §§ 544, 545, 547, 548, 724.
533. Id. § 522(c).
534. Id. § 523(g).
535. Id. § 522(f).
536. Id. §§ 101(27), 522(f)(1).
537. Id. § 522(f)(2). If the bankrupt chooses the federal scheme, this property is exempted under §§ 522(d)(3), (6), and (9). See also U.C.C. §§ 9-107, -109(2) (broadly defining
if the state excludes residents from the federal schedule, the bankrupt may avoid liens on the property exempt under state law.\textsuperscript{538} Finally, if the trustee could have avoided certain liens or transfers but failed to, the debtor may avoid the lien or transfer to the extent the property could have been exempted.\textsuperscript{539} Generally, administrative expenses will not be charged against exempt property, but exempt property must bear its share of the expense of preserving the bankrupt's exemptions, as for example, the cost of recovering it or avoiding a lien.\textsuperscript{540} The prudent creditor who obtains a security interest in the debtor's property may find that it cannot enforce its security after the debtor files bankruptcy.

The bankrupt has a statutory right to redeem exempt or abandoned personal property used in the home from a lien that secures a dischargeable consumer debt by paying the creditor the allowed secured claim.\textsuperscript{541} The consumer bankrupt may couple this with the right to avoid nonpossessory, nonpurchase money security interests on household property. Creditors with security interests in household goods that are worth less than the debt often threaten to repossess to coerce the bankrupt into reaffirming the discharged debt. Such provisions, which allow the bankrupt to avoid the security interest or redeem the property, prevent this creditor tactic and advance the fresh start for the consumer bankrupt.\textsuperscript{542}

V Secured Creditors

Bankruptcy classifies creditors as either secured, priority, or general and deals differently with each group. Secured creditors occupy the golden circle. Creditors take security interests to protect themselves against debtors' insolvency. Bankruptcy, however, is the crucible of security. The trustee uses her lien avoidance powers

\begin{footnotesize}
\begin{enumerate}
\item The author would prefer for the debtor to be allowed to redeem by paying the lower of the debt or the fair market value of the collateral, but the Senate rejected this for the amount of the debt. \textit{Compare} Commission Report, supra note 4, Part I, at 173 with S. Rep. No. 989, supra note 20, at 95, reprinted in Ad. News, supra note 20, at 5881.
\end{enumerate}
\end{footnotesize}
against security interests.\textsuperscript{543} Pervasive policy conflicts plague this area; debtors should be rehabilitated, creditors should be treated equally, and secured creditors should be recognized.

If a creditor has a valid lien, the bankrupt’s discharge will not bar the creditor from enforcing that lien.\textsuperscript{544} If the debt exceeds the collateral, the creditor cannot recover the deficiency from the bankrupt because his personal liability is discharged.\textsuperscript{545} Priority among fully secured creditors is determined under nonbankruptcy, usually state, law. The policy conflict emerges in a procedural guise. To say that bankruptcy does not affect a valid lien is not quite safe.

Creditors are entities with claims against the bankrupt. A claim includes almost any right to payment.\textsuperscript{546} A secured creditor’s claim is a lien that relates to collateral. A lien is a “charge against or interest in property to secure payment of a debt or performance of an obligation.”\textsuperscript{547} This includes interests in both real and personal property. Although bankruptcy recognizes three types of liens—judicial liens, statutory liens, and consensual liens or security interests\textsuperscript{548}—it treats all valid liens identically. Bankruptcy no longer mentions equitable liens,\textsuperscript{549} which are remedial devices rather than liens.\textsuperscript{550} Creditors with liens against property of the estate\textsuperscript{551} are affected by the debtor’s bankruptcy because the creditor and the estate have interests in the property.

When the debtor goes bankrupt the secured creditor has several

\textsuperscript{543} To distinguish between the terms lien and security interest, a lien is a generic term; it can be judicial, statutory, or consensual. A security interest, however, can only be consensual, particularly under the UCC.


\textsuperscript{545} 11 U.S.C.A. § 727(b) (West Supp. 1979).

\textsuperscript{546} Id. § 101(4)(A).

\textsuperscript{547} Id. § 101(28).


\textsuperscript{549} See 11 U.S.C.A. § 544(a) (West Supp. 1979); U.C.C. § 9-301(1)(c).


options.\textsuperscript{552} To participate in the proceeding, the secured creditor should file proof of claim.\textsuperscript{553} If the debt exceeds the collateral the partially secured creditor may file proof of claim for the unsecured deficiency. Filed proofs are considered allowed unless another party objects.\textsuperscript{554} If someone objects, then the judge will determine whether, on the date of bankruptcy, the bankrupt had a defense, and if the judge upholds a defense, the claim will be disallowed.\textsuperscript{555}

The amount of the claim often is more important than its validity. The claim will be divided into an allowed secured claim and, if the creditor's claim exceeds the collateral's value, an allowed unsecured claim.\textsuperscript{556} The size of the creditor's interest is critical in this division. The Code tells the court to consider the purpose of the inquiry in determining the property's value.\textsuperscript{557} Thus, the creditors may argue that the collateral is worth more when the question is adequate protection than when it is the amount of the unsecured claim. The creditor will share in the estate as a general, unsecured creditor for the unsecured portion of its claim.\textsuperscript{558}

Second, the secured creditor may waive its security and claim simply as a general creditor.\textsuperscript{559} The creditor may consent to surrender the collateral, which becomes available to all. Filing a proof of claim for the full debt without listing security may be masochistic or mistaken; if the creditor fails to amend in a timely fashion, it may be reduced to recovering as a general creditor. Filing an unsecured proof may admit reality, however, when the creditor's security interest is doubtful or the collateral has little value or is exempt.\textsuperscript{560}

\footnotesize{552. The following is adopted from Kennedy, \textit{Priorities and Liens}, in \textit{Bankruptcy and the Chapter Proceedings} 163, 177-83 (G. Holmes ed. 1976). See also United States Nat'l Bank v. Chase Nat'l Bank, 331 U.S. 28, 33-34 (1947).}

\footnotesize{553. 11 U.S.C.A. § 501(a) (West Supp. 1979). Under the '98 Act, creditors often decided not to file proof of claim because that would consent to bankruptcy court jurisdiction. Under 28 U.S.C.A. § 1471 (West Supp. 1979), the bankruptcy court now has jurisdiction over everything related to bankruptcy and over a secured creditor whether it files a claim or not.}

\footnotesize{554. 11 U.S.C.A. § 502(a) (West Supp. 1979).}

\footnotesize{555. \textit{Id.} § 502(b).}

\footnotesize{556. \textit{Id.} § 506(a).}

\footnotesize{557. \textit{Id.}}

\footnotesize{558. \textit{Id.} § 726(a)(2).}

\footnotesize{559. \textit{Id.} § 501(a).}

\footnotesize{560. \textit{Id.} § 522.}
LIQUIDATION BANKRUPTCY

The secured creditor may do nothing and benignly sit out bankruptcy as a spectator. For example, a thrift institution with a mortgage on a consumer bankrupt’s house may realize that the potential claims for a personal deficiency judgment will be discharged, but be content to rely on its collateral. If the loan plus the bankrupt’s homestead exemption exceed the value of the house, the creditor can be confident that the trustee will not sell it to realize on the bankrupt’s equity of redemption. If necessary, the creditor will wait until after the discharge dissolves the stay to enforce the security. But the consumer, freed from other debts, may be a better debtor after bankruptcy.

The secured creditor’s incentive to sit tight is enhanced by the automatic stay.561 Judicial proceedings to enforce a valid security interest are stayed automatically when the petition is filed.562 All efforts to collect or foreclose outside of bankruptcy end, and orderly, unified administration of all the bankrupt’s property begins. Creditors may not repossess, replevy, foreclose, file an action, collect accounts receivable, or dispose of collateral.563 To obtain surcease, the creditor must request the bankruptcy court to terminate, modify, or condition the stay.564 If the estate lacks equity in the collateral, the judge may allow the secured creditor to proceed outside bankruptcy.565 If the collateral remains in the estate, the trustee may sell the collateral free of the lien even though the secured creditor objects.566

The debtor’s bankruptcy may cause the secured creditor to be more than merely idle. Generally, a secured creditor that possesses an asset subject to the estate’s interest must relinquish that property to the trustee.567 Included are assets the trustee may use or liquidate568 or the bankrupt may claim as exempt.569 Creditors who

561. Id. § 362; see text accompanying notes 69-86 supra.
562. See supra notes 64-65 and accompanying text. Id. § 362.
565. Id. §§ 554, 725.
566. Id. § 363(f). The creditor may bid the amount of its allowed claim, id. § 363(k), but the trustee will pay the cost of the sale before the secured claim. Id. § 506(c).
567. Id. § 542.
568. Id. § 363.
569. Id. § 542.
repossess household items from consumer debtors should know that the bankrupt may redeem the collateral, avoid the lien, and exempt the property. Simply repossessing or foreclosing before bankruptcy may be inadequate to avoid becoming entangled in the bankruptcy. The estate's interest will be defined under bankruptcy law, and a right to redeem the collateral may be a sufficient interest. If the estate has an interest, the bankruptcy court has jurisdiction. Perhaps secured creditors who dispose of the collateral, agree to dispose of it, or accept it in satisfaction of the debt will escape the bankruptcy court's writ, but by then they will be neither secured nor creditors.

VI. UNSECURED CREDITORS

A. Priorities

After valid liens are satisfied, the estate pays the remaining liabilities in order of their priority. A priority, which is a right to be paid first from unencumbered assets, must be distinguished from a lien, which is a right to enforce a security interest in collateral. Liens may be contractual, statutory, or judicial, and a lienor may enforce its interest outside of insolvency. A priority is a statutory right to be paid at a given point when the debtor's assets are distributed in insolvency. Priority schemes distribute to certain classes of claims before others. Bankruptcy pays valid liens before beginning to distribute to unsecured creditors; it satisfies priority claimants after lienors but before general creditors. Each priority class is paid in full before moving to the next, and the creditors in the priority class which exhausts the fund share pro rata.

