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Preface

Federal bankruptcy law is sometimes (and not unreasonably) compared to the interminable case of *Jarndyce v Jarndyce* in Charles Dickens' Bleak House. Cases may linger on for years, and only highly trained bankruptcy counsel seem to understand the ebbs and flows of the action. Add to that mix the vagaries of California real estate law, and the result is a complex, litigious arena where many attorneys fear to tread.

CEB customers asked for help in this area, especially as the real estate market declined steadily in 2008-2009. Both transactional attorneys and litigators looked to us for help in holding on to clients who were considering a real estate-related bankruptcy, help in filing claims by and defending adversary actions against clients, and help in intelligently discussing and strategizing their client's case with specialty bankruptcy counsel. CEB already had this information at our fingertips; however, it was spread across several of our existing titles. There was no single source to help an attorney address a client's real estate bankruptcy issues. Accordingly, we identified and gathered together the relevant chapters from our existing titles, written by some of California's best bankruptcy attorneys and devoted specifically to California real estate. These chapters were reviewed, revised, updated, adapted, polished, and burnished to fit the need. The result is an easy to use, one volume guide suitable for both neophytes and experts—a one-stop shop at the intersection of federal and state real estate bankruptcy law.

In this one-of-a-kind title you will find:

- **Chapter 1:** an overview of federal bankruptcy law in California, including discussion of the major concepts, terminology, and procedure;
- **Chapter 2:** what does and does not constitute property of a bankruptcy estate, as well as a review of the "strong-arm" powers of the bankruptcy trustee to avoid liens, transfers, and fraudulent conveyances and the defenses against them;
- **Chapter 3:** the objectives and goals behind creditors' claims, a hands-on guide to filing the claim, and guidance in defending against objections to the claim;
- **Chapter 4:** the workings of bankruptcy case administration—imposition of the automatic stay; relief from stay; creditors' meetings; debtor examinations; adversary proceedings; and conversion, dismissal, or closing of the case;
- **Chapter 5:** the basics of reorganization bankruptcies (Chapters 11, 12, and 13) and liquidation bankruptcies (Chapter 7), including plan confirmation, lien stripping, cramdown of creditors, and discharge of debts and debtors;
- **Chapter 6:** the consequences of the assumption and rejection of executory contracts by the debtor;
- **Chapter 7:** obtaining relief from the automatic stay to proceed with an eviction and the specific consequences of assumption and rejection of unexpired leases by a tenant or landlord debtor (the chapter covers both residential and commercial leases and discusses the most relevant forms used in this area);
- **Chapter 8:** the treatment of security deposits, letters of credit, and other tenant credit enhancements in bankruptcy, including how these instruments may interact with the landlord cap on damages after rejection of a lease;
- **Chapter 9:** the handling of perfected and unperfected mechanics' liens, stop notices, joint checks, and other construction remedies after a bankruptcy is filed; and
- **Chapter 10:** managing real property secured loans in bankruptcy, including strategies to enforce the lien and continue a foreclosure, protection of undersecured lenders, valuation issues, the use of cash collateral, and the potential bankruptcy sale of the collateral.

CEB gratefully acknowledges the assistance of Kimberly S. Winick, who gave generously of her time and knowledge in reviewing many of the chapters of this book. We are also indebted to the 18 CEB authors who wrote the chapters drawn upon in creating this new title. See the acknowledgments on the next page for a list of the specific contributors.

CEB plans to update this book on a regular basis. We eagerly solicit your suggestions and comments to help us

expand its coverage, address the common issues you handle in practice, keep it accurate, and include the latest developments.

CEB Attorney Editors Kay F. Rubin (Managing Editor) and Bonnie C. Maly and Legal Editors Mary Claugus and Ragnhild Fougner contributed to this book. Administrative support was provided by Nila Kanzaria and Akanke Peyton. Linda Marousek handled copyediting and production. Robert Burke created the index. Composition was performed by CEB's Electronic Publishing staff.

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California Landlord-Tenant Practice (2d ed Cal CEB 1997)
California Mechanics' Liens and Related Construction Remedies (3d ed Cal CEB 1998)
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§1.1 I. SOURCES OF BANKRUPTCY LAW AND PROCEDURE

Our bankruptcy laws derive from the laws of ancient Rome (see Albert, *The Insolvency Law of Ancient Rome,* 28 Cal Bankr J 3 (2006)); however, modern bankruptcy law is based on statutes first enacted by Congress in 1898. From time to time, the bankruptcy law has been revised and "improved" by lawmakers. Significant revisions occurred in 1979 when the Bankruptcy Code (Title 11 of the United States Code) was enacted. Substantial revisions to the Bankruptcy Code were made in 2005, with passage of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23). But even the 2005 changes echo themes from the Bankruptcy Act of 1898.

As an introduction for real estate practitioners, this chapter provides an overview of federal bankruptcy law and procedure, federal bankruptcy courts, different types of bankruptcy relief, and parties to bankruptcy proceedings.

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§1.2 A. Prior Law: The Bankruptcy Act of 1898

The former Bankruptcy Act of 1898 (Pub L 55-541, 30 Stat 544) marked the beginning of the era of permanent federal bankruptcy legislation. The 1898 Act remained in effect until it was replaced by the Bankruptcy Reform Act of 1978. Much of the 1898 Act was directed not at debtor relief, but rather at facilitating the equitable and efficient administration and distribution of the debtor's property to creditors.

In the years before the onset of the Great Depression, Congress made many changes to the bankruptcy laws, in part to ameliorate the perceived extreme pro-debtor orientation of the 1898 Act. Subsequent legislation added grounds for denial of discharge and debts excepted from the discharge. Corporations were made eligible for voluntary bankruptcy in 1910. A flurry of bankruptcy legislation in the 1930s came to a head in 1938 with the passage of the Chandler Act (Pub L 75-696, 52 Stat 840), which substantially revised virtually every provision of the 1898 Act. Among other things, the Chandler Act reworked the reorganization provisions into the form that prevailed for the next 40 years.

In 1970, Congress created the Commission on the Bankruptcy Laws of the United States to study and report on the existing law. Almost a decade of study and debate about bankruptcy reform culminated when the Bankruptcy Reform Act of 1978 replaced the 1898 Act with the current Bankruptcy Code.

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§1.3 B. The Bankruptcy Code

The Bankruptcy Code comprises Title 11 of the United States Code. It was enacted on November 6, 1978, and became applicable to all bankruptcy cases filed on or after October 1, 1979. See Pub L 95-598, 92 Stat 2549. Post-October 1, 1979 cases were referred to as "Code cases" to distinguish them from then-pending Act cases. Although the former Bankruptcy Act of 1898 (Pub L 55-541, 30 Stat 544) was replaced in its entirety, cases decided under it are sometimes used for historical and interpretive purposes.

NOTE: There are important bankruptcy statutes in other parts of the United States Code, notably Title 28, which includes statutes governing bankruptcy court jurisdiction, venue, appeals, bankruptcy trustees, the U.S. Trustee, and bankruptcy fees, and Title 18, which includes statutes defining bankruptcy crimes.

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§1.4 C. Development of Bankruptcy Code: 1984 and 1994 Revisions

The Bankruptcy Code is often subject to major and minor amendments. Major amendments were made in 1984, 1994, and 2005.

In 1984, ostensibly in response to the U.S. Supreme Court's decision in *NLRB v Bildisco & Bildisco* (1984) 465 US 513, 79 L Ed 2d 482, 104 S Ct 1188 (making collective bargaining agreements subject to rejection as executory contracts), and to address jurisdictional issues, many changes were enacted to reflect the country's first few years of experience under the Code.

The Bankruptcy Reform Act of 1994 (Pub L 103-394, 108 Stat 4106) contained further amendments creating a new "small business election" to allow a qualifying debtor to expedite the plan confirmation procedure. For further information on the small business election, see §1.63. It also implemented a new type of case, the "single asset real estate case," designed to force debtors holding only one real estate asset to propose a reorganization plan within a shortened period (see 11 USC §362(d)(3); see also §§1.64, 4.22, 10.29), and other provisions designed to reduce debtors' flexibility.

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§1.5 D. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA)

In 1994, the Bankruptcy Reform Act (Pub L 103-394, 108 Stat 4106) created the National Bankruptcy Review Commission. Over a decade later, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) was enacted into law. BAPCPA made major changes throughout the Bankruptcy Code. Many practitioners and scholars believe that BAPCPA reflects Congress's intent to shift from a system that has been too protective of debtor's rights and too insensitive to creditor's rights. A minority argue that the changes, although numerous, simply fine-tune a bankruptcy system that has been working reasonably well since 1898. Almost everyone agrees that BAPCPA includes provisions that are unclear, confusing, and in need of technical correction.

Most BAPCPA provisions are effective in bankruptcy cases filed on or after October 17, 2005. Selected provisions were effective on April 20, 2005, or other dates.

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§1.6 E. Structure of Bankruptcy Code

All Bankruptcy Code sections have the same numbers as corresponding sections in Title 11 of the United States Code and are properly cited as "11 USC §___." In bankruptcy parlance, a "case" refers to the "umbrella" case commenced by the filing of the bankruptcy and a "proceeding" refers to a matter, generally an adversary proceeding or a contested matter (see §§4.42-4.50), that arises within the bankruptcy case. See Fed R Bankr P 9014.

The first three chapters of the Code (Chapters 1, 3, and 5) contain general provisions, definitions, and provisions on case administration, trustees, attorneys, the automatic stay, property of the estate, use and sale of estate property, executory contracts, allowance of claims, exemptions, discharge, preferences, and fraudulent transfers. These chapters apply to each of the five types of bankruptcy relief unless otherwise indicated in the particular relief chapter. The five distinct types of bankruptcy relief are set forth in Chapters 7 (liquidation), 9 (municipalities), 11 (reorganization), 12 (family farmer), and 13 (adjustment of debts of individuals). The provisions of these relief chapters apply only to cases filed under the respective chapters.

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§1.7 II. MAJOR CONCEPTS OF CODE

The three-fold purposes of bankruptcy include:

- Punishment of the fraudulent debtor;
- Rehabilitation of the unfortunate but innocent debtor; and
- Equitable distribution of the debtor's insufficient assets among all creditors.

See Olmstead, *Bankruptcy and Commercial Regulation,* 15 Harv L Rev 829 (1902). See also *Sherwood Partners, Inc. v Lycos*, *Inc.* (9th Cir 2005) 394 F3d 1198, 1203. These concepts are manifest in several major themes that run throughout the Code.

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§1.8 A. Order for Relief; Petition Date; Commencement of Case

A bankruptcy case is commenced by the filing of a voluntary or involuntary petition under a particular relief chapter of the Bankruptcy Code. 11 USC §§301, 303. The date on which the petition is filed is often called the "petition date." The "commencement of the case" triggers several consequences (regardless of whether there has been an order for relief), including the creation of a bankruptcy estate consisting of the debtor's property under 11 USC §541(a) (see §§2.2-2.23); the automatic stay under 11 USC §362(a) (see §§4.1-4.26); and establishing the preference period for purposes of 11 USC §547(b)(4)(A)-(B) (see §§2.37-2.55).

The commencement of a voluntary case under the Bankruptcy Code automatically constitutes an order for relief under the particular chapter under which the petition is filed. Throughout this book, the date of the order for relief is generally referred to as the "petition date." Certain events occur on the date of the order for relief, such as the appointment of a Chapter 7 or 13 trustee (see 11 USC §§701(a)(1), 1302) and the beginning of the time period for assuming or rejecting executory contracts and unexpired leases (see 11 USC §365(d)(1), (d)(4)). In an involuntary bankruptcy case, however, the order for relief is not entered on the filing of the petition, but only after the petitioners have proved their case after trial (see 11 USC §303(h)), and all events that are tied to the entry of the order for relief thus are delayed.

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§1.9 B. Estate and Exemptions

When a bankruptcy petition is filed, a "bankruptcy estate" is created. See §§2.2-2.23 for discussion of the many discrete rules for including and excluding property rights in the bankruptcy estate under 11 USC §541. Bankruptcy Code §541(a) defines property of the estate in the broadest terms "wherever located and by whomever held," including "all legal or equitable interests of the debtor in property." 11 USC §541(a).

Under 11 USC §522(c), certain property of the estate may be determined to be *exempt* (*i.e.,* eligible to be retained by the debtor), and not sold by a bankruptcy trustee or subject to liability for claims against the debtor (with certain exceptions) that arose before commencement of the case. Exemptions may be claimed, whether the debtor receives a discharge or not. Exemptions are for individual debtors only. They may not be available to entities such as corporations, partnerships, or limited liability companies. The Bankruptcy Code and the Federal Rules of Bankruptcy Procedure provide the details for the method and manner of claiming exemptions (see 11 USC §522(b); Fed R Bankr P 4003) and the implications of their use.

Section 522 sets forth two alternative sets of exemptions that may be claimed by individual debtors. These are the (1) so-called federal exemptions in 11 USC §522(d), which are available unless a state has affirmatively "opted out" of the federal exemption scheme; or (2) exemptions available under applicable nonbankruptcy law in the state where the debtor is domiciled under 11 USC §522(b)(1)-(3). The California legislature has opted out and elected not to authorize the federal exemptions in §522(d). See CCP §703.130. See generally *DeMassa v MacIntyre (In re MacIntyre)* (9th Cir 1996) 74 F3d 186. The Ninth Circuit has held that the California exemption statutes should be applied with "liberality," and that the exemption determination should be made on the basis of conditions existing at the time the bankruptcy petition is filed. *Gill v Stern (In re Stern)* (9th Cir 2003) 345 F3d 1036, 1044.

The two alternative sets of exemptions are available to individual debtors in bankruptcy cases. These are (1) the exemptions in CCP §703.140(b) (sometimes referred to as the "703-series" exemptions); and (2) all of the regular state-law exemptions (sometimes referred to as the "704-series" exemptions), including the homestead exemption, in CCP §§703.010-704.995 (except those in CCP §703.140(b)). See CCP §703.140(a). See generally *DeMassa v MacIntyre (In re MacIntyre), supra*. The two sets of exemptions are alternatives; a debtor cannot "stack" exemptions from each set, but must elect one set or the other. CCP §703.130(a). Which set of exemptions to elect will depend on the nature and extent of a debtor's assets.

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§1.10 C. Discharge

For individuals, the primary purpose of filing Chapter 7 bankruptcy is to obtain a discharge of prepetition debts. See 11 USC §727. Discharge is the essence of the "fresh start." Yet it is among the most misunderstood concepts of the Bankruptcy Code.

The bankruptcy discharge is an *injunction* that permanently restrains the collection of a debt or the enforcement of a judgment against the debtor. See 11 USC §524(a)(2). Although a discharge voids any judgment based on a discharged debt (see 11 USC §524(a)(1)), the discharge does not eradicate the underlying claim. The discharged claim continues to exist in order to support the creditor's right to proceed against the debtor's insurance company, co-signor, guarantor, or other co-obligor. See also §§2.82-2.83, 5.57-5.63.

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§1.11 D. Equitable Distribution

Equitable distribution of property of the estate among all creditors is the area where bankruptcy has the most profound impact on state-law regulation of debtor-creditor relations. Outside of bankruptcy, creditors typically obtain payment of their claims on a "first-come, first-served" basis, with the result that the first creditor to obtain a judgment and seize the debtor's assets usually receives proportionately more than the other creditors. Bankruptcy prevents this from happening by stopping all individual collection efforts and imposing an equitable distribution scheme, based on a complex set of rules designed to implement many policies, both historical and political, governing such issues as:

- Priority of payment of claims (*e.g.,* 11 USC §§503(b) (administrative claims), 507(a) (priorities));
- Limitations on claims (*e.g.*, 11 USC §502(b)(6) (cap on lessor's claim for breach of lease));
- Treatment of secured claims (*e.g.*, 11 USC §§506(a) (valuation), 1129(b)(2)(A) (cramdown));
- Method of payment (*e.g.*, 11 USC §§726(a) (distribution of property of the estate), 1129(b)(2)(B) (absolute priority rule));
- Avoidance of prepetition and unperfected transfers (*e.g.*, 11 USC §§547(b) (preferences), 544(a) (strong-arm power)); and
- Disclosure obligations (*e.g.*, 11 USC §521(a)(1) (duty to file schedules); Fed R Bankr P 1007(h) (certain interests arising or acquired after the petition)).

See chap 3 for discussion of proof and payment of creditors' claims in bankruptcy cases.

Counsel must become familiar with the Bankruptcy Code scheme for distribution of estate assets in order to properly advise the client of the appropriateness and consequences of bankruptcy, as well as actions that must be taken to protect his or her rights. The debtor will be concerned about myriad issues, such as the implications of any prepetition transfers of assets, whether nondischargeable claims will be paid from available assets, and the impact of bankruptcy on third parties. See chap 9 for further discussion of debtor issues and strategies. Similarly, the creditor will be concerned about its place in the distribution scheme, its liability to disgorge to the trustee a payment received within the preference period of 11 USC §547(b) (see §§2.37-2.55), and actions that must be taken to protect its claim and enhance its chances for payment. See chap 3 for general discussion of creditor claims in bankruptcy, chap 5 for discussion of cramdown of creditors' claims, and chap 10 for discussion of real property lender strategies.

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§1.12 E. Automatic Stay

Stays and injunctions in bankruptcy arise under the Bankruptcy Code and the Federal Rules of Civil Procedure. Title 11 USC §105 gives the bankruptcy court wide discretion to issue injunctions to facilitate the bankruptcy process, although §105 injunctions are generally issued only for cause, on request of a party in interest, and after notice and a hearing. Bankruptcy courts also have the power to issue injunctions in adversary proceedings under Fed R Bankr P 7065 and Fed R Civ P 65.

Under 11 USC §362(a), in most cases, the filing of a petition in bankruptcy operates automatically as a stay against a variety of acts affecting the debtor, property of the debtor, property of the estate, or property held by the estate, without need for further action by the debtor. This stay is known as the "automatic stay." For detailed discussion of the automatic stay and its exceptions, see §§4.1-4.26. The automatic stay constitutes the fundamental Bankruptcy Code protection for both debtors (safeguarding against dismemberment of the estate) and creditors (ensuring equitable distribution).

The provisions of 11 USC §362 are interrelated with other Code provisions. For example, whether or not the stay has been violated may depend on whether the act is against property that belongs to the estate under 11 USC §541. See §§2.2-2.23, 4.7. See also *McCarthy, Johnson & Miller v North Bay Plumbing, Inc. (In re Pettit)* (9th Cir 2000) 217 F3d 1072, 1077 (reversing bankruptcy court contempt holding against attorney who obtained funds posted to secure payment of judgment; funds were not property of the estate once judgment was entered).

Further, because creditor actions against the debtor on nondischargeable claims are stayed until entry of discharge, it may be in the debtor's interest to defer entry of discharge (see Fed R Bankr P 4004(c)(2)) or even to delay resolution of an objection to a claim in order to keep the stay in effect (see 11 USC §362(c)(2)). Moreover, the principle of equality of distribution is furthered by restraining creditors not only from seizing property of the debtor or the estate, but also from perfecting liens against such property. See 11 USC §362(a)(4).

As discussed more fully in §§4.11-4.13, violations of the stay may subject the offending party to damages and sanctions. *Knupfer v Lindblade (In re Dyer)* (9th Cir 2003) 322 F3d 1178 (damages may be recovered under contempt authority in 11 USC §105 or §362(k)).

There are several new exceptions and other limitations on the stay. In certain circumstances, *e.g.,* if the debtor was involved in another bankruptcy proceeding within the prior year, the stay may not go into effect at all, or may terminate in 30 days, unless the debtor files a motion for continuation of the stay and demonstrates that the new case was filed in good faith. See 11 USC §362(c)(3)-(4). In enacting BAPCPA, Congress also attempted to address certain bankruptcy scams, *e.g.,* fractionalizing interests in real property collateral to delay foreclosure through serial bankruptcy filings by the fractional owners, thus forcing the secured creditor to file multiple motions for relief from stay. To avoid this, in rem stay relief is now available to the secured creditor. 11 USC §362(d)(4).

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§1.13 III. TERMINOLOGY AND DEFINITIONS

Extensive definitions are provided throughout the Bankruptcy Code, including a comprehensive glossary in 11 USC §101. Some of the most important and the most misused or misunderstood terms are discussed in §§1.14-1.26.

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§1.14 A. Case; Proceeding

A "case" refers to the umbrella case commenced by the filing of the bankruptcy petition; a "proceeding" refers to a contested matter or adversary proceeding (see §§1.31-1.32) within the main case—in effect, a "case within a case." Terms such as "bankruptcy proceeding" and "chapter proceeding" are technically incorrect although frequently used.

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§1.15 B. Debtor; Person

The Bankruptcy Code defines "debtor" as "a person… concerning which a case under this title has been commenced." 11 USC §101(13). "Person" is defined to include an individual, a partnership, and a corporation, but not a governmental unit. 11 USC §101(41). Although not specifically mentioned in §101(41), limited liability companies are also considered "persons." *Gilliam v Speier (In re KRSM Props., LLC)* (BAP 9th Cir 2004) 318 BR 712. Sole proprietorships, however, are not distinct "persons." 318 BR at 717.

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§1.16 C. Insolvent; Insolvency

The term "insolvent" is used conceptually by attorneys and accountants in either of two senses: "Equitable" insolvency historically means the inability to pay one's debts as they come due (the cash-flow test) and is one of the grounds for involuntary bankruptcy. See 11 USC §303(h)(1). "Bankruptcy" insolvency means the financial condition in which liabilities exceed assets (the balance-sheet test); it is one of the elements of a preference (see 11 USC §547(b)(3)) and of some fraudulent conveyance actions (see 11 USC §548). See also chap 2. "Insolvent" is defined in 11 USC §101(32). Insolvency (of either kind) is not a precondition for filing a voluntary case under any chapter except Chapter 9 (municipal bankruptcies), although, with the means test discussed in §§4.82, 5.54, BAPCPA introduced certain financial standards for Chapter 7 eligibility.

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§1.17 D. Insider

The Bankruptcy Code definition of "insider" in 11 USC §101(31), although comprehensive, is nonexclusive. If a person does not fall within one of the specified classes of insider, the person may still be found to be an insider if it controls the debtor. Further, an individual can be an "insider" in relation to another individual, even if that individual is not a relative of the debtor. See 11 USC §101(45) defining "relative."

In *Miller Ave. Prof. & Promotional Serv., Inc. v Brady (In re Enterprise Acquistions Partners, Inc.)* (BAP 9th Cir 2004) 319 BR 626, 631, the Bankruptcy Appellate Panel of the Ninth Circuit explained that there are two distinct types of insiders: (1) the entities specifically mentioned in 11 USC §101(31) (including, *e.g.,* "relative," "partnership," "general partner," and "corporation"), which the court referred to as "per se insiders"; and (2) persons or entities not listed in §101(31), but who have a "sufficiently close relationship with the debtor that… conduct is made subject to closer scrutiny than those dealing at arm's length with the debtor." 319 BR at 631. (Citations omitted.)

There is a common but erroneous assumption that there is a stigma or penalty to being an insider of the debtor. In fact, insider status has implications only in specific situations, *e.g.,* the extended preference reach-back period (see §2.42; 11 USC §547(b)(4)(B)); a greater risk of equitable subordination (see §3.18; 11 USC 510(c)); and exclusion from calculation of claims for impaired-class acceptance in a Chapter 11 case (see §5.15; 11 USC §1129(a)(10)).

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§1.18 E. Transfer

Because a transfer may be voluntary or involuntary, and includes "each mode… *voluntary or involuntary,* of disposing of or parting with… an interest in property" (11 USC §101(54)), it may consist of a seizure of assets or recordation of an abstract of judgment. Creation of a security interest is a transfer. See *Hughes v Lawson (In re Lawson)* (9th Cir 1997) 122 F3d 1237 (granting deed of trust is transfer under 11 USC §727(a)(2)).

