

BANKRUPTCY CONCEPTS AND FUNDAMENTALS

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Early bankruptcy laws provided for violent and punitive results to debtors. In fact, the term “bankruptcy” is derived from the medieval practice in Italian city-states of breaking the benches of a merchant who may have left without paying his creditors. Under early English law, bankrupts were sometime hanged.

Today’s bankruptcy laws are a far cry different. Perhaps this more lenient treatment of debtors accounts for what has been a generally steady increase in bankruptcy filings in this country.

The relatively dramatic increase in bankruptcy filings began with the passage of the 1978 Bankruptcy Reform Act. This act was the first major revision and overhaul of the 1898 Bankruptcy Reform Act and provides us with our current bankruptcy code. The code recently underwent its most extensive revision, with the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA). Most of those amendments became effective October 17, 2005.

A. Basic Differences Between Chapter 7 and Chapter 13

1. Availability of Various Chapter Proceedings. The code comprises Title 11 of the United States Code and is divided into chapters. It was originally enacted with only odd-numbered chapters, being Chapters 1, 3, 5, 7, 9, 11, 13 and 15. The even-numbered chapters were left available for future amendments which Congress might enact. It did so in 1986, adding Chapter 12 to deal with the problems facing family farmers. Chapter 15 dealt with the United States Trustee and was deleted in 1986. Provisions regarding the United States Trustee are now located in Title 28. Chapter 15 has been recreated to deal with ancillary and cross-border cases.

Chapters 1, 3, and 5 contain general provisions applying to all bankruptcy cases. The remaining chapters deal with specific types of bankruptcies, as follows:

Chapter 7	Liquidation
Chapter 9	Municipal Bankruptcy
Chapter 11	Business Reorganization
Chapter 12	Family Farmers
Chapter 13	Wage Earners
Chapter 15	Ancillary and Cross-Border Cases

2. Chapter 7 □ Liquidation

a. Purpose. Chapter 7 provides an organized and orderly means of collecting and garnering the assets of the debtor, returning to the debtor those assets which may be exempt from execution and which the debtor is allowed to retain, and distributing the remaining assets to creditors. The debtor receives a fresh start by virtue of the discharge granted him.

b. Eligibility. Chapter 7 is available to all “persons,” including “individuals,” partnerships, and corporations. Railroads, insurance companies, and banking institutions may not file a Chapter 7 case. 11 U.S.C. §109. However, debtors above certain income levels may have to convert to Chapter 13 or face dismissal of their cases. 11 U.S.C. §707(b).

c. Functions. A Trustee is appointed as soon as a Chapter 7 case is commenced. The Trustee is to collect the debtor’s property excepting that portion which is exempt in an individual case, and supervise the liquidation of that property. The Trustee has powers to invalidate certain types of both prepetition and postpetition transfers of the debtor’s property, to avoid certain liens, and to contest creditors’ claims. The Trustee is also required to distribute the cash proceeds of the estate property to the various creditors in the order of their priority as determined by the Bankruptcy Code. 11 U.S.C. §502.

d. Discharge. The granting of a discharge relieves the debtor from personal liability on prepetition debts. Only an individual may receive a discharge. Certain kinds of debts, however, may not be discharged. Under some circumstances, the debtor will receive no discharge at all.

Types of debts not dischargeable are set forth at 11 U.S.C. §523(a). They include the following types:

- Most types of taxes
- Debts incurred by fraud
- Debts incurred through false writings
- Certain credit card abuses, primarily cash advances and luxury items
- Unscheduled creditors
- Debts arising from fraud or larceny or defalcation while a fiduciary
- Alimony, maintenance, and child support (domestic support obligations) 11 U.S.C. §101(14A)
- Debts arising from willful and malicious injury
- Fines and penalties to a government unit
- Student loans under most conditions
- Debts arising from death or personal injury caused by operating a motor vehicle, vessel, or aircraft while intoxicated
- Debts denied discharge in a prior case

3. Chapter 13 □ Adjustment of Debts of an Individual With Regular Income

a. Purpose. Chapter 13 may be used for many purposes, but the goal of Congress in enacting it was to provide an incentive for people to avoid Chapter 7 liquidations and attempt to pay at least some dividend to creditors. To achieve that goal, Congress provided Chapter 13 debtors with certain advantages over those enjoyed by debtors in other chapters. Many of those advantages have been removed by BAPCPA.

b. Eligibility. Chapter 13 is available only to an “individual with regular income.” Because of this, Chapter 13 plans are sometimes called “wage earner plans,” but other persons may qualify if their income is sufficiently stable and regular to enable payments under a Chapter 13 plan. Self-employed persons often file Chapter 13 plans.

Chapter 13 also imposes debt limits which affect the eligibility to qualify for this relief. Those limits are imposed upon the debtor’s indebtedness as of the date of the bankruptcy filing, as follows:

- \$307,675 of noncontingent, liquidated, unsecured debt; and
- \$922,975 of noncontingent, liquidated secured debt.

c. Functions. The debtor proposes a plan for repayment of his obligations. The plan must be filed within 15 days after the bankruptcy petition is filed (FRBP 3015(b)), and the first plan payment is due within 30 days after the filing of the case. 11 U.S.C. §1326(a)(1). Plan payments shall be for three years unless the debtor’s disposable income is above the median family income for a family of the same size. In that event, the plan must run for five years. 11 U.S.C. §1325(b)(4). In any event, the longest payment period permitted is five years. 11 U.S.C. §1322(d).

A Chapter 13 trustee oversees the case, but with a quite different role than the Chapter 7 trustee. The trustee’s Chapter 13 role is to evaluate the plan for confirmation purposes. Once confirmed, the trustee receives plan payments from the debtor and distributes them in accordance with the plan. 11 U.S.C. § 1326.