Assigning a priority to certain classes of debts and creditors and ranking these classes are policy decisions. Congress must adjust the sovereign's claims for taxes and other debts, the wages due to employees, and administrative expenses; it also must bear in mind that each penny paid as priority dilutes the policy of distributing

the estate equally to all creditors. The way the '78 Code treats the sovereign shows the policy adjustments. Tax claims enjoy lien status if the government complies with notoriety requirements.\textsuperscript{575} If, however, the government's tax claim lacks a lien status, it is entitled to a priority\textsuperscript{576} Congress debated few sections more than the tax priority and transformed few so radically from earlier proposals.\textsuperscript{577} But Congress subordinated tax liens to administrative expenses and wages,\textsuperscript{578} moved taxing authorities down two rungs on the priority ladder,\textsuperscript{579} and eliminated the priority previously accorded general governmental debts.\textsuperscript{580} As a result, contentiousness continues in the courts as creditors jockey for priority status and seek to achieve higher priority.\textsuperscript{581}

Administrative expenses plus filing fees and other charges constitute the first group of unsecured claims to be accorded priority status.\textsuperscript{582} Bankruptcy estates pay the cost of their own administration; those who administer an estate must be reimbursed. Most priority creditors are those whose claims accrued before bankruptcy. Administrative expenses, however, are incurred after bankruptcy; this priority compensates those who have served the estate.

The judge will decide whether an expense is administrative and if so, its amount. Congress establishes several types of administrative expenses.\textsuperscript{583} The estate pays fees and mileage for witnesses to attend administration proceedings.\textsuperscript{584} Expenses incurred by creditors to pursue estate property, prosecute criminal offenses, and assume custody of the property are entitled to administrative prior-

\textsuperscript{575} I.R.C. § 6323.
\textsuperscript{577} 3 COLLIER, supra note 510, ¶ 507.04[6], at 507-45.
\textsuperscript{578} 11 U.S.C.A. § 724(b) (West Supp. 1979).
\textsuperscript{582} 11 U.S.C.A. §§ 503(b), 507(a)(1), 726(a) (West Supp. 1979).
\textsuperscript{583} Id. § 503(b)(1).
\textsuperscript{584} Id. § 503(b)(6); 28 U.S.C.A. § 1821 (West Supp. 1979). Cf. R. BANKR. P 205(g) (distinguishing between the bankrupt and other witnesses, prepaying expenses only for the latter).
The estate also reimburses creditors for the expense of filing an involuntary petition. These expenses generally are incurred before the trustee takes over and should be distinguished from the expense of the unified administration under the trustee. The estate may compensate the trustee and professionals such as accountants, appraisers, auctioneers, and attorneys. The administrative expenses also include taxes plus fines or penalties related to those taxes incurred by the estate after the petition is filed.

Two super-priorities exist among the administrative expenses that apply primarily in rehabilitation cases. First, postpetition creditors who receive assurance of adequate protection that is ineffectual possess claims for administrative expenses that will be paid before other administration expenses. Second, when a bankruptcy is converted from rehabilitation to liquidation, the administrative expenses arising out of the liquidation are paid before the rehabilitation administrative expenses.

After a creditor files an involuntary petition, the subject may continue to do business. Creditors may not be paid for goods or services furnished or money lent during the period between the petition and the order for relief or the appointment of a trustee. The Code denies these involuntary gap creditors administrative expense status, but it allows their unsecured claims as prefiled claims and grants them the second priority, behind administrative expenses.

Wage and salary claims, vacation pay, severance pay, and commissions comprise the next priority class. The emolument must

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586. Id. § 503(b)(3)(A); cf. id. § 303(e) (requiring filing of a bond); R. BANKR. P 115(e) (allowing awarding of costs).
588. Id. §§ 503(b)(1)(B)(i), (b)(1)(C); 3 COLLIER, supra note 510, § 503.04[1][b], at 503.23. I.R.C. § 6012(b)(3) tells trustees of bankrupt corporations to file tax returns and Bankruptcy Code § 1106(a)(6) tells trustees to furnish information required by the government regarding taxes not paid by the bankrupt, but § 505 allows the trustee to escape personal liability for the bankruptcy estate's tax. 11 U.S.C.A. §§ 505, 1106(a)(6) (West Supp. 1979).
590. Id. § 726(b).
591. Id. § 303(f).
592. Id. § 502(f).
593. Id. § 507(a)(2).
594. Id. § 507(a)(3).
have been earned in the ninety days preceding the earlier of the petition or the end of the debtor’s business.\footnote{595} Recognizing that the dollar’s value has decreased, Congress raised the wage priority to $2,000.\footnote{596} Any excess will be a general claim.\footnote{597} This priority is based on the social welfare idea of protecting those who rely on periodic wages. The ’98 Act aimed the priority at subordinate employees by limiting it to “workmen, servants, clerks, or traveling or city salesmen.”\footnote{598} The employer who may have caused the problem and who may benefit from exemptions and a discharge should not be entitled to a wage priority also. The ’78 Code enacts these policies imperfectly by saying only that the priority amount must be “earned by an individual.”\footnote{599} State statutes require employers to pay salaries weekly or bimonthly.\footnote{600} In any event, few employees will work long without pay so these types of wage claims are normally of small value. The wage priority, therefore, centers on vacation pay, severance pay, and NLRB backpay awards.\footnote{601}

Some questions remain under the new wage priority. Claims for anticipatory damages for breach of an employment contract probably are not entitled to priority because anticipatory damages are not “earned.” Arguably, however, such damages might be the equivalent of “severance pay” and entitled to priority.\footnote{602} Under the ’98 Act, a prebankruptcy NLRB backpay award to an illegally discharged employee was entitled to wage priority even though it was not earned.\footnote{603} If this continues under the ’78 Code, the question then arises whether the policy of deterring employers from unfair labor practices is more important than deterring breach of private employment contracts so as to justify entitling the former to prior-

ity status but not the latter. Is it even relevant to compare policies when the employer will be discharged from both claims? Another court held that postbankruptcy backpay awards are an administrative priority. This creates an irony—an employee with a wage priority loses to another employee with a backpay award. Apparently, people are paid more for not working than they are for working.

Finally, is a worker's compensation award for an industrial injury entitled to a wage priority? A court under the '98 Act held that a compensation award was ineligible for priority because it was not "earned." The Code, however, may change that result; it includes "sick leave pay" within the priority. Arguably, this would encompass a compensation award. One student has suggested that if the worker's compensation claim were for fingers or a limb that had been cut off, the employee could claim the wage priority for "severance pay."

Congress rejected ill-advised interpretations of the '98 Act and included as the next priority class the payments to employee benefit plans unpaid within the 180 days before the petition or the end of business to be wages. Employee benefits include health insurance, life insurance, pension payments, and other nonwage compensation.

The fifth priority reflects commiseration for consumers. People dealing with large businesses such as health clubs, dance studios, rental companies, and retailers often make deposits, purchase on lay-away, or pay in advance for services. Absent a priority, if the business files bankruptcy, the consumer becomes a general creditor. The '78 Code recognizes that consumer creditors differ from business creditors by extending to consumers a $900 per

claimant priority for prepetition deposits to purchase, lease, or rent property or services for use in or around the home when the bankrupt fails to deliver the property or render the services.¹¹¹

Next to be discussed is the dismal subject of debts to the government. First the good news. The federal government lost the bankruptcy priority that it shared with landlords in the '98 Act.¹¹² Both are now general creditors.¹¹³ Unsecured nontax debt to the government is general, unsecured credit.¹¹⁴ Thus, although wage and layaway consumer creditors with a federal bankruptcy priority lose to Uncle Sam out of bankruptcy because of the government's nonbankruptcy priority; they will beat him in bankruptcy. Because those creditors will be better off in bankruptcy than in nonbankruptcy insolvency proceedings the wise course of action for them is to file involuntary bankruptcy.

Congress demoted the taxing sovereigns to sixth priority.¹¹⁵ The tax lienor with a perfected tax lien now follows the consumer priority.¹¹⁶ The tax priority along with the federal tax lien act¹¹⁷ is almost impossible to understand.¹¹⁸ Generally, the tax priority governs prebankruptcy taxes; taxes that accrue after bankruptcy are administrative expenses.¹¹⁹ If employees receive wage priorities, the trustee will withhold taxes and these taxes will be entitled to the wage priority.¹²⁰ Only allowed unsecured taxes are entitled to

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¹¹³ The Virginia landlord's priority, VA. CODE § 55-231 (Repl. Vol. 1974), will be invalidated by the trustee under Bankruptcy Code § 545 and the landlord will recover past and future rent under § 502(b)(7) and § 726(a)(2). 11 U.S.C.A. §§ 502(b)(7), 545, 726(a)(2) (West Supp. 1979); see text accompanying notes 676-80 infra.


¹¹⁷ I.R.C. § 6321.

¹¹⁸ H.R. Rep. No. 595, supra note 27, at 189-93, reprinted in AD. NEWS, supra note 27, at 6149-54 (cryptically discussing the tax priority).


The tax priority contemplates priority for income or gross receipts tax, taxes required to be withheld, employment taxes, property taxes, and certain excise taxes and customs duties. Congress intended to forbid judges from allowing a property tax that exceeds the value for the estate's interest in the property. This raises questions about allowance and priority for three types of cases: property tax on exempt property; property secured by a lien; and property the bankrupt sold before bankruptcy. Under the '78 Code, all three types of property come into the estate. Because of this change, as well as changes in the language of the new Code, prior decisions provide no assistance.

B. General Claims

1. Proof and Allowance

The history of a claim begins when the debtor schedules a debt and files bankruptcy. The clerk will send notice of the bankruptcy to each of the creditors scheduled. Filing a proof of claim is the way a creditor presents its claim to the court.

Under the '98 Act, the creditor had to cross three barriers. The creditor's claim, first of all, had to be provable. It also had to be proved and allowed. The provability concept was elusive and unnecessary but important to both the bankrupt and the creditor. If the creditor's claim was unprovable, it was not discharged, and the bankrupt continued to owe the creditor after the case closed. In addition, creditors were barred from recovering unprovable claims from the estate. The '78 Code abolishes the provability concept as a barrier to both the bankrupt's discharge and the creditors' employee's share, with employer's share receiving third priority only to the extent that wages have been paid. S. REP. No. 989, supra note 20, at 69, reprinted in Ad. News, supra note 20, at 5855.