For preference purposes, when payment is made by check, the transfer does not occur until the check clears the bank. *Barnhill v Johnson* (1992) 503 US 393, 118 L Ed 2d 39, 112 S Ct 1386. For transfers of real property, the transfer does not occur until the conveyance is recorded. See 11 USC §§544(a)(3), 547(e)(1)(A). Similarly, a transfer of personal property must be perfected as against a judgment-lien creditor. See 11 USC §§544(a)(1), 547(e)(1)(B). See also §§2.37-2.43.

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§1.19 F. Claim; Debt

"Claim" and "debt" are often used interchangeably, but in fact a "debt" is a "liability on a claim." 11 USC §101(12). The definition of "claim" is notable for its breadth (see 11 USC §101(5)), implementing the bankruptcy policy that even the most remote liability be included within the debtor's discharge (see 11 USC §524(a)(1)), be entitled to participate in the estate (see 11 USC §§501(a), 502(b)), and be subject to the automatic stay (see 11 USC §362(a)(1)). *FCC v NextWave Personal Communications, Inc.* (2003) 537 US 293, 303, 154 L Ed 2d 863, 875, 123 S Ct 832 (FCC license fees, although regulatory conditions, are obligations dischargeable as debts); *Cohen v de la Cruz* (1998) 523 US 213, 218, 140 L Ed 2d 341, 346, 118 S Ct 1212 ("debt" defined as "liability on a claim," "claim" defined as "right to payment," and "right to payment" defined as an enforceable obligation); *Pennsylvania Dep't of Pub. Welfare v Davenport* (1990) 495 US 552, 559, 109 L Ed 2d 588, 596, 110 S Ct 2126 (award of treble damages is "enforceable obligation" of debtor; creditor has corresponding "right to payment").

A claim may be "unliquidated" (*e.g.,* a personal injury claim not yet reduced to judgment), "contingent" (*e.g.,* liability on a guaranty before demand), or "disputed." See §§3.38-3.41. It need not be reduced to judgment, and it may include an equitable remedy. For detailed discussion of claims in bankruptcy cases, see chap 3.

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§1.20 G. Cramdown

"Cramdown" is a term of art, not defined in the Bankruptcy Code, that refers to the process in a reorganization case by which the rights of a creditor (usually secured) are modified without its consent or over its objection. For example, a Chapter 11 plan may be "crammed down" with the consent of only one impaired class of creditors if the plan is shown to be fair and equitable with respect to the nonconsenting creditor. See 11 USC §1129(b). See chap 5 for discussion of cramdown in the context of Chapter 11, 12, and 13 plans.

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§1.21 H. Trustee; United States Trustee

The trustee in a bankruptcy case, who is appointed from a panel to administer the particular case, is sometimes confused with, but is not the same person as, the U.S. Trustee. The U.S. Trustee is chief of the regional administrative agency responsible for supervising the administration of bankruptcy cases as well as appointing and supervising the case or "panel" trustees in the region. The Office of the U.S. Trustee is a division of the U.S. Department of Justice. There are 21 regional U.S. Trustees nationwide, including three in California. See Directory for website.

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§1.22 I. First-Day Orders

"First-day orders" refers to a series of orders, usually entered as soon as possible after commencement of a Chapter 11 business reorganization case, governing such administrative issues as use of cash collateral by the debtor, payment of the debtor's employees during the case, and retention and payment of attorneys and accountants for the debtor.

PRACTICE TIP: Motions seeking entry of these orders generally are filed with the petition or in the first couple of days after the filing of the petition, and are heard in the first week or two of the case. Prompt attention to these matters is required on learning that a case has been filed.

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§1.23 J. Voluntary; Involuntary

"Voluntary" and "involuntary" refer to the two ways of commencing a case under Chapter 7 or 11. (No involuntary petitions are allowed under Chapter 12 or 13.) A voluntary petition constitutes an immediate "order for relief" under 11 USC §301 (see §1.8) and may be filed jointly by the debtor and a spouse in what is known as a "joint petition" under 11 USC §302.

An involuntary petition is governed by 11 USC §303, and requires three petitioning creditors if the debtor has 12 or more creditors. Under BAPCPA, petitioning creditors must hold claims that are "noncontingent, undisputed" (11 USC §303(b)(1)), and not the "subject of a bona fide dispute as to liability or amount" (11 USC §303(b)(1), (h)(1)). Although the order for relief does not issue until the court grants the petition in an involuntary case, many of the consequences of bankruptcy occur when the petition is filed. See §1.8.

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§1.24 K. Secured Claims; Liens

The special treatment of secured creditors is woven throughout the Bankruptcy Code, and an understanding of state-law treatment of the holders of both real and personal property security interests is essential to the practice of bankruptcy law. A secured claim is a claim secured by property in which the estate has an interest. 11 USC §506(a). The definition of "lien" is stated generally as a "charge against or interest in property to secure payment of a debt or performance of an obligation" (11 USC §101(37)) and includes a broad range of interests ranging from the consensual security interest of a deed of trust to the involuntary lien of an abstract of judgment. See §§3.4-3.7 for further discussion of secured claims in bankruptcy cases. See chap 10 for further discussion of real property secured loans in bankruptcy.

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§1.25 L. Conversion; Dismissal

A case is "converted" when it is changed from one relief chapter to another. The term has a negative connotation because it usually indicates that a Chapter 11 or Chapter 13 has failed and is ordered into Chapter 7. See 11 USC §§1112(b), 1307(c); see also §§4.72-4.78, 5.64. Conversion does not change the date of the commencement of the case. 11 USC §348(a).

Dismissal results in the termination of the case and reinstates the status quo ante. 11 USC §349(b)(1). Leave of court is generally required in order to dismiss, which is not readily given unless the court is satisfied that the creditors' interests are protected. See generally §§4.79-4.91. The only exception is in Chapter 13 cases, in which a first-time debtor's right to dismiss is absolute. See 11 USC §1307(b).

Perhaps the most controversial change introduced by BAPCPA is the means test applicable to individual debtors in Chapter 7 cases, under which a case is subject to conversion or dismissal for "abuse" if the debtor's income exceeds statutory benchmarks. See generally 11 USC §707(b); see also §§4.82, 5.54.

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§1.26 M. Executory Contract

The term "executory contract" is not defined but is treated extensively in the Bankruptcy Code at 11 USC §365. See chap 6 for general discussion of executory contracts and chap 7 for additional discussion of unexpired commercial and residential real property leases in bankruptcy cases. In general, the term "executory contract" refers to a contract with performance obligations remaining on both sides, such that a failure by either party to perform will constitute a material breach. *Everex Sys. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673.

The distinction between an executory contract and an unsecured claim has implications for a creditor because, if the contract is executory, the creditor may be able to convince the debtor to accept the contract, which will require the debtor to cure all defaults. See 11 USC §365(b)(1). The debtor, in turn, may obtain additional time to cure defaults or may obtain relief from a burdensome contract by rejecting it. See 11 USC §365(a).

Bankruptcy Code §365 includes special protections for commercial landlords, which have been enhanced by BAPCPA. Among other things, the trustee or debtor in possession is required to perform all of the debtor-tenant's obligations under the lease until the lease is either assumed or rejected. See *K-4, Inc. v Midway Engineered Wood Prods., Inc. (In re Treesource Indus.)* (9th Cir 2004) 363 F3d 994; *Cukierman v Uecker (In re Cukierman)* (9th Cir 2001) 265 F3d 846, 849. See generally chaps 6-7.

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§1.27 IV. BANKRUPTCY PROCEDURES

The Federal Rules of Bankruptcy Procedure govern procedure in all cases under Title 11 of the United States Code and are formally cited as Fed R Bankr P. First promulgated in 1983 by the U.S. Supreme Court, the Bankruptcy Rules are usually amended after the enactment of amendments to the Bankruptcy Code. There are over 100 rules, excluding subparts. They do not track the numbering system of the Bankruptcy Code, but are divided into nine parts, as discussed in §1.29.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/1 Overview of Federal Bankruptcy Law/ §1.28 A. Relationship of Federal Rules of Bankruptcy Procedure to Federal Rules of Civil Procedure

§1.28 A. Relationship of Federal Rules of Bankruptcy Procedure to Federal Rules of Civil Procedure

The litigator who is comfortable in federal court should be comfortable litigating in bankruptcy court. Bankruptcy practice, especially bankruptcy litigation, is largely governed by the same rules of procedure that apply in general federal civil practice. This is because about 70 of the 92 Federal Rules of Civil Procedure are imported, in whole or in part, into the Federal Rules of Bankruptcy Procedure.

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§1.29 B. Overview of Federal Rules of Bankruptcy Procedure

The Federal Rules of Bankruptcy Procedure are divided into nine parts. They have the force of law and must be followed. See 28 USC §2075. Most of the time periods and deadlines for certain actions are not in the Code, but in the Rules, *e.g.,* Fed R Bankr P 3002 (deadlines for filing proofs of claim), 4003(b) (deadline for objecting to exemptions), and 4007(c) (time for filing objection to dischargeability of debt).

The nine parts of the Federal Rules of Bankruptcy Procedure, and their major provisions, are as follows:

- **Part I. Commencement of the Case; Proceedings Relating to Petition and Order for Relief.** This part contains 20 rules governing such matters as voluntary and involuntary petitions (see §§1.8, 1.23), requirements and time limits for the schedules and statement of affairs, procedures for dismissal and conversion (see §§1.25, 4.72-4.91), death of the debtor, and the deadline for filing the small business election or, in California bankruptcy courts, the deadline for filing a small business debtor designation (see §1.63).
- **Part II. Officers and Administration; Notices; Meetings; Examinations; Elections; Attorneys and Accountants.** This part contains rules governing such matters as notice requirements for most actions under the Code, the examination of the debtor or other entity (see §§4.35-4.37), disclosure requirements relating to the employment and compensation of professionals, and appointment of trustees.
- **Part III. Claims and Distribution to Creditors and Equity Interest Holders; Plans.** This part contains extensive rules governing the method and manner of filing, transferring, and objecting to claims (see chap 3); rules relating to Chapter 12 and 13 plans; and rules on the Chapter 11 plan and disclosure statement process.
- **Part IV. The Debtor: Duties and Benefits.** This part may be the most important to the debtor's counsel because of its detailed provisions on relief from stay motions (see §§4.15-4.26), exemptions (see §1.9), and dischargeability (see §§1.10, 5.57-5.63). It also contains several important deadlines. See *Kontrick v Ryan* (2004) 540 US 443, 157 L Ed 2d 867, 124 S Ct 906 (extensive discussion of deadlines prescribed in Part IV rules).
- **Part V. Courts and Clerks.** This part contains rules governing the administration of cases such as closing and reopening cases (see §§4.92-4.97) and motions to withdraw the reference (see §1.49) or to request the bankruptcy court to abstain from hearing a proceeding (see §§1.50, 4.55-4.58).
- **Part VI. Collection and Liquidation of the Estate.** This part is most frequently used by trustees and debtors in possession and contains rules governing sale of property (see §§2.72-2.82), assumption of executory contracts (see chaps 6-7), and abandonment of property (see §§2.83-2.84).
- **Part VII. Adversary Proceedings.** Crucial to litigation, the rules in this part closely track the Federal Rules of Civil Procedure by incorporating many of them by reference, using a corresponding numbering scheme. Counsel must note that certain of the civil rules are modified by the bankruptcy rules in important respects, so each should be carefully reviewed. See §§4.38-4.68.
- **Part VIII. Appeals to District Court or Bankruptcy Appellate Panels.** This part contains rules such as those governing filing a notice of appeal, interlocutory appeals, and stays pending appeal. See §4.68.
- **Part IX. General Provisions.** This part contains several very important procedural rules, including the definition of "contested matter" (see §§4.42-4.50). It also contains provisions corresponding to certain of the Federal Rules of Civil Procedure.

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C. Frequently Used Procedures

§1.30 1. "After Notice and a Hearing"

"After notice and a hearing" is the term for a practice authorized by 11 USC §102(1), whereby the court may authorize an act *without a hearing* if notice has been given and no timely objection is made. The notice periods are fixed by Fed R Bankr P 2002, which also specifies the parties entitled to receive notice. Local rules, discussed in §§1.36 and 4.52, broaden the scope of, and refine the procedures for, bankruptcy court action without a hearing. The local rules detail procedures for "notice and opportunity for hearing" whereby one party initiates a request for relief without setting a hearing, but gives the other party an opportunity to request one. In addition, Fed R Bankr P 2002 specifies the many situations in which a debtor must give notice before taking certain actions. But 11 USC §102(1) is not a substitute for normal due process.

A creditor or other party in interest may file a Request for Special Notice (see §§7.2, 7.69). This request does not entitle the requesting party to receive anything more than the notices that are otherwise served and does not obligate parties to provide copies of pleadings or other documents filed. Nevertheless, filing such a request is good practice. The common practice for moving parties is to serve parties requesting special notice with all of the moving papers. Many judges will check whether a motion was served on all parties who requested special notice.

NOTE: The U.S. Bankruptcy Court for the Central District of California has limited the availability of the Request for Special Notice and instead provides for interested parties to file requests for courtesy electronic notice. See §1.41 on electronic case filing.

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§1.31 2. Adversary Proceedings

Much bankruptcy court litigation is conducted in the form of an *adversary proceeding,* which is an ordinary lawsuit tried in the bankruptcy court under essentially the same rules of procedure as a "civil action" in federal district court. Each adversary proceeding has a separate docket number; features a summons and complaint, an answer, pretrial procedure, discovery, and a formal trial (or motion for summary judgment); and ends with either a judgment or dismissal. Jury trials in adversary proceedings, however, are rare. See §§4.65-4.66. For further discussion of adversary proceedings in bankruptcy court, see §§4.42-4.50.

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§1.32 3. Contested Matters

Contested matters are disputes that do not rise to the level of an adversary proceeding, yet may involve a substantial controversy, such as a proceeding to avoid a lien. See Fed R Bankr P 7001, 9014. Contested matters are frequently brought before the court quickly, either in the form of a noticed motion or under the notice and hearing procedure described in §1.30, and are frequent traps for those unfamiliar with bankruptcy practice. There is often uncertainty, even among experienced bankruptcy practitioners and judges, as to whether an issue should be resolved in a contested matter or an adversary proceeding. For further discussion of contested matters and adversary proceedings, see §§4.42-4.50.

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§1.33 4. Rule 2004 Examinations

Under Fed R Bankr P 2004, on motion of any party in interest, the bankruptcy court may order the examination of any entity relating to the "acts, conduct, or property, or to the liabilities and financial condition of the debtor, or to any matter which may affect the administration of the debtor's estate, or to the debtor's right to a discharge." Fed R Bankr P 2004(b). These examinations are known as "Rule 2004" examinations. Because of the breadth of the rule and the fact that motions for Rule 2004 examinations are routinely approved (often by the court clerk), the rule is subject to abuse. Although it may be used to allow a trustee or other party to gather information to decide whether suit should be filed, it may not be used as a substitute for formal discovery once an adversary proceeding is commenced. See, *e.g., In re Dinubilo* (ED Cal 1993) 177 BR 932. For further discussion of Rule 2004 examinations, see §§4.35-4.37.

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§1.34 5. Time Periods and Deadlines

In addition to the deadlines in Fed R Bankr P 2002, time periods and deadlines are found throughout the bankruptcy rules. Examples include Fed R Bankr P 1007(c) (14 days to file schedules and statement of financial affairs), 3002(c) (deadlines for filing proofs of claim), 4003(b) (30 days to file objections to debtor's exemptions), and 4007 (60 days following the first date set for the 11 USC §341(a) hearing to file complaint to determine dischargeability of debt).

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§1.35 D. Official Forms

The Official Forms are part of the Federal Rules of Bankruptcy Procedure. Chief among them are the forms of voluntary petition, and schedules and statement of financial affairs. The Official Forms are available to print or download from the main U.S. Courts website, listed in the Directory. Forms for preparation of bankruptcy petitions, schedules, and related documents also may be purchased from several publishers as software programs.

NOTE: The U.S. Bankruptcy Court for the Central District of California has developed customized versions of many of the Official Forms, all of which are available on the court's website, listed in the Directory. Use of many of these forms is mandatory. Other bankruptcy courts in California may also issue and require use of special versions of one or more of the official forms. Counsel should become familiar with all of the special forms developed by the bankruptcy court in which the case is, or will be, filed and should verify that any commercial bankruptcy software programs they use meet local bankruptcy court requirements.

The importance of correctly filling out the schedules and statement of financial affairs is underscored by *Hamilton v State Farm Fire & Cas. Co.* (9th Cir 2001) 270 F3d 778, which imposed a judicial estoppel on the debtor for failure to disclose an asset in his schedules. Failure to file complete and accurate bankruptcy schedules under 11 USC §521(a)(1) may be sufficient grounds for the bankruptcy court to deny the debtor's discharge (see 11 USC §727(a)(4)) or may support an indictment for a bankruptcy crime (see 18 USC §§152, 157).

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§1.36 E. Local Rules and Forms

Each of California's four bankruptcy court districts has promulgated local rules and forms, some of which are quite extensive. Some local forms are mandatory; others are optional. Local rules generally tend to fill gaps in the Federal Rules of Bankruptcy Procedure. They impose important calendaring and notice requirements. The rules vary from district to district, with the Central and Southern Districts having the most comprehensive sets of local rules. See Directory.

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§1.37 F. Federal District Court Local Rules

Each federal district court in California has its own local rules. The local bankruptcy rules are technically a part of the district court rules and may incorporate district court rules by reference. For example, in the Northern District, ND Cal Local Bankr R 1001-2 expressly incorporates, with some changes, 64 local district court civil rules. Although this scheme makes federal court litigators more comfortable in bankruptcy court, it also makes it a more formidable task for a newcomer to federal practice to master bankruptcy procedure. In contrast, the local bankruptcy rules in the Central District of California stand alone, with no local district court rules incorporated by reference.

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§1.38 G. "Local-Local" Rules; General Orders

Many bankruptcy judges, in the interests of removing uncertainty and avoiding inconsistency, express their own preference on how certain matters should be handled in their courtrooms or even on the interpretation of a particular rule of law. These preferences are known as judicial variances, guidelines, or "local-local" rules. Counsel unfamiliar with these nuances can be at a serious disadvantage. Special forms and instructions promulgated by individual bankruptcy judges may be posted on the U.S. Bankruptcy Court's website. See Directory for website information; see also §1.42.

Local bankruptcy court rules may be supplemented by General Orders of the U.S. Bankruptcy Court for particular federal judicial districts. Copies of General Orders may be obtained from the clerk of the applicable bankruptcy court or from the court's website.

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§1.39 H. Federal Rules of Evidence

Because bankruptcy practice is in federal court, evidentiary issues in litigation, including motion practice as well as adversary proceedings, are governed by the Federal Rules of Evidence. See §4.54. Counsel should be mindful that written declarations and other evidence submitted with bankruptcy court motions must comply with the Federal Rules of Evidence, and counsel can expect the responding party to submit written evidentiary objections. Attorney declarations are not a substitute for evidence. *Latman v Burdette* (9th Cir 2004) 366 F3d 774, 786, reprinted as amended 2004 US App Lexis 11212 (declaration attached to bank account records inadmissible under Fed R Evid 602 because declarant attorney relied on information supplied by bank employee concerning authenticity of records). To be admissible, the witness must have "actually perceived or observed that which he testifies to." *M.B.A.F.B. Fed. Credit Union v Cumis Ins. Soc'y* (4th Cir 1982) 681 F2d 930, 932.

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§1.40 I. United States Trustee Guidelines

Each of California's three regional offices of the U.S. Trustee publishes written guidelines, which are consistent with the procedural guidelines adopted by the Executive Office of the U.S. Trustee (see 28 USC §586(a)(3)), but which have been tailored to local practice. Copies of U.S. Trustee guidelines may be obtained from the local Office of the U.S. Trustee or its website (see Directory). The guidelines contain procedural requirements for applications for compensation, service of papers on the U.S. Trustee, monthly operating reports, and the like. Compliance with applicable U.S. Trustee guidelines is mandatory.

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§1.41 J. Electronic Case Filing (ECF) System; PACER System

All federal bankruptcy courts in California have now implemented electronic case filing (ECF) systems. All cases and adversary proceedings are assigned to the ECF system, and the clerk maintains an electronic docket. Certain documents as designated by the bankruptcy court clerk, including original bankruptcy petitions, may be filed (and sometimes *must* be filed) electronically. Each court's procedures will govern the disposition of original signatures, voluminous exhibits, etc. Attorneys must obtain an ECF system login and password from the court clerk in order to participate. Counsel should consult the applicable bankruptcy court's website (see §1.42 and Directory).

Each of the four bankruptcy court districts of California uses the PACER (Public Access to Court Electronic Records) computerized docket system for tracking bankruptcy filings. The PACER electronic files include each bankruptcy case's docket number, an index of pleadings and other documents filed in the case, and the claims register. Counsel should consult the applicable bankruptcy court's website for further information. See Directory for website addresses.

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§1.42 K. Bankruptcy Resources on Internet

There are a number of excellent bankruptcy-related websites on the Internet. For example, the website of the American Bankruptcy Institute (ABI), a national organization of bankruptcy practitioners, covers many subjects and provides an excellent legislative watch. See Directory for the ABI's website address.

Each of California's four federal bankruptcy court districts maintains a website containing local rules, information on local procedures, and judges' unpublished decisions. See Directory for information. In addition, some local divisions within a district may have their own websites.

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§1.43 V. INTERPLAY OF BANKRUPTCY LAW AND CALIFORNIA STATE SUBSTANTIVE LAW

State substantive law constitutes an important underpinning of bankruptcy law, particularly with regard to property rights. The Bankruptcy Code provides the structure, and the bankruptcy court provides the forum, to determine the rights and obligations of parties in interest that arose before bankruptcy under applicable state law (and federal nonbankruptcy substantive law). It is, therefore, crucial that California lawyers understand the interplay of bankruptcy law with California state law in many important areas, including:

- Property of the bankruptcy estate, community property, and creditors' rights in community property. See §§2.1-2.23 for discussion of property of the bankruptcy estate.
- Perfection of transfers of real or personal property, and the creation of liens, under state law, in relation to the so-called strong-arm powers of the trustee (or debtor in possession). See generally §§2.32-2.71.
- The availability of exemptions to individual debtors under state and federal law. See §1.9.
- The validity and allowance of claims against the bankruptcy estate. See generally chap 3.

Under the so-called Rooker-Feldman doctrine (see *Rooker v Fidelity Trust Co.* (1923) 263 US 413, 68 L Ed 362, 44 S Ct 149; *District of Columbia Court of Appeals v Feldman* (1983) 460 US 462, 75 L Ed 2d 206, 103 S Ct 1303), a federal bankruptcy court is bound by a California state court decision on a matter of California state law, even though the state court decision is on appeal and is not final for purposes of claim preclusion under state law. *Williams v Swenson (In re Williams)* (BAP 9th Cir 2002) 280 BR 857. For discussion of the parameters of the Rooker-Feldman doctrine, see *Exxon Mobil Corp. v Saudi Basic Indus. Corp.* (2005) 544 US 280, 161 L Ed 2d 454, 125 S Ct 1517.

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§1.44 VI. FEDERAL BANKRUPTCY COURTS

The federal bankruptcy court is essentially an adjunct to the federal district court, which explains why the jurisdictional statutes vest jurisdiction in the *district court*. See 28 USC §1334(a). For bankruptcy *cases,* and cases involving bankruptcy professionals (28 USC §1334(e)(2)), that jurisdiction is exclusive. In addition to exclusive jurisdiction over bankruptcy *cases,* the federal district courts have original but nonexclusive jurisdiction over *proceedings* that arise in or are related to bankruptcy cases. 28 USC §1334(b).