The plan allows debtors to exercise significant creativity. The plan may not discriminate between creditors unfairly, and unsecured creditors must receive at least the value they would have received in a Chapter 7 liquidation. 11 U.S.C. §1325(a)(4). Secured creditors must either accept the plan, receive their collateral, or retain their existing liens and receive payments with a present discounted value at least equal to the value of the collateral. 11 U.S.C. §1325(a)(5). There are exceptions to this ability to strip-down liens when the liens are purchase money security interests. 11 U.S.C. §1325(a)(9).

No disclosure statement is provided to creditors and unsecured creditors do not vote on the plan. In practice, secured creditors do not vote on the plan either, although 11 U.S.C. §1325 refers to their acceptance of the plan. Generally, the plan is considered accepted if no objection is received. If the trustee or any unsecured creditor objects to the plan, the debtor is required to pay into the plan all of his “disposable income” for the applicable commitment period unless all claims are to be paid in full. 11 U.S.C. §1325(b).

d. Discharge. The Chapter 13 discharge is granted upon completion of the plan. The discharge is somewhat broader than that under Chapter 7. For example, debts arising from a divorce, but which are not in the nature of maintenance or support, may also be discharged. Chapter 13 debtors may also be able to pay unsecured tax debts without further accrual of interest or penalties.

Under some circumstances, the debtor may receive a discharge despite not having completed the plan. In those instances, the failure to complete the plan payments must be due to circumstances for which the debtor should not be held accountable, the creditors must have already received as much as they would have received under a Chapter 7 liquidation, and modification of the plan must not be practical. 11 U.S.C. §1328(b).

B. When to Use One As Opposed to the Other

1. Desire to Pay. Chapter 13 offers many advantages over Chapter 7. Some debtors truly wish to pay what they can toward their debts. They may be prevented from doing so because one creditor is aggressively pursuing its claims, such as by garnishment. In this instance, Chapter 13 can provide the necessary protection to the debtor, while at the same time allowing the debtor to pay his disposable income for distribution to his creditors.

2. Expanded Discharge. The discharge which a Chapter 13 debtor receives upon completion of his plan is somewhat broader than the discharge available under Chapter 7. Debts arising from a divorce, and which are not for maintenance or support, are dischargeable.

3. Reduction of Tax Claims. Tax claims that are not dischargeable in either a Chapter 7 or Chapter 13 case may nonetheless be more easily paid through a Chapter 13 Plan. The automatic stay under 11 U.S.C. Section 362 prevents lien filings or levies upon wages or assets. Moreover, the balance due upon tax obligations may be paid without interest or penalty through a Chapter 13 Plan. This can result in substantial savings to the taxpayer/debtor.

Note though, that the tax claims must be paid in full through the Plan and that the IRS generally will not negotiate while a taxpayer is in bankruptcy. This refusal to negotiate removes the offer in compromise procedure as an option for the debtor.

4. Homestead Protection □ **11 U.S.C. §1322(b)(5).** Under a Chapter 13 Plan, a debtor may cure and reinstate the original maturity on long-term debts. In re Clark, 738 F.2d 869 (7th Cir. 1984). Most often, these debts are notes secured by mortgages upon the debtor’s homestead.

For example, debtor has a 30-year term upon his mortgage note with 27 years remaining. Unfortunately, the debtor has failed to make payments for the past 6 months and is now \$3,000 in arrears.

Under §1322(b)(5), the debtor may cure that default over a reasonable time and reinstate the original mortgage and its original maturity. However, while curing the arrearage through the Plan, the debtor must continue to make all current payments due under the note directly to the mortgagee. Interest need be paid upon the arrearage only to the extent provided by the note and mortgage. 11 U.S.C. §1322(e). *In re Young*, 310 B.R. 127 (Bankr. E.D. Wis. 2004).

5. Lien Stripping of Secured Debt. A Chapter 13 debtor may bifurcate the claims of undersecured creditors. Thus, such creditor has a secured claim to the extent of the value of the collateral and an unsecured claim for the balance.

Under the Chapter 13 Plan, the debtor may pay the secured claim, with interest thereon to provide the creditor with the present value of the claim, while treating the unsecured claim along with all other unsecured claims. The practical effect is often such that the secured claim will be paid in full through the Plan, thereby releasing the lien upon the debtor's property serving as collateral, while the unsecured claim will receive a very small portion of the amount due.

Such lien stripping is not available in Chapter 7. *Dewsnup v. Timm*, 502 US 410, 112 S. Ct. 773. 116 L. Ed. 2d 903 (1992). Note also that such lien stripping and bifurcation is not available for claims secured only by a lien upon the debtor's residence. 11 U.S.C. 1322(b)(2). *Nobelman vs. American Savings Bank*, 113 S. Ct. 2106, 127 L.Ed. 2d 228 (1993).

6. Protecting Nonexempt Property. In Chapter 7 cases, all nonexempt property is liquidated with proceeds applied to administrative expenses and then distributed to creditors. In Chapter 13, a debtor may keep nonexempt property, provided the Plan satisfies the "best interests of creditors" test under 11 U.S.C. §1325(a)(4). This test requires that all claims be paid at least as much as they would receive in a Chapter 7 liquidation. Thus, the Chapter 13 debtor can retain nonexempt equity in property so long as the distribution to unsecured creditors is at least as great as the amount those creditors would receive in a Chapter 7.

For example, suppose the debtor has \$5,000 worth of nonexempt equity in his vehicle. He does not wish to sell the vehicle and needs it for his employment. In a Chapter 7 liquidation the trustee would force the sale of the vehicle in order to distribute the proceeds to unsecured creditors. The Chapter 13 debtor, however, may retain the vehicle provided payments into the Plan for distribution upon unsecured claims total at least \$5,000.