622. Id. § 502(b)(4).
623. Id. § 541(a)(1).
627. Id. § 17a, 11 U.S.C. § 35a.
recovery 629

(a) Proof

To recover a "dividend" from a bankrupt's estate under the '78 Code, the creditor must file a proof of claim630 and the claim must be allowed.631 Creditors are entities with claims against the bankrupt generally arising before bankruptcy632 Creditors are entitled to file proofs of claim633 but are not required to do so. Failing to file will not prevent the debt from being discharged; bankruptcy will discharge scheduled debts, not just those on which proofs are filed. Having been frustrated in bankruptcy before, many creditors merely will write off the debt. These creditors will recover nothing; proof must be filed for the claim to be allowed and only allowed claims share.634 But the creditor may plan to recover from a source other than the estate, for example, collateral, a codebtor, or the bankrupt. The present rules provide, and the new rules will provide, that if no assets exist the creditors will receive notice that they may omit to file proof, but if assets later materialize, they will receive notice and be allowed to file claims at that time.635

Every inveterate creditor should develop an office routine to obey the automatic stay and to file a proof of claim. When the first notice of a debtor's bankruptcy arrives, the creditor should suspend collection tactics to avoid contempt and file a simple, previously prepared proof of claim form.636 Creditors who continue computer billing, for example, risk contempt for violation of the automatic stay Because few creditors file proofs, the return for the cost of a stamp is often surprisingly good. In one eastern Virginia bankruptcy, no creditor filed a proof of claim and the bankrupt

631. Id. § 502.
632. Id. § 101(9)(A); see id. § 101(14) ("entity"). Under certain circumstances, entities with postbankruptcy claims against the bankrupt are creditors. See id. § 101(9)(B).
633. Id. § 501(a). So may indenture trustees, id. § 101(23), and holders of equity securities, id. §§ 101(15), (16).
634. Id. §§ 502, 726(a)(2).
635. R. BANKR. P 203(b), 302(e)(4).
636. OFFICIAL BANKR. FORMS 15, 16, 16A can be adopted for almost any creditor's office routine.
went home with a discharge and a $9000 estate. Previously, creditors disdamed to file because that subjected them to the bankruptcy court's jurisdiction by "consent," but the court now has almost plenary jurisdiction over every conflict under the bankruptcy title. Thus, the court has jurisdiction in actions to recover alleged preferences despite any constructive possession or fictional consent.

Promptness is an essential aspect of any efficient system. The '78 Code provides for filing claims without setting a cut-off date. The present rule remains in effect and probably will be a model for the new rule. It allows creditors six months, but provides more time for the government, infants, incompetents, disappointed formerly secured creditors, and creditors to estates that turn up assets when none previously existed. Amendments for tardy creditors who wake up late on the last morning doubtless will be countenanced.

Because some claims, such as ones for alimony or taxes, will not be discharged, those creditors may sit out bankruptcy planning to recover from the bankrupt after the case closes. As a result, the estate will be distributed to those who do file, but the nondischarged claims will not be reduced and the bankrupt's fresh start will be blunted. The bankrupt will be "saddled with liabilities, particularly for taxes, which remain unpaid" because creditors with nondischargeable claims failed to "file proofs of claim and receive distributions thereon." The '78 Code minimizes this danger by allowing either the bankrupt or the trustee to file proof when a creditor fails to do so. This enhances the bankrupt's fresh start by reducing nondischargeable claims generally to taxes, family support, and educational debts.

Most claims grow out of prepetition liabilities. Some claims,

638. Convoluted machinations such as Katchen v. Landy, 382 U.S. 323 (1966), are no longer necessary.
640. R. BANKR. P 302.
641. Id. 302(e).
642. Id. 303, Advisory Committee Note.
643. 11 U.S.C.A. § 501(c) (West Supp. 1979); see INTERIM R. BANKR. P 3004.
however, neither arise nor become fixed until after bankruptcy and
the '78 Code allows proof of those claims to be filed. Creditors
may file proof even though the claim did not exist until after bank-
ruptcy if their claims arose after an involuntary petition was filed
but before adjudication; when the trustee rejected an executory
contract or unexpired lease; when the trustee or the bankrupt up-
set certain liens, interests, or offsets; or after bankruptcy was filed
and is for a priority tax. The new rule will set the time limits for
filing these claims.

(b) Allowance

Proved claims must be allowed before the creditor may receive
anything from the estate. Allowance most often will be routine;
the existence and amount of timely filed claims will be allowed au-
tomatically "unless a party in interest objects." Improper claim-
ants should not share in the assets. The trustee’s duties include
examining proofs and, “if a purpose would be served”, objecting to
improper claims. No purpose will be served by examining proofs
when no assets are available to distribute.

As discussed earlier, the bankrupt may file proofs of claim for
some creditors. May the bankrupt object to claims? Although he
must cooperate with the trustee, the bankrupt can reduce liens
on some exempt property to general claim status. The bankrupt,
however, has no right to object to incorrect or inflated claims, even
though they may reduce the amount of nondischargeable debt that
remains. Similarly, a creditor’s recovery is clearly diluted by an-
other’s bogus or inflated claim. Collier’s, however, says that the
trustee speaks for all creditors; instead of moving directly to seek
disallowance, creditors only may register disapproval with the
court. Denying the creditors and the bankrupt the right to chal-

645. Id. § 501(d).
646. Id.
647. Id. § 726(a)(2).
648. Id. § 502(a).
649. Id. § 704(4).
650. R. BANKR. P 306, Advisory Committee Note.
652. Id. § 522(t).
653. 3 COLLIERS, supra note 510, ¶ 502.01[2].
lenge based on a policy of expeditious and orderly administrations may permit the damage caused by a supine trustee to go uncorrected. Congress or the Rules Advisory Committee should change this.

If the trustee objects to a claim, the judge gives the creditor notice and provides it a right to be heard. The creditor’s filed proof establishes the claim and the trustee must carry forward the burden of disproving the claim. Once the trustee introduces contrary evidence, however, the creditor must assume the ultimate burden to persuade. If the evidence becomes testimonial or complex, the matter may shift to full adversary treatment.

The judge must consider a number of factors in deciding whether to allow claims. First, claims unenforceable against the debtor or the debtor’s property are disallowed. The trustee accedes to all the bankrupt’s defenses. If applicable law bars the claim because of the running of the statute of limitations, fraud, or failure of consideration, then the claim will be disallowed. Similarly, if the security interests are illegal, the judge will disallow claims based on them. Unmatured and contingent claims are allowed, but if their liquidation will delay closing the estate the judge will estimate their value.

Second, the judge will disallow claims for unmatured interest. Interest accrues until the date bankruptcy begins, but to ease administration and to avoid varying rates distorting equal distribution, no interest will be computed after filing. This includes interest not obvious initially such as unearned interest on a discounted note. The Code carries forward the holding in City of New York

655. Id. § 502(a).
656. 3 COLIER, supra note 510, ¶ 502.01[3], at 502-19 (bursting bubble theory of presumptions in MCCORMICK'S HANDBOOK OF THE LAW OF EVIDENCE § 345(A) (E. Cleary ed. 1972)).
658. Id. § 541(e).
659. See, e.g., U.C.C. § 9-204(3).
661. Id. § 502(c).
662. Id. § 502(b)(2). But cf. id. § 726(a)(5) (allowing interest from date of filing).
by refusing to allow postpetition interest on tax claims. Fully secured creditors, however, will receive contractual or statutory interest to the date they are paid provided sufficient collateral to pay it exists.665

Third, the judge will disallow claims that the creditor could offset against a debt that the creditor owes the bankrupt.666 Another part of the Code, however, says that a claim subject to setoff is an allowed secured claim.667 Collier's suggests resolving the conflict in favor of the last part added to the Code, and ignoring the later section that disallows the claim the creditor could offset.669

Fourth is a provision that relates only to unsecured ad valorem property taxes. The judge should not allow such taxes to the extent they exceed the value of the estate's interest in the property.670 Instead of abandoning the asset, the trustee may seek to disallow the excess of tax over the asset's value to the estate. The disallowed claim is not entitled to priority or general status.671

Fifth, unreasonable claims for the services of a lawyer or an insider are disallowed.672 The subsection deals with services of any kind and supplements the provisions for upsetting or reducing excessive filing fees.673 This prevents insiders and their attorneys from inflating claims to loot a failing business.

Sixth, claims for unmatured, nondischargeable family support debts are disallowed.674 If the bankrupt owes periodic family support, the future payments excepted from discharge are disallowed; the creditor may proceed against assets the bankrupt acquires after the case is closed. Arrearages, however, are allowable and, therefore, share in the estate. If the creditor fails to file proof of

666. Id. § 553.
667. Id. § 502(b)(3).
668. Id. § 506(a).
669. 3 COLLIER, supra note 510, ¶ 502.02[3].
671. Id. § 507(a)(6) (priority to allowed tax claims); id. § 726(a)(1) (distribution of allowed and priority claims).
672. Id. § 502(b)(5); see id. § 101(25) (defines "insider").
673. Id. § 329; R. BANKR. P 220.
them, the bankrupt may file.\textsuperscript{675}

The Code limits the allowable claims of landlords and victims of breached employment contracts.\textsuperscript{676} Both the landlord and the victim should reallocate their resources after bankruptcy. Although Congress recognized that landlords of bankrupt tenants should be compensated, it realized also that allowing the entire amount of a long-term lease could wipe out the estate to the detriment of general creditors.\textsuperscript{677} Accordingly, the landlord’s allowable claim from a terminated real estate lease is limited to the greater of one year’s unaccelerated rent or fifteen percent of the lease value, not to exceed three years’ unaccelerated rent plus rent that is unpaid and due.\textsuperscript{678} The legislative history from both the Senate and the House proclaim that the venerable \textit{Oldden v. Tonto Realty Corp.}\textsuperscript{679} remains viable, indeed vital.\textsuperscript{680} The court in \textit{Oldden} stated that if the landlord holds a security deposit, it will be deducted from the allowable claim, not the total claim for damages under the lease.\textsuperscript{681} Moreover, if the security deposit exceeds the allowable claim, the excess will become an estate asset. For the same policy reasons, an employee’s allowable claim for a terminated employment contract is limited to a claim for an unaccelerated one-year’s compensation plus unpaid compensation due.\textsuperscript{682}

Another standard for allowability deals with employment tax claims.\textsuperscript{683} If a business pays the state unemployment insurance fund too late to take the federal credit and then becomes bankrupt, the court will disallow the federal government’s claim for taxes to the extent that the bankrupt’s credit is reduced. Congress apparently felt that creditors of failing businesses should not be penalized because the business paid wages instead of unemploy-

\textsuperscript{675} Id. § 501(c); Interim R. Bankr. P 3004.
\textsuperscript{678} 11 U.S.C.A. § 502(b)(7) (West Supp. 1979); see id. § 365(b)(2).
\textsuperscript{679} 143 F.2d 916 (2d Cir. 1944).
\textsuperscript{681} 143 F.2d at 921.
\textsuperscript{682} 11 U.S.C.A. § 502(b)(8) (West Supp. 1979); see id. § 507(a)(3) (wage priority).
\textsuperscript{683} Id. § 502(b)(9).
ment taxes. The government's disallowed claim does not share in the estate at all.

Finally, the judge will disallow a creditor's claim when that creditor has lost a proceeding to set aside a transfer but has not complied with the decision. If the judge determines that the creditor should either turn over property to the estate or pay an equivalent amount to the estate, the creditor's otherwise appropriate proof will be disallowed until the creditor complies. This is a coercive tool, short of contempt or a decretal transfer, to collect the estate's property. Creditors no longer may avoid bankruptcy court jurisdiction in the trustee's actions to recover improper transfers by failing to file claims. This provision strengthens the policy of expanded jurisdiction by insisting that creditors comply with other court orders before the court will allow their claims.