Federal district courts do not exercise this extensive grant of jurisdiction directly. Although bankruptcy jurisdiction is formally vested in the district courts, *cases* arising under the grant are automatically referred to the U.S. Bankruptcy Court for that district. The order of reference is found in either a local rule or general order, *e.g.,* US Dist Ct CD Cal General Order 266 (Oct. 9, 1984), which provides for the automatic referral of all bankruptcy matters from the district court to the bankruptcy court. The process by which a matter is returned to the district court is known as the "withdrawal of the reference" and is discussed in §1.49.

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§1.45 A. Venue in California Bankruptcy Courts

Because the bankruptcy courts are adjuncts to the district courts, the state is divided into four federal bankruptcy court districts that coincide with the four federal district court districts, *i.e.,* Central, Eastern, Northern, and Southern. Each district is further subdivided into geographical divisions, and it is essential for counsel to ascertain the correct division in which a bankruptcy case must be filed. This information is available on each bankruptcy court's website. See Directory for information.

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§1.46 B. Federal Bankruptcy Judges

The bankruptcy court is staffed by bankruptcy judges appointed to 14-year terms by the U.S. Court of Appeals for the circuit. 28 USC §152(a)(1). Bankruptcy judges are not appointed in accordance with the requirements of Article III of the United States Constitution: the president does not appoint them, the Senate does not ratify their appointments, and they do not hold lifetime appointments. Instead, bankruptcy judges are appointed under Article I. See US Const art I, §8, cl 4. Because bankruptcy judges are not appointed in accordance with Article III requirements, the U.S. Supreme Court has held that they may not exercise the full judicial power of the United States. *Northern Pipeline Constr. Co. v Marathon Pipe Line Co.* (1982) 458 US 50, 71, 73 L Ed 2d 598, 615, 102 S Ct 2858.

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§1.47 C. Bankruptcy Court Jurisdiction

The federal jurisdictional statutes address the constitutional limitations on the Article I bankruptcy courts by dividing the bankruptcy jurisdiction created by 28 USC §1334 into "core" and "noncore" components and restricting the bankruptcy courts' role in noncore matters. 28 USC §157(b). See generally *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074, 1080. Examples of core proceedings are set forth in 28 USC §157(b)(2) and include administration of the estate and adjudication of the debtor's rights and liabilities toward creditors in such matters as the allowance of claims, counterclaims against persons filing claims, motions for relief from stay, and plan confirmation. Core matters also include proceedings to recover money or property for the estate from third parties, such as preference or fraudulent conveyance actions. For further discussion of core and noncore proceedings, see §§4.38-4.41.

In core proceedings, bankruptcy judges may "hear and determine" the matter and enter final judgment, subject only to appeal under 28 USC §158. 28 USC §157(b)(1). For matters that are not core proceedings but are "otherwise related" to bankruptcy cases, 28 USC §157(c)(1) requires the bankruptcy judge to submit proposed findings of fact and conclusions of law to the district court, which reviews de novo any "matters to which any party has timely and specifically objected." If the parties consent, the bankruptcy judge can enter a final order in an "otherwise related" case. 28 USC §157(c)(2).

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§1.48 D. Further Limits on Original Jurisdiction

Bankruptcy courts may be precluded from adjudicating claims otherwise within the original federal bankruptcy jurisdiction under 28 USC §1334(b) for the following reasons:

- Withdrawal of the reference under 28 USC §157(d) (see §1.49);
- Abstention under 28 USC §1334(c) (see §1.50);
- Enforcement of arbitration clauses (see §1.51); and
- State sovereign immunity under the Eleventh Amendment (see §1.52).

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§1.49 1. Withdrawal of the Reference

Under 28 USC §157(d), a district court may withdraw either the entire bankruptcy case or any proceeding within the case from a bankruptcy court "for cause." *Canter Family Trust v Canter (In re Canter)* (9th Cir 2002) 299 F3d 1150.

Withdrawal of the entire case is referred to as "withdrawal of the reference," meaning withdrawal of the general reference of all bankruptcy cases from the district courts to the bankruptcy courts. See §1.44. In deciding whether cause exists, the district court must consider "the efficient use of judicial resources, delay and costs to the parties, uniformity of bankruptcy administration, the prevention of forum shopping, and other related factors." *Canter Family Trust v Canter (In re Canter), supra*.

The district court must withdraw a matter "if the court determines that resolution of the proceeding requires consideration of both title 11 and other laws of the United States regulating organizations or activities affecting interstate commerce." 28 USC §157(d). Case law provides for mandatory withdrawal when "substantial and material consideration" of federal statutes in addition to the Bankruptcy Code is required. *Pension Benefit Guar. Corp. v Official Parent Creditors' Comm. (In re Chateaugay Corp.)* (SD NY 1989) 108 BR 27, 28. Even if withdrawal is mandatory in the case, the actual hearing may still be held in the bankruptcy court. In *Pension Benefit,* the district court referred the proceedings to the bankruptcy court for findings of fact and conclusions of law under 28 USC §157(c)(1).

For procedural requirements for withdrawal of the reference, see Fed R Bankr P 5011 and the associated local rules posted on the websites of the local bankruptcy courts. See Directory for information. Withdrawal of the reference does not occur often in bankruptcy cases. Although a withdrawal of the reference is not appealable, a party may seek a writ of mandamus from the court of appeals to correct an abuse of jurisdiction. *Canter Family Trust v Canter (In re Canter), supra*.

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§1.50 2. Abstention

Under 28 USC §1334(c)(2), federal district courts must abstain from hearing a state law cause of action over which they have jurisdiction solely because the claim is "related to a case under title 11," if an action on the claim "is commenced, and can be timely adjudicated, in a State forum of appropriate jurisdiction." A state court proceeding must be pending at the time the order to abstain is entered. See *Security Farms v International Bhd. of Teamsters* (9th Cir 1997) 124 F3d 999. This interpretation usually restricts §1334(c)(2) mandatory abstention to suits brought by debtors against third parties before the bankruptcy case is filed. Mandatory abstention under §1334(c)(2) does not apply to "related to" actions that could have been brought in federal court under diversity or federal-question jurisdiction. For further discussion of abstention, see §§4.55-4.58.

Counsel representing a party in a suit against the debtor must be aware that state court actions pending against the debtor at the time of bankruptcy normally become claims in the bankruptcy case. The debtor usually designates such claims as "unliquidated" or "disputed." See generally §§3.38-3.41. The state court action is automatically stayed by 11 USC §362, and the plaintiff must file a proof of claim in the bankruptcy court, which will then either allow or disallow the claim. The proceeding to collect the claim in bankruptcy is one "arising in a case under title 11" rather than one "related to a case under title 11" and is a core proceeding. 28 USC §157(b)(2)(B). Thus, 28 USC §1334(c)(2) does not apply. (Although §1334(c)(2) refers to "the district court," that reference also applies to the bankruptcy court, which is treated as a unit of the district court. 28 USC §151.)

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§1.51 3. Arbitration

The automatic stay in bankruptcy applies to arbitration proceedings as well as to litigation pending in a court. See 11 USC §362(a)(1). Subject to relief from stay "for cause" under 11 USC §362(d)(1) and discretionary abstention under 28 USC §1334(d), all dispute resolution is centralized in the federal bankruptcy court, particularly for core matters as defined in 28 USC §157(b)(2).

There is confusion over the scope of a bankruptcy court's discretion to refuse to enforce arbitration clauses. A number of bankruptcy courts, including bankruptcy courts within the Ninth Circuit, have held that bankruptcy courts must enforce arbitration agreements in noncore proceedings, but have discretion to deny enforcement in core proceedings. See, *e.g., MCI Telecommunications Corp. v Gurga (In re Gurga)* (BAP 9th Cir 1994) 176 BR 196, 198; *McDonald v Cash N Advance, Inc. (In re Lucas)* (Bankr D Nev 2004) 312 BR 407, 409. Compare *New Cingular Servs. v Burkart (In re Wire Comm Wireless, Inc.)* (ED Cal 2008) 2008 US Dist Lexis 79273 (primacy of bankruptcy claim controls, not whether matter is core or noncore). For discussion of the distinction between core and noncore matters, see §§4.38-4.41.

The Third Circuit has held that the Federal Arbitration Act of 1947 (FAA) (9 USC §§1-14) promotes a strong policy in favor of arbitration, which mandates that a bankruptcy court "does not have the discretion to deny enforcement of an otherwise applicable arbitration clause" in most circumstances. *Mintze v American Fin. Servs., Inc. (In re Mintze)* (3d Cir 2006) 434 F3d 222, 229. Even in core proceedings, a party opposing arbitration must establish a congressional intent to create an exception to the FAA for that party's claims, either based on the text or the legislative history of the Bankruptcy Code or based on an inherent conflict between arbitration and the underlying purposes of the Bankruptcy Code. 434 F3d at 231. See also *Shearson/Am. Express, Inc. v McMahon* (1987) 482 US 220, 96 L Ed 2d 185, 107 S Ct 2332; *Selcke v New England Ins. Co.* (7th Cir 1993) 995 F2d 688. The Second Circuit has ruled consistently with *Mintze*. See *MBNA Am. Bank, N.A. v Hill* (2d Cir 2006) 436 F3d 104. The Ninth Circuit Court has yet to rule on this issue.

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4. Sovereign Immunity

§1.52 a. Generally

A further limitation on federal bankruptcy court jurisdiction is the Eleventh Amendment to the United States Constitution, which embodies the principle of state sovereign immunity. Section 106 of the Bankruptcy Code addresses state sovereign immunity by purporting to abrogate the sovereign immunity of any "governmental unit," which includes agencies of the United States, state governments, local governments, and foreign governments. 11 USC §101(27). The unmistakable intent of Congress was to subject governmental units to the general provisions of the Bankruptcy Code—including the claims adjudication process, the automatic stay, the avoiding powers of the trustee, and the discharge provisions—to the same extent as private parties. In *Seminole Tribe v Florida* (1996) 517 US 44, 134 L Ed 2d 252, 116 S Ct 1114, however, a closely divided U.S. Supreme Court found that the Eleventh Amendment precluded Congress from abrogating state sovereign immunity through the exercise of its legislative powers under Article I of the Constitution.

Seminole Tribe was not a bankruptcy case, and the U.S. Supreme Court has not yet ruled squarely on the issue of whether 11 USC §106(a) represents a constitutional exercise of congressional power. In *Tennessee Student Assistance Corp. v Hood* (2004) 541 US 440, 158 L Ed 2d 764, 124 S Ct 1905, however, the Court held that a bankruptcy court proceeding initiated by an individual Chapter 7 debtor to determine the dischargeability of a state-guaranteed student loan is a proceeding in rem and is, therefore, not a suit against the state for purposes of the Eleventh Amendment. The Court explained that bankruptcy courts have exclusive, in rem jurisdiction over property of the estate, which includes jurisdiction to enter discharge orders binding all creditors, including creditors who do not participate actively in the bankruptcy proceedings. Bankruptcy court discharge orders are equally binding on state creditors and do not infringe on state sovereignty. 541 US at 448, 158 L Ed 2d at 775. See also *Krystal Energy Co. v Navajo Nation* (9th Cir 2004) 357 F3d 1055 (Congress unequivocally abrogated sovereign immunity of Indian tribes when it enacted Bankr C §106); *Russell v Fort McDowell Yavapai Nation* (Bankr D Ariz 2003) 293 BR 34; *Warfield v Navajo Nation (In re Davis Chevrolet, Inc.)* (Bankr D Ariz 2002) 282 BR 674, 683 n5 ("other domestic government" includes Indian tribes).

Seminole Tribe has had an adverse impact on the ability of a debtor or trustee to bring an adversary proceeding in bankruptcy court against a state in personam. For example, a claim to avoid a preferential transfer to a state agency under 11 USC §547 or to collect an account receivable from a state agency cannot be brought in bankruptcy court. A debtor-attorney's action against the State Bar of California, in which the debtor sought to enjoin disciplinary proceedings against him, could not be maintained in bankruptcy court. *Franceschi v State Bar (In re Franceschi)* (BAP 9th Cir 2001) 268 BR 219, aff'd (9th Cir 2002) 43 Fed Appx 87. Moreover, despite its authority to determine tax liabilities under 11 USC §505, the bankruptcy court is prohibited by the Eleventh Amendment from determining a state tax liability and its dischargeability.

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§1.53 b. Waiver of Sovereign Immunity

Courts have found waivers of sovereign immunity in bankruptcy proceedings based on certain conduct of the state or state agency. For example, courts have found the filing of a proof of claim by a state agency to constitute a waiver. See, *e.g., Wyoming Dep't of Transp. v Straight (In re Straight)* (10th Cir 1998) 143 F3d 1387; *Schlossberg v Maryland (In re Creative Goldsmiths)* (4th Cir 1997) 119 F3d 1140. In *State Bd. of Equalization v Harleston (In re Harleston)* (9th Cir 2003) 331 F3d 699, the Ninth Circuit Court of Appeals held that when a state or a state agency files a proof of claim, the state waives sovereign immunity with respect to all claims of the estate arising from the same transaction or occurrence as the state's claim. To determine whether a claim against the state arises out of the same transaction or occurrence as the state's proof of claim, the Ninth Circuit applies the "logical relationship" test for compulsory counterclaims (*Montana v Goldin (In re Pegasus Gold Corp.)* (9th Cir 2005) 394 F3d 1189, 1195 (logical relationship exists when counterclaim arises from same aggregate set of operative facts as initial claim or same facts activate otherwise dormant additional legal rights). See also *Arizona v Bliemeister (In re Bliemeister)* (9th Cir 2002) 296 F3d 858 (waiver found when state answered plaintiff's complaint and filed a motion for summary judgment without asserting immunity defense); *Confederated Tribes v White (In re White)* (9th Cir 1998) 139 F3d 1268 (waiver found when agency voted against and objected to confirmation of Chapter 11 plan). In *Montana v Goldin (In re Pegasus Gold Corp.), supra*, however, the Ninth Circuit found that the state had not waived its sovereign immunity with respect to contract claims that did not arise out of the same transaction or occurrence as the state's original proofs of claim.

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§1.54 E. Personal Injury Claims

Expressly excluded from the category of core proceedings are claims against the estate for personal injury tort or wrongful death. 28 USC §157(b)(2)(B). These claims must be tried in the federal district court. 28 USC §157(b)(5). A jury may be demanded in such cases. 28 USC §1411.

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§1.55 F. Removal and Remand

Removal of state court litigation to the federal district court is governed by 28 USC §1441, which provides for removal of "any civil action brought in a State court of which the district courts of the United States have original jurisdiction." Under 28 USC §1452, any claim or cause of action over which the district court has jurisdiction under 28 USC §1334 (except U.S. Tax Court proceedings or civil actions by a governmental unit to enforce its police power) is subject to removal to the district court, regardless of whether the lawsuit of which the claim is a part was pending in another court when the related bankruptcy case was filed. Removal of bankruptcy-related claims is common and such matters are routinely referred to the bankruptcy court. Procedures for removal are set forth in Fed R Bankr P 9027.

Once a claim or cause of action has been removed, any nonremoving party to the litigation may file a motion for remand under 28 USC §1452(b). Such motions are generally filed with the district court. This section grants broad jurisdiction to the bankruptcy or district court to remand the claim or cause of action back to the state court in which it originated on "any equitable ground." One obvious ground for remand is if the particular matter is subject to mandatory abstention under 28 USC §1334(c)(2). See §1.50.

For further discussion of removal and remand in connection with bankruptcy court proceedings, see §§4.59-4.63.

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§1.56 G. Jury Trials

The right to a jury trial is not clearly defined in the Bankruptcy Code, and historically there has been some uncertainty over the extent of that right in bankruptcy court. The Bankruptcy Reform Act of 1978 originally provided (in former 28 USC §1480) that "this chapter and title 11 do not affect any right to trial by jury… that is provided by any statute in effect on September 30, 1979." Unfortunately, §1480 was repealed in 1984 and replaced with 28 USC §1411, which provides that "this chapter and title 11 do not affect any right to trial by jury that an individual has under applicable nonbankruptcy law with regard to a personal injury or wrongful death tort claim." The statute does not speak to the right to trial by jury on other issues that might arise in bankruptcy. The U.S. Supreme Court in *Granfinanciera, S.A. v Nordberg* (1989) 492 US 33, 42 n3, 106 L Ed 2d 26, 40 n3, 109 S Ct 2782, acknowledged that 28 USC §1411 is "notoriously ambiguous." See §4.65 for further discussion of *Granfinanciera* and the right of jury trial.

The right to a jury trial will be lost if the defendant/creditor fails to make a demand for a jury trial. *Daewoo Motor Am., Inc. v Gulf Ins. Co. (In re Daewoo Motor Am., Inc.)* (CD Cal 2003) 302 BR 308.

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§1.57 VII. TYPES OF BANKRUPTCY RELIEF

In general, there are two types of bankruptcy relief. The first, and usually simpler procedurally, is liquidation. Liquidation is typically carried out under Chapter 7 of the Bankruptcy Code. (It is also possible to carry out a liquidation in Chapter 11, under a court-confirmed plan.) The second type of bankruptcy relief is reorganization, governed by Chapter 11, 12, or 13 of the Bankruptcy Code.

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§1.58 A. Chapter 7

In a Chapter 7 liquidation, as in other bankruptcy proceedings, all property in which the debtor had an interest on the date of bankruptcy becomes part of the bankruptcy estate, to be sold or otherwise disposed of by the Chapter 7 trustee. See 11 USC §541(a). See generally §5.56.

A debtor who is an individual is entitled to exempt certain property from the estate based on state law. See §1.9. The exempt property is normally not seized by the trustee. The estate is administered by the trustee who will sell, or otherwise reduce to cash, all nonexempt property of the estate, including claims and causes of action held by the debtor. Creditors who file proofs of claim receive the proceeds of the liquidation in accordance with the priorities established by the Bankruptcy Code. See generally §§3.3-3.18.

An individual debtor will then be released (discharged) from personal liability on all dischargeable debts, in consideration of his or her surrender of all nonexempt property for liquidation, assuming that he or she has not committed fraud or other misconduct. The discharge order operates as a permanent injunction to prohibit creditors from attempting to collect on the discharged debts. See 11 USC §524; *Tennessee Student Assistance Corp. v Hood* (2004) 541 US 440, 447, 158 L Ed 2d 764, 775, 124 S Ct 1905. For additional discussion of representation of debtors and creditors in Chapter 7 cases, see §§5.52-5.64.

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§1.59 B. Chapter 13

The simplest form of reorganization is available under Chapter 13 of the Bankruptcy Code. Chapter 13, titled "Adjustment of Debts of an Individual With Regular Income," is available only to individuals with less than $336,900 of noncontingent, liquidated, unsecured debts, and less than $1,010,650 of noncontingent, liquidated, secured debts. 11 USC §109(e).

NOTE: The dollar amounts stated in §109(e) are subject to adjustment every 3 years to reflect changes in the Consumer Price Index. They are scheduled to be amended on April 1, 2010.

The great advantage of Chapter 13 is that the debtor can get the benefit of a discharge without losing nonexempt property. In consideration for retaining nonexempt assets, the debtor must formulate a plan. Under the plan, the debtor is required to pay creditors not less than the value of the nonexempt assets that the debtor is retaining, over a period of no more than 5 years. Another major benefit of Chapter 13 for a debtor is that creditors have no right to vote on the debtor's plan. The bankruptcy court will confirm the plan if it meets the requirements of 11 USC §1325, binding creditors to its terms.

The debtor in a Chapter 13 case is not discharged until he or she completes performance under the plan. See 11 USC §1328(a). There is a trustee in Chapter 13 cases, but his or her duties differ from those of a Chapter 7 trustee. The only property of the estate that normally comes into the hands of the Chapter 13 trustee is the debtor's earnings that are the source of payments under the plan. The primary duty of a Chapter 13 trustee is to make the required disbursements to creditors and monitor the debtor's performance of the plan.

For additional discussion of representation of debtors and creditors in Chapter 13 cases, see §§5.27-5.40.

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§1.60 C. Chapter 11

Chapter 11 may be used by both individuals and organizations, but it is designed primarily for business organizations. It resembles Chapter 13 in that the debtor is normally allowed to keep its assets and continue its business. The debtor proposes a plan of reorganization under which creditors will be paid, usually over a period of time, from assets of the estate or postconfirmation earnings of the debtor. Unlike Chapter 13, a Chapter 11 plan is not confirmed until after it has been accepted by the various classes of creditors and holders of equity interests in the debtor. Like Chapter 13, confirmation of a Chapter 11 plan is binding on all creditors, even those who have not consented to it. The debtor will receive a discharge as and to the extent provided in the plan, and is usually revested with all property of the estate on confirmation. For additional discussion of representation of debtors and creditors in Chapter 11 cases, see §§5.4-5.26.

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§1.61 D. Chapter 12

Chapter 12 provides for the rehabilitation of "family farmers" as defined in 11 USC §101(18) and "family fishermen" as defined in 11 USC §101(19A). Chapter 12 is similar to Chapter 13, but it incorporates some elements of Chapter 11. It is specifically designed to make it easier for family farmers or fishermen who are threatened with loss of their farms or fishing operations to restructure their debt in bankruptcy while continuing their commercial operations. Chapter 12 cases are rare. For additional discussion of representation of debtors and creditors in Chapter 11 cases, see §§5.41-5.51.

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§1.62 E. Chapter 9

Chapter 9 governs bankruptcy of municipalities and other local governmental units, such as school districts and airport land use commissions. Chapter 9 cases are somewhat rare and are not treated in this book.

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§1.63 F. "Small Business" Chapter 11 Cases

The "small business" (a debtor with liquidated noncontingent debts not exceeding $2.19 million) provisions of Chapter 11 eliminate the requirement of a separate disclosure statement hearing. Instead, the court conditionally approves the disclosure statement on an ex parte basis and allows it to be transmitted to creditors along with the plan. Creditors present their disclosure statement objections at the time of plan confirmation. See generally 11 USC §§101(51C)-(51D), 1121(e), 1125(f); Fed R Bankr P 3017.1. BAPCPA made significant changes to the small business provisions of Chapter 11. For further discussion of small business Chapter 11 cases, see §4.4.

NOTE: The dollar amount stated in 11 USC §101(51D) is subject to adjustment every 3 years to reflect changes in the Consumer Price Index. They are scheduled to be amended on April 1, 2010.

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§1.64 G. Single Asset Real Estate Cases

Strict deadlines are imposed on Chapter 11 debtors with assets consisting solely of a single parcel of real estate. See 11 USC §101(51B). These debtors must file a Chapter 11 plan and disclosure statement within 90 days of the order of relief or within 30 days of the bankruptcy court's determination that the case is a single asset case. Secured creditors may be granted relief from stay in single asset real estate cases unless the debtor is making current interest payments at the nondefault contract rate or has filed a feasible plan of reorganization within 90 days. 11 USC 362(d)(3). See §§4.22, 10.29 for further discussion of single asset real estate cases.

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§1.65 H. Consumer Bankruptcies and Debt Relief Agencies

In consumer bankruptcy cases filed after the effective date of BAPCPA, attorneys and bankruptcy petition preparers who come within the definition of a "debt relief agency" under 11 USC §101(12A) must comply with a series of rules found in 11 USC §§526-527. With certain exceptions, any person who provides "bankruptcy assistance" to an "assisted person" is a "debt relief agency" under 11 USC §101(12A). (The exceptions include nonprofit organizations, creditors assisting individuals to restructure their debts, banks, and credit unions. See 11 USC §101(12A)(A)-(E).) "Assisted persons" are defined as individuals with primarily consumer debts and less than $164,250 of nonexempt assets. 11 USC §101(3). Under the definition of "bankruptcy assistance" in 11 USC §101(4A), most consumer bankruptcy attorneys will qualify as debt relief agencies.