The Chapter 13 debtor need not retain all property, though, and may craft a Plan which provides for sale or surrender of various assets.

7. Protection of Codebtors. The automatic stay extends to codebtors of the debtor, at least with respect to consumer debts. The stay is limited, however, and applies only to the extent that the codebtor obligation is provided for by the Plan. 11 U.S.C. §1301.

In some districts, including the Western District of Wisconsin, Chapter 13 plans may provide for priority treatment of codebtor obligations. Thus, the codebtor obligations may be paid before other distributions to unsecured creditors.

The same result might be achieved in a Chapter 7 case, either by reaffirmation of the codebtor obligation or by payment of same by the debtor following discharge.

8. Eight-Year Discharge Bar. Chapter 13 filings are often necessary for debtors who have previously received a Chapter 7 discharge. A new Chapter 7 discharge may not be obtained within eight years of a prior Chapter 7 discharge, or in many cases, within six years of a prior Chapter 13 discharge. 11 U.S.C. §727(a)(9).

In fact, a Chapter 13 filing following a Chapter 7 filing is often planned even before the Chapter 7 filing. Such strategy is often beneficial and is allowed by law. *Johnson v. Home State Bank*, 501, US. 1216, 111 S. Ct. 2150, 115 L.Ed 2150 (1991).

9. Ability to Dismiss. Chapter 13 debtors have an absolute right to dismiss their case at any time. 11 U.S.C. §1307(b). This right can be very beneficial to debtors. It can provide enforced protection while negotiating with creditors, it can allow time to determine uncertain status of exemptions or marital property, and can allow time for the debtor to prosecute asset claims such as personal injury suit or collections.

Hint: A secured creditor who wishes to prevent a debtor from refiling (thus thwarting a repossession or foreclosure effort) may want to file a motion for relief. Then any voluntary dismissal by the debtor would preclude another filing for 180 days. 11 U.S.C. §109(g). The motion could probably even be filed after the debtor files his request for dismissal.

10. Excess Income. Chapter 13 may be required, or at least preferable to no bankruptcy at all, for debtors whose income is such that a presumption of abuse exists under the means test. 11 U.S.C. §707(b).

C. The Bankruptcy Estate

Note that such property includes any interest that the debtor might acquire within 180 days after the date of filing, by property settlement or divorce decree with the debtor's spouse, by inheritance, or as beneficiary of a life insurance policy. 11 U.S.C. §541(a)(5).

Property of the estate does not include funds in an education Individual Retirement Account (IRC §530(b)(1)) if those funds were placed in the account more than a year prior to filing, and subject to certain limitations. 11 U.S.C. §541(b)(5). Such property also does not include funds contributed pursuant to IRC §529(b)(1) for college tuition expenses, such as EdVest, again subject to certain limitations. 11 U.S.C. §541(b)(6).

The estate also does not include amounts withheld by employers from wages of the debtor, or received by the employer from the debtor as contributions, to ERISA plans under IRC §414(d), deferred compensation plans under IRC §457, or tax-deferred annuities under IRC §403(b). It also does not include amounts contributed by the employee to health insurance plans regulated by state law. 11 U.S.C. §541(b)(7)(B).

Spendthrift trusts enforceable under Wisconsin law would not constitute property of the estate. 11 U.S.C. §541(c)(2).

The estate also includes all interest of the debtor and the debtor's spouse in community property at the time of the commencement of the case. 11 U.S.C. §541(a)(2). Note, however, that only a debtor may claim property as exempt in the bankruptcy case. 11 U.S.C. §522(b). Significant care should always be exercised if a married debtor is making a single-spouse filing.

D. Exemptions

Under Wisconsin law certain property is exempt from execution. Thus, creditors are unable to obtain this property or to have it liquidated for the satisfaction of their debts. Most, but not all, of such exempt property is described in Chapter 815 of the Wisconsin Statutes.

The Bankruptcy Code provides individual debtors with exemption rights in certain property of the estate. 11 U.S.C. §522(b). Wisconsin debtors in bankruptcy cases are allowed to choose between the state and federal exemptions. These exemptions are claimed by filing Schedule C, which is due within 15 days of the date of the bankruptcy filing. FRBP 1007 and 4003. Debtors may not mix state and federal exemptions, and in a joint filing both husband and wife must claim the same type of exemptions. If they cannot agree, both will have to choose the federal exemptions. 11 U.S.C. §522(b).

Thus, the debtor has a choice of either the federal exemptions found in 11 U.S.C. §522(d), or state exemptions and federal exemptions not found in 11 U.S.C. §522(d). The debtor must be domiciled in a state for 730 days prior to filing in order to elect that state's exemptions. Otherwise, the debtor must use the exemptions for the state of the debtor's domicile during the longest portion of the 180 days preceding the 730-day period. 11 U.S.C. §522(b)(3).

Unless a party in interest objects, the property claimed as exempt is exempt. 11 U.S.C. §522(l). Objections must be filed within 30 days after conclusion of the Section 341 meeting of creditors or within 30 days after filing of any amendment or supplement to the claimed exemptions, whichever is later. FRBP 4003(b). If the time to object is expired, an exemption may not be contested, even if the debtor had no colorable basis for claiming the exemption. *In re Taylor v. Freeland & Kronz*, 112 S. Ct. 1644 (1992). This time limit can be extended for cause, provided the request for extension is filed before the time to object expires. Copies of the objection must be served upon the trustee, the debtor, and the debtor's counsel. FRBP 4003(b). The objection shall be governed by the motion procedures under FRBP 9014. The burden of proof will be upon the objecting party. FRBP 4003(c).