Several types of claims are allowable even though they do not arise or mature until after the bankruptcy petition. First, after an involuntary petition is filed, the debtor may continue to operate. If the judge upholds the petition and enters an order for relief, obligations the bankrupt incurred in the ordinary course between the petition and the order for relief are allowable claims. These claims are entitled to be paid in the second priority. Second, if the trustee rejects a bankrupt's executory contract or unexpired lease, the '78 Code gives the nonbreaching party an allowable prepetition claim as of the date of bankruptcy. Third, if the trustee or the bankrupt avoids a creditor's lien or offset, the Code grants the former lienor or offsetting creditor a prepetition allowable claim. Finally, the Code provides allowable prepetition status for priority tax claims even though they arise after the

686. The creditor may be required to return the debtor's property to the estate based upon one of the turnover or transfer avoidance sections of the Code. Id. §§ 522(f), 542, 543, 545, 547, 548, 549, 550, 553.
689. Id. § 507(a)(2).
690. Id. §§ 365, 502(g).
691. Id. §§ 522(i), 550, 553.
692. Id. § 502(h).
693. Id. § 507(a)(6).
Claims once allowed are not res judicata, perpetuated as error in the interest of finality. Allowed claims "may be reconsidered for cause." This gives the previous decision a law of the case effect. The judge, however, should allow the affected creditor an opportunity to argue that "cause" to reconsider is absent. The trustee should be required to show new evidence or another compelling reason for finding the earlier decision incorrect. Reconsideration must occur before the bankruptcy case is closed; however, after the creditors receive their distributions, it may be too late to put it back together again.

VII. CODEBTORS: PROOF AND ALLOWANCE

Codebtors will be discussed separately from other creditors because of the discrete problems they raise. A codebtor may be anyone who tells the creditor, "if not the debtor, me." It includes anyone jointly or secondarily liable as a surety, guarantor, or endorser and it includes a person who has secured a creditor with collateral but without personal liability. The debtor's bankruptcy discharge will not release a codebtor but it discharges the debtor's debt to both the creditor and the codebtor.

When the debtor files bankruptcy, the creditor may or may not file proof of claim. When the creditor fails to file a timely proof of claim, the codebtor may file. The present rule allows the codebtor to file after the first creditors' meeting, even though the creditor itself still may file; but if the creditor files after the codebtor, that proof supersedes the codebtor's. This avoids the "double" recovery that would result from two dividends measured by the same debt.

694. Id. § 502(i).
695. Id. § 502(j). The provision does not deal with whether to allow a previously disallowed claim.
698. But see id. 307.
700. Id. § 501(b).
702. The rule ignores the related problem of proofs filed by two or more primarily obligated codebtors.
When the codebtor pays the creditor either before or after bankruptcy begins, the codebtor becomes the creditor; the codebtor either subrogates to the principal creditor's claim as the bankrupt's creditor or the creditor assigns the claim to the codebtor. The former creditor's claim is eliminated and, therefore, no double recovery occurs. The codebtor files proof of claim in his own name and receives whatever distribution the estate produces.\textsuperscript{703}

Two situations create problems in allowing the codebtor's claims: when the creditor recovers from the codebtor, and the subrogated codebtor files proof; and when the creditor fails to file proof and the codebtor files. In each, the codebtor files proof to achieve whatever recovery the bankruptcy estate will provide to reduce his loss to the creditor. The codebtor who pays the creditor in full subrogates to the creditor's claim against the bankrupt debtor and receives whatever the estate would have paid the creditor.\textsuperscript{704}

The codebtor who pays the creditor in part must stand behind the creditor in the debtor's bankruptcy; the creditor may prove the entire claim and collect from the estate until the codebtor's part payment and the bankruptcy distribution pay the claim in full. Then the codebtor, claiming partial subrogation, may take any further dividends from the estate.\textsuperscript{705}

Claims are allowed unless someone objects; the codebtor's claim is allowable as if it "had become fixed before" the petition was filed.\textsuperscript{706} This accommodates the codebtor's possible secondary or contingent liability. The codebtor takes the creditor's claim with all its burdens, and if the creditor's basic claim is not allowable the codebtor's claims likewise will be disallowed.\textsuperscript{707} Because the codebtor may not share in the bankruptcy distribution until the creditor is fully paid, the judge will delay consideration of the allowability of contingent codebtors' claims.\textsuperscript{708} This recognizes the difference between the codebtor and the creditor whose claim is


\textsuperscript{705} Alternatively, the creditor holds the excess as trustee for the codebtor. Textile Banking Co. v. Widener, 265 F.2d 446 (4th Cir. 1959); Swarts v. Fourth Nat'l Bank, 117 F. 1 (8th Cir. 1902).

\textsuperscript{706} 11 U.S.C.A. §§ 502(a), (e)(2). See also id. § 502(c).

\textsuperscript{707} Id. § 502(e)(1)(A); see id. § 502(d).

\textsuperscript{708} Id. § 502(e)(1)(B).
merely uncertain in amount. The codebtor’s claim becomes fixed and noncontingent when he pays the creditor and establishes his right to be paid by the debtor. For allowance purposes, however, codebtors who pay the creditor after the bankruptcy petition and file a claim to be reimbursed are considered to hold prepetition claims.709 The subrogating codebtor’s claim may be disallowed for the same reasons the codebtor’s claim is disallowed.

The codebtor must choose either to file as a codebtor or to pay the creditor and subrogate to the creditor’s rights. The judge will disallow a codebtor’s claim if it seeks to be subrogated to the creditor’s rights without paying the creditor.710 If the codebtor is secured as codebtor, then a codebtor’s claim will be preferable. If the creditor is secured in the debtor’s property and paying the creditor will subrogate the codebtor to the creditor’s security,711 then subrogation is best for the codebtor. The codebtor’s claim against the bankrupt debtor will be discharged regardless of whether it is a codebtor’s or a subrogated claim.712 The limitations on the codebtor’s right to have its claim allowed have been discussed. The subrogating codebtor’s claim may be disallowed for similar reasons. The subrogated codebtor may take nothing from the debtor’s bankrupt estate until, between the codebtor and the estate, the creditor is paid completely713 This prevents the creditor and the codebtor from competing for the estate’s limited assets,714 and may advance the reason for the codebtor assuming liability715

American Surety Co. v. Sampsell,716 addresses this issue. In that case, the Bond Company bonded the Construction Company against labor and material claims on a construction contract. After several labor and material creditors failed to satisfy the prerequisites to recover on the bond, the Construction Company went bankrupt. The Bond Company paid other labor and material credi-

709. Id. § 502(e)(2).
710. Id. § 502(e)(1)(C); see id. § 509.
711. Sauve v. Fleschutz, 219 F. 542 (8th Cir. 1915).
716. Id.
tors, subrogated, and filed a claim. The Bond Company and the unpaid labor and materials creditors competed for the bankrupt Construction Company’s assets.

The court held that the estate should ensure that all labor and material creditors were paid in full before paying anything to the Bond Company. The Bond Company was postponed until all the creditors protected by the bond were paid in full. This advanced the policy of requiring the bond. The labor and material creditors were intended to be beneficiaries of the bond, and the Bond Company was in the business of accepting consideration to assure payment of labor and material creditors when construction companies defaulted. The Bond Company argued in Sampsell that the labor and material creditors who failed to satisfy the prerequisites to recover on the bond should not be paid first from the estate. The Court, however, insisted that they too were in the group protected by the bond.717

A. Subordination

Although the ‘98 Act did not provide for subordination, the courts developed two types, equitable subordination and subordination agreements; the ‘78 Code includes both. The bankruptcy courts, acting through their equitable jurisdiction, developed the concept of equitable subordination.718 For example, in Taylor v. Standard Gas & Electric Co.,719 the Supreme Court subordinated a parent company’s claim against its subsidiary to the subsidiary’s preferred shareholders because of “the history of spoliation, mismanagement, and faithless stewardship of the affairs of the subsidiary by Standard to the detriment of the public investors.”720 This “Deep Rock” doctrine allowed the bankruptcy court to subordinate, defer, or disallow claims and to transfer liens721 to the estate to enforce insider obligations to the corporation, shareholder-

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717. Id. at 273-74.
720. Id. at 324; see Pepper v. Litton, 308 U.S. 295, 308 (1939).
721. Transferring liens to the estate is accomplished by subrogating the trustee to the lienor’s lien.
The '78 Code provides for equitable subordination. Congress intended the new statute to "codify case law." Subordination only may follow notice and a hearing. The court may subordinate "all or part of an allowed claim" to other claims or transfer a lien securing a subordinated claim to the estate. Courts have limned the standards for subordination imprecisely: "The claimant must have engaged in some type of inequitable conduct. The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant. Equitable subordination must not be inconsistent with the provisions of the Bankruptcy Act." Whether the courts will follow Professor Countryman's suggestion and move subordination out of the business arena to disallow debts based on unconscionable consumer contracts and improvident extensions of credit remains to be seen.

Despite the '98 Act's silence, subordination also was recognized by the courts' enforcement of subordination agreements. Viewing consensual priority as more important than distributing the estate equally to creditors, the courts paid the subordinated creditor's dividend to the senior creditor. The '78 Code follows these decisions; bankruptcy courts enforce a subordination agreement in liquidation proceedings "to the same extent that such agreement is enforceable under applicable nonbankruptcy law." Creditors may contract for inequality and bankruptcy courts will recognize their agreements.

Subrogation is related to subordination. The court will deny a codebtor's request to subrogate when the codebtor has agreed to subordinate. Equitable subordination is broader than subordination by agreement but the codebtor still will be denied subrogation when the creditor's claim would have been subordinated for equi-

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726. Countryman, supra note 6, at 431.
728. See, e.g., In re Wyse, 340 F.2d 719 (6th Cir. 1965) (Canadian bankruptcy paid subordinated creditor's dividend to senior creditor).
VIII. Liquidation of the Estate

The Code directs the trustee to reduce the property of the estate to money. The section that governs liquidation also applies to ongoing businesses in the process of rehabilitation. Sales under the '78 Code will be conducted by the trustee acting as the vendor unless following notice, a party requests a hearing. Notice should be written and creditors should be allowed ample time to raise money and inform others. It is in everyone's interest that the property realize as much as possible.