NOTE: The concept that an attorney qualifies as a "debt relief agency" has been challenged, most recently in *Milavetz, Gallop & Milavetz, P.A. v U.S.* (8th Cir 2008) 541 F3d 78, cert granted (2009) 174 L Ed 2d 269, 129 S Ct 2766. In addition to seeking a determination of whether attorneys are debt relief agencies, the other issue on certification to the U.S. Supreme Court in the *Milavetz* case queries what are the limitations on advice that can be given if attorneys are, indeed, found to be debt relief agencies within the meaning of 11 USC §101(12A).

PRACTICE TIP: Clients often take more than 1 week to decide which counsel to retain; counsel should therefore refrain from providing any bankruptcy assistance services until counsel is formally retained, to ensure that the 5-business-day period does not run out prematurely. All consumer bankruptcy attorneys should study carefully the new requirements for debt relief agencies set forth in 11 USC §§526-528 and ensure that they comply with them. Any fee agreement between a debt relief agency and an assisted person that does not comply materially with 11 USC §§526-528 is void and unenforceable. 11 USC §526(c)(1). There are many other sanctions for noncompliance. See 11 USC §526(c).

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§1.66 VIII. PARTIES TO BANKRUPTCY PROCEEDINGS

Parties in bankruptcy proceedings may include the debtor; the trustee (in Chapter 7 and 13 cases); the U.S. Trustee; a creditors' committee (in many Chapter 11 cases); the U.S. Attorney (who prosecutes bankruptcy crimes); secured and unsecured creditors; shareholders, directors, and officers of corporations; partners of partnerships; and members of limited liability companies. Other interested parties in bankruptcy proceedings may include third party defendants in avoidance actions, account debtors of the debtor, prospective purchasers of bankruptcy assets, and the press. Each player will have a unique role and agenda in any given case.

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§1.67 A. Debtor

Under 11 USC §301, a voluntary case can be commenced by "any entity that may be a debtor." "Entity" is defined in 11 USC §101(15) to include "person, estate, trust, and governmental unit." The word "include" is not limiting. 11 USC §102(3). Not all entities may be debtors; only a person or a municipality may be a debtor under 11 USC §109(a). "Person" is defined in 11 USC §101(41) to include individuals, partnerships, and corporations, but not governmental units. "Corporation" is defined in 11 USC §101(9) to include some entities that are not corporations under state law, such as joint stock companies, unincorporated associations, and business trusts. Limited liability companies are eligible to be debtors under the Bankruptcy Code, based on their similarities to corporations. *Gilliam v Speier (In re KRSM Props., LLC)* (BAP 9th Cir 2004) 318 BR 712. The definitions exclude governmental units other than municipalities, and estates and trusts, unless the trust is a business trust. A business trust, which the Bankruptcy Code does not define, qualifies as a "debtor" because it is included in the definition of "corporation," and is thereby included in the definition of "person." A sole proprietorship, however, is not deemed to be a "person" eligible to file a bankruptcy case as a separate entity. *Gilliam v Speier (In re KRSM Props., LLC), supra*. Therefore, an individual who owns and operates an unincorporated business as a sole proprietor must file bankruptcy as an individual.

Section 109(b) and (d) of the Bankruptcy Code further limit the persons eligible for filing bankruptcy by excluding insurance companies, banks, and similar financial institutions. These institutions are regulated by other statutory schemes. For example, railroads may be debtors under Chapter 11 but not under Chapter 7; brokerages may not reorganize under Chapter 11, but they may liquidate under special provisions of Chapter 7.

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§1.68 B. Trustee

In a Chapter 7 case, the bankruptcy estate is administered by a trustee who may be either an individual or a corporation. 11 USC §321. The duties of the trustee in a Chapter 7 case are listed in 11 USC §704. The trustee's principal obligation is to collect the property of the estate, sell it, and use the proceeds to pay administrative expenses and creditor claims. In each district, the U.S. Trustee maintains a panel of persons who have been qualified to serve as trustees in Chapter 7 cases. An interim trustee is appointed from this panel promptly after the case commences. 11 USC §701.

There are trustees in cases under Chapters 12 and 13, but their duties and powers in such cases are limited. The only property of the bankruptcy estate that normally comes into the hands of a trustee in Chapter 12 or 13 cases is the debtor's earnings, which are the source of payments under the plan.

Normally, there is no trustee in a Chapter 11 case. Rather, the debtor continues in possession of its property as a "debtor in possession" with the rights and powers, and also the obligations, of a trustee in bankruptcy. 11 USC §1107(a). A trustee may be appointed in a Chapter 11 case only in unusual circumstances, such as those involving fraud, dishonesty, gross incompetence, or gross mismanagement of the affairs of the debtor in possession. 11 USC §1104(a). A Chapter 11 trustee displaces the debtor's management and assumes control over the case in lieu of the debtor in possession. The Chapter 11 trustee is paid from the bankruptcy estate as an administrative creditor.

As a less drastic alternative to appointment of a Chapter 11 trustee, the bankruptcy court may appoint an examiner to investigate the status of the debtor's assets and liabilities, and the adequacy of its current management. 11 USC §1104(c). Historically, the examiner's role was usually limited to the preparation of a written report. Today, the examiner's role is broader and may include an investigation of suspicious prepetition transactions between the debtor and its affiliates, identification of issues involved in the plan of reorganization, negotiations with principal parties, and generally the furtherance of the reorganization process.

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§1.69 C. United States Trustee

The U.S. Trustee is an official of the U.S. Department of Justice charged with responsibility for supervising the administration of bankruptcy cases. Instituted as a pilot project in 1980, there are now 21 U.S. Trustees, each assigned to a region that encompasses one or more of the nation's 91 federal judicial districts (except Alabama and North Carolina). California has three regions: Region 15 covers the Southern District of California, Hawaii, Guam, and the Northern Mariana Islands; Region 16 covers the Central District of California; and Region 17 covers the Northern and Eastern Districts of California as well as the District of Nevada. See Directory for offices, links to websites, and contact information for the U.S. Trustees with jurisdiction in California.

To perform its functions, each U.S. Trustee office is staffed with attorneys and analysts who review all bankruptcy petitions and pleadings filed in bankruptcy cases in their region. Many of these attorneys are well-seasoned and are an excellent source of information and advice concerning pending cases. The positions taken by attorneys for the U.S. Trustee tend to carry great weight in bankruptcy court. Counsel should, therefore, cooperate and coordinate with them on an ongoing basis throughout the case, although in some proceedings, such as a §707(b) motion to dismiss, the interests of the debtor may be adverse to the interests of the U.S. Trustee.

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§1.70 D. Creditors

The Bankruptcy Code defines "creditor" as an "entity that has a claim against the debtor that arose at the time of or before the order for relief concerning the debtor." 11 USC §101(10). As noted in §1.19, "claim" is defined very broadly in the Bankruptcy Code to include any right to payment, whether "liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 USC §101(5). See generally §3.2. Creditors in a bankruptcy case may include taxing agencies (state, federal, and local), institutional lenders, domestic and foreign government agencies, landlords, secured creditors, unions, guilds (who often have substantial claims in entertainment bankruptcies), attorneys, tort claimants, contract claimants, ex-employees, holders of executory contracts and unexpired leases (including licensors, licensees, and lessees), trade creditors, bondholders, the nondebtor spouse or ex-spouse of an individual debtor, and others.

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§1.71 E. Creditors' Committee

The U.S. Trustee is authorized to appoint creditors' committees (and committees of equity security holders) in Chapter 11 cases under 11 USC §1102. Creditors' committees are appointed in many, if not all, Chapter 11 cases if the creditors are willing to serve as unpaid committee members and if there are assets available to pay committee legal expenses. The committee is responsible for representing the interests of general unsecured creditors. The creditors' committee will usually retain counsel, who will appear at every major hearing in the case. Secured creditors are generally ineligible to serve on creditors' committees. Some creditors prefer not to participate on committees, because the fiduciary duties to other creditors that arise from participation as a member of a committee may conflict with a creditor's own economic interests.

The creditors' committee may take certain actions on behalf of the estate if the debtor or trustee refuses to act, such as avoidance actions against insiders of the debtor. See §§2.32-2.70 for general discussion of avoidance actions. See also *Avalanche Maritime, Ltd. v Parekh (In re Parmetex, Inc)* (9th Cir 1999) 199 F3d 1029 (unsecured creditors had standing to bring avoidance actions under court-approved stipulation with trustee); *Duckor Spradling & Metzger v Baum Trust (In re P.R.T.C., Inc.)* (9th Cir 1999) 177 F3d 774 (bankruptcy court can authorize assignment of trustee's power to bring avoidance action to creditor if creditor is pursuing interests common to all creditors and exercise of that power will benefit remaining creditors).

PRACTICE TIP: Membership on a creditors' committee can be highly prized in large bankruptcies. In times of depressed real estate values, creditors who thought they were secured may find that their security is valueless, and thus may seek a position on the committee. Members are usually the first to know of events affecting the case, which can be valuable knowledge. Members of creditors' committees are not compensated for their time, so unless a creditor-client is willing to pay for counsel's time, it is preferable to have the client (instead of counsel) sit on the committee. Note that creditors who sit on creditors' committees have fiduciary duties to other creditor-members and often are required to sign confidentiality agreements. They may, therefore, have limited ability to act on any valuable information obtained in committee meetings.

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§1.72 F. Equity Security Holders

Equity security holders are holders of equity interests in an entity, and may include stockholders of a corporation, holders of partnership interests in a general or limited partnership, holders of membership interests in a limited liability company, and holders of rights to purchase or sell such equity securities. See 11 USC §101(16)-(17). In most bankruptcy cases, equity interest holders have no economic interest, because the debtor's assets are insufficient to pay creditors' claims and no assets are available for distribution to holders of equity interests.

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§2.1 I. INTRODUCTION

What constitutes property of the bankruptcy estate is a key question because it delimits the pool of assets that will be available to satisfy creditors' claims. Property of the estate is subject to the jurisdiction of the bankruptcy court and is administered over the course of the bankruptcy proceedings by the trustee or, in a Chapter 11 case, the debtor in possession. In Chapter 7 liquidation cases, property of the estate will be sold by the trustee under 11 USC §704 to pay creditors' claims (although the trustee may seek court approval under 11 USC §721 to operate a debtor's business property for a limited period of time). In Chapter 11 reorganizations, property of the estate may be operated and maintained, or sold, by the debtor in possession for the benefit of creditors during the course of the reorganization or in accordance with the terms of a confirmed Chapter 11 plan. In Chapter 13 debt adjustment cases, property of the estate will be used by the debtor to fund payments due to creditors under the confirmed Chapter 13 plan.

In general, under 11 USC §541, all of the debtor's property as of the commencement of the bankruptcy case becomes property of the estate, except for certain assets expressly excluded by the Bankruptcy Code and certain assets that an individual debtor may claim as exempt under 11 USC §522. The exclusions from property of the estate are discussed in §§2.14-2.23. For discussion of individual debtor exemptions, see §1.9.

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II. "PROPERTY OF THE ESTATE" DEFINED

§2.2 A. Scope of Property of the Estate

The commencement of a bankruptcy case under 11 USC §301 (voluntary petition), §302 (joint case by individual and spouse), or §303 (involuntary petition) creates an estate. 11 USC §541(a). Bankruptcy Code §541 defines "property of the estate" quite broadly to include all of the debtor's legal or equitable interests in property, wherever located, including all real and personal property as of the date the bankruptcy petition is filed. 11 USC §541(a). A potential estate asset is not outside the scope of that definition merely because it is novel or contingent or because enjoyment of it must be postponed. *Segal v Rochelle* (1966) 382 US 375, 379, 15 L Ed 2d 428, 432, 86 S Ct 511 (decided under the 1898 Act; see §1.2); *Barowsky v Serelson (In re Barowsky)* (10th Cir 1991) 946 F2d 1516, 1519 (tax refund attributable to prepetition portion of taxable year constitutes property of the estate); *Rau v Ryerson (In re Ryerson)* (9th Cir 1984) 739 F2d 1423 (postpetition proceeds from contingent prepetition contract are part of estate).

The estate succeeds only to the specific rights in property the debtor possessed as of the commencement of the case. Whether the debtor has an interest in property is determined by applicable nonbankruptcy law. *Butner v U.S.* (1979) 440 US 48, 55, 59 L Ed 2d 136, 141, 99 S Ct 914 ("[p]roperty interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding"); *U.S. v Lawrence* (9th Cir 1999) 189 F3d 838 (whether property belongs to estate is matter of state law). See also *Abele v Modern Fin. Plans Servs., Inc. (In re Cohen)* (9th Cir 2002) 300 F3d 1097, 1104. The debtor's property rights under state law may be affected by timing issues. For example, in *McCarthy, Johnson & Miller v North Bay Plumbing, Inc. (In re Pettit*) (9th Cir 2000) 217 F3d 1072, the debtors' interest in a security deposit was held not to be property of the estate when an adverse judgment was entered against the debtors prepetition and an order was signed prepetition directing the funds to be released to the opposing parties, even though a check for the funds was not issued until after the petition was filed.

The Bankruptcy Code imposes a time limit on inclusion of certain types of inchoate property rights. See 11 USC §541(a)(5); see also §2.8. Any property interests acquired by the *estate* after the commencement of the case are also included in the estate. See 11 USC §541(a)(7); see also §2.10.

Within 14 days after filing the petition (unless the court extends the time), the debtor must file schedules setting forth, among other things, all assets and liabilities (see 11 USC §521; Fed R Bankr P 1007). Included in assets are potential claims the debtor has against creditors, and if they are not listed in the schedules, this may present problems for the debtor or trustee in defending against adversary proceedings, creditors' claims, and stay relief motions. Included in liabilities are potential claims that creditors may have against the debtor and against particular pieces of property. For example, one or more mechanics' liens may be filed against the debtor's real property and should accordingly be reflected in the schedules.

The Bankruptcy Code lists several particular categories of property of the estate. See 11 USC §541(a). These categories are discussed in §§2.3-2.13.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/ B. Property Included in Estate/§2.3 1. Real Property

B. Property Included in Estate

§2.3 1. Real Property

All of the debtor's real property interests are included in property of the estate. These interests may include, without limitation:

- Fee interests;
- Tenancies in common;
- Joint tenancy property;
- Tenancies by the entirety;
- Any interest the debtor may have as a mortgagee or beneficiary under a deed of trust;
- Any interest the debtor may have under a land sale contract or lease of real property (subject to the debtor's right to reject or assume and assign such an interest under 11 USC §365; see generally chaps 6-7); and
- Any equity of redemption a debtor may have as a mortgagor or trustor under a deed of trust.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.4 2. Personal Property

§2.4 2. Personal Property

All of the debtor's personal property interests are included in property of the estate. These interests may include, without limitation:

- Any interest the debtor has under a contract (subject to the right to reject or assume and assign the contract under 11 USC §365; see generally chap 6);
- Property seized before commencement of the case;
- All tangible personal property interests (such as goods, equipment, machinery, furniture, inventory, or vehicles); and
- All intangible personal property interests (such as accounts, bank accounts, copyrights, patents, trademarks, tax refunds, and other tax attributes such as a Subchapter S election, choses or rights in action, goodwill, and benefits under noncompete agreements).

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§2.5 3. Community Property

Property of the estate includes all interests of the debtor and the debtor's spouse in community property, wherever located, as of the beginning of the bankruptcy case, that is either (11 USC §541(a)(2)):

- Under the sole, equal, or joint control of the debtor; or
- Liable for an allowable claim against the debtor, or for both an allowable claim against the debtor and an allowable claim against the debtor's spouse, to the extent that such interest is so liable.

In the context of §541(a)(2), property "liable" for an allowable claim means any community property that could be levied on by an execution creditor; it is not limited to property subject to existing liens.

If one spouse alone files a bankruptcy petition, all community property of both spouses is included in the estate of the filing spouse. *Dumas v Mantle (In re Mantle)* (9th Cir 1998) 153 F3d 1082. See 11 USC §541(a)(2)(A). The effect of this provision is to terminate the right of the nonfiling spouse to manage and control the community property. As a result, if the spouses are involved in dissolution of marriage proceedings, one spouse may initiate a bankruptcy case in order to gain control over the community. This tactic is more common if there are assets of significant value and the filing spouse seeks to reorganize under Chapter 11. This tactic would have little or no significance in a Chapter 7 case in which estate property is controlled by the bankruptcy trustee.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.6 4. Property Recovered by Trustee

§2.6 4. Property Recovered by Trustee

Property that a trustee (or the debtor in possession in Chapter 11 cases) recovers from third parties is included as property of the estate. 11 USC §541(a)(3). Some examples of recoverable property include:

- Excessive compensation paid to attorneys (11 USC §329(b));
- In a public sale at which the sale price was controlled by an agreement among the bidders, the excess of the value of the property sold over the purchase price, as well as attorney fees and costs (11 USC §363(n));
- Property turned over by a custodian (see §2.31), including an assignee for the benefit of creditors (11 USC §543);
- Property or damages from transfers that were avoided by the trustee (or debtor in possession) under 11 USC §544, §545, §547, §548, §549, §553(b), or §724(a) (see §§2.32-2.67) (11 USC §550);
- Certain claims offset by a creditor (11 USC §553) (see *Parker v Community First Bank (In re Bakersfield Westar Ambulance, Inc.*) (9th Cir 1997) 123 F3d 1243 (trustee allowed to recover funds set off prepetition by bank under 11 USC §553(b))); and
- When the debtor is a partnership with insufficient property to pay all allowed claims, amounts from the general partners sufficient to make up the deficiency, to the extent that the general partners are personally liable under applicable nonbankruptcy law for the deficiency (11 USC §723).

Unless recovered by the trustee (or debtor in possession), however, property transferred by the debtor to a third party before bankruptcy does not become property of the estate. *U.S. v Lawrence* (9th Cir 1999) 189 F3d 838, 845 (assets transferred to irrevocable trust prepetition are not part of estate unless, as in this case, transfer was void).

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§2.7 5. Property Preserved for Benefit of Estate

The estate includes any interest in property preserved for the benefit of the estate or transferred to it under 11 USC §510(c) (subordination of claims) or §551 (preservation of avoided transfers). 11 USC §541(a)(4). For example, if a judgment lien is avoided by the court as preferential (see §§2.37-2.55) and there are subordinate secured lien claims, the avoided judgment lien is preserved so that the estate will realize on the value of the avoided lien before the subordinate lien claim is paid. See 11 USC §510(c). Preservation of the avoided judgment lien will prevent a junior lien from gaining a more senior position as a result of action by the trustee or debtor in possession, and thereby receiving a windfall. See *Retail Clerks Welfare Trust v McCarty (In re Van de Kamp's Dutch Bakeries)* (9th Cir 1990) 908 F2d 517 (avoided transfers are preserved for estate's benefit despite state law remedies available to junior lienholders; preserved transfer succeeds to priority that transferred interest enjoyed over competing interests). The policy behind §541(a)(4) is to maximize the assets available for distribution to creditors.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.8 6. Bequests, Divorce Settlements, and Life Insurance Payments

§2.8 6. Bequests, Divorce Settlements, and Life Insurance Payments

Property of the estate includes property that the debtor acquires, or becomes entitled to acquire, within 180 days after the filing of the bankruptcy petition by bequest, devise, or inheritance; under a settlement agreement with a spouse or a divorce decree; or as a beneficiary under a life insurance policy. 11 USC §541(a)(5).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.9 7. Proceeds, Rents, Profits, Postpetition Earnings

§2.9 7. Proceeds, Rents, Profits, Postpetition Earnings

Generally, all proceeds, products, offspring, rents, or profits from property of the estate (whether received or accrued before or after the filing of the petition) are included in the estate. 11 USC §541(a)(6). For example, if estate property includes an apartment building, postpetition rent derived from it is also included in the estate. Similarly, if the estate includes a business, profits from its operation are property of the estate. If the debtor purchased a lottery ticket before filing the petition, the lottery ticket is property of the estate (11 USC §541(a)(1)), as are any proceeds from the ticket.

In cases filed under Chapter 11 (on or after October 17, 2005) or under Chapter 12 or 13, the estate also includes earnings from services performed by an individual debtor after the bankruptcy petition is filed but before the case is closed, dismissed, or converted to another relief chapter. See 11 USC §§1115(a)(2), 1207(a)(2), 1306(a)(2); see also §2.15. In Chapter 7 cases, however, the estate does not include postpetition earnings for services performed by individual debtors. See 11 USC §541(a)(6).

NOTE: The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) arguably should have included, but did not include, cross-references in §541(a)(6) to conform the exception for personal service earnings found in §541(a)(6) with the provisions of 11 USC §§1115(a)(2), 1207(a)(2), and 1306(a)(2), which require such earnings to be included in the estate in Chapter 11, 12, and 13 cases.

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§2.10 8. Interests Acquired Postpetition

Property interests acquired by a Chapter 7 or Chapter 11 trustee, a Chapter 13 debtor, or a debtor in possession in a Chapter 11 case after the petition has been filed constitute property acquired *by the estate* and are therefore property of the estate. 11 USC §§541(a)(7), 1306(a)(1). For example, when the trustee or debtor in possession enters into a contract after the case has commenced, the contract and all benefits derived from it are property of the estate.

Property interests acquired by an individual debtor in a Chapter 11 case (filed on or after October 17, 2005), or by the debtor in a Chapter 12 or 13 case, after the petition has been filed but before the case is closed, dismissed, or converted to another relief chapter, are property of the estate. 11 USC §§1115(a)(1), 1207(a)(1), 1306(a)(1).

It is important to note that §541(a)(7) does not apply to property acquired postpetition by the *debtor* (as distinct from the trustee) in a Chapter 7 case. See *Sliney v Battley (In re Schmitz)* (9th Cir 2001) 270 F3d 1254 (postpetition grant of fishing rights). Usually, §541(a)(7) is relevant in a Chapter 7 case only if the trustee is operating a business in accordance with 11 USC §721.

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9. Assets Subject to Restrictions or Conditions

§2.11 a. Some Restrictions or Conditions Are Unenforceable

The debtor's interest in property becomes property of the estate despite any restriction or condition in an agreement, transfer instrument, or nonbankruptcy law on the debtor's ability to transfer the interest. 11 USC §541(c)(1).

An example of such a restriction or condition is a right of first refusal held by a third party. If an asset is subject to a right of first refusal, the underlying asset becomes an asset of the estate despite that restriction. The right of first refusal, however, may be preserved if it is properly perfected before bankruptcy (*e.g.,* properly recorded) and subsequently enforced when the trustee or debtor seeks to transfer the underlying asset. But see *Steffan v McMillan (In re Coordinated Fin. Planning Corp.)* (BAP 9th Cir 1986) 65 BR 711 (right of first refusal was executory contract, subject to rejection by trustee); see also §§6.29, 7.59. Further, property of the estate includes any property subject to a condition relating to the insolvency or financial condition of the debtor, the commencement of a bankruptcy case, or the appointment of a custodian prepetition that causes (or gives the beneficiary of the condition a right to cause) a forfeiture, modification, or termination of the debtor's interest in the property in question. 11 USC §541(c)(1)(A)-(B). An example of the latter would be the debtor's interest in a partnership operating under an agreement that provided for the termination of the partnership in the event of a partner's insolvency (a so-called ipso facto clause). See *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702 (term of option contract that right would terminate if bankruptcy was filed was not enforceable under 11 USC §541(c)). See also 11 USC §365(e). See §6.53.

Section 541(c)(1) renders all of the debtor's assets property of the estate regardless of any restrictions or conditions on transfer. 11 USC §541(c). Its applicability extends to leases and executory contracts; in general, it renders ineffective restraints on alienation that would otherwise prevent assets from becoming property of the estate. But see §2.12 for an exception to the unenforceability in bankruptcy of restraints on alienation.