However, such failure to object may still allow the trustee or a creditor to object to the value of the exemption. "Objection to the value of the exemption is different from an objection to the exemption itself..." *In re Page*, 171 BR 349, 352 (Bankr. W.D. Wis. 1994) J. Martin.

Except for the Wisconsin homestead exemption, exemptions generally apply separately to each debtor in a joint case. 11 U.S.C. §522(m). Wis. Stats. §815.18(8). Consider objecting to exemptions claimed for tools of trade by spouses who are not participating in the trade or business. *In re Flake*, 32 BR 360 (Bankr. W.D. Wis. 1983). Be aware, though, that the threshold for such participation may be quite low. *In re Parrish*, 186 BR 246 (Bankr. W.D. Wis. 1995). Judge Martin found that a debtor could exempt farm equipment which she did not use herself, but which her father used on his farm. The debtor resided upon the farm and contributed the equipment as the equivalent of her rent.

A spouse who is not himself or herself an heir may not be entitled to claim an exemption in a bequest to or inheritance by the other spouse. *In re Freund*, 32 BR 622 (Bankr. W.D. Wis. 1983).

Exemptions can only be claimed in "the debtor's interest" in property. Thus, the debtor cannot exempt property that is fully encumbered.

However, the debtor may be able to avoid the fixing of a lien upon an interest in property under various circumstances. Judicial liens may be avoided, other than those that are for domestic support obligations. 11 U.S.C. §522(f)(1)(A).

Also, nonpossessory, nonpurchase-money security interests in certain assets may be avoided, as follows:

(i) household furnishings, household goods, wearing apparel, appliances, books, animals, crops, musical instruments, or jewelry that are held primarily for the personal, family, or household use of the debtor or a dependent of the debtor;

(ii) implements, professional books, or tools, of the trade of the debtor or the trade of a dependent of the debtor; or

(iii) professionally prescribed health aids for the debtor or a dependent of the debtor.

11 U.S.C. §522(f)(1)(B).

BAPCPA now defines the term “household goods” and specifically excludes certain items, as follows:

(4)(A) Subject to subparagraph (B), for purposes of Paragraph (1)(B), the term household goods means—

- (i) clothing
- (ii) furniture
- (iii) appliances
- (iv) 1 radio
- (v) 1 television
- (vi) 1 VCR
- (vii) linens
- (viii) china
- (ix) crockery
- (x) kitchenware
- (xi) educational materials and educational equipment primarily for the use of minor dependent children of the debtor
- (xii) medical equipment and supplies
- (xiii) furniture exclusively for the use of minor children, or elderly or disabled dependents of the debtor
- (xiv) personal effects (including the toys and hobby equipment of minor dependent children and wedding rings) of the debtor and the dependents of the debtor
- (xv) 1 personal computer and related equipment

(B) The term household goods does not include—

- (i) works of art (unless by or of the debtor, or any relative of the debtor)
- (ii) electronic entertainment equipment with a fair market value of more than \$500 in the aggregate (except 1 television, 1 radio, and 1 VCR)
- (iii) items acquired as antiques with a fair market value of more than \$500 in the aggregate
- (iv) jewelry with a fair market value of more than \$500 in the aggregate (except wedding rings)
- (v) a computer (except as otherwise provided for in this section), motor vehicle (including a tractor or lawn tractor), boat, or a motorized recreational device, conveyance, vehicle, watercraft, or aircraft

Lien avoidance of this type is usually undertaken with respect to high interest rate consumer loans, and is accomplished by notice and a hearing.

E. The Automatic Stay

1. Imposition of the Stay. An automatic stay is imposed by the filing of a bankruptcy petition. 11 U.S.C. §362(a). This stay is one of the most important protections afforded the debtor. Some cases are even filed principally to take advantage of the stay. It prevents harassment of debtors and efforts to disrupt reorganization which might occur if creditors were allowed to pursue separate actions. *Matthews v. Rosene*, 739 F.2d 249 (7th Cir. 1984). It is designed to maintain the status quo, at least for a limited time, by having the bankruptcy court control resolution of actions and claims against the debtor and the debtor's property. The stay is broad. It generally precludes actions against the debtor, property of the debtor and property at the bankruptcy estate. Some examples might be:

- Filing suit against the debtor, whether you are seeking damage, a declaratory judgment or injunctive relief.
- Continuing suit against the debtor, or prosecuting an appeal, whether you are seeking damage, a declaratory judgment or injunctive relief.
- Entering a judgment against the debtor, whether you are seeking damage, a declaratory judgment or injunctive relief.
- Written or verbal demands for payment or offers of settlement.
- Action to recover a fraudulent transfer from the debtor's transferee.

Thus, repossession and foreclosure activities are prohibited as soon as the case is filed. No acts may be taken to recover possession of the property or to enforce the lien. *Nobelman v. American Savings Bank*, 113 S.Ct. 2106 (1993).

The stay goes into effect by operation of law in all cases, whether voluntary or involuntary, immediately upon the filing of the bankruptcy case. It requires no hearing or order from the court and enjoins most actions that affect the debtor or property of the estate. It enjoins any efforts by creditors to commence or to continue any action to recover from the debtor, if the claim arose before the commencement of the case.

The automatic stay not only prohibits taking actions against the debtor or property of the bankruptcy estate, but imposes an affirmative duty to stop violations from occurring. For example, a garnishment action may have been commenced and process served. Upon the filing of the bankruptcy petition, the creditor must take action necessary to halt the garnishment. Another example would be if suit were commenced and summons sent for service prior to the bankruptcy filing. Upon that filing, the plaintiff must contact the process server to ensure process is not served.

The automatic stay is effective even if the creditor has no notice that the case has been filed. Notice becomes an issue only in determining whether a creditor who violates the automatic stay should be sanctioned. An individual injured by a willful violation of the automatic stay "shall recover actual damages, including costs and attorney fees, and in appropriate circumstances, may recover punitive damages." 11 U.S.C. §362(h).