The '78 Code simplifies bankruptcy sales dramatically. Formerly, sales were auctions open to the public. They were advertised in advance and sales were on cash terms. The judge had to confirm the sales before they became final. The '78 Code only requires the trustee to give notice of the sale. Collier's calls this a "radical change," notes that these sales may not be "viewed as being entitled to the full dignity of a judicial sale," and suggests a formal hearing to obtain judicial approval of the notice and sale. This is unnecessary because the sale is purely administrative and the procedure is contemplated by the Code. The UCC, however, reduces formality when a creditor sells repossessed collateral. What formality the new rules will require for bankruptcy sales remains to be seen.

The trustee may sell collateral free of a lien under any one of several circumstances: when nonbankruptcy law permits it; when the creditor consents; when the collateral will realize enough to pay the lien and generate a surplus; when the parties dispute whether the lien is valid; or when a nonbankruptcy court could compel the

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730. Id. § 704(1).
731. Id. § 363.
732. Id. §§ 102(1), 363(b). Rules 203(a) and 701(3) continue in effect, requiring 10 days notice and commencing an adversary proceeding. R. BANKR. P 203(a), 701(3).
733. R. BANKR. P 606.
735. 2 COLLIER, supra note 70, ¶ 363.03.
creditor to accept money for its interest.\textsuperscript{738} Fully secured creditors may be reduced to asking to have their security interest attach to the proceeds.\textsuperscript{739} Creditors with valid liens may bid the amount of their debt and offset the debt against the selling price.\textsuperscript{740}

The trustee also may sell the estate’s property free of a coowner’s interest or any dower or curtesy right.\textsuperscript{741} Such sales are so hedged with restrictions that they will be uncommon under the ’78 Code. Virginia entireties property normally will be exempt.\textsuperscript{742} Even if nonexempt, the trustee may sell jointly owned property only if partition is impractical, selling free of the nonbankrupt’s interest will realize more than selling an undivided interest, and the benefit of selling free of the nonbankrupt’s interest outweighs the detriment to the nonbankrupt joint owner.\textsuperscript{743} If the trustee sells jointly owned property or property subject to dower or curtesy, the spouse or coowner may wait until before the sale is consummated and purchase or redeem the property at the sale price.\textsuperscript{744} The joint owner receives a share of the proceeds when a third party buys and may be charged with the proportionate cost of the sale, but the coowner need not compensate the trustee.\textsuperscript{745}

\begin{itemize}
\item \textsuperscript{738} Id. § 363.
\item \textsuperscript{740} 11 U.S.C.A. § 363(k) (West Supp. 1979). Their right to bid is not affected by the division between allowed secured and unsecured claims under § 506(a) and they may bid the entire debt. Id. § 506(a); 124 Cong. Rec. H11,093 (daily ed. Sept. 28, 1978); 124 Cong. Rec. S17,409 (daily ed. Oct. 6, 1978). The Senate Report indicates that § 506(a) valuation would not limit the bidding right, and that a bid at sale “would be determinative of value.” S. Rep. No. 989, supra note 20, at 56, reprinted in Ad. News, supra note 20, at 5842. Cf. id. at 68, reprinted in Ad. News, supra note 20, at 5854, where the report utilizes a “valuation early in the case under sections 361-363” as an example of variability of valuation, and states, “[t]hroughout the bill, references to secured claims are only to the claim determined to be secured under this subsection, and not to the full amount of the creditors claim.” The Senate Report seems to be inelictously phrased.
\item \textsuperscript{741} 11 U.S.C.A. §§ 363(g), (h) (West Supp. 1979).
\item \textsuperscript{742} Id. § 522(b); Va. Code § 34-3.1 (Cum. Supp. 1979); see notes 166-69 supra & accompanying text.
\item \textsuperscript{743} 11 U.S.C.A. §§ 363(h)(1) to (3) (West Supp. 1979). See also id. § 363(h) which applies to public utilities.
\item \textsuperscript{744} Id. § 363(i).
\item \textsuperscript{745} Id. § 363(j).
\end{itemize}
A. Final Distribution

To conclude this survey of creditors’ rights, let us descend the ladder of creditors. On the top rung stands the valid, indefeasible lienor: the creditor with the perfected consensual security interest or the judgment lien filed outside the ninety days preceding bankruptcy. The priority creditors are next. They are, in order: administrative expenses; involuntary gap creditors; wage, salary, and commission creditors; employee benefit contribution claimants; prepaying consumers; subordinated tax lienors; and tax and customs duty claimants. After paying the priority creditors, the trustee flings her largesse to the great unwashed mass of general creditors: doctor, lawyer, merchant, paper carrier, government, diaper services, and credit card company. First are the timely-filed and allowed general claims. Congress even goes further and tells the trustee how to divide the estate in the exceptional bankruptcy when someone discovers oil or gold on the estate’s property. In rough order, this estate is divided among general creditors who filed tardy claims; subordinated creditors; and creditors owed fines, penalties, and multiple or punitive damages. Finally, the trustee will pay postpetition interest at the legal rate on all the preceding general claims before giving any surplus to the bankrupt.

IX. Discharge

The discharge in bankruptcy, as Judge Friendly said, “is ‘social legislation’ of the greatest consequence.” Unlike old age survivors insurance and food stamps, the bankruptcy discharge is not a transfer payment filtered through a government mechanism. This discharge does not create or destroy wealth because the resources or services exist or are consumed just the same. The discharged

746. Id. § 506. Fully secured creditors recover from the collateral and receive no dividends from the estate. Id. §§ 507(a), 726(a)(2).
747. Id. §§ 507(a)(1), 726(a)(1).
748. Id. § 726(a)(2).
749. Id. § 726(a)(2)(C).
750. Id. § 510(c).
751. Id. § 726(a)(4).
752. Id. §§ 726(a)(5), (6).
753. Fallick v. Kehr, 369 F.2d 899, 906 (2d Cir. 1966) (dissent).
bankrupt receives something for which others pay. Bankrupt discharge redistributes wealth by extinguishing the bankrupt's obligation to pay.

There ain't no free lunch, and we must ask, who does pay for the bankrupt's discharge. Bankruptcy spreads the cost of failure. Creditors pay when the number of bankruptcies rise and the cost is not included in the interest rate. If the creditor has a market mechanism, other customers pay. Finally, if the creditor takes the bad debt tax deduction, all taxpayers pay indirectly. Economic trends affect bankruptcy losses more than legal doctrine, and observers find it difficult or impossible to measure the way legal change causes conduct to change. Some of the loss may be revealed indirectly in the form of more prudence in extending credit and fewer improvident loans.

Discharge underlies the fresh start policy. Congress rejected the notion that allowing a bankrupt to avoid paying just debts threatens the nation's collective moral fiber. The idea of a fresh start has broad connotations. It is related to the idea that bankruptcy is due to things beyond the individual's control, like economic trends, illness, and unemployment. The Commission thought that discharges would rehabilitate enervated debtors, restore them to productive activity, allow them to be more effective consumers in the future, and thereby boost the economy.

Courts often have said that bankruptcy provides relief and a fresh start for the honest debtor. What kind of honesty are the courts referring to? Should the debtor have a fresh start at the expense of especially deserving creditors? Any discharge releases the bankrupt from just debts, and discharging contract debts approves breaking promises. If the purpose of the discharge is to rehabilitate the bankrupt, should we waste the discharge on reprobates? What type of procedural mechanism should be devised to distinguish the improvident, the unfortunate, and the stupid from the deceitful and the crooked? An examination of complete bars to

754. I.R.C. § 166.
757. See, e.g., Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).
discharge, bars to dischargeability of certain debts, and the effect of the discharge follows.

A. *Bars to Discharge*

Bars to dischargeability \(^{789}\) limit the effect of the discharge. Some of the bankrupt’s debts remain valid after bankruptcy. Undischargeable debts have moral and policy underpinnings; they single out classes of claims like taxes and family support obligations that survive bankruptcy. They say that even bankrupts should pay these creditors. Total bars to discharge \(^{789}\) also focus on the dishonest or uncooperative bankrupt by forcing him to cooperate and disclose fully or emerge from bankruptcy stripped of property, but still owing the balance of all his debts.

The Code denies a discharge to a bankrupt who, within the year preceding bankruptcy while intending to hinder, delay, or defraud a creditor or the trustee, transfers, removes, mutilates, conceals, or permits another to transfer, remove, mutilate, or conceal the bankrupt’s or the estate’s property.\(^{760}\) This bar to discharge is related to fraudulent conveyances, but is both broader and narrower. It is broader because it includes concealment, removal, and mutilation; it is narrower because it insists on actual fraudulent intent. Preferences do not bar discharge under this provision. The gravamen of this bar is wrongful conduct that depletes the estate.

Bankrupts may be barred from discharge if they conceal, destroy, mutilate, falsify, or fail to retain records necessary for the trustee to ascertain the bankrupt’s business history and condition.\(^{761}\) The trustee should receive all of the bankrupt’s books.\(^{762}\) Congress intended this provision to put teeth in the bankrupt’s duty to the trustee. The standard is flexible. Failure to keep records, the Code says, may be “justified under all the circumstances of the case.”\(^{763}\) Whether the bankrupt kept books in an acceptable manner, moreover, “is a question in each instance of

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\(^{759}\) Id. § 727.
\(^{760}\) Id. § 727(a)(2).
\(^{761}\) Id. § 727(a)(3).
\(^{762}\) Id. § 521(3). *See also id.* § 727(a)(4)(D); 18 U.S.C.A. § 152 (West Supp. 1979).
reasonableness in the particular circumstances."\textsuperscript{764} Courts often deny discharges to gamblers for failing to keep records of their transactions.\textsuperscript{765} This may cloak passing moral judgment on the bankrupt's way of life in statutory terms. Courts forgive wage earners and consumers from the duty to keep accurate books.\textsuperscript{766} Any acquaintance with bankruptcy will convince the observer that failing to budget intelligently and to keep adequate records is associated with financial difficulty. Denying discharges, however, would exacerbate the difficulty with scant educational effect. As Robert Frost wrote in "The Hardship of Accounting":

\begin{quote}
Never ask of money spent 
Where the spender thinks it went 
Nobody was ever meant 
To remember or invent 
What he did with every cent.
\end{quote}

The court may deny a discharge to a bankrupt who "knowingly and fraudulently, in or in connection with the case made a false oath or account."\textsuperscript{767} The bankrupt must know that the statement was false and intend that it deceive. The matter may be either a statement or omission. Commonly it occurs either in the schedules filed or during the course of the proceedings. For example, the bankrupt may fail to schedule property and then lie about it under oath at a meeting or turnover hearing.\textsuperscript{768}

The next bar to discharge supplements and complements failure to keep books. It denies a discharge to a bankrupt who cannot explain satisfactorily why he lacks assets to pay his debts.\textsuperscript{769} This bar is two pronged; it insists that the bankrupt explain both where the assets went and why there is not enough to go around. Courts have