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§2.12 b. Spendthrift Trust Exception

The Bankruptcy Code recognizes an exception to the unenforceability of restraints on alienation of the debtor's interests in property for so-called spendthrift trusts. A spendthrift trust is a trust with a provision intended to prevent access to trust assets by creditors of the beneficiary, by prohibiting voluntary or involuntary transfers of the beneficiary's interest. See generally Prob C §§15300-15301. California has imposed statutory limitations on the enforceability of spendthrift trusts. See Prob C §15306.5; *Ammco Ornamental Iron, Inc. v Wing* (1994) 26 CA4th 409, 31 CR2d 564. Under 11 USC §541(c)(2), restrictions on the transfer of the debtor's beneficial interest in a trust that are enforceable under applicable nonbankruptcy law are enforceable in bankruptcy proceedings. 11 USC §541(c)(2). Thus, in California, spendthrift clauses will be enforceable to the extent they are enforceable outside of bankruptcy. See *Ehrenberg v Southern Cal. Permanente Med. Group (In re Moses)* (9th Cir 1999) 167 F3d 470 (valid spendthrift trust under California law in medical group retirement plan with Chapter 7 debtor participant was excluded from property of estate). This is the Bankruptcy Code's only express exception to the general rule of 11 USC §541(c)(1) invalidating restrictions on transfer of the debtor's interest in property.

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§2.13 10. Property in Which Debtor Holds Legal Title but Not Equitable Ownership

To the extent that the debtor holds legal title to, but not an equitable ownership interest in, property, the estate succeeds only to the debtor's legal title and not to the beneficial interest in the property. 11 USC §541(d). This provision was added to the Bankruptcy Code to facilitate secondary mortgage market transactions. If an entity retains legal title to a mortgage for loan-servicing purposes, the beneficial interest sold to third party investors will not constitute property of the estate if the loan servicer files a bankruptcy case.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.14 C. Property Excluded From Estate

§2.14 C. Property Excluded From Estate

Although the definition of property of the estate is quite expansive, the Bankruptcy Code provides some specific exclusions. See 11 USC §541(b). The most notable exclusions are discussed in §§2.15-2.23.

NOTE: Property excluded from the estate should be distinguished from property that individual debtors may claim as exempt under 11 USC §522 and CCP §§703.101-704.995. For discussion of individual debtor exemptions, see §1.9. If an individual debtor does not affirmatively claim an exemption for property eligible for an exemption, the property remains property of the estate.

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§2.15 1. Personal Service Income

Earnings from services performed by an individual (as distinct from an entity such as a corporation, partnership, or limited liability company) after the commencement of the bankruptcy case are excluded from property of the estate in Chapter 7 cases, but not in Chapter 11 cases filed on or after October 17, 2005, or Chapter 12 or 13 cases. See 11 USC §§541(a)(6), 1115(a)(2), 1207(a)(2), 1306(a)(2). See also §2.9. In an individual Chapter 11 case, the plan of reorganization must provide for payment to creditors of all or such portion of earnings from personal services performed by the debtor after commencement of the case or other future income of the debtor as is necessary for execution of the plan. 11 USC §1123(a)(8). Under a Chapter 12 or 13 plan, the debtor must normally dedicate postpetition "disposable income" to fund plan payments to creditors in order to confirm a plan of adjustment and obtain the benefits of a discharge. See 11 USC §§1225(b), 1228, 1325(b), 1328.

If the debtor's compensation takes the form of a commission, an issue may arise as to what portion of the commission is attributable to services performed during the prebankruptcy period and is therefore property of the estate. For example, a real estate broker may receive a commission after his or her bankruptcy case has been filed on account of work performed in the prebankruptcy period. The test is not when the transaction closes, but instead when the personal services were rendered. A real estate broker's commission will be property of the estate if the services were performed prepetition, even if the underlying escrow does not close until after the petition date. *Tully v Taxel (In re Tully)* (BAP 9th Cir 1996) 202 BR 481.

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§2.16 2. Powers Debtor Can Exercise Solely for Another

Property of the estate does not include powers that the debtor can exercise solely for the benefit of an entity other than the estate. 11 USC §541(b)(1). For example, a custodial parent's right to collect child support arrearages is not property of the estate. See *In re Anders* (Bankr D Nev 1993) 151 BR 543; *In re Welch* (Bankr D Kan 1983) 31 BR 537 (applying §541(b)(1) by analogy).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.17 3. Debtor's Interest Under Terminated Nonresidential Real Property Lease

§2.17 3. Debtor's Interest Under Terminated Nonresidential Real Property Lease

Property of the estate does not include the debtor's interest as a lessee under a nonresidential real property lease that terminates by the expiration of its stated term before the commencement of the bankruptcy case. 11 USC §541(b)(2). Nonresidential real property leases, as well as other leases and executory contracts to which the debtor is a party, that remain in effect after the bankruptcy case is filed are subject to 11 USC §365 and may be assumed or rejected by the trustee or debtor in possession in accordance with that section. See generally chaps 6-7.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.18 4. Education Individual Retirement Accounts; Tuition Credits or Accounts Under State Tuition Programs

§2.18 4. Education Individual Retirement Accounts; Tuition Credits or Accounts Under State Tuition Programs

For cases filed on or after October 17, 2005, property of the estate does not include funds placed in an education individual retirement account as defined in IRC §530(b)(1) or funds used to purchase a tuition credit or contribute to an account under a qualified state tuition program in accordance with IRC §529(b)(1), provided the criteria set forth in 11 USC §541(b)(5)-(6), (e) are met.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.19 5. Contributions to Certain Employee Benefit Plans

§2.19 5. Contributions to Certain Employee Benefit Plans

In cases filed on or after October 17, 2005, property of the estate does not include amounts withheld from an employee's wages by an employer or received by an employer from an employee for payment of a contribution to an employee benefit plan subject to Title 1 of the Employee Retirement Income Security Act of 1974 (ERISA), a governmental employee benefit plan under IRC §414(d), a deferred compensation plan under IRC §457, a tax-deferred annuity under IRC §403(b), or a health insurance plan regulated by state law. 11 USC §541(b)(7).

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§2.20 6. Property Pledged to Personal Property Lender

In cases filed on or after October 17, 2005, under the so-called "pawnbroker" exclusion, property of the estate does not include a debtor's interest in tangible personal property pledged or sold as collateral for a loan or advance by a person licensed under state law to make such loans or advances, provided that (1) the tangible personal property is in the possession of the pledgee or transferee; (2) the debtor has no obligation to repay the money, redeem the collateral, or buy back the property at a stipulated price; and (3) neither the debtor nor the trustee have timely exercised any right to redeem the property under the contract or state law. 11 USC §541(b)(8).

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§2.21 7. Debtor's Interest in ERISA-Qualified Pension Plan

Pension plans qualified under the Employee Retirement Income Security Act of 1974 (ERISA) (29 USC §§1001-1461) are not included in property of the estate. *Patterson v Shumate* (1992) 504 US 753, 119 L Ed 2d 519, 112 S Ct 2242. See also *Raymond B. Yates, M.D., P.C. Profit Sharing Plan v Hendon* (2004) 541 US 1, 158 L Ed 2d 40, 124 S Ct 1330. Like spendthrift trusts (see §2.12), ERISA-qualified plans include restrictions on transfer of the debtor's beneficial interest that are enforceable under applicable nonbankruptcy law (in this case, ERISA), and are therefore enforceable in bankruptcy under 11 USC §541(c)(2). *Patterson,* 504 US at 757, 119 L Ed 2d at 526; *IRS v Snyder* (9th Cir 2003) 343 F3d 1171. In fact, ERISA requires an antialienation provision for ERISA qualification of the plan, and such provisions constitute enforceable transfer restrictions under 11 USC §541(c)(2). However, when the pension plan is established by the debtor's wholly owned corporation and the debtor is the sole beneficiary, the result may be different, and the interest may be included as property of the estate. *Watson v Proctor (In re Watson)* (9th Cir 1998) 161 F3d 593.

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§2.22 8. Constructive Trusts

When it would be appropriate to impose a constructive trust because of fraudulent or illegal conduct by the debtor, the property that would be the subject of the trust may in certain instances be excluded from the estate. *Torres v Eastlick (In re North Am. Coin & Currency, Ltd.)* (9th Cir 1985) 767 F2d 1573, amended at 774 F2d 1390. The creditor seeking to impose a constructive trust, however, must take some action before commencement of the bankruptcy case that would give a judicial lien creditor or bona fide purchaser for value notice of the creditor's potential constructive trust claim. See *In re Indian River Estates, Inc.* (Bankr ND Ohio 2003) 293 BR 429 (constructive trust recognized in bankruptcy where court judgment established trust prior to bankruptcy). This action could be the initiation of a state court action and the filing of a lis pendens. If the creditor fails to do so, the bankruptcy court will not subsequently impose a constructive trust on the debtor's property, at least not on real property. See *Chbat v Tleel (In re Tleel)* (9th Cir 1989) 876 F2d 769; *National Bank v Erickson (In re Seaway Express Corp.)* (9th Cir 1990) 912 F2d 1125.

A party attempting to impress a constructive trust on commingled funds has the burden of tracing the funds directly back to the alleged illegal transaction. *Taylor Assocs. v Diamant (In re Advent Mgmt. Corp.)* (9th Cir 1997) 104 F3d 293.

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§2.23 9. Resulting Trusts Distinguished

When the parties to a prepetition transaction intended that their arrangement was in fact a trust, as distinguished from the equitable remedy of a constructive trust, a bankruptcy court may give effect to that intent by recognizing the resulting trust and excluding the trust property from the estate. This requires that the trustee be on notice of the existence of the trust. See *Siegel v Boston (In re Sale Guar. Corp.)* (BAP 9th Cir 1998) 220 BR 660, aff'd (9th Cir 2000) 199 F3d 1375 (debtor was accommodator for tax-deferred exchanges; exchange property was subject to resulting trust and did not become property of the estate); *Texas Comptroller of Pub. Accounts v Megafoods Stores, Inc. (In re Megafoods Stores, Inc.)* (9th Cir 1998) 163 F3d 1063 (Texas state sales taxes created statutory trust fund if traceable, despite commingling, which was not property of estate; state was entitled to interest).

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III. TURNOVER OF PROPERTY HELD BY ANOTHER

§2.24 A. Generally

Generally, persons or entities who are not officers of the bankruptcy court are required to turn over and account for any property of the debtor in their possession that the trustee (or debtor in possession in a Chapter 11 case) may utilize as property of the estate. See 11 USC §542(a). Two Bankruptcy Code sections are relevant: §542, which deals with turnover generally (see §§2.25-2.30), and §543, which addresses turnover of property by a custodian (see §2.31).

NOTE: "Custodian" is broadly defined in the Bankruptcy Code to include a receiver or trustee of any of the debtor's property appointed under nonbankruptcy law, an assignee for the benefit of the debtor's creditors, or a trustee, receiver, or agent under applicable law or contract that is appointed or authorized to take charge of property of the debtor to enforce a lien on the property or otherwise to administer the property for the benefit of the debtor's creditors. See 11 USC §101(11).

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B. Turnover Under 11 USC §542

§2.25 1. Generally

Bankruptcy Code §542 requires an entity (other than a custodian) in possession, custody, or control, while the bankruptcy case is pending, of property that the trustee (or debtor in possession) may use, sell, or lease under 11 USC §363, or that the debtor may exempt under 11 USC §522, to turn over the property to the trustee (or debtor in possession) and account for it, unless it is of inconsequential value or benefit to the estate. 11 USC §542(a).

The turnover powers are quite broad. See, *e.g., U.S. v Whiting Pools, Inc.* (1983) 462 US 198, 76 L Ed 2d 515, 103 S Ct 2309 (IRS compelled to turn over seized property that was also held by secured creditors).

A prepetition tax return is property of the estate. Consequently, the trustee is entitled to seek turnover from the debtors, pursuant to 11 USC §542, of the value of the debtors' prepetition income tax refunds that the debtors irrevocably elected to apply to postpetition tax liabilities. *Nichols v Birdsell (In re Nichols)* (9th Cir 2007) 491 F3d 987.

NOTE: The language in the statute excusing turnover if the "property is of inconsequential value or benefit to the estate" (11 USC §542(a)) should be read in the conjunctive to require that the property be of both inconsequential value *and* inconsequential benefit to the estate. When, for example, the market value of the debtor's interest in property levied on by a creditor was small but the property was all that was necessary to run the debtor's business, turnover was compelled. *Alpa Corp. v Commissioner (In re Alpa)* (Bankr D Utah 1981) 11 BR 281.

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§2.26 2. Turnover Procedures

Turnover actions are normally initiated by complaint in an adversary proceeding. See Fed R Bankr P 7001(1); see also §§4.42-4.50. The turnover of books and records under 11 USC §542(e), however, may be compelled by motion because that section expressly provides for the turnover of books, records, and documents "after notice and a hearing." See §§2.30-2.31. A turnover action requires the court to determine the nature and extent of the estate's property interest. *Hancock Mut. Life Ins. Co. v Watson (In re Kincaid)* (9th Cir 1990) 917 F2d 1162. A debtor who fails to timely comply with a trustee's turnover demand may be subject to a damage claim. *Lundell v Ulrich (In re Lundell)* (BAP 9th Cir 1999) 236 BR 720.

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§2.27 3. Payment of Debts Owed to Debtor by Third Parties

An entity owing a debt that is property of the estate and that is matured, payable on demand, or payable on order is required to pay the debt to the trustee or debtor in possession, subject to any right of offset that may exist. 11 USC §542(b). A question arises as to what a "matured" debt is. The outstanding balance on an open account is clearly a matured debt. Contract claims, however, may not be mature, because defenses may be available to the obligor under the contract that render the claim contingent or subject to offset.

Section 542(b) also requires banks and other depository institutions to honor checks drawn by the trustee or debtor in possession on the debtor's bank account, subject to any right of offset the bank may have for amounts owed by the debtor to the bank.

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§2.28 4. Entities Without Knowledge of Case

An entity that has neither actual notice nor actual knowledge of the commencement of the debtor's bankruptcy case may transfer property of the estate or pay a debt owed to the debtor, in good faith, to an entity other than the trustee or debtor in possession with the same effect as if the bankruptcy case had not been initiated. 11 USC §542(c). "Entity" includes a person, estate, trust, governmental unit, and the U.S. Trustee. 11 USC §101(15). This provision is intended only to protect the transferor or payor, not the transferee or payee. See 124 Cong Rec H 11,097 (daily ed Sept. 28, 1978), reprinted in 1978 US Code Cong & Ad News 6436, 6456 (statement of Hon. Don Edwards, Chair, Subcommittee on Civil and Constitutional Rights of House Committee on Judiciary). A transferee or payee may still have exposure to the trustee under 11 USC §§549 (avoidance of unauthorized postpetition transfers) and 550 (recovery of avoided transfers; see §2.6).

PRACTICE TIP: To guard against the possibility that a transferee of real property may become a bona fide purchaser without knowledge, it is good practice for debtor's counsel to record a certified copy of the bankruptcy petition in the county where the debtor's real property is located. See 11 USC §549(c).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.29 5. Exception for Certain Life Insurance Company Actions

§2.29 5. Exception for Certain Life Insurance Company Actions

A life insurance company may transfer property of the debtor or the debtor's estate to itself, in good faith, as if no bankruptcy case had been filed, to pay a premium or to carry out a nonforfeiture option, as long as the payment was required to be made automatically under the insurance contract. The contract must have been entered into before the bankruptcy case was filed and must be property of the debtor's bankruptcy estate. 11 USC §542(d).

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§2.30 6. Turnover of Books and Records

Subject to any applicable privilege, after notice and a hearing, the court may order an attorney, accountant, or other person who holds recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs to turn over or disclose such recorded information to the trustee (or to the debtor in possession in a Chapter 11 case). 11 USC §542(e).

In general, all books, records, documents, or papers must be turned over, even if they are not property of the debtor, as long as they are relevant to the debtor's property or financial condition. Sometimes professionals such as accountants and attorneys attempt to withhold records to obtain payment of their fees ahead of other creditors, but §542(e) was intended to prevent this practice. *In re Beef N' Burgundy, Inc.* (Bankr ND Ga 1982) 21 BR 69, 70.

That §542(e) is subject to applicable privileges raises the question of just who holds, and has the power to waive, the attorney-client privilege in this context. The U.S. Supreme Court has ruled that, if the debtor is a corporation, the trustee is the holder of, and can waive, the privilege with respect to prebankruptcy communications. *Commodity Futures Trading Comm'n v Weintraub* (1985) 471 US 343, 85 L Ed 2d 372, 105 S Ct 1986. Thus, in a corporate Chapter 7 liquidation, the attorney-client privilege resides with the trustee who can compel turnover, even from the debtor's counsel. In *Weintraub,* however, the U.S. Supreme Court specifically declined to rule on whether a trustee in an individual Chapter 7 case is the holder of the privilege.

PRACTICE TIP: An attorney should advise a client who is contemplating a Chapter 7 filing that information conveyed to the attorney in confidence could be subject to disclosure to a bankruptcy trustee after the client files the bankruptcy case. The attorney should consider obtaining appropriate conflict-of-interest waivers from the client.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.31 C. Turnover by Custodian Under 11 USC §543

§2.31 C. Turnover by Custodian Under 11 USC §543

Generally, a custodian (see §2.24) with knowledge of the commencement of a bankruptcy case may not make any disbursement from, or take any action in administration of, property of the debtor (including proceeds, products, rents, or profits of such property), except as necessary to preserve the property. 11 USC §543(a).

After commencement of the case, the Bankruptcy Code imposes certain duties on the custodian. The custodian must (11 USC §543(b)(1)-(2)):

- Deliver to the trustee (or debtor in possession) any property of the debtor (along with all proceeds, rents, or profits of the property) that is in the custodian's possession, custody, or control on the date the custodian learns of the case; and
- File an accounting of any property of the debtor (and any proceeds, rents, or profits of such property) that was in the custodian's possession, custody, or control.

The bankruptcy court may excuse the custodian from its duty to turn over and account for property if the interests of creditors (and in the case of a solvent debtor, equity security holders) would be better served by permitting the custodian to remain in possession or control of the debtor's property. 11 USC §543(d)(1). If the custodian is an assignee for the benefit of the debtor's creditors who was appointed or took possession more than 120 days before the petition date, then the court must excuse compliance with the turnover duty unless it is necessary to prevent fraud or injustice. 11 USC §543(d)(2).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.32 IV. THE AVOIDING POWERS

§2.32 IV. THE AVOIDING POWERS

The Bankruptcy Code grants trustees (and debtors in possession in Chapter 11 cases) the power to void or rescind certain transfers made by the debtor to third parties or, in the alternative, to recover the value of the property transferred. These so-called avoidance powers are codified in 11 USC §§544-550 and reflect the fundamental policy of bankruptcy law that the debtor's assets should be distributed ratably among the debtor's creditors. *Elliott v Frontier Props. (In re Lewis F. Shurtleff, Inc.)* (9th Cir 1985) 778 F2d 1416, 1420. The avoidance powers enable the trustee or debtor in possession to nullify transfers of money or other property by the debtor that conferred a benefit on one creditor that was not shared proportionately by the other creditors. As a consequence of exercise of the avoiding powers, money or property from the rescinded transaction is returned to the estate, which is thereby augmented for the benefit of all creditors.

NOTE: Creditors generally cannot initiate avoidance actions, but may do so with court approval if the trustee so stipulates. *Avalanche Maritime, Ltd. v Parekh (In re Parmetex, Inc)* (9th Cir 1999) 199 F3d 1029 (unsecured creditors had standing to bring avoidance actions under court-approved stipulation with Chapter 7 trustee). See also *Duckor Spradling & Metzger v Baum Trust (In re P.R.T.C., Inc.)* (9th Cir 1999) 177 F3d 774 (court can authorize assignment to creditor of trustee's powers to sue and avoid if creditor is pursuing interests common to all creditors and creditor's exercise of those powers will benefit remaining creditors).

All of the avoiding powers are exercised by filing a complaint in the bankruptcy court, thus initiating an adversary proceeding in the bankruptcy case. Fed R Bankr P 7001. An adversary proceeding is necessary for the bankruptcy court to obtain personal jurisdiction over the third party transferee. See generally §§4.42-4.50. If the trustee or debtor in possession is successful, the bankruptcy court will issue an order requiring the transferee to return the money or property transferred (or its value) to the estate.

In general, the proper venue for an avoidance action is in the district court (or bankruptcy court) where the bankruptcy case is pending. 28 USC §1409(a). However, if the avoidance claim is for recovery of (1) a money judgment or property worth less than $1100, (2) a consumer debt of less than $16,425, or (3) a nonconsumer debt of less than $10,950 from a noninsider, then venue is in the district court (or bankruptcy court) for the district in which the defendant resides. 28 USC §1409(b).

On the avoiding powers as they apply to real property secured lenders, see chap 10.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.33 A. 'Strong-Arm' Avoidance Power

§2.33 A. "Strong-Arm" Avoidance Power

The so-called strong-arm power of 11 USC §544 enables the trustee (or the debtor in possession in a Chapter 11 case) to avoid unperfected liens and security interests in personal property of the estate and unrecorded transfers of the debtor's real property. See 11 USC §544. The strong-arm powers operate by conferring on the trustee (or debtor in possession), as of the commencement of the bankruptcy case, with respect to the debtor's property, the legal status of (11 USC §544(a)(1)-(3)):

- A judicial lien creditor;
- An execution creditor whose levy of execution was returned unsatisfied; and
- A bona fide purchaser of real property (other than fixtures) who has properly perfected the transfer from the debtor.

The legal status conferred by §544(a) is hypothetical, because it is effective whether or not a judicial lien creditor, execution creditor, or bona fide purchaser actually exists. Moreover, the trustee's strong-arm powers are not limited by the amount of the total distribution to unsecured creditors. *Acequia, Inc. v Clinton (In re Acequia, Inc.)* (9th Cir 1994) 34 F3d 800.

Section 544(a) is one of the most important provisions in the Bankruptcy Code, because it elevates the priority of the legal rights of the trustee or debtor in possession in property that is or will become property of the estate. As a result of §544(a), the rights of the trustee or debtor in possession in personal property are senior in priority to the rights of a holder of an unperfected security interest in the same property, and the rights of the trustee or debtor in possession in real property are senior in priority to the rights of a transferee of the same property who did not record the transfer instrument before the debtor's bankruptcy filing. See generally *In re Wheaton Oaks Office Partners Ltd. Partnership* (7th Cir 1994) 27 F3d 1234 (§544(a) vests trustee with rights of hypothetical lien creditor whose lien was perfected as of petition date; if security interest holder has not taken necessary steps under applicable law to put other potential creditors on notice of its interest, then trustee can subordinate or avoid that security interest, thus relegating creditor to status of unsecured creditor of estate).

The nature and extent of the rights of the trustee or debtor in possession as a judicial lien or execution creditor or a bona fide purchaser are established by the substantive law of the jurisdiction governing the property in question. The question of whether a security interest in personal property has been properly perfected can be complex, depending on the type of collateral. See generally Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

The applicable real property recording acts establish the priority of a bona fide purchaser over the holder of an unrecorded real property interest. See CC §§1213-1220; *Swiss Bank Corp. v Van Ness Assocs., Ltd (In re Van Ness Assocs., Ltd)* (Bankr ND Cal 1994) 173 BR 661 (state law determines whether debtor in possession's status as bona fide purchaser of real property would defeat bank's unrecorded deed of trust lien on strip of that property). An attachment lien obtained before the petition date may survive an attack under §544(a) as long as actions are taken (either after relief from stay is granted or after the bankruptcy case has been closed) to obtain a judgment and perfect a levy on the judgment. *Diamant v Kasparian (In re Southern Cal. Plastics, Inc.)* (9th Cir 1999) 165 F3d 1243. See also *Southern Cal. Bank v Zimmerman (In re Hilde)* (9th Cir 1997) 120 F3d 950 (service of order to appear (ORAP) for judgment debtor examination under CCP §708.110(d) created lien against all of debtor's nonexempt personal property; ORAP lien was not avoidable by trustee under 11 USC §544 or §547 when lien arose more than 90 days before bankruptcy petition was filed).