2. Codebtor Stay. The stay generally does not protect guarantors or codebtors of the debtor. Thus, proceedings against a guarantor or codebtor, or against the property of such persons, is not considered an act against the debtor or the property of the estate.

An exception exists, and the stay applies to some degree, to codebtors of debtors, in Chapter 12 and Chapter 13 cases. There, the automatic stay applies to efforts of a creditor to collect all or any part of a consumer debt of the debtor from any codebtor, unless that codebtor became liable on the secured debt in the ordinary course of the codebtor's business. This stay of actions against the

codebtor will apply until the case is closed, dismissed, or converted to one under Chapter 7 or Chapter 11.

This stay of actions against a codebtor can be lifted upon motion of the secured creditor upon any of three grounds, and to the following extents:

1. The codebtor received the consideration for the claim held by the creditor;
2. The plan filed by the debtor proposes not to pay the secured creditor's claim; or
3. The creditor's interest would be irreparably harmed by continuation of the stay.

11 U.S.C. §1201(c) and §1301(c). If neither the debtor nor the codebtor objects within 20 days of the creditor's motion, the codebtor stay will be lifted.

In very limited instances, bankruptcy courts have enjoined actions against guarantors or codebtors where those actions would have adversely affected the bankruptcy estate or interfered with a reorganization. *In re Fernstrom Storage & Van Co.*, 938 F.2d 731 (7th Cir. 1991). These injunctions are issued under the court's equitable powers. 11 U.S.C. §105(a).

Individual partners will not be protected by the automatic stay effected by the filing of a bankruptcy by the partnership. *In re Dreske*, 25 BR 268 (Bk WI 1982). This is because a partnership is recognized under bankruptcy law as a separate and distinct entity from the partners. The only protection available to the partners might be that afforded by the court under 11 U.S.C. §105.

3. Setoff. Secured creditors often are both a creditor of, and obligated to, the debtor. A bank or other financial institution may be a creditor by having made a loan to the debtor, but may also have possession of funds belonging to the debtor in the debtor's checking or savings account. Most states, including Wisconsin, recognize a right of setoff in favor of such a creditor. However, the automatic stay prohibits the creditor from setting off mutual debts which arose before the case was filed. 11 U.S.C. §362(a)(7). Any setoff by the creditor after the filing of the bankruptcy case could subject the creditor to sanctions for violation of the automatic stay. In addition, the bankruptcy trustee or the debtor in possession may have the power to recover any amounts so set off.

The best approach for creditor institutions in such situations is swiftly to freeze the debtor's account and file a motion for relief from the automatic stay to permit setoff of that account. The refusal by the financial institution to pay over to the debtor the funds in the debtor's account, provided that refusal is only temporary while the lender seeks relief under 11 U.S.C. §362, will not constitute a setoff under 11 U.S.C. §362(a)(7). The refusal to pay must not be permanent or absolute. Such an administrative hold has been held not to violate 11 U.S.C. §362. *Citizens Bank of Maryland v. Strumpf*, 116 S.Ct. 286 (1995).

4. Exceptions to the Stay. Not all creditor activities are stayed. 11 U.S.C. §362(b) sets forth at least 28 separate exceptions. A few common exceptions are as follows:

a. The commencement or continuation of actions by governmental units to enforce police and regulatory powers. 11 U.S.C. §362(b)(4). This section would, for example, entitle a local health department to order the debtor to cure any defect in the debtor's rental properties. This section also exempts from the automatic stay such administrative procedures as worker's compensation adjudications.

b. Income tax refunds may be set off by the appropriate governmental unit. §362(b)(26).

c. Governmental units may conduct tax audits, issue notices of tax deficiency, demand tax returns, and make tax assessments. 11 U.S.C. §362(b)(8).

d. If the debtor is a tenant under a lease of nonresidential real property, and if the lease has terminated by expiration of the stated term of the lease before commencement of the case, or during the case, the lessor may proceed to obtain possession of the property. 11 U.S.C. §362(b)(10). Thus, landlords in nonresidential leases may commence or continue eviction actions under these circumstances.

e. The holder of a negotiable instrument, such as a check, may proceed with presentment and notice of dishonor of that instrument. 11 U.S.C. §362(b)(11). A negotiable instrument may be presented for payment. *In re Roete*, 936 F.2d 963 (7th Cir. 1991). A debt may be accelerated after the bankruptcy filing, since acceleration does not affect the debtor's rights with respect to the claim. *Matter of LHD Realty Corp.*, 726 F.2d 327 (7th Cir. 1984).

The automatic stay does not toll or suspend the running of a redemption period. That time continues to run even after the case is filed. *Johnson v. First National Bank of Monte Video*, Minn., 719 F.2d 270 (8th Cir. 1983), cert. denied, 465 U.S. 1012 (1984). The debtor may be able, however, to get up to a 60-day extension of the redemption period, if the bankruptcy filing is made before the redemption period has expired. In that instance, the redemption period will expire when originally scheduled or 60 days after the bankruptcy filing, whichever is later. 11 U.S.C. §108(b). Even if the redemption period has run and a foreclosure sale has been held, a secured creditor must obtain relief from the stay before proceeding with the hearing for confirmation of sale. *United States v. Molitor*, 91-C-308-C (W.D. Wis. 1992).

f. Exception for Domestic Support Obligations. BAPCPA added a new definition at 11 U.S.C. §101(14)(A) for the term domestic support obligation (DSO):

The term “domestic support obligation” means a debt that accrues before, on, or after the date of the order for relief in a case under this title, including interest that accrues on that debt as provide under applicable nonbankruptcy law notwithstanding any other provision of this title, that is—