\textsuperscript{764} In re Underhill, 82 F.2d 258, 259-60 (2d Cir.), cert. denied, 299 U.S. 546 (1936).
\textsuperscript{765} See, e.g., McBee v. Sliman, 512 F.2d 504 (5th Cir. 1975); Klein v. Morris Plan Indus. Bank, 132 F.2d 809 (2d Cir. 1942).
\textsuperscript{766} See, e.g., Morris Plan Indus. Bank v. Henderson, 131 F.2d 975 (2d Cir. 1942).
\textsuperscript{768} Bankrupts who knowingly and fraudulently use or present false claims in or in connection with their bankruptcies will be denied discharges. 11 U.S.C.A. § 727(a)(4)(B) (West Supp. 1979). Also bankrupts who knowingly and fraudulently seek to obtain a pecuniary advantage on the promise of same for "acting or forebearing to act" will not be discharged. Id. § 727(a)(4)(C); cf. 18 U.S.C.A. § 152 (West Supp. 1979) (fines and imprisonment). This bar is much reduced; it applies only to the bankrupt's particular case.
not defined in detail what exactly is enough to "explain satisfactorily." If defunct businesses could explain insolvency, they might have prevented bankruptcy. Consumer bankrupts often explain their problems with glittering generalities like "mismanagement." Courts cannot read the statute's language literally. This provision is valuable for examining a bankrupt who is not required to keep books; some bankrupts' situations, even absent detailed accounting, speak for themselves. Courts should interpret this bar in light of its purpose, to discharge the silly or stupid but to bar or to smoke out the dishonest or recalcitrant.

The ability to bar discharge also constitutes a backup for the court's power to coerce with contempt; the judge may deny a discharge to a bankrupt who refuses to obey a lawful court order. This may be an order to appear, to obey a subpoena, to produce material, or to answer a question. The order must be lawful, which means correct. The bankrupt may show that he is unable to comply. Changing prior law, the Code now provides that a bankrupt who properly invokes the privilege against self-incrimination may not be denied a discharge. A bankrupt who is granted immunity, however, must testify or be barred from discharge. Other evidentiary privileges seem to be included in the requirement that the bankrupt must answer a material question that the judge approves. If the witness properly invokes a privilege, the judge should refuse to approve the question.

Who may be denied a discharge? First, Congress intended to prevent trafficking in corporate shells; only persons can receive a discharge. Thus, only people who are otherwise eligible for discharge may be denied one. Most bars to discharge refer to the bankrupt's conduct in or preceding his particular discharge. Indi-

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773. Id. § 521(4).
776. Id. § 727(a)(6)(C).
777. Id. § 727(a)(1); H.R. REP. No. 595, supra note 27, at 384, reprinted in Ad. News, supra note 27, at 6340.
viduals who are insiders\textsuperscript{778} are treated differently. Bankrupts who are insiders in bankrupt firms and who do something in the firm's bankruptcy that would bar discharge are barred from discharge in their individual bankruptcies.\textsuperscript{778}

Congress also uses bars from discharge to advance the policy of preventing too frequent resort to bankruptcy to avoid debt. Bankrupts are allowed only one discharge every six years. Discharged bankrupts or bankrupts who have had chapter plans confirmed in cases commenced within the six years preceding the instant filing, measured filing to filing, will not be discharged.\textsuperscript{780} Bankrupts whose Chapter 13 plans have been confirmed within that period will not be discharged, however, unless they paid the unsecured creditors or made a good faith and largely successful effort to pay them.\textsuperscript{781}

B. Procedure for Challenging Discharge

A creditor or the trustee may object to discharge.\textsuperscript{782} Objections to discharge are governed by the adversary part of the present rules.\textsuperscript{783} If no one objects, the bankrupt is automatically discharged.\textsuperscript{784} An objector must proceed in a timely fashion.\textsuperscript{785} The objection will be adjudicated at a hearing or trial. The proponent must prove the elements of the objection by a preponderance of the evidence even when the conduct also is criminal.\textsuperscript{786} After one year, the need for repose and finality outweigh the need for correct


\textsuperscript{779}Id. § 727(a)(7). This provision is phrased so that the reader can only understand it by reading it with id. § 101(25)(B).

\textsuperscript{780}Id. § 727(a)(8).

\textsuperscript{781}Id. § 727(a)(9).

\textsuperscript{782}Id. § 727(c)(1); see id. § 704(5) (trustee's duty); id. § 727(c)(2) (court's role).

\textsuperscript{783}R. Baker. P 404(e), 701.

\textsuperscript{784}Id. 404(d).

\textsuperscript{785}Id. 404(a) (court fixes time to object).

\textsuperscript{786}Shanberg v. Saltzman, 69 F.2d 262 (1st Cir. 1934). Because of the differences in burden of proof: 1) a criminal conviction precludes relitigation by the bankrupt in a later objection to discharge; 2) a criminal acquittal would not preclude objectors from seeking to bar discharge; 3) a successful bar to discharge would not preclude the bankrupt from defending a later criminal prosecution; 4) and an unsuccessful bar to discharge should preclude a later criminal prosecution, although the differences in parties may mean that the objector's defeat does not bind the district attorney. See generally A. Vestal, Res Judicata/Preclusion V-366 to V-390 (1969).
decisions. The proponent must prove the facts essential to the objection.\textsuperscript{787}

The new rules supersede some of the '98 Act's presumptions for objecting to discharge. The objector must satisfy the burden to produce, adducing a prima facie case.\textsuperscript{788} The ultimate burden of proof never shifts to the bankrupt but because the bankrupt has access to most of the proof, the judge may impose the burden of going forward on the bankrupt. While the bankrupt must go forward with the evidence, the objector bears the ultimate risk of nonpersuasion.\textsuperscript{789} Thus, it is now more difficult for the objector to show a reasonable basis for barring discharge; the objector may no longer shift the burden of proof to the bankrupt and sit back while the judge bars discharge because he disbelieves the bankrupt.\textsuperscript{786}

The bankrupt's discharge also may be revoked.\textsuperscript{791} A party entitled to object should request revocation. The court, after notice and a hearing, should revoke if the bankrupt obtained the discharge through intentional fraud which the objector previously did not know about; the bankrupt acquired estate property, for example by inheritance,\textsuperscript{792} and failed to report it;\textsuperscript{793} or the bankrupt, after being discharged, refused to obey a court order or answer a proper question.\textsuperscript{794} The objector has only one year from the entry of discharge to ask the judge to revoke a discharge for fraud.\textsuperscript{795}

C. Debts Excepted from Discharge

Because Congress made a series of policy decisions about the nature of classes of obligations, bankruptcy does not discharge a bankrupt from certain specific debts.\textsuperscript{786} The '78 Code consolidates these exceptions into one section\textsuperscript{787} in contrast with the '98 Act,

\textsuperscript{787} R. Bankr. P 407.
\textsuperscript{788} Id.
\textsuperscript{789} Id. 407, 917; Fed. R. Evid. 301, 1101.
\textsuperscript{790} Cf. Morris Plan Indus. Bank v. Schorn, 135 F.2d 538 (2d Cir. 1943) (requiring bankrupt to explain absence of funds).
\textsuperscript{793} Id. § 727(d)(2).
\textsuperscript{794} Id. § 727(a)(6).
\textsuperscript{795} Id. § 727(e)(1); R. Bankr. P 924.
\textsuperscript{797} Id.
which used both the provability concept\textsuperscript{798} and the exceptions section.\textsuperscript{799} The Code defines “claim” broadly to permit comprehensive relief for the bankrupt\textsuperscript{800} and discharges all claims save those specifically excepted, even though the creditor fails to file the claim and even though the claim, if filed, is disallowed.\textsuperscript{801}

Taxing authorities are involuntary creditors and most tax debts are nondischargeable.\textsuperscript{802} Bankruptcy does not discharge the following taxes: prepetition taxes entitled to priority;\textsuperscript{803} taxes that arise between the filing of an involuntary petition and the order for relief;\textsuperscript{804} taxes for which the bankrupt was required to file a return but either did not file or filed after the return was due but within two years of the beginning of bankruptcy;\textsuperscript{805} and taxes based on a fraudulent return or tax evasion.\textsuperscript{806} Interest on the tax claim accrues until bankruptcy,\textsuperscript{807} and the bankrupt owes postbankruptcy interest on nondischarged tax debts.\textsuperscript{808} Generally, bankruptcy will not discharge excise and income taxes less than three years old, taxes required to be collected and withheld, and income taxes that are assessable but not assessed more than 240 days before the petition is filed.\textsuperscript{809} The sovereign preserves its nondischargeable tax debt without filing a claim,\textsuperscript{810} and it may collect nondischarged taxes from the bankrupt’s exempt property.\textsuperscript{811} Bankruptcy does discharge property taxes more than one year old,\textsuperscript{812} income taxes dating beyond three years before the bankruptcy petition is


\textsuperscript{802.} Id. § 523(a)(1).

\textsuperscript{803.} Id. §§ 507(a)(2), (6).

\textsuperscript{804.} Id. § 523(a)(1)(A).

\textsuperscript{805.} Id. § 523(a)(1)(B).

\textsuperscript{806.} Id. § 523(a)(1)(C). See also United States v. Sotelo, 436 U.S. 268 (1978).

\textsuperscript{807.} See, e.g., I.R.C. § 6601.

\textsuperscript{808.} Bruning v. United States, 376 U.S. 358 (1964).


\textsuperscript{810.} But the debtor or trustee may file. 11 U.S.C.A. § 501(c) (West Supp. 1979).

\textsuperscript{811.} Id. § 522(c)(1).

\textsuperscript{812.} Id. § 507(a)(6)(B).
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filed, and excise taxes in which the bankrupt's return is due earlier than the three years before the petition is filed.

The bankrupt also emerges from bankruptcy owing debts based on false pretenses, false representations, or false financial statements. This is the single largest headache for the bankrupt's attorneys. The Code changes prior law slightly by codifying the requirement that the creditor must reasonably rely on the fraudulent statement. If the bankrupt obtains value, including services, or an extension, renewal or refinancing of credit by actual fraud, a fraudulent representation, or false pretenses, that liability will not be discharged. Adding "services" changes decisions under the '98 Act. The fraud required for this exception to discharge must be actual, based on knowing misrepresentations. A creditor cannot reasonably rely on a statement it knows to be false.