If the holder of an unperfected security interest or unrecorded real property interest does not voluntarily acknowledge the rights of the trustee or debtor in possession in the property at issue, the trustee or debtor in possession may commence an adversary proceeding by filing a complaint in bankruptcy court, in the nature of a declaratory judgment action, to confirm the rights of the trustee or debtor in possession in the property and, if necessary, to order the property at issue to be returned to the estate. See §4.45.

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§2.34 B. Transfers Voidable by Unsecured Creditor

Bankruptcy Code §544 includes an additional provision enabling the trustee (or debtor in possession in a Chapter 11 case) to avoid any transfer of an interest of the debtor in property, or any obligation incurred by the debtor, that is voidable under applicable law by a creditor holding an unsecured claim. 11 USC §544(b)(1). This subsection does not create any independent avoidance power; it merely recognizes the right of an actual creditor to avoid a transfer or obligation under any applicable nonbankruptcy law, and it confers standing on the trustee or debtor in possession to initiate and prosecute such a claim. For example, 11 USC §544(b) allows a trustee or debtor in possession to assert, for the benefit of the estate, a creditor's rights under the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12) as adopted in California. See generally *Acequia, Inc. v Clinton (In re Acequia, Inc.)* (9th Cir 1994) 34 F3d 800.

The existence of a cause of action under §544(b), however, depends on whether a creditor existing at the time the transfers were made still had a viable claim against the debtor at the time the bankruptcy petition was filed. If no such creditor exists, the trustee or debtor in possession is without power to act under §544(b). *Sender v Simon* (10th Cir 1996) 84 F3d 1299; *Acequia, Inc. v Clinton (In re Acequia, Inc.), supra*; *Dicello v Jenkins (In re Int'l Loan Network, Inc.)* (Bankr D DC 1993) 160 BR 1. In effect, an action under §544(b) requires the existence of a creditor who was economically harmed by the transfer. It is important to note, however, that §544(b) does not confer standing on the creditor itself or a creditors' committee to avoid the transfer. Only the trustee or debtor in possession has that power. See *Tri-Star Techs. Co. v Pitocchelli (In re Tri-Star Techs. Co.)* (Bankr D Mass 2001) 260 BR 319.

NOTE: If an action under §544(b) is successful, the entire transfer is rescinded for the benefit of the estate, not merely a portion equal to the amount of the claim of the creditor whose rights are asserted by the trustee. The entire transfer is preserved for the benefit of the creditor body as a whole, not just the creditor whose rights were assumed and enforced by the trustee. See *Moore v Bay* (1931) 284 US 4, 76 L Ed 133, 52 S Ct 3; *Acequia, Inc. v Clinton (In re Acequia, Inc.), supra*. See also 11 USC §550(a).

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C. Avoidance of Certain Statutory Liens

§2.35 1. Generally

Certain statutory liens are avoidable by the trustee or debtor in possession. See 11 USC §545. A statutory lien is a creature of statute, which arises automatically in the circumstances or on the conditions set forth in the statute, rather than by agreement of the parties. See 11 USC §101(53). Examples of statutory liens that are subject to avoidance under §545 include *unperfected* tax liens, mechanics' liens, artisans' liens, and liens for rent or liens of distress for rent. By definition under the Bankruptcy Code, a statutory lien does not include a security interest or a judicial lien (even though such liens are also governed by statute). 11 USC §101(53). Under the Bankruptcy Code, statutory liens subject to avoidance also do not include warehousemen's liens. See §2.36.

On mechanics' and other construction liens, see chap 9. For further discussion of tax liens, see §§3.12-3.15. See also *Battley v U.S. (In re Berg)* (9th Cir 1997) 121 F3d 535 (Chapter 13 trustee not allowed to avoid federal tax lien under IRC §6321). If the statute creating the lien does not include formal perfection requirements, however, the lien may not be avoidable. See *Saslow v Andrew (In re Loretto Winery Ltd)* (9th Cir 1990) 898 F2d 715 (state law producer's lien with no formal perfection requirements not avoidable by trustee).

NOTE: BAPCPA added a rather obscure exception to 11 USC §545(2), which was apparently intended to prevent a bankruptcy trustee without actual notice of a recorded tax lien from defeating the lien. The proper interpretation of this exception is presently unclear. See Klee, *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005—Business Bankruptcy Amendments* (2005) (available online, see Directory).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.36 2. Warehousemen's Liens

§2.36 2. Warehousemen's Liens

Title 11 USC §546(i)(1) prohibits the trustee from avoiding warehousemen's liens for storage, transportation, or other costs incidental to the storage and handling of goods. The prohibition is to be applied consistently with any state statute applicable to the lien that is similar to UCC §7-209 (see Com C §7209). 11 USC §546(i)(2).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.37 D. Avoidance of Preferential Transfers

§2.37 D. Avoidance of Preferential Transfers

A preference is any transfer of an interest of the debtor in property that meets all the following five statutory conditions (11 USC §547(b)(1)-(5)):

(1) The transfer was made to or for the benefit of a creditor (see §2.38);

(2) The transfer was made for or on account of an antecedent debt owed by the debtor before the transfer was made (see §§2.39-2.40);

(3) The transfer was made while the debtor was insolvent (see §2.41);

(4) The transfer was made (see §2.42):

(A) On or within 90 days before the filing of the petition; or

(B) Between 90 days and 1 year before the petition date, if the creditor at the time of the transfer was an "insider" as defined in 11 USC §101(31); and

(5) The transfer enabled the creditor to receive more than it would receive if (see §2.43):

(A) The bankruptcy case had been filed under Chapter 7;

(B) The transfer had not been made; and

(C) The creditor received payment of the debt to the extent provided by the Bankruptcy Code.

A preferential transfer is avoidable by the trustee or debtor in possession unless it falls within one of the statutory exceptions. See 11 USC §547(c); see also §§2.45-2.55.

The purpose of the preference statute is to discourage a debtor from favoring one creditor over another as the debtor's financial condition deteriorates. It is also intended to discourage creditors from dismantling the debtor by levying writs of execution and the like while the debtor is on the brink of insolvency.

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1. Elements of Avoidable Preference

§2.38 a. Transfer to or for Benefit of Creditor

To be subject to avoidance as a preference, a transfer must be to or for the benefit of a creditor. 11 USC §547(b)(1). "Creditor" generally refers to an entity with a claim against the debtor that arose at the time of or before the debtor's petition was filed in a voluntary case. See 11 USC §101(10).

Both direct and indirect transfers to a creditor are subject to preference attack. A common example of a transaction implicating both a direct and an indirect transfer is a payment by the debtor of an obligation that is guaranteed by a third party. The debtor's payment to the creditor (the primary obligor) is considered a direct transfer. Because the payment also relieves the obligation of the guarantor under the guaranty pro tanto and because the guarantor's right of subrogation makes the guarantor a contingent creditor of the debtor, the payment is also an indirect transfer to the extent that it benefits the guarantor. Another type of indirect transfer relates to the debtor's reimbursement obligation to the issuer of a letter of credit. If a bank (or other financial institution) issues a conditional letter of credit to a creditor of the debtor and, within 90 days of the petition date, concurrently secures the debtor's reimbursement obligation to the bank (or other issuer) with a security interest in the debtor's assets, the creditor, as distinguished from the issuer, may be considered to have received a transfer for purposes of §547(b). See also §1.18.

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§2.39 b. Transfer of Debtor's Property

For a transfer to be preferential, it must be a transfer of the *debtor's* property. The transfer in question may be voluntary (*e.g.,* a payment by the debtor) or involuntary (*e.g.,* a levy of execution). See 11 USC §101(54). For example, when a parent corporation or shareholder of a debtor corporation transfers its own property to a creditor of the debtor, the transfer would not be preferential, because it does not involve property of the debtor.

Sometimes situations arise when a third party provides funds to the debtor earmarked for payment to a specific creditor. See, *e.g., Stingley v AlliedSignal (In re Libby Int'l, Inc.)* (BAP 8th Cir 2000) 247 BR 463, 467 (discussing earmarking doctrine). In a classic earmarking case, the result of the transaction is merely to substitute one creditor for another; the estate is not diminished. See, *e.g., Sierra Steel Inc. v S & S Steel Fabrication (In re Sierra Steel Inc.)* (BAP 9th Cir 1989) 96 BR 271 (analysis of earmarking in construction context).

If the debtor has no discretion to use the funds other than to pay a specific creditor designated by the third party, the transfer will not be considered a transfer of the debtor's property and is not preferential. See *Adams v Anderson (In re Superior Stamp & Coin Co.)* (9th Cir 2000) 223 F3d 1004. Under this analysis, prepetition withholding tax payments to the IRS are not considered transfers of property of the debtor. *Begier v Commissioner* (1990) 496 US 53, 110 L Ed 2d 46, 110 S Ct 2258.

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§2.40 c. Transfer for or on Account of Antecedent Debt

To be avoidable as a preference, the transfer must have been made for or on account of an antecedent debt owed by the debtor before the transfer was made. 11 USC §547(b)(2). To satisfy this requirement, the date when the debt was incurred must be compared with the date of the transfer; if the debt was in existence before the transfer, it is antecedent for purposes of the preference statute. See *National Motor Freight Traffic Ass'n v Superior Fast Freight, Inc. (In re Superior Fast Freight, Inc.)* (BAP 9th Cir 1996) 202 BR 485. This requirement may be at issue if there is a delay in the perfection of a security interest or the recordation of a transfer of an interest in real property. The Bankruptcy Code considers that a transfer is "made" at the time the transfer takes effect between the transferor and the transferee as long as the transfer is perfected within 30 days (10 days for bankruptcy cases filed before October 17, 2005) after that time. 11 USC §547(e)(2)(A). Otherwise, the transfer is deemed "made" when it is perfected. 11 USC §547(e)(2)(B).

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§2.41 d. Transfer While Debtor Was Insolvent

To be considered preferential, the transfer must have been made while the debtor was insolvent. 11 USC §547(b)(3). "Insolvency" for this purpose essentially means "balance sheet insolvency," *i.e.,* that the sum of the debtor's debts is greater than the debtor's assets at a fair valuation. 11 USC §101(32)(A). See §1.16. There is a rebuttable presumption that the debtor is insolvent within the 90-day period preceding commencement of the bankruptcy case. 11 USC §547(f). For transfers made more than 90 days before the bankruptcy filing, the trustee must prove the insolvency of the debtor at the time of the transfer. In defending a preference action, the creditor has the burden of producing evidence of solvency to rebut the presumption of insolvency. 11 USC §547(g).

The question of insolvency may be rendered more difficult by the existence of unliquidated, contingent, or unmatured claims. See generally §§3.38-3.41. In evaluating insolvency, such claims must be considered even if they do not appear on the debtor's balance sheet. In large cases, experts such as investment bankers may be retained to analyze and resolve solvency questions. In Chapter 11 cases, the debtor's assets will be evaluated at a going-concern value unless the debtor's business was not viable and liquidation was imminent when the case was filed. *Wolkowitz v American Research Corp. (In re DAK Indus.)* (9th Cir 1999) 170 F3d 1197.

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§2.42 e. Transfer Within 90 Days (for Noninsiders) or Within 1 Year (for Insiders)

To be deemed preferential, the transfer must have been made within 90 days before the petition was filed. 11 USC §547(b)(4)(A). For creditors who are insiders (as defined in 11 USC §101(31)), however, the 90-day period is extended to 1 year before the petition date (11 USC §547(b)(4)(B)). See *Loo v Martinson (In re Skywalkers, Inc.)* (9th Cir 1995) 49 F3d 546 (1-year preference period applied when guarantor-officers received benefit of transfer). The 90-day and 1-year periods are often called the "preference period."

BAPCPA added 11 USC §547(i), which provides that if the trustee avoids a transfer made between 90 days and 1 year before the petition date by the debtor to an entity that is not an insider but for the benefit of an insider, the transfer is deemed avoided only with respect to the creditor who is an insider.

Sometimes a question arises as to the timing of the transfer. In a situation involving a payment by check, the transfer is deemed to have occurred when the bank honors the check. *Barnhill v Johnson* (1992) 503 US 393, 118 L Ed 2d 39, 112 S Ct 1386. See also *Hall-Mark Electronics Corp. v Sims (In re Lee)* (9th Cir 1997) 108 F3d 239 (subsequent dishonor of check was not transfer); *Hansen v MacDonald Meat Co. (In re Pacific Fisheries, Inc.)* (9th Cir 1994) 16 F3d 313 (transfer by payment on bank account with negative balance was transfer of debtor's interest in property when check was honored). Federal Rules of Bankruptcy Procedure 9006(a) governs the computation of the 90-day period. See *MBNA Am. v Locke (In re Greene)* (9th Cir 2000) 223 F3d 1064 (transfer that occurred 91 days before bankruptcy filing was not avoidable; Rule 9006 did not extend 90-day period on account of weekends or holidays).

NOTE: California law provides for the automatic release of a levy on a writ of attachment or a temporary protective order that is made within 90 days after a bankruptcy case has commenced. CCP §493.030. There is a question, however, of whether this statute is consistent with 11 USC §547(b), because if the debtor were solvent at the time of the levy, the attachment lien would not be avoidable under §547(b) and arguably should not be subject to an automatic release under CCP §493.030. Code of Civil Procedure §493.030, however, may be interpreted as an independent basis for releasing a writ of attachment or temporary restraining order. To the extent not preempted by the Bankruptcy Code, states retain the right to define the scope and extent of their own prejudgment remedies. In this instance, California law restricts the efficacy of a writ of attachment or temporary restraining order if obtained within 90 days of a bankruptcy filing or the making of a general assignment without reference to either federal or state preference law. See CCP §493.030(c). Consequently, even if state preference law is preempted by federal law, a writ of attachment or temporary protective order should nevertheless be released if obtained within 90 days of a bankruptcy filing. See CCP §493.030; *Sherwood Partners, Inc. v Lycos, Inc.* (9th Cir 2005) 394 F3d 1198. But see *Haberbush v Charles & Dorothy Cummins Family Ltd. Partnership* (2006) 139 CA4th 1630, 43 CR3d 814 (disagreeing with Ninth Circuit Court of Appeals, holding CCP §1800 not inconsistent with, and therefore not preempted by, federal bankruptcy law). See also *Credit Managers Ass'n v Countrywide Home Loans, Inc.* (2006) 144 CA4th 590, 50 CR3d 259 (CCP §1800 does not interfere with bankruptcy distribution and is not preempted by 11 USC §547).

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§2.43 f. Transfer Enables Creditor to Receive More Than in Liquidation of Debtor

A transfer is avoidable as preferential if it enabled the creditor to receive more than the creditor would have received if the bankruptcy case had been filed under Chapter 7, the transfer had not been made, and the creditor had received payment of the debt in the Chapter 7 case to the extent permitted by the Bankruptcy Code. 11 USC §547(b)(5)(A)-(C); *Batlan v Transamerica Commercial Fin. Corp. (In re Smith's Home Furnishings, Inc.)* (9th Cir 2001) 265 F3d 959. Under this analysis, the creditor is charged with the value of the property transferred plus any additional amount that the creditor would be entitled to receive in a Chapter 7 liquidation. The net result is that, for insolvent debtors, any partial payment to an unsecured creditor during the preference period will enable that creditor to receive more than the creditor would have received in Chapter 7 if the payment had not been made. *Committee of Creditors Holding Unsecured Claims v Koch Oil Co. (In re Powerine Oil Co.)* (9th Cir 1995) 59 F3d 969 (as long as bankruptcy distribution is less than full amount owed to all unsecured creditors, any payment on account to any unsecured creditor will satisfy §547(b)(5)). *Elliott v Frontier Props. (In re Lewis F. Shurtleff, Inc.*) (9th Cir 1985) 778 F2d 1416, 1421. As a consequence, this requirement is usually satisfied, although it remains an element of a preference case that must be proved. See *Batlan v Transamerica Commercial Fin. Corp. (In re Smith's Home Furnishings, Inc.), supra* (trustee had burden of proof that each payment that debtor made on loan secured by floating lien on inventory and proceeds was made at time lender was not fully secured, even though debtor's funds were commingled and trustee would be required to trace source of each payment).

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§2.44 2. Bringing Preference Actions

Preference actions are initiated by complaint as adversary proceedings in the bankruptcy court. Fed R Bankr P 7001. See §§4.45-4.50. If a creditor has filed a proof of claim in the bankruptcy case, the creditor will have no right to a jury trial on any preference claim. *Langenkamp v Culp* (1990) 498 US 42, 112 L Ed 2d 343, 111 S Ct 330. In contrast, a creditor who has not filed a proof of claim is entitled to a jury trial. *Langenkamp v Culp*, *supra.* For further discussion of jury trials in bankruptcy cases, see §§1.56, 4.65-4.66. Adversary proceedings to set aside preferential transfers against a state agency are not barred by the doctrine of sovereign immunity. *Central Va. Community College v Katz* (2006) 546 US 356, 163 L Ed 2d 945, 126 S Ct 990. Generally, the trustee (or debtor in possession) has the burden of proving the elements of a preference, and the creditor has the burden of proving defenses. 11 USC §547(g).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.45 3. Defenses to Preference Claim

§2.45 3. Defenses to Preference Claim

Bankruptcy Code §547(c) sets forth ten specific exceptions to transfers that would otherwise constitute avoidable preferences. 11 USC §547(c). See §§2.46-2.55.

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§2.46 a. Contemporaneous Exchange Exception

A transfer that was intended by the debtor and the creditor (for whose benefit the transfer was made) to have been a contemporaneous exchange for new value and in fact was a contemporaneous exchange for new value is shielded from attack as a preference. 11 USC §547(c)(1)(A)-(B). "New value" means money or money's worth in goods, services, or new credit, or a release by a transferee of property previously transferred to the transferee in a transaction that is neither void nor voidable by the debtor or trustee. It does not include an obligation substituted for an existing obligation. 11 USC §547(a)(2). The concurrent making of a loan and securing of the loan obligation would fall within this exception if consistent with the parties' intent. See *Paulman v Gateway Venture Partners III, L.P. (In re Filtercorp, Inc.)* (9th Cir 1998) 163 F3d 570 (UCC-1 financing statement filed within 5 days of creation of security interest was substantially contemporaneous exchange); *Sulmeyer v Pacific Suzuki (In re Grand Chevrolet, Inc.)* (9th Cir 1994) 25 F3d 728 (new value was conferred for contemporaneous exchange purposes by releasing automobile title documents in exchange for checks, even though vehicles had been released 1 month earlier); *O'Rourke v Seaboard Sur. Co (In re E.R. Fegert, Inc.)* (9th Cir 1989) 887 F2d 955 (prepetition payments to subcontractors were contemporaneous exchanges when payments avoided automatic creation of statutory liens). See also *Committee of Creditors Holding Unsecured Claims v Koch Oil Co. (In re Powerine Oil Co.)* (9th Cir 1995) 59 F3d 969 (contemporaneous exchange defense protects payments to extent covered by secured letter of credit). But see *Endo Steel, Inc. v Janas (In re JWJ Contracting Co.)* (9th Cir 2004) 371 F3d 1079 (replacement check issued within 90 days of bankruptcy for bounced check given in exchange for unconditional release of performance bond was payment on account of antecedent debt, not contemporaneous exchange for new value).

See also discussion of exchange for new value and mechanics' liens in §§9.57-9.63.

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§2.47 b. Ordinary Course of Business Exception

For preference claims in bankruptcy cases filed on or after October 17, 2005, the ordinary course of business defense shields transfers in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee, provided that the transfer was either (11 USC §547(c)(2)):

- Made in the ordinary course of the business or financial affairs of the debtor and the transferee (11 USC §547(c)(2)(A)), *or*
- Made according to ordinary business terms (11 USC §547(c)(2)(B)).

For preference claims in bankruptcy cases filed before October 17, 2005, the ordinary course of business defense under former 11 USC §547(c)(2) requires that the transfer was (1) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and transferee, (2) made in the ordinary course of business of the debtor and the transferee, *and* (3) made according to ordinary business terms. All three elements must be satisfied.

The ordinary course of business defense is perhaps the most common defense raised in preference actions. It protects ordinary trade creditors who customarily extend trade credit. The ordinary course of business exception reflects a policy to encourage trade creditors to maintain normal relationships with customers who are on the brink of bankruptcy.

The Ninth Circuit Court of Appeals has articulated standards for what constitutes an ordinary course of business transaction. Even a first-time transaction between the debtor and the creditor may qualify as "ordinary course of business." *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118. The first-time debt must be ordinary in relation to the debtor's and the creditor's past practices in dealing with other similarly situated parties. Only if a party has never engaged in similar transactions should the court consider more generally whether the debt is similar to debts incurred by similarly situated parties "where the debtor is not sliding into bankruptcy." 482 F3d at 1126. A court cannot limit "ordinary business terms" to the "average" transactions in the industry, but must consider the broad range of terms that encompass the practices employed by similarly situated debtors and creditors facing the same or similar problems. *Ganis Credit Corp. v Anderson (In re Jan Weilert RV, Inc.)* (9th Cir 2003) 315 F3d 1192, 1198, amended 326 F3d 1028.

The fact that the obligation of the debtor to the creditor is a long-term debt does not preclude application of the ordinary course defense. *Union Bank v Wolas* (1991) 502 US 151, 116 L Ed 2d 514, 112 S Ct 527. The payment of a debt under a restructuring agreement is not automatically outside the ordinary course of business exception. Whether this exception applies is a question of fact and depends on whether it is in the ordinary and usual industry practice to restructure past-due obligations. *Arrow Electronics, Inc. v Justus* (*In re Kaypro)* (9th Cir 2000) 218 F3d 1070.

On ordinary course of business defense and mechanics' liens, see §§9.64-9.67.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.48 c. Enabling Loan Exception

§2.48 c. Enabling Loan Exception

A trustee or debtor in possession may not avoid a transfer that creates a security interest in property acquired by the debtor to the extent that (11 USC §547(c)(3)(A)-(B)):

- The security interest secures new value (1) given at or after the debtor's execution of a security agreement in favor of the seller, (2) describing the property, (3) given to enable the debtor to acquire the property, and (4) that was in fact used to acquire the property; and
- The security interest was perfected within 20 days (within 30 days if the bankruptcy petition was filed on or after October 17, 2005) after the debtor obtained possession of the property.

This exception shields purchase money security interests from preference attack. Under this exception, a transaction in which the creditor lends money to the debtor to enable the debtor to acquire property and takes back a security interest in the property is protected as long as the creditor's security interest in the property is perfected within 20 days (within 30 days if the bankruptcy petition was filed on or after October 17, 2005) after the debtor receives the property.

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§2.49 d. Subsequent New Value Exception

When a creditor provides new value after the transfer date, the transfer is protected from avoidance to the extent of the subsequent new value given. 11 USC §547(c)(4). A common example is a payment from a debtor to a trade vendor who ships on open invoice. Often, in the course of their business dealings, the debtor may make payments before receiving shipments of goods or the creditor may ship goods before payment is received. In applying the subsequent new value defense, the value of subsequent shipments of goods will be netted against payments that would otherwise be avoidable as preferential transfers. If payment is made by check, the date of delivery of the check constitutes the date of the transfer for purposes of §547(c)(4). *Hall-Mark Electronics Corp. v Sims (In re Lee)* (9th Cir 1997) 108 F3d 239. See also *Mosier v Ever-Fresh Food Co. (In re IRFM, Inc.)* (9th Cir 1995) 52 F3d 228 (subsequent new value may be used to offset any previous preference until exhausted; new value defense does not allow credit for new value paid for by something other than avoidable transfer under §547(c)(4)(B)); *Wadsworth Bldg. Components, Inc. v Cal-Wood Door (In re Wadsworth Bldg. Components, Inc.)* (9th Cir 1983) 711 F2d 122.