(A) owed to or recoverable by—

(i) a spouse, former spouse, or child of the debtor or such child's parent, legal guardian, or responsible relative; or

(ii) a governmental unit;

(B) in the nature of alimony, maintenance, or support (including assistance provided by a governmental unit) of such spouse, former spouse, or child of the debtor or such child's parent, without regard to whether such debt is expressly designated;

(C) established or subject to establishment before, on, or after the date of the order for relief in a case under this title, by reason of applicable provisions of—

(i) a separation agreement, divorce decree, or property settlement agreement;

(ii) an order of a court of record; or

(iii) a determination made in accordance with applicable nonbankruptcy law by a governmental unit; and

(D) not assigned to a nongovernmental entity, unless that obligation is assigned voluntarily by the spouse, former spouse, child of the debtor, or such child's parent, legal guardian, or responsible relative for the purpose of collecting the debt.

Formerly, the automatic stay applied to divorce and family proceedings generally. It excepted commencement or continuation of an action or proceeding to establish paternity, or to establish or modify an order for alimony, maintenance, or support. An exception also existed for the collection of alimony, maintenance, or support from property that was not property of the estate.

Under BAPCPA, it appears that almost any action related to divorce and custody is excepted from the automatic stay, other than property division when the property to be divided is property of the estate. 11 U.S.C. §362(b) now provides in part that:

The filing of a petition . . . does not operate as a stay—

. . . .

(2) under subsection (a)—

(A) of the commencement or continuation of a civil action or proceeding—

(i) for the establishment of paternity;

(ii) for the establishment or modification of an order for domestic support obligations;

(iii) concerning child custody or visitation;

(iv) for the dissolution of a marriage, except to the extent that such proceeding seeks to determine the division of property that is property of the estate; or

(v) regarding domestic violence;

(B) of the collection of a domestic support obligation from property that is not property of the estate;

(C) with respect to the withholding of income that is property of the estate or property of the debtor for payment of a domestic support obligation under a judicial or administrative order or a statute;

(D) of the withholding, suspension, or restriction of a driver's license, a professional or occupational license, or a recreational license, under state law, as specified in section 466(a)(16) of the Social Security Act;

(E) of the reporting of overdue support owed by a parent to any consumer reporting agency as specified in section 466(a)(7) of the Social Security Act;

(F) of the interception of a tax refund, as specified in sections 464 and 466(a)(3) of the Social Security Act or under an analogous state law; or

(G) of the enforcement of a medical obligation, as specified under title IV of the Social Security Act.

5. Duration of the Stay. The automatic stay applies to any act against property of the estate until that property is no longer property of the estate. In a Chapter 7 no-asset case, this is usually accomplished by the trustee filing a no-asset report. The no-asset report is equivalent to an abandonment of the trustee's interest in the property of the estate. *In re John W. Alt, Jr.* (Bk W.D. WI).

In any case, exempt property will revert in the debtor. Thus, if no objection is made to the claimed exemption within 30 days after the meeting of creditors, the property will be deemed exempt and become property of the debtor rather than property of the estate.

A third method by which property may cease to be property of the estate is by abandonment pursuant to 11 U.S.C. §554(b). Such abandonment requires a motion and demonstration that the property sought to be abandoned is burdensome to the estate or is of inconsequential value and no benefit to the estate. Notice must be provided to all parties in interest. If no objection is made, the court will generally grant the order for abandonment without hearing.

Even when collateral is no longer property of the estate, the stay may remain in effect pursuant to 11 U.S.C. §362(a)(5). That section does not refer to property of the estate, but to property of the debtor. The stay of any act, other than one against property of the estate, continues until the earliest of:

- The time the case is closed;
- The time the case is dismissed; or
- The time a discharge is granted or denied in a case under Chapters 11, 12, or 13, or under Chapter 7 if the debtor is an individual. 11 U.S.C. §362(c).

Thus, even if the property has been abandoned, the foreclosing party must await the dismissal of the case or the discharge of the debtor before proceeding with foreclosure activity.

F. Discharge/Dischargeability

1. Denial of Discharge. In most cases, the goal of the debtor is to obtain a discharge. That discharge may be denied because of the debtor's status or because of wrongful acts by the debtor.

Only an individual may be entitled to a discharge under Chapter 7. No other entity will receive a discharge under that chapter. 11 U.S.C. §727(a)(1). Even an individual may not receive a Chapter 7 discharge if that individual has previously received a Chapter 7 or Chapter 11 discharge within eight years. §727(a)(8).

A similar but shorter six-year bar also applies in a limited manner to Chapter 13 cases. A debtor who has received a discharge in a Chapter 13 case commenced within six years of the present Chapter 7 filing will not receive a Chapter 7 discharge, unless the payments under the Chapter 13 plan in that earlier case totaled at least:

- 100% of the allowed unsecured claims in that case; or
- 70% of such claims and the plan was proposed by the debtor in good faith and was the debtor's best effort. §727(a)(9).

Nearly all of the other grounds for objecting to discharge involve wrongful acts on the part of the debtor. Those categories of acts are as follows:

a. Debtor's intentional destruction or concealment of property. Discharge may be denied if the debtor transfers, removes, destroys, mutilates or conceals property of the debtor within one year prior to the filing of the case, or property of the estate after the filing. These acts by the debtor must be with intent to hinder, delay or defraud a creditor or the trustee. 11 U.S.C. §727(a)(2). Intent may be shown by the "badges of fraud." For example, a presumption of such intent may exist if the debtor makes a gift or transfer on the eve of bankruptcy. *Matter of Ramos*, 8 B.R. 490 (Bankr. W.D. Wis. 1981).