The problem of the debtor who silently purchases on credit while perhaps not intending to pay will continue to trouble the courts. Many of these debts will be based on prebankruptcy credit card "sprees" and NSF checks. Some will argue that an overt misrepresentation is unnecessary when the debtor is hopelessly insolvent. Fraudulent intent is evident from numerous small credit card purchases that cumulatively exceed the limit on credit. Others will assert that failure to disclose insolvency is not a false representation and that, if it had intended to bar discharge, Congress should have followed the Commission and singled out debts incurred without intending to pay and in contemplation of bankruptcy. The problem with the Commission's proposal is that it would invite creditors to litigate on very slim evidence of fraud. The National Bankruptcy Conference discounted the spree-NSF problem and said that the Commission's proposal was "using an elephant gun to kill a flea." Because Congress apparently re-

813. Id. § 507(a)(6)(D).
814. Id. § 507(a)(6)(E). See also id. § 507(a)(6)(F) (customs duties).
815. Id. § 523(a)(2); see Zaretsky, The Fraud Exception to Discharge Under the New Bankruptcy Code, 53 AM. BANKR. L.J. 253 (1979).
817. Gleason v. Thaw, 236 U.S. 558 (1915) (legal services are not property excepted from discharge under the '98 Act).
818. U.C.C. § 2-702, Comment 2; 3 COLLIER, supra note 510, ¶ 523.08[4].
819. COMMISSION REPORT, supra note 4, Part I, at 176.
jected the Commission's proposal, credit card-NSF check creditors should show more overt evidence of fraud and misrepresentation than an insolvent bankrupt and a simple debt. 821

Bankrupts will continue to owe debts obtained with a false financial statement. 822 The creditor must show that the bankrupt, intending to deceive, used a materially false written statement in describing his financial condition to obtain the debt and that the creditor did reasonably rely on the statement in extending credit. 823 Congress included in this exception from discharge, the false financial statement of an "insider" relied upon by creditors in extending credit to a business. 824 The Code, continuing to ameliorate the effect of using a false financial statement, deals with both business and consumer cases by excepting the particular debt obtained from discharge instead of barring discharge altogether.

The false financial statement was the most litigated exception under the '98 Act and this probably will continue to be true under the '78 Code. Several issues will trouble factfinders: Was the statement substantially defective? Did the debtor know it? Did the creditor know that it was false? Was the creditor's reliance reasonable? Did the creditor rely on the statement in whole or in part, or an independent credit check, or prior dealings? The court must focus on whether the debtor was honest and above-board as well as whether the creditor loaned providently

Debts that the bankrupt fails to list or schedule will continue to burden him after discharge. 825 This enforces the bankrupt's duty to "file a list of creditors." 826 Creditors deserve timely notice of the bankruptcy in order to file claims and bar discharge; if they lack both legal notice and actual knowledge, their debt is not discharged. The bankrupt should supply the name and mailing ad-

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825. Id. § 523(a)(3).
826. Id. § 521(1); R. Bankr. P 108; Official Bankr. Form 6.
dress of creditors so that the clerk may send each creditor notice of
the case and allow it to assert its rights. 827 The bankrupt may
amend the schedule after the trustee is selected, but the later-
scheduled creditor is entitled to file proof of claim and move to bar
discharge. 828 No one is certain what "actual notice" is. 829 Commu-
nication through the newspaper or by word-of-mouth is sufficient,
but whether the creditor who subscribes to a legal newspaper that
lists bankruptcies will be held to "know" everything in it is
unclear.

Debts that result from a bankrupt's larceny or embezzlement or
from a bankrupt fiduciary's fraud or defalcation will be excepted
from discharge. 830 We must distinguish fiduciary defalcation and
fraud from general false pretenses or representations discussed
above. Fiduciary capacity refers to express trusts and persons act-
ing as attorneys, executors, and guardians; it does not refer to
agents, brokers, and partners. 831 Defalcation encompasses more
than misappropriation and embezzlement. 832

Family support obligations are not dischargeable. 833 The Code
changes and clarifies prior law in several significant ways. Congress
adopted a federal standard of what constitutes alimony, mainte-
nance, or support instead of assuming that state law governs. 834
Thus, bankruptcy judges will develop uniform national standards
for determining whether property settlements, costs, attorneys’
fees, and orders to pay creditors are family support. The Code
ends sex discrimination by substituting "spouse" for "wife"; sup-
port due exhusbands from bankrupt wives will not be dis-
charged. 835 Family support obligations assigned to another entity

827. The bankrupt may state expressly that he does not know, but his interest demands
that he attempt to conquer ignorance first.
829. See U.C.C. §§ 1-201(25), (26), (27).
831. 3 COLLIER, supra note 510, ¶ 523.14[1][c].
832. Id. ¶ 523.14[1][b].
834. Id. § 523(a)(5)(B); H.R. Rep. No. 595, supra note 27, at 364, reprinted in Ad. News,
note 20, at 5865.
835. The discrimination was probably unconstitutional anyway under a Supreme Court
decision that struck down a statute providing alimony only for wives. Orr v. Orr, 440 U.S.
are dischargeable; bankruptcy will discharge arrearages owed if a spouse who is receiving welfare assigns the debt to a governmental agency. The Code excepts from discharge a debt "for willful and malicious injury to person or property." Willful means "deliberate or intentional." This provision relates to intentional torts such as assault, battery, false imprisonment, and alienation of affection as well as exacerbated breaches of contract. Congress did not intend to except from discharge liability for technical conversions and negligent torts; the legislative history rejects decisions that excepted debts based on the bankrupt's "reckless disregard" for the plaintiff. In examining a prior tort judgment against the bankrupt to determine whether liability is discharged, the court is not confined to the prior judgment and record; it may consider extrinsic evidence to determine whether the bankrupt's conduct was willful and malicious.

The bankrupt will continue to owe debts for fines, penalties, or forfeitures "payable to and for the benefit of a governmental unit." Previously, these debts were nondischargeable because they were unprovable. In the Code, Congress specifically excepted these liabilities from discharge by adopting the holding in Parker v. United States that compensatory contempt "fines" payable to wronged litigants may be discharged by requiring that the sum "benefit" the government. A contempt award, however,

837. Id. § 523(a)(6).
843. 11 U.S.C.A. § 523(a)(7) (West Supp. 1979). See also id. § 726(a)(4) (payment of these liabilities from the estate).
844. In re Moore, 111 F. 145 (W.D. Ky. 1901).
845. 153 F.2d 66 (1st Cir. 1946).
846. But cf. 3 Collier, supra note 510, § 523.17, at 523-129 n.1, 523-130 n.3 (citing criti-
may be nondischargeable if the bankrupt’s conduct was willful and malicious.\(^{847}\) Also, the dischargeability of tax penalties that actually represent the amount of tax due\(^ {848}\) will depend on whether the underlying tax is discharged.\(^ {849}\)

Discharge of educational debts is limited. Debts owed to or guaranteed by the government or owed to a nonprofit institution of higher education for educational loans generally are not discharged. The educational debt will be discharged if the debt first became due more than five years before bankruptcy or if continuing to owe debt “will impose an undue hardship.”\(^ {850}\) Students borrow money for education and enhance their future earnings; Congress apparently felt that those students should not be allowed to refuse to repay the debt from those enhanced earnings. Moreover, the scandal of recent graduates lining up for bankruptcy to discharge educational debts endangered the student loan programs. Other unsecured debts are discharged, however, even those for frivolous activities. The strong arguments on both sides led to compromise.\(^ {851}\) Congress aimed the provision at those who borrow, leave school, file bankruptcy, and assume well-paying jobs.

Finally, if the bankrupt still owes debts not discharged in a prior
bankruptcy because he waived or was denied a discharge, then the court will except those debts in a later bankruptcy. There are exceptions to this exception. If the prior debts were denied discharge in a second case because of the six-year bar from an earlier bankruptcy, they will be discharged in the third brought more than six years after the first. Nor are debts denied discharge in an earlier bankruptcy because of failure to pay filing fees excepted from discharge in a paid up second proceeding. Bankrupts may discharge other debts that were not discharged in a prior bankruptcy if the time or procedural bars to earlier discharge are satisfied in the second bankruptcy. These debts include taxes, unscheduled debts, priority wages, and student loans. Congress allows people to discharge debts not discharged in earlier bankruptcies when those debts do not reveal fraud, dishonesty, or refractoriness.

D. Dischargeability Procedure

Disputants seek a friendly forum. In basketball, this is called a "home court advantage"; in law, it often is referred to as jurisdiction. The bankruptcy court is the bankrupt's home court; bankruptcy judges are more familiar with the policies of bankruptcy than state judges. The creditor's home court is a state court of general or limited jurisdiction which is often a collection mill.

Several features of earlier law limited the effect of the discharge. Discharge was an affirmative defense to be asserted when the creditor chose to sue. Bankrupts also could reaffirm debts discharged in bankruptcy. The creditor sued where it felt most comfortable and could secure jurisdiction, and that court ruled on the effect of the discharge including whether the debt was discharged or reaffirmed. State judges, unsympathetic to bankrupts and unfamiliar with bankruptcy law, often ruled incorrectly that bankrupts still owed debts. The 1970 Amendments and the Rules of Bankruptcy Procedure attempted to ameliorate those abuses. The '78

856. See id.
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Code incorporates these reforms.

The '78 Code grants the bankruptcy court plenary jurisdiction to deal with bankruptcy issues.\textsuperscript{857} Proceedings to bar discharge must be brought in the bankruptcy court.\textsuperscript{858} When bankruptcy begins, the court will automatically stay creditors from collecting debts\textsuperscript{859} and fix the time for filing complaints to determine whether certain debts are discharged.\textsuperscript{860} A creditor who is owed a debt allegedly excepted from discharge because of the bankrupt's false statements,\textsuperscript{861} embezzlement, or larceny,\textsuperscript{862} or willful and malicious injury\textsuperscript{863} must file a complaint in the bankruptcy court to except that debt from the discharge.\textsuperscript{864} Creditors, even those with prebankruptcy judgments, who fail to file a timely complaint in the bankruptcy court will be barred from suing on the claim elsewhere.\textsuperscript{865} The type of litigation that overreached bankrupts in state court now is under the exclusive jurisdiction of the bankruptcy court.