Normally, the contemporaneous exchange exception to preference avoidance in 11 USC §547(c)(1) (see §2.46) does not apply to a cashier's check issued in lieu of a previously dishonored check. In the construction industry, however, a cashier's check given by a debtor-contractor to the surety, even if as a replacement check, may constitute new value for the purposes of the "subsequent new value exception" of 11 USC §547(c)(4) if the cashier's check reduces the equitable lien of a surety who is fully secured. See *Janas v Marco Crane & Rigging Co. (In re JWJ Contracting Co.)* (BAP 9th Cir 2002) 287 BR 501, aff'd (9th Cir 2004) 371 F3d 1079.

See also discussion of new value and mechanics' liens in §9.68.

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§2.50 e. Improvement of Position Exception

A transfer that creates a perfected security interest in inventory, receivables, or the proceeds of either is protected from a preference attack except to the extent that the transfer improved the creditor's position. The improvement may have occurred because the collateral base increased or because the amount of the creditor's claim was reduced; either must occur during the 90-day period before the filing of the bankruptcy petition (for a noninsider creditor holding the secured claim) or 1 year before the filing (for an insider creditor). 11 USC §547(c)(5)(A)(i)-(ii).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.51 f. Certain Statutory Liens

§2.51 f. Certain Statutory Liens

Statutory liens that are not avoidable under 11 USC §545 (see §§2.35-2.36) are also protected from avoidance as a preference. See 11 USC §547(c)(6).

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§2.52 g. Domestic Support Obligations

A transfer that was a bona fide payment of a debt for a domestic support obligation is not avoidable as a preference. 11 USC §547(c)(7). See 11 USC §101(14A) for the definition of the term "domestic support obligation."

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.53 h. Certain Payments on Consumer Debt

§2.53 h. Certain Payments on Consumer Debt

Aggregate transfers to a creditor of less than $600 made by an individual debtor on account of a consumer debt are excepted from avoidance as a preference. 11 USC §547(c)(8).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.54 i. Small Payment Exception in Nonconsumer Cases

§2.54 i. Small Payment Exception in Nonconsumer Cases

In cases in which the debtor's debts are not primarily consumer debts, the trustee or debtor in possession cannot avoid as preferential a transfer if the aggregate value of all property that constitutes, or is affected by, such transfer is less than $5475. 11 USC §547(c)(9). Because the definition of a preference in 11 USC §547(b)(1) refers to a single creditor, the $5475 cap should apply separately to each of the debtor's creditors.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.55 j. Payments Under Alternative Repayment Schedule

§2.55 j. Payments Under Alternative Repayment Schedule

The trustee cannot avoid as preferential any transfers made as part of an alternative repayment schedule between the debtor and any creditor of the debtor created by an approved nonprofit budgeting and credit counseling agency. 11 USC §547(h).

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§2.56 E. Fraudulent Transfers and Obligations

The Bankruptcy Code contains its own version of the Uniform Fraudulent Transfer Act (UFTA), similar to that adopted in many states. See 11 USC §548; compare §548 with CC §§3439-3439.12. In addition, a trustee or debtor in possession may set aside a transfer that is fraudulent under state law as made applicable to bankruptcy cases by 11 USC §544(b)(1). See §2.34. If a fraudulent transfer claim is brought under §548 in a case filed before October 17, 2005, the trustee or debtor in possession will be subject to a 1-year limitation period under which only transfers made within 1 year before the date the bankruptcy petition was filed can be challenged. See former 11 USC §548(a)(1). For cases filed more than 1 year after April 20, 2005, the 1-year lookback period is extended to 2 years. See 11 USC §548(a)(1). California's fraudulent transfer law, however, has a much longer "reach back" period. See CC §3439.09. Under 11 USC §544(b)(1) and CC §3439, the trustee or debtor in possession can set aside transfers made up to 4 years before the petition was filed.

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§2.57 1. Fraudulent Transfer Defined

A trustee or a debtor in possession may avoid as a fraudulent transfer any transfer of the debtor's interest in property, or any obligation of the debtor, made or incurred within the relevant lookback period (see §2.56), if the debtor, voluntarily or involuntarily (11 USC §548(a)(1)):

- Made the transfer or incurred the obligation with the actual intent to hinder, delay, or defraud a creditor, who either was a preexisting creditor or became one after the transfer was made (11 USC §548(a)(1)(A)); or
- Received less than a reasonably equivalent value in exchange for such transfer or obligation (11 USC §548(a)(1)(B)(i)); and
- Was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation (11 USC §548(a)(1)(B)(ii)(I));
- Was engaged in business or a transaction, or was about to engage in business or a transaction, for which any property remaining with the debtor was an unreasonably small capital (11 USC §548(a)(1)(B)(ii)(II);
- Intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured (11 USC §548(a)(1)(B)(ii)(III)); or
- Made the transfer to or for the benefit of an insider, or incurred the obligation to or for the benefit of an insider, under an employment contract and not in the ordinary course of business (11 USC §548(a)(1)(B)(ii)(IV)).

There are essentially two types of fraudulent transfers: The first type includes intentionally fraudulent transactions made with the actual intent to hinder, delay, and defraud creditors. See 11 USC §548(a)(1)(A). A typical example is a transfer of property by a debtor to relatives, friends, or an affiliated company without consideration, in the face of levying creditors or other financial crisis, with the intent that the debtor will retain the benefit of those assets as if the transfer had not been made.

Often, there is no direct evidence of actual intent to hinder, delay, or defraud creditors. In such cases, courts have applied so-called indicia or "badges" of fraud to find actual intent, including (1) actual or threatened litigation against the debtor; (2) a purported transfer of all or substantially all of the debtor's property; (3) insolvency or other unmanageable indebtedness on the part of the debtor; (4) a special relationship between the debtor and the transferee; and, (5) after the transfer, retention by the debtor of the property involved in the putative transfer. The presence of several badges of fraud may constitute conclusive evidence of actual intent, in the absence of clear evidence of a legitimate purpose for the transfer at issue. *Acequia, Inc. v Clinton (In re Acequia, Inc.)* (9th Cir 1994) 34 F3d 800, 806.

The California state fraudulent transfer law sets forth a nonexclusive list of factors that courts may consider in determining whether a transfer was made with actual intent to hinder, delay, or defraud creditors. See CC §3439.04. These factors correspond to the historical badges of fraud used in fraudulent transfer analysis and may influence a bankruptcy court—even in cases not brought under the state statute.

The second type of fraudulent transfer includes "constructively" fraudulent transfers made without the debtor's receiving reasonably equivalent value in exchange. See 11 USC §548(a)(1)(B). Examples include gifts, dividends, or other distributions to shareholders, and upstream guaranties by subsidiary corporations of their parent corporation's obligations to third parties. Such transactions are deemed fraudulent without regard to the debtor's actual fraudulent intent. They are available because the pool of assets available for creditors is diminished if the debtor is insolvent and transfers assets for less than a reasonably equivalent value.

Where a lender advances funds to a corporation's shareholders and that loan is secured by the assets of the corporation, it is not a fraudulent transfer if the corporation received the benefit of the loan proceeds. *Frontier Bank v Brown (In re Northern Merchandise, Inc).* (9th Cir 2004) 371 F3d 1056 (no fraudulent conveyance when lender's acceptance of security interest of value equivalent to loan did not diminish debtor's estate).

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§2.58 2. Bringing Fraudulent Transfer Action

Like other avoidance actions, fraudulent transfer actions are initiated by complaint in an adversary proceeding in the bankruptcy court. Fed R Bankr P 7001. A transferee who did not file a proof of claim in the bankruptcy case may be entitled to a jury trial in a fraudulent transfer action. See *Granfinanciera, S.A. v Nordberg* (1989) 492 US 33, 106 L Ed 2d 26, 109 S Ct 2782. See generally §§1.56, 4.42-4.50, 4.65.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.59 3. Tax Attributes

§2.59 3. Tax Attributes

The debtor's election to waive a net operating loss carryback and forgo a tax refund in favor of carrying certain losses forward can constitute an avoidable fraudulent conveyance. *Feiler v Sims (In re Feiler)* (9th Cir 2000) 218 F3d 948.

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§2.60 4. Leveraged Buyouts

A leveraged buyout (LBO) is a transaction in which the stock or assets of a company are sold, typically to a group of company insiders who use the unencumbered assets of the company as collateral to finance the purchase price. The LBO has two essential characteristics: First, the buyers obtain the funds necessary for the acquisition through borrowings secured, directly or indirectly, by the assets of the company being acquired. Second, the lender who provides the acquisition financing looks to the future operating revenues of the acquired company or to the proceeds of future sales of assets of the company, rather than to other assets of the buyers, as the source of repayment of the borrowings. *Bay Plastics, Inc. v BT Commercial Corp. (In re Bay Plastics, Inc.)* (Bankr CD Cal 1995) 187 BR 315, 323.

If the LBO occurred more than 1 or 2 years (depending on the relevant lookback period; see §2.56) before the filing of the debtor-corporation's bankruptcy, the trustee cannot pursue the fraudulent conveyance under 11 USC §548, because of the statute of limitations, but must resort to state fraudulent conveyance law and §544(b). In that situation, there must be at least one unsecured creditor who held a claim at the time of the LBO. If there was no pretransaction creditor, an LBO may not be assailable as a fraudulent conveyance. See *Kupetz v Wolf* (9th Cir 1988) 845 F2d 842; *Lippi v City Bank* (9th Cir 1992) 955 F2d 599. If a secured lender knows that the loan proceeds will be used to fund an LBO, the lender may also be liable as the recipient of a fraudulent transfer. *U.S. v Tabor Court Realty Corp.* (3d Cir 1986) 803 F2d 1288. See also *Jones v National City Bank (In re Greenbrook Carpet Co.)* (11th Cir 1984) 722 F2d 659.

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§2.61 5. Foreclosure Sales

The price received for real property at a foreclosure sale regularly conducted in accordance with state law will be considered "reasonably equivalent value," and the sale will not be avoidable as a fraudulent conveyance. *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 114 S Ct 1757. Thus, absent fraud or some other irregularity, a foreclosure sale of real property will generally withstand a fraudulent conveyance attack. An action to set aside a deed of trust as a fraudulent transfer is not an action on a contract for purposes of recovering attorney fees under CC §1717. *Rothery v Marshack (In re Rothery)* (BAP 9th Cir 1996) 200 BR 644, aff'd (9th Cir 1998) 145 F3d 1340. See discussion of fraudulent transfers and real property secured loans in §10.83. On real property foreclosure sales generally, see California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009).

The rule is less clear with regard to foreclosure sales of personal property. Most personal property foreclosures are governed by Article 9 of the Uniform Commercial Code. See Com C §§9610-9619. In certain circumstances, *e.g.,* if the foreclosure sale price were unreasonably low, it might be possible to argue that a foreclosure sale of personal property should be subject to avoidance as a fraudulent transfer. The same circumstances, however, might also give rise to a claim that the sale was not conducted in a commercially reasonable manner and may provide a basis for a damage claim under state law. See Com C §9625; Secured Transactions in California Commercial Law Practice §§5.42-5.49 (2d ed Cal CEB 2001).

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§2.62 6. Conversion of Nonexempt Assets to Exempt Assets

The intentional conversion of nonexempt assets to exempt assets on the eve of bankruptcy is not per se fraudulent. *Gill v Stern (In re Stern)* (9th Cir 2003) 345 F3d 1036, 1043. After a large judgment was entered against him, the debtor in *Gill* transferred the proceeds of his IRA account into a retirement account that was exempt under California law. The judgment creditor brought a fraudulent transfer action in state court; the debtor then filed a bankruptcy case. The Ninth Circuit held that the bankruptcy trustee had not met his burden of proof that the transfer was fraudulent. 345 F3d at 1045. But see *Wolkowitz v Beverly (In re Beverly)* (BAP 9th Cir 2007) 374 BR 221 (distinguishing *Stern* as involving transfer from one form of exempt asset to another form of exempt asset, which then passed through nonexempt account).

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§2.63 7. Disclaimer Under a Will

If state law provides that a beneficiary under a will has no interest in a disclaimed bequest, the debtor-beneficiary who disclaims a bequest does not thereby transfer an interest in the property that could be avoided under 11 USC §548. *Wood v Bright (In re Bright)* (BAP 9th Cir 1999) 241 BR 664. *Bright* is still good law in the wake of *Drye v U.S.* (1999) 528 US 49, 145 L Ed 2d 466, 120 S Ct 474, which held that a disclaimer of an inheritance cannot remove the disclaimed property from the reach of a federal tax lien. See *Gaughan v Edward Dittlof Revocable Trust (In re Costas)* (9th Cir 2009) 555 F3d 790 (rejecting application of *Drye* to fraudulent conveyance cases).

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§2.64 8. Charitable Contributions

In most instances, a gift, *e.g.,* to family members or to a religious or other charitable institution, is deemed "fraudulent" under the test in 11 USC §548(a)(1)(B) in that the debtor does not receive a reasonably equivalent economic return for the contribution (regardless of any emotional or psychological gratification). To protect charitable contributions from being challenged as fraudulent transfers in bankruptcy cases, Congress enacted 11 USC §548(a)(2) to shelter certain transfers, including those to a "qualified religious or charitable entity or organization." For this purpose, qualified charitable entities are those defined in IRC §170(c). 11 USC §548(d)(3).

Charitable transfers are protected as long as the contribution is not more than 15 percent of the debtor's gross annual income for the year the contribution was made, although the contribution may exceed 15 percent of the debtor's annual income if the transfer was consistent with the debtor's usual charitable practices. 11 USC §548(a)(2)(A)-(B).

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§2.65 9. Transfers Made by Debtor Partnership to General Partner

A trustee of a debtor partnership (or a debtor in possession that is a partnership) may avoid any transfer of the debtor's interest in property, or any obligation incurred by the debtor, that was made or incurred within 1 year before the date the petition was filed to a general partner of the debtor, if the debtor was insolvent or became insolvent at the time the transfer was made or the obligation incurred. 11 USC §548(b).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.66 10. Transfers to Asset Protection Trusts

§2.66 10. Transfers to Asset Protection Trusts

Under 11 USC §548(e), a trustee or debtor in possession may avoid

> any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition, if—
> (A) such transfer was made to a self-settled trust or similar device;
> (B) such transfer was by the debtor;
> (C) the debtor is a beneficiary of such trust or similar device; and
> (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

For purposes of §548(e), a transfer includes any transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by, (1) any violation of federal or state securities laws, regulations, or orders, or (2) fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any federally registered security.

NOTE: Section 548(e) apparently requires the trustee (or debtor in possession) to prove that the transfer was made specifically to avoid payment of a particular creditor's claim, rather than merely for general asset protection purposes.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.67 11. Good Faith Transferee for Value Defense

§2.67 11. Good Faith Transferee for Value Defense

Except to the extent the challenged transfer is subject to avoidance under 11 USC §544, §545, or §547 (see §§2.32-2.55), a transferee (or obligee) who takes for value and in good faith has a lien on, or may retain, any interest transferred (or may enforce any obligation incurred, as the case may be) to the extent that the transferee or obligee gave value to the debtor in exchange for the transfer or obligation. 11 USC §548(c). "Value" for these purposes means property, or the satisfaction or securing of a present or antecedent debt of the debtor, but it does not include an unperformed promise to furnish support to the debtor or a relative of the debtor. 11 USC §548(d)(2)(A).

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§2.68 F. Avoidable Postpetition Transfers

Generally, a trustee or debtor in possession may avoid any transfer of property of the estate that is not otherwise authorized under the Bankruptcy Code (such as a transfer in the ordinary course of the debtor's business under 11 USC §363) and that occurs after commencement of the bankruptcy case. 11 USC §549(a). Section 549 applies to postpetition transfers by the debtor—which are not expressly prohibited by the automatic stay—rather than postpetition transfers by creditors. *Burkart v Coleman (In re Tippett)* (9th Cir 2008) 542 F3d 684. A postpetition payment made by the debtor on account of a prepetition unsecured claim will almost invariably be avoidable under §549. If the debtor pays by check, the transfer is deemed to have been made on the date of the creditor's receipt of the check, as opposed to the date the check was mailed. *Mora v Vasquez (In re Mora)* (9th Cir 1999) 199 F3d 1024.

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§2.69 1. Exception: Bona Fide Purchasers

There is an exception in 11 USC §549 for transfers to bona fide purchasers of real property who purchase in good faith without knowledge of the bankruptcy case. Such transfers will not be subject to avoidance unless a copy of the bankruptcy petition (or notice of it) was recorded in the county recorder's office before the date of the transfer. 11 USC §549(c). See §10.15. For the protection of such good faith purchasers, BAPCPA added an exception to the automatic stay in 11 USC §362(b)(24), covering transfers that are not avoidable under 11 USC §549. BAPCPA thus legislatively overruled *40235 Wash. St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, which held that a postpetition tax sale to an individual who had no knowledge of the property owner's bankruptcy filing was void as in violation of the automatic stay.

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§2.70 2. From Whom May Transfer Be Recovered?

If a transfer is subject to avoidance under 11 USC §544, §545, §547, §548, §549, §553(b), or §724(a), the trustee (or debtor in possession in a Chapter 11 case) may recover the property (or the value thereof) from either "(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or (2) any immediate or mediate transferee of such initial transfer." 11 USC §550(a). The trustee's right of recovery differs significantly under each subsection. Under 11 USC §550(a)(1), "the trustee's right to recover from an initial transferee is absolute." *Schafer v Las Vegas Hilton Corp. (In re Video Depot)* (9th Cir 1997) 127 F3d 1195, 1197. Under 11 USC §550(a)(2), the trustee may recover only if the subsequent transferee did not accept the transfer for value, in good faith, and without knowledge of the transfer's voidability. 127 F3d at 1197. The "good faith" safe harbor is therefore available only to subsequent transferees.

The term "transferee" is not defined in the Bankruptcy Code. In construing the term "transferee," the Ninth Circuit has adopted the dominion test, which focuses on whether the recipient of the funds has legal title to the funds and the ability to use them as it sees fit. *Universal Serv. Admin. Co. v Post-Confirmation Comm. of Unsecured Creditors of Incomnet Communications Corp. (In re Incomnet, Inc.)* (9th Cir 2006) 463 F3d 1064, 1071. See also *Abele v Modern Fin. Plans Servs. (In re Cohen)* (9th Cir 2002) 300 F3d 1097, 1102; *Schafer,* 127 F3d at 1198. "In practical terms, the 'dominion test' requires that a transferee be free to invest the whole [amount] in lottery tickets or uranium stocks." Dominion is different from mere possession. It is analogous to legal control, *e.g.,* a right to invest transferred funds as the transferee chooses. *Abele,* 300 F3d at 1102.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.71 G. Statute of Limitations

§2.71 G. Statute of Limitations

The statute of limitations for bringing an avoidance action under 11 USC §544, §545, §547, §548, or §549 (see §§2.32-2.70) is the earlier of the following dates (11 USC §546(a)(1)-(2)):

- The later of:
- 2 years after entry of the order for relief (the date when the bankruptcy petition is filed in voluntary cases); or
- 1 year after appointment or election of a trustee if the appointment occurs before 2 years after the entry of the order for relief; *or*
- The time when the bankruptcy case is closed or dismissed.

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V. USE, SALE, OR LEASE OF PROPERTY OF THE ESTATE

§2.72 A. Transactions Within Ordinary Course of Business

With certain exceptions (see §§2.73-2.74), if the debtor's business is to be operated under 11 USC §721, §1108, or §1304, the Chapter 7 trustee, Chapter 13 debtor, or Chapter 11 trustee or debtor in possession (as the case may be) may use, sell, or lease property of the estate in the ordinary course of business without court approval. 11 USC §363(c)(1). See 11 USC §§704, 1107, 1303. If the property at issue constitutes collateral for a loan, however, the trustee or debtor may need to furnish the lender with "adequate protection" of the lender's interest in the property. 11 USC §§361, 363(e). The lender has the right to request the court to limit the estate's use of the lender's collateral and to obtain adequate protection of its lien interest in the property. Fed R Bankr P 4001(a)(1).

"Adequate protection" is a term of art under the Bankruptcy Code that refers to economic consideration sufficient to compensate the lender for any diminution in value of its lien resulting from the estate's continued use of the lender's collateral. See 11 USC §361; see also §§4.20, 10.67-10.68. Adequate protection may take the form of lump-sum or periodic cash payments to the lender, or a replacement lien on other property of the estate, or other relief that would give the lender the "indubitable equivalent" of its original lien. 11 USC §361. With respect to use, sale, or lease of real property that also secures a loan, see §§10.63-10.76.

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§2.73 B. Cash Collateral Exception

An exception to the rule permitting use of property of the estate in the ordinary course of business without court approval (see §2.72) exists if the property in question is "cash collateral." 11 USC §363(c)(2). See §§10.63-10.66. Cash collateral includes any or all of the following property of the estate in which a creditor has a lien or security interest: cash, cash equivalents (*e.g.,* deposit accounts, negotiable instruments, documents of title, or securities), and the proceeds, products, rents, or profits of property, including hotel and motel revenues as well as residential and commercial leasehold revenues. 11 USC §363(a). The trustee or debtor in possession may use cash collateral only with consent of the creditors who have liens on or security interests in it, or with court approval after notice and a hearing. 11 USC §363(c)(2).

PRACTICE TIP: A Chapter 11 debtor in possession often negotiates a cash collateral stipulation with the secured creditor, containing the terms and conditions under which the cash collateral may be used. See §10.65. Typically, such stipulations provide the secured creditor with an operating budget for the debtor's business, periodic financial reports, a right of audit, an acknowledgment of the creditor's prepetition liens and claims, replacement liens on the debtor's assets, periodic payments on the secured creditor's claim, and a modification of the automatic stay permitting the secured creditor to enforce its lien in the event of a default under the stipulation. The stipulation itself must be approved by the bankruptcy court. Fed R Bankr P 4001.

If the secured party does not consent to use of cash collateral, the debtor may still obtain court approval for such use. See §10.66. Because the debtor's business often cannot survive for long without the ability to use collections from accounts receivable, the debtor typically seeks court authorization to use cash collateral very soon after filing the case, under local bankruptcy court rules permitting motions on shortened notice. To authorize such use, the court must find that the creditor's interest in cash collateral will be adequately protected from diminution or dissipation. See 11 USC §361; see also §2.72.

In Chapter 11 cases, when evaluating the adequate protection offered by the debtor in possession (or the Chapter 11 trustee), courts have given great weight to the importance of allowing a debtor to continue operations. See, *e.g., In re Prime, Inc.* (Bankr WD Mo 1981) 15 BR 216, 218 (granting and subsequently increasing amount of cash collateral to preserve debtor's business). In *Security Leasing Partners, LP v ProAlert, LLC (In re ProAlert, LLC)* (BAP 9th Cir 2004) 314 BR 436, the Bankruptcy Appellate Panel of the Ninth Circuit affirmed the bankruptcy court's order allowing the debtor to use cash collateral without considering whether the requirements for a surcharge under 11 USC §506(c) were met.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.74 C. Exception for Personally Identifiable Information

§2.74 C. Exception for Personally Identifiable Information

Another exception to the rule permitting use of property of the estate in the ordinary course of business without court approval (see §2.72) concerns transfers that involve personally identifiable information about individuals. Personally identifiable information, defined in 11 USC §101(41A), includes names, birthdates, addresses, electronic addresses, telephone numbers, Social Security numbers, credit card account information, and similar information. This exception generally requires the trustee (or debtor in possession in a Chapter 11 case) to observe the terms of any privacy policy of the debtor. See 11 USC §363(b)(1).