The one-year period prior to the filing of the case may be enlarged in the event of concealment. In such instance, the concealment is continuing, and each day of concealment would constitute another day for determining the one-year period. *Matter of Kauffman*, 675 F.2d 127 (7th Cir. 1981). *Matter of Ries*, 22 B.R. 343 (Bankr. W.D. Wis. 1982).

b. Concealment or destruction of financial or business books and records. Discharge may be denied if the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve recording information from which the debtor's financial condition and business transactions might be ascertained. 11 U.S.C. §727(a)(3). This does not mean that debtors must maintain and retain all business papers. Discharge may still be granted if the act or failure to act was justified under the circumstances of the case. *Id.* Intent is not a necessary element for denial of discharge on these grounds. *Matter of Juzniak*, 89 F.3d 424 (7th Cir. 1996); *In re Scott*, 172 F.3d 959 (7th Cir. 1999).

c. False oaths or withholding information. Another ground for denying discharge involves commission of bankruptcy crimes. These wrongful acts include the debtor knowingly and fraudulently, in connection with the bankruptcy case:

- Making a false oath or account
- Presenting or using a false claim
- Giving, offering, receiving or attempting to obtain money, property or advantage, or a promise of same, for acting or forbearing to act
- Withholding from the trustee any recorded information relating to the debtor's property or financial affairs.

11 U.S.C. §727(a)(4).

Although these actions are commonly referred to as "bankruptcy crimes," the standard of proof for the purpose of objecting to discharge is a preponderance of the evidence, not the criminal standard of proof beyond a reasonable doubt. *In re Scott*, 172 F.3d 959 (7th Cir. 1999). The party objecting to discharge has the burden of proof. FRBP 4005; *In re Thirtyacre*, 36 F.3d 697 (7th Cir. 1994).

d. Failure to explain loss or deficiency of assets. Discharge may be denied if the debtor fails satisfactorily to explain any loss of assets or any deficiency of assets. 11 U.S.C. §727(a)(5). Vague and evasive explanations will not be sufficient. *In re D'Agnesse*, 86 F.3d 732 (7th Cir. 1996).

e. Refusal to obey a lawful order of the bankruptcy court. Discharge may be denied if the debtor refuses to obey a lawful order of the bankruptcy court, other than an order to respond to a material question or to testify. Discharge may be denied if the debtor refuses to testify after having been granted immunity, or after improperly invoking the constitutional privilege against self incrimination. Discharge will only be denied in these instances. 11 U.S.C. §727(a)(6).

f. Wrongful acts in connection with another bankruptcy involving an insider. If within one year before filing of the bankruptcy case, or during the case itself, the debtor commits any of the acts described above in connection with another bankruptcy case concerning an insider, the discharge may be denied. 11 U.S.C. §727(a)(7). Any of these acts will be sufficient. *Matter of Krehl*, 86 F.3d 737 (7th Cir. 1996).

An objection to discharge requires an adversary proceeding, and is commenced by the filing of a complaint and the issuance of a summons. FRBP 7001(4). In a Chapter 7 case, the complaint must be filed within 60 days following the first date set for the meeting of creditors. In Chapter 11, the complaint must be filed before the first date set for the confirmation hearing. FRBP 4004(a).

2. Revocation of Discharge. Once a Chapter 7 discharge is granted, it may be revoked only upon one of three statutory grounds. The first is that the discharge was obtained through fraud on the part of the debtor and the party objecting did not know of the fraud until after the discharge was granted. 11 U.S.C. §727(d)(1).

The second available ground might be that the debtor acquired or became entitled to property of the estate and knowingly and fraudulently failed to report that acquisition or entitlement, or to deliver or surrender the property, to the trustee. 11 U.S.C. §727(d)(2).

The third ground incorporates that shown above, being the debtor's refusal to obey a lawful order of the court. 11 U.S.C. §727(d)(3).

The trustee, a creditor, or the United States trustee, may request revocation of discharge. The request must be made within one year after the granting of the discharge if the grounds are newly discovered fraud. If either of the other two grounds are the basis for the revocation request, the request must be made before the later of one year after the discharge is granted or the time the case is closed. 11 U.S.C. §727(e).

As with an objection to discharge, a request for revocation must be made by adversary proceeding. FRBP 7001(4).

3. Contesting Dischargeability. Objections to discharge are relatively rare, at least in comparison to objections to the dischargeability of a particular claim. Certain debts are excepted from discharge, as set forth at 11 U.S.C. §523(a). These exceptions to discharge have been enlarged over the years by Congress, so that there are now 18 specific subsections. Those of most relevance to creditors are the following:

a. Debts incurred by fraud. 11 U.S.C. §523(a)(2)

False representations or fraud. A Chapter 7 debtor is not discharged from any debt for money, property, services, or for an extension, renewal or refinancing of credit, if such consideration was acquired by false pretenses, a false representation, or actual fraud. This exception does not apply to a statement respecting the debtor's or an insider's financial condition. The debtor must have known the representation was false, or must have acted with such reckless disregard as to constitute willfulness. *Matter of Sheridan*, 57 F.3d 627 (7th Cir. 1995). A creditor must show justifiable reliance on the false representations. Justifiable reliance does not necessarily mean reasonable reliance. Thus, a creditor need not show it investigated the debtor's representations before relying upon them. *Field v. Mans*, 116 S. Ct. 437 (1995).

Reliance may not be necessary at all if the fraud takes a form other than misrepresentation. See *McClellan v. Bobbie Cantrell*, 217 F.3d 890 (7th Cir. 2000).