If the creditor files a timely complaint in the bankruptcy court to bar discharge of a debt, the proceeding will be adversary.\textsuperscript{866} The creditor also may seek a judgment on the claim, and either the debtor or the creditor may request a jury.\textsuperscript{867} A decision in favor of the creditor that the bankrupt owes a nondischargeable debt will lead to an enforceable federal judgment. To discourage creditors from coercing settlement by filing or threatening to file to bar discharge of consumer debts the Code allows the court discretion to charge to an unsuccessful creditor the bankrupt's attorney's fees and costs.\textsuperscript{868}

\textsuperscript{857} 28 U.S.C.A. § 1471(b) (West Supp. 1979).
\textsuperscript{858} 11 U.S.C.A. § 727(c) (West Supp. 1979).
\textsuperscript{859} Id. § 362.
\textsuperscript{860} Off. Bankr. Interim Form 13.
\textsuperscript{862} Id. § 523(a)(4).
\textsuperscript{863} Id. § 523(a)(6).
\textsuperscript{864} Id. § 523(c); R. Bankr. P 404(d).
\textsuperscript{866} R. Bankr. P 409, 701-82.
\textsuperscript{867} Id. 409(b). The jury trial will be placed on the district court calendar. The jury will determine the liability issue but not dischargeability; there is no constitutional right to a jury trial on the issue of whether a debt is discharged. Annot., 18 A.L.R. Fed. 789 (1974); Countryman, supra note 555.
Decisions about whether other debts are discharged may be made in nonbankruptcy courts. These debts are those the bankrupt failed to list or schedule, taxes, family support, fines, penalties and forfeitures, and educational debts. The automatic stay bars collection efforts, but the creditor with such claims either may move for relief from the stay or wait until discharge terminates the stay. The passage of time, short of the statute of limitations, does not bar creditors from asserting these claims. Such creditors may sue in a bankruptcy or nonbankruptcy court. If the action is outside the bankruptcy court, the bankrupt may either adjudicate dischargeability there or remove the issue to the bankruptcy court. This jurisdiction is called concurrent because federal and state courts share it. Because the bankrupt has power to remove from a nonbankruptcy to a bankruptcy court it is Animal Farm concurrency: jurisdiction is concurrent but federal jurisdiction is more concurrent than state jurisdiction. As with adjudication on exclusive jurisdiction issues, the bankruptcy court may rule that the claim is not discharged and enter a federal judgment.

E. Discharge Hearing

If the court decides to discharge a bankrupt, a hearing will be held at which the judge "shall inform the debtor that a discharge has been granted or the reason why a discharge has not been granted." A certain amount of formality and a short sermon by the judge is in order at this stage. An individual or group hearing is

printed in Ad. News, supra note 20, at 5866.
871. Id. §§ 505, 523(a)(1).
872. Id. § 523(a)(5).
873. Id. § 523(a)(7).
874. Id. § 523(a)(8).
875. Id. § 362(d).
876. Id. § 362(c)(2)(C).
878. Id. § 1478(b) allows the bankruptcy court to remand removed cases but this will occur infrequently.
a good idea and should be encouraged.\textsuperscript{880}

The judge must hold a hearing if there has been a proceeding to
bar discharge or if the bankrupt seeks to reaffirm a discharged
debt. Under the common law, bankrupts could reaffirm discharged
debts without further consideration because the “moral obligation”
to repay remained and was deemed sufficient consideration.\textsuperscript{881} Virginia requires the promise to be in writing.\textsuperscript{882} The ’78 Code requires more. The bankrupt must reaffirm before discharge and may do so only with the judge’s approval.\textsuperscript{883} The judge must advise the bankrupt of the effect of reaffirmation. If the debt is a consumer obligation not secured by real property, the judge must find that reaffirmation does not impose a hardship and approve it, determine that the bankrupt reaffirmed in good faith to settle dischargeability litigation, or find that the bankrupt reaffirmed to redeem secured personal property.\textsuperscript{884} The bankrupt may rescind a reaffirmation within the thirty days after it becomes enforceable.\textsuperscript{885} Because reaffirmations are only enforceable if the hearing is held, the bankrupt apparently has thirty days after the hearing to rescind.

Bankrupts still may revive discharged debts with a new promise, but Congress made the procedure so complex and protective that reaffirmation will be rare. This will end the abusive and coercive efforts by creditors to seek reaffirmation, which were allowed under the ’98 Act.\textsuperscript{886} Creditors’ attorneys, however, will still seek reaffirmation to settle pending dischargeability complaints. It will not, however, prevent a bankrupt from voluntarily repaying a discharged debt.

F Effect of Discharge

The 1970 Amendments and the ’78 Code replaced the discharge


\textsuperscript{881} Murray on Contracts § 99 (2d rev. ed. 1974).

\textsuperscript{882} Va. Code § 11-2.01 (Repl. Vol. 1978) (promise must be written).

\textsuperscript{883} 11 U.S.C.A. §§ 523(c), (d) (West Supp. 1979).

\textsuperscript{884} Id. § 722. The bankrupt may redeem personal property used about the home from a lien securing a dischargeable consumer debt by paying the debt.

\textsuperscript{885} Id. § 524(c).

\textsuperscript{886} See, e.g., In re Thompson, 416 F Supp. 991 (S.D. Tex. 1976).
as an affirmative defense with the discharge as an injunction. The
court's discharge order, which all creditors will receive, voids all
personal judgments on discharged debts and enjoins creditors from
employing legal process, beginning or continuing lawsuits, or "any
act to collect, recover, or offset" a discharged debt. The '78 Code
authorizes a broader injunction than the 1970 Amendments; the
'98 Act enjoined only lawsuits or process. The '78 Code also en-
joins efforts "to collect," which apparently include calls, letters,
and personal contact. This should end coercive reaffirmation tac-
tics such as threatening to institute and later instituting criminal
proceedings against a bankrupt. Previously, these criminal pro-
ceedings were found not to constitute contempt of the injunction
because they were outside the injunction against "employing
process." Bankrupts are spared from asserting the discharge as an affirma-
tive defense in courts chosen by the creditor. When the creditor
proceeds on a discharged debt or harasses the bankrupt, the bank-
rupt has several options. He may ignore actions, because any judg-
court may impose one of three contempt remedies: a punitive criminal contempt sanction to punish the

omits § 524(a)(2) changes.

889. 11 U.S.C.A. § 524(a)(2) (West Supp. 1979); H.R. REP. No. 585, supra note 27, at 365-
66, reprinted in Ad. News, supra note 27, at 6321-22; S. REP. No. 989, supra note 20, at 80,

891. FED. R. Civ. P 8(c) need not be amended to delete discharges from affirmative de-
fenses because a creditor with an allegedly nondischarged debt may sue in a court with
concurrent jurisdiction; the bankrupt may choose not to remove the case, interposing the
discharge there as a defense. Nor should state legislatures repeal statutes like VA. CODE
§ 8.01-455 (Repl. Vol. 1977) which tell clerks to mark judgments "discharged in bankruptcy."
These words may satisfy a nervous title examiner better than any injunction.

893. 28 U.S.C.A. § 1481 (West Supp. 1979) circumscribes the bankruptcy judge's power to
impose contempt.
creditor; a coercive order, such as a daily fine or imprisonment pending compliance, to effect better cooperation; or a compensatory contempt award paid to the bankrupt, measured by his damages. Finally, if the creditor's conduct is questionable or if the debt may not be discharged, the bankrupt may remove to the bankruptcy court and request a declaration of discharge and a broadened or more specific injunction.

The Code protects bankrupts against some discriminatory governmental treatment. Perez v. Campbell concerned a statute that provided that an uninsured driver who failed to pay a tort judgment lost the right to a driver's license even though the judgment was discharged in bankruptcy. The Supreme Court noted that this statute coerced bankrupts to pay discharged debts, and it held that the statute conflicted with the fresh start policy and was invalid under the Supremacy Clause. Congress codified Perez in the '78 Code. Governmental units are prohibited from taking negative employment, licensing, or franchise action against a former bankrupt. Some statutory exceptions related to agricultural processors exist. Also, the negative action must be "solely" because of bankruptcy, which means that the government may consider future financial and managerial responsibility.

Congress codified past law conservatively, yet allowed the courts to develop the doctrine of protecting bankrupts from indirect government action to collect a discharged debt. The codification of Perez should be read in conjunction with the discharge injunction

899. See 7 U.S.C. §§ 181, 193-95, 202, 207, 214-20, 499a-r (1970); 7 U.S.C.A. §§ 182-83, 191-92, 193(b), 196, 201-02(a), 203-06, 207(f), 208-09, 210(b), 211-13, 499a(d), (7), b(5), c(b), d(a), d(e), f(c), f(d), g(a), m(b) to (f), s (Cum. Supp. 1980).
which interdicts collection. Although a private employer could fire a bankrupt employee, an order to pay the credit union or be fired violates the discharge injunction. The question is whether the tactic is an indirect device to collect the debt. Under the '98 Act, a court allowed a private college to withhold a transcript from a bankrupt former student until all debts were paid. Today, this would violate the Code’s injunction against collection action even though no formal “process” is involved. On the other hand, two state courts have excluded lawyers from the bar on findings that they lacked good moral character because they had defaulted on student loans, absent exceptional circumstances, by declaring bankruptcy. This does not seem to be an indirect collection tactic that violates the injunction. In order to avoid illegal discrimination against former bankrupts, however, the applicant may be excluded only after the state bar finds something apart from the fact of bankruptcy like fraud, serious misconduct, or lack of managerial ability. The state may not discriminate against bankrupts to discourage others from filing bankruptcy, encourage those who do file bankruptcy to discharge certain classes of debts, or limit the occupational alternatives available to the bankrupts. The observer must question whether it would be permissible to deny a license to practice to a lawyer who discharged educational loans under the ’78 Code after the bankruptcy judge found that repayment would create “undue hardship.”

X. Conclusion

While this Article was being written, the nation, plagued with unprecedented inflation, tottered on the brink of a recession. Inflation squeezes the middle class and people on fixed incomes because

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905. Florida Bd. of Bar Examiners, 364 So. 2d 454 (Fla. 1978); In re Gahan, 279 N.W.2d 826 (Minn. 1979).
formerly fixed costs, such as costs for energy, fuel, and food, rise faster than income. Inflation hits construction and retail business disproportionately as the expense of necessary credit devours profit. After only a short period to work out the kinks, the '78 Code will be tested in the crucible of increased filings.

Commentators assert that the '78 Code will generate business for the Bar. 909 One subtitiled his article "The Full-Employment-For-Lawyers Bill." 910 These remarks are not well taken. Bankruptcy has been so comprehensively changed that all lawyers must learn something about the new regime. But the Act, with its amendments and interpretations, was ready to fall from its own weight. The Code, moreover, recognized the consumer bankrupt and developed a system more oriented toward the consumer's discharge and fresh start. Some of the remonstrances against the Code simply may veil the authors' preference for a system that protects creditors more and better.

This Article attempts to summarize a liquidation bankruptcy under the Code. Large parts of it are irrelevant to the streamlined, mass-produced, assetless consumer bankruptcy. It is hoped, however, that the Article will help lawyers and judges to understand the easy problems and to solve the hard problems in individual or business bankruptcies. Despite this Article's length, it is a modest effort, a guide to the Code not a substitute for it.

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