Under §363(b)(1), if the debtor, in connection with offering a product or a service, has disclosed to an individual a policy prohibiting the transfer of personally identifiable information about individuals to persons that are not affiliated with the debtor, and if such policy is in effect on the petition date, then the trustee or debtor in possession may not sell or lease personally identifiable information to any person unless the sale is consistent with the policy, a consumer privacy ombudsman is appointed under 11 USC §332, and the court approves the sale after notice and a hearing.

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§2.75 D. Transactions Outside Ordinary Course of Business

Transactions outside the ordinary course of business require prior court approval and notice to all creditors. 11 USC §363(b)(1). The most common nonordinary course transactions are sales of all or a significant portion of the debtor's assets. What constitutes an ordinary course transaction is a fact-intensive inquiry; the Ninth Circuit Court of Appeals articulated two guidelines in *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700. The first is a "horizontal dimension" test, in which the debtor's business is compared with similar businesses and a determination is made whether the transaction would occur in the day-to-day operation of such businesses. The second test, the "vertical dimension" or "creditor's expectation" test, examines the transaction from a creditor's standpoint and considers whether it would subject a creditor to economic risks different from those assumed by the creditor when it decided to extend credit originally. 853 F2d at 704.

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1. Sales Outside Ordinary Course of Business

§2.76 a. Standards for Court Approval of Sale

The standards for approval of a sale outside of the ordinary course of business require the proponent of the sale to establish that (1) there is a sound business purpose for the sale, (2) accurate and reasonable notice was provided, (3) the price is fair, and (4) good faith (*i.e.,* the absence of any lucrative deals with insiders) exists. See *In re Global Crossing, Ltd.* (Bankr SD NY 2003) 295 BR 726, 742; *In re Channel One Communications, Inc.* (Bankr ED Mo 1990) 117 BR 493, 496. A bankruptcy court in the Central District of California has developed an alternative five-prong test for asset sales in Chapter 11 cases, which differs somewhat (*In re American Dev. Corp.* (Bankr CD Cal 1989) 95 BR 735, 739):

- Does the proposed sale satisfy the business judgment test?
- Is the proposed sale in the best interest of creditors?
- Is the proposed sale premature?
- Are there other options for reorganization?
- Is the proposed sale likely to facilitate a plan of reorganization?

To maximize the likelihood that the court will approve the sale, the trustee or debtor in possession should demonstrate that it has taken all reasonable steps to maximize the sales price of the assets to be sold by, *e.g.,* retaining an experienced broker to assist with the sale and advertising the sale in trade magazines or other publications as appropriate in view of the type of asset to be sold. This is especially true if the buyer is an insider of the debtor.

See also discussion of sale of real property collateral in §§10.69-10.73.

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§2.77 b. Procedures for Obtaining Court Approval

Bankruptcy court approval of a proposed sale of estate assets is initiated by a noticed motion. 11 USC §363(b)(1). See generally *In re Mama's Original Foods, Inc.* (Bankr CD Cal 1999) 234 BR 500 (procedures for liquidation sales by Chapter 7 trustees). Local bankruptcy court rules or court guidelines may impose additional requirements. See, *e.g.,* U.S. Bankruptcy Court, Northern District of California, San Jose Division, *Guidelines for the Sale of Substantially All Assets Under §363 Within 60 Days of the Filing of the Petition* (Mar. 26, 2003) and *Guidelines for Early Disposition of Assets in Chapter 11 Cases/Pre-Packaged Plans/The Sale of Substantially All Assets Under §363* (Aug. 26, 1999). For U.S. Bankruptcy Court articles, see Directory. Creditors and other interested parties will then have an opportunity to object and be heard by the court. If a public sale or auction is contemplated, the trustee or debtor in possession often seeks to establish bidding procedures at or before the hearing on the motion to approve the sale. Court approval of the bidding procedures is usually requested in a separate motion; the motion will outline the amount of the deposit required for persons desiring to bid, bidder qualification requirements, minimum overbids, sale confirmation procedures, and the like.

Court approval of payment of a break-up fee may also be requested in connection with a bankruptcy court sale. See §2.78.

If the buyer at a court-authorized sale purchased the assets in good faith, then any reversal or modification on appeal of the court order authorizing the sale will not affect the validity of the sale unless the order is stayed pending appeal. 11 USC §363(m). Failure to obtain a stay of the sale authorization order may render the appeal moot. Section 363(m) reflects a policy not to disturb closed transactions with third party purchasers who have acted in good faith.

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§2.78 c. Break-Up Fees

A break-up fee is a fee paid to a prospective buyer who has invested a substantial amount of time and money evaluating the assets and negotiating with the trustee (or debtor in possession in a Chapter 11 case) in advance of the sale hearing, but who is outbid at the hearing and therefore unable to consummate the transaction. The fee is intended to compensate the unsuccessful bidder for its reliance interest in completing the purchase. Outside of bankruptcy, break-up fees are presumptively valid under the business judgment rule. *Official Comm. of Subordinated Bondholders v Integrated Resources, Inc.* (*In re Integrated Resources, Inc.)* (Bankr SD NY 1992) 147 BR 650. By contrast, in bankruptcy, a break-up fee may be authorized as an administrative expense only when it is necessary to preserve the value of the estate. The business judgment rule is not the proper test. *Calpine Corp. v O'Brien Envt'l Energy, Inc. (In re O'Brien Envt'l Energy, Inc.)* (3d Cir 1999) 181 F3d 527.

In considering whether a break-up fee will be allowed, bankruptcy courts typically use a case-by-case approach, taking into consideration what is in the best interests of the estate. *In re America W. Airlines* (Bankr D Ariz 1994) 166 BR 908, 912 (standard for approval of break-up fees is whether the transaction will further the diverse interests of the debtor, creditors, and equity holders alike). Break-up fees will not be allowed in the absence of a binding agreement. As a result, an agreement that provides for a break-up fee requires bankruptcy court approval in order to be enforceable. *In re Diamonds Plus, Inc.* (Bankr ED Ark 1999) 233 BR 829. Bankruptcy courts carefully scrutinize proposed break-up fee arrangements to ensure that the bankruptcy estate is not unduly burdened and that the relative rights of the parties are protected. *In re Hupp Indus.* (Bankr ND Ohio 1992) 140 BR 191, 196.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/ 2. Sales Free and Clear of Liens, Claims, and Encumbrances/§2.79 a. Generally

2. Sales Free and Clear of Liens, Claims, and Encumbrances

§2.79 a. Generally

The Bankruptcy Code gives the trustee or debtor in possession power to sell property outside of the ordinary course of business "free and clear" of any lien or other interest of an entity other than the estate, if *any one* of the following five conditions is met (11 USC §363(f)):

- Applicable nonbankruptcy law permits sale of the property free and clear of such interests (11 USC §363(f)(1));
- The entity consents (11 USC §363(f)(2));
- The interest is a lien, and the sale price for the property is greater than the aggregate value of all liens on the property (11 USC §363(f)(3));
- The interest is in bona fide dispute (11 USC §363(f)(4)); or
- The entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its interest (11 USC §363(f)(5)).

NOTE: Section 363(f) is written in the *disjunctive*; satisfaction of any of the five conditions is sufficient to sell free and clear of liens. *Citicorp Homeowners Servs. v Elliot (In re Elliot)* (ED Pa 1988) 94 BR 343, 345.

Section 363(f) has been invoked to allow the sale of estate property that is subject to liens or security interests, particularly if secured creditors do not consent to the sale. It applies to all types of secured claims, including blanket security interests in all of the debtor's assets, a deed of trust on a particular parcel of real estate, and security interests in specific pieces of equipment. See generally *Darby v Zimmerman (In re Popp)* (BAP 9th Cir 2005) 323 BR 260.

If the secured creditor consents, 11 USC §363(f)(2) permits a sale free and clear of liens and encumbrances. A more difficult situation exists if the secured creditor does not consent. Depending on the factual circumstances, 11 USC §363(f)(1), (f)(3), (f)(4), or (f)(5) may provide a basis for the court to authorize the sale despite the lack of creditor consent.

Often, the amount of the sale price will exceed the amount of the secured claim. In that event, the court will permit the sale under 11 USC §363(f)(3) if the sale proceeds equal or exceed the amount of the secured claim. The secured creditor's lien will attach to the sale proceeds to the same extent as the secured creditor's lien on the property sold. See *In re Terrace Gardens Park Partnership* (Bankr WD Tex 1989) 96 BR 707.

In bankruptcy, the value of a lien is usually limited to the value of the property securing the lien. 11 USC §506(a). See §§3.5-3.7. Thus, although the language of 11 USC §363(f)(3) appears to permit a sale free and clear of liens only if the price is "greater than the aggregate value of all liens on the property," some bankruptcy courts may approve a sale free and clear of liens when the price is less than the total amount of the liens (sometimes referred to as a "short sale") if the proposed sale is justified by the circumstances and the sale price is a fair market price. See, *e.g., In re Beker Indus. Corp.* (Bankr SD NY 1986) 63 BR 474, 477, rev'd on other grounds (SD NY 1988) 89 BR 336 ("collateralized property might be sold for less than the amount of a lien over the objection of a secured creditor where justified by special circumstances"); *Hatfield Homes, Inc. v Pennview Sav. Ass'n (In re Hatfield Homes, Inc.)* (Bankr ED Pa 1983) 30 BR 353, 355 ("if the proposed sale price is the best price obtainable under the circumstances of a particular case, then the fact that junior lienholders may receive little or nothing from the proceeds of the sale would not, standing alone, constitute reason for disapproving the proposed sale"). The Ninth Circuit, however, steadfastly holds that "§363(f)(3) does not authorize the sale free and clear of a lienholder's interest if the price of the estate property is equal to or less than the aggregate amount of all claims held by creditors who hold a lien or security interest in the property being sold." *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25, 40.

Section 363(f)(5) provides another independent basis for the sale of assets free and clear of liens. Under that subsection, assets may be sold free and clear of liens if the entity with a lien "could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." 11 USC §363(f)(5). For example, if the entity asserting the lien could be compelled to accept the sale in the context of a cramdown in a reorganization plan under 11

USC §1129(b), the sale may proceed preconfirmation, free and clear of liens. See generally chap 5. In *Hunt Energy Co. v U.S. (In re Hunt Energy Co.)* (Bankr ND Ohio 1985) 48 BR 472, aff'd in part and rev'd in part (ND Ohio 1988) 1988 US Dist Lexis 14295, the court held that, if the property was to be sold for its highest value and the lenders' lien on the property would be transferred to the proceeds of the sale, the requirements of §1129(b)(2)(A) would be met. The proposed sale in *Hunt* was therefore approved free and clear of liens under §363(f)(5). Similarly, in *Seidle v Modular Paving, Inc. (In re 18th Ave. Dev. Corp.)* (Bankr SD Fla 1981) 14 BR 862, the court held that a sale of property of the estate out of the ordinary course of business could proceed free and clear of liens under §363(f)(5) if the property was marketed at the highest possible price and the liens on the property would be transferred to the proceeds of the sale.

If the secured claim is the subject of a bona fide dispute, the court can authorize the sale free and clear of the claim under 11 USC §363(f)(4). Whether a bona fide dispute exists is a factual inquiry, which the bankruptcy court must make in connection with the sale motion. Section 363(f)(4) does not allow a sale of property that the debtor claims is exempt before the debtor's exemption rights in the property have been determined. *Moldo v Clark (In re Clark)* (BAP 9th Cir 2001) 266 BR 163.

All creditors, and secured creditors in particular, are required to be given notice of any sale out of the ordinary course of business. See Fed R Bankr P 2002(a)(2). To preserve their rights, creditors opposing a sale free and clear of liens must act in a timely manner. The sale motion is considered a "contested matter" under Fed R Bankr P 9014, and as such would enable a creditor to take discovery in connection with defending its position and opposing the sale. See generally §§4.42-4.50. Given the expedited nature of motion practice in bankruptcy, however, the creditor will have to act swiftly if it intends to contest the motion.

Although this issue is beyond the scope of this text, there is a question as to whether a sale free and clear of liens, claims, and encumbrances in bankruptcy court will cut off successor liability claims. For example, if a claim based on an injury from an allegedly defective product arises before the sale, but the claimant does not receive actual or constructive notice of the sale, a court might permit the injured person to pursue the buyer of the assets. It is by no means clear whether 11 USC §363(f) cuts off those types of claims. For an extensive discussion of §363(f)—including the issue of successor liability—in the context of a heavily contested sale of assets, see *EEOC v Knox-Schillinger (In re Trans World Airlines, Inc.)* (3d Cir 2003) 322 F3d 283 (affirming bankruptcy court approval of asset sale free and clear of employment discrimination claims).

See also detailed discussion of sale of lender's collateral in §10.70 and discussion of procedure governing sale in §10.71.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/2 Property of the Estate/§2.80 b. Exception for Consumer Claims and Defenses

§2.80 b. Exception for Consumer Claims and Defenses

Under 11 USC §363(o), 11 USC §363(f) cannot operate to cut off a consumer's claims and defenses arising in a consumer credit transaction subject to the Truth in Lending Act or under any consumer credit contract. If consumer credit contracts are sold in a §363(f) sale in bankruptcy court, any claims or defenses arising under such contracts are preserved to the same extent as if the sale had occurred outside of bankruptcy court.

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§2.81 3. Sales Free of Interests of Co-Owners

The trustee or debtor in possession can in some instances sell the interests of nondebtor co-owners in property, such as the interest of a tenant in common, joint tenant, or tenant by the entirety. 11 USC §363(g)-(h). The power to sell a nondebtor's interest is exercisable only if (11 USC §363(h)(1)-(4)):

- Partition of the property under applicable state law is impractical;
- The estate would realize significantly less from the sale of its undivided interest in the property than a sale free of the interests of the nondebtor co-owner(s);
- The benefit to the estate of a sale free of the interests of the nondebtor co-owner(s) outweighs the detriment (if any) to the nondebtor co-owner(s); and
- The property is not used to produce, transmit, or distribute gas or electricity for heat, light, or power.

Procedurally, the trustee or debtor in possession may exercise this power only by commencing an adversary proceeding against the nondebtor co-owners. Fed R Bankr P 7001(3); *Lyons v Lyons (In re Lyons)* (9th Cir 1993) 995 F2d 923. See §4.45. Even if the sale is ordered over a nondebtor co-owner's objections, under 11 USC §363(j), the objecting co-owner will be required to share the expenses of sale, because the sale proceeds will ultimately be divided between the co-owner and the bankruptcy estate. *Stine v Diamond (In re Flynn)* (BAP 9th Cir 2003) 297 BR 599. In *Diamond v Stine (In re Flynn)* (9th Cir 2005) 418 F3d 1005, the Ninth Circuit held that only those costs and expenses that do not include trustee compensation may be deducted from the sale proceeds before they are divided. The trustee's attorney fees incurred for preserving and disposing of property of the estate are matters squarely within the duties of a Chapter 7 trustee and should not be charged against a nondebtor co-owner's share of the sale proceeds. Moreover, the trustee may not temporarily withhold the nondebtor co-owner's share of the proceeds, even pending claims in a partition dispute between the co-owner and the bankruptcy trustee. 418 F3d at 1008.

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§2.82 E. Transfers by Nonprofit Organizations

Under 11 USC §363(d)(1) (see also 11 USC §1129(a)(16)), a trustee or debtor in possession may not use, sell, or lease property of a nonprofit corporation or trust, either in or outside the ordinary course of business, in a manner that is not in accordance with applicable nonbankruptcy law. This restriction is particularly applicable in health care insolvency cases.

Under 11 USC §541(f), property of tax-exempt corporations can be transferred to entities that are not tax-exempt, but only under the same conditions that would apply if the transferor had not filed a bankruptcy case. Section 541(f) was apparently intended as a limitation on property of the estate, although its application in that context is not entirely clear.

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VI. ABANDONMENT OF PROPERTY OF THE ESTATE

§2.83 A. Technical Abandonment on Closing of Case

Property does not stay in the bankruptcy estate forever. Under 11 USC §554(c), "any property scheduled under [11 USC §]521(1) of this title not otherwise administered at the time of the closing of a case is abandoned to the debtor and administered for purposes of section 350 of this title." It is common for bankruptcy trustees to abandon nonliquid assets worth less than a few thousand dollars. In bankruptcy court districts with heavier caseloads, the value of nonliquid assets typically abandoned may be higher.

NOTE: The reference in 11 USC §554(c) to "§521(1)" actually refers to 11 USC 521(a)(1). The "(a)" was added to §521 in 2005, but §554 has not been updated since 1986.

At times, a bankruptcy case moves very quickly. A trustee will issue a "no asset" report after the initial meeting of creditors. Soon afterward, the court clerk will close the bankruptcy case. Closing of the case triggers 11 USC §554(c), and any assets in the estate are then automatically abandoned back to the debtor. *Schwaber v Reed (In re Reed)* (9th Cir 1991) 940 F2d 1317, 1321, confirms that abandonment occurs when the court clerk closes the case (a ministerial act), rather than when a trustee files his or her "no asset" report. The bankruptcy court, however, has the power to alter or prevent such abandonment in appropriate circumstances. *Spear v Schafler (In re Schafler)* (ND Cal 2001) 263 BR 296.

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§2.84 B. Abandonment During the Case

At other times, a bankruptcy case will remain open for months or years. If there is a particular item that cannot be liquidated for the benefit of the estate, the trustee has the right, after notice and a hearing, to abandon "any property of the estate that is burdensome to the estate or that is of inconsequential value and benefit to the estate." 11 USC §554(a). See also *Johnston v Webster (In re Johnston)* (9th Cir 1995) 49 F3d 538, 540. The trustee may proceed even if the debtor objects and the abandonment will adversely affect the debtor (*e.g.,* because of adverse tax consequences). "Impact on the debtor is not listed as one of the factors to be considered in authorizing abandonment, which suggests that impact on the debtor is not a necessary consideration. This makes sense in the context of the Bankruptcy Code as a whole." 49 F3d at 541.

If the trustee is unwilling to abandon an asset promptly, any party in interest may move for an order to compel abandonment of a particular asset. The court may then order the trustee to abandon the asset after notice and a hearing, if the asset is "burdensome to the estate or… of inconsequential value and benefit to the estate." 11 USC §554(b); Fed R Bankr P 6007(b).

Abandonment under either 11 USC §554(a) or §554(b) requires a noticed motion and a hearing. An order granting relief from the automatic stay to permit a lender to foreclose on certain property does not constitute abandonment of the property unless the stay relief order so states and the notice and hearing procedures in 11 USC §554(b) are satisfied. (Any excess proceeds from the foreclosure sale after satisfaction of the lender's claim remain property of, and are payable to, the estate.) *Catalano v Commissioner* (9th Cir 2002) 279 F3d 682.

Notice of a proposed abandonment under either 11 USC §554(a) or §554(b) is governed by Fed R Bankr P 6007. Under Fed R Bankr P 6007(a), the trustee (or a debtor in possession in a Chapter 11 case) must give notice to the U.S. Trustee, all creditors, any indenture trustee, and any committee of creditors or equity holders. Local bankruptcy court rules should be consulted for additional procedures concerning abandonment of estate assets. See Directory for website information. Unless an objection is filed, abandonment will usually be authorized without a formal hearing. Fed R Bankr P 6007(a).

In *Midlantic Nat'l Bank v New Jersey Dep't of Envt'l Protection* (1986) 474 US 494, 88 L Ed 2d 859, 106 S Ct 755, the U.S. Supreme Court set a limit on the trustee's right to abandon assets under 11 USC §554. The Court held that a trustee will not be permitted to abandon a burdensome estate asset if abandonment would permit a continuing violation of state health and safety laws. Bankruptcy laws and state environmental laws are meant to be read in harmony, whenever possible. In *Midlantic,* the trustee was not permitted to abandon "oil contaminated with a toxic carcinogen," even though it was clear that the trustee could not liquidate the oil for the benefit of creditors and that the contaminated oil was a burden on the bankruptcy estate. On abandonment of estate property and secured lenders, see §10.74. On abandonment and mechanics' liens, see §9.25.

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§2.85 VII. UNSCHEDULED PROPERTY

Occasionally, an asset is not properly listed on the bankruptcy schedules. An unscheduled asset is never technically "administered" and remains property of the estate forever. It will not revert to the debtor on closing of the case. 11 USC §554(d); *Cusano v Klein* (9th Cir 2001) 264 F3d 936. If the missing asset is discovered later by a lucky creditor, the creditor will usually move to reopen the bankruptcy case. In Chapter 7 cases, a trustee may be appointed to administer the discovered asset. Missing assets often include causes of action, such as personal injury or other litigation claims. See also *Diamond Z Trailer, Inc. v JZ L.L.C. (In re JZ L.L.C.)* (BAP 9th Cir 2007) 371 BR 412 (discussing treatment of unscheduled property under different chapters of bankruptcy code).

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§3.1 I. INTRODUCTION

After the debtor, the most important parties to a bankruptcy case are the creditors—the holders of claims against the debtor. If there is valuable property in the bankruptcy estate, holders of "allowed" claims (see §3.35) will receive payments on account of their claims (also known as "dividends")—in Chapter 7, at the conclusion of the case, or in Chapter 11 or 13, after confirmation of the plan. The Bankruptcy Code gives certain claims priority over others in right of payment from the estate. Higher priority claims are paid first, in the order of their statutory priority; lower priority claims share pro rata in any remaining funds. Thus, the primary objectives of a claimholder are, first, to have its claim allowed for payment by the bankruptcy court and, second, to ensure that its claim is classified properly so that it receives the highest priority to which it is entitled under the Code.

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§3.2 II. WHAT IS A CLAIM?

A claim is defined in the Bankruptcy Code as either (11 USC §101(5)):

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

This definition is significant for two reasons. First, a claim is the vehicle by which creditors recover money owed to them from property of the debtor's estate. Second, only *claims* can be discharged in a bankruptcy case. See generally *FCC v NextWave Personal Communications, Inc.* (2003) 537 US 293, 302, 154 L Ed 2d 863, 875, 123 S Ct 832 (the term "claim" has the "broadest available definition").

The unqualified term "right to payment" in §101(5) encompasses many, but not necessarily all, of the rights a party may have outside of bankruptcy. With few exceptions (see 11 USC §101(10)(B)-(C)), only creditor's claims arising before the bankruptcy petition was filed will be eligible for payment from the bankruptcy estate. 11 USC §101(10)(A). Determining when a right to payment arises can be tricky. See *Cool Fuel, Inc. v Board of Equalization (In re Cool Fuel, Inc.)* (9th Cir 2000) 210 F3d 999 (bankruptcy law governs when claims arise; claim can be ripe even if underlying cause of action has not yet accrued); *Knutson v Tredinnick (In re Tredinnick)* (BAP 9th Cir 2001) 264 BR 573.

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§3.3 III. TYPES OF CLAIMS

The analysis of a creditor's rights in bankruptcy does not end with a determination of whether the creditor has a claim against the estate. It is also necessary to determine what type of claim a creditor holds, because this may have a substantial impact on the amount that the creditor can hope to recover from the bankruptcy estate. Claims fall into two main categories: secured and unsecured claims. Unsecured claims, in turn, are categorized as either priority claims or general unsecured claims. Even if a creditor holds a claim that has priority in distribution from the estate, in some circumstances that claim may be subordinated to other claims against the estate. See §3.18.

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A. Secured Claims

§3.4 1. Validity and Priority of Secured Claims

A secured claim is a claim secured by a valid lien or charge on real or personal property of the debtor. Although the Bankruptcy Code does not expressly so state, it is a fundamental principle that secured claims have priority over