False financial statements. If the debtor obtained the above-described consideration by use of a false financial statement, the creditor may be successful in objecting to dischargeability. The statement must be in writing, must be materially false, and must be with respect to the debtor's or an insider's financial condition. The creditor must have reasonably relied upon the false statement. See *In re Morris*, 223 F.3d 548 (7th Cir. 2000). (No reasonable reliance by creditor which reached settlement with debtor without investigation and with prior knowledge of alleged dishonesty.) The creditor must also show the debtor caused the statement to be made or published it with intent to deceive. Intent to deceive can be inferred from false statements. *In re Green*, 241 B.R. 550 (Bankr. N.D. Ill. 1999).

Consumer debts owed to a single creditor and aggregating more than \$500 for luxury goods or services, incurred within 90 days of the bankruptcy filing, are presumed to be nondischargeable. Similarly, cash advances aggregating more than \$750 are presumed to be nondischargeable if obtained within 70 days before the filing.

b. Debts not listed or scheduled. 11 U.S.C. §523(a)(3). A debt which is neither listed nor scheduled in time to permit the creditor to file a timely proof of claim will not be discharged, unless the creditor had actual knowledge or notice of the case in time for such a timely filing. Because most cases are no-asset cases, with no distributions to creditors, this limitation does not often arise.

More often, a creditor may object to dischargeability of its debt because the debt was not listed, and was a debt obtained by false pretenses, by fraud in a fiduciary capacity, or for willful and malicious injury by the debtor or property division debts arising from a divorce. These types of objections to dischargeability, under §523(a)(2), (4), (6), and (15) apply only if the creditor makes a timely request for a determination of dischargeability. Such a determination must be made by adversary proceeding under FRBP 7001, with the complaint filed within 60 days of the first date set forth the meeting of creditors. FRBP 4007(a). If a creditor does not have notice of the case, it will not have the ability to file a complaint to determine dischargeability. Thus, the debt will not be discharged.

However, a creditor without grounds to object to dischargeability will in a no-asset case find its debt discharged, even if that creditor was neither listed nor scheduled by the debtor. *In re Guseck*, 310 B.R. 400 (Bankr. E.D. Wis. 2004). The rationale is that even had the creditor known of the case, there were no assets available for distribution. In no-asset cases, no bar date is set, so the creditor never lost an opportunity to file a proof of claim.

c. Debts for fiduciary fraud, embezzlement or theft. Debts incurred by embezzlement or larceny are not dischargeable, nor are debts incurred by fraud or defalcation while the debtor is acting in a fiduciary capacity. 11 U.S.C. §523(a)(4). A creditor objecting to dischargeability upon embezzlement or larceny grounds must prove intentional fraud, while defalcation by a fiduciary requires less proof. *In re Gumienny*, 8 B.R. 602 (Bankr. Wis. 1981). A common example of such a debt is a theft by contractor claim against the contractor who diverted construction funds to purposes other than paying subcontractors or material suppliers on that project. *Matter of Thomas*, 729 F.2d 502 (7th Cir. 1984). Another example would be failure of a debtor to turn over lottery ticket sale proceeds. *Matter of Marchiando*, 13 F.3d 1111 (7th Cir. 1994).

Whether or not the debtor is a fiduciary for these purposes will be a question of federal law. *In re Loken*, 32 B.R. 205 (Bankr. W.D. Wis. 1983).

d. Willful and malicious injury to persons or property. 11 U.S.C. §523(a)(6). This objection would include conversion of collateral by the debtor. The conduct must be deliberate and intentional. *In re Chambers*, 23 B.R. 206 (Bankr. W.D. Wis. 1982). The amount of the nondischargeable debt will be limited to the value of the property converted.

e. Previously nondischarged debts. Debts which were not discharged in an earlier bankruptcy case on any grounds other than the debtor having been granted a discharge within the previous six years will not be discharged in this later case by the debtor.

The creditor objecting to dischargeability has the burden of proof. *In re Bogstad*, 779 F.3d 370 (7th Cir. 1985). In most cases, each element must be proven by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279 (1991).

f. Alimony, maintenance, and support and other obligations arising from a divorce or separation. 11 U.S.C. (a)(5) and (a)(15) deal with these exceptions. Debts for alimony, maintenance, or support are known as domestic support obligations (DSO) and are not dischargeable in bankruptcy. DSOs may be owed to or recoverable by a spouse, former spouse, or child, or by a governmental unit. 11 U.S.C. §523(a)(5). The bankruptcy court is not bound by the divorce court's characterization, although that will likely be an important factor. *Matter of Chambers*, 36 B.R. 42 (Bankr. W.D. Wis. 1984).

Other obligations arising from a divorce or separation may or may not be dischargeable, depending upon the bankruptcy chapter involved and other factors. Such debts are dischargeable in a Chapter 13 case but could be the subject of an adversary proceeding under the other chapters. The adversary proceeding must be filed in the bankruptcy court within the time fixed for filing such actions, usually within 60 days after the first date for the meeting of creditors. B.R. 4007(c).

The bankruptcy court and the divorce court have concurrent jurisdiction to determine whether a debt constitutes a DSO. Only the bankruptcy court has jurisdiction to determine dischargeability of property division debts under §523(a)(15). Chapter 13 debtors can discharge the type of obligations described in 11 U.S.C. §523.

The creditor objecting to dischargeability has the burden of proof. *In re Bogstad*, 779 F.3d 370 (7th Cir. 1985). *Matter of VandeZande*, 22 B.R. 328 (Bankr. W.D. Wis. 1982). In most cases, each element must be proven by a preponderance of the evidence. *Grogan v. Garner*, 498 U.S. 279 (1991).

The doctrine of issue preclusion may collaterally stop the debtors from contesting the objection to discharge. For example, in *In Re Cole*, 234 B.R. 417 there was a prior determination that the debtor committed battery. Because the charge was defined as “intentionally causing bodily harm to another,” Judge Martin granted summary judgment to the state on claims of nondischargeability under 11 U.S.C. §523(a)(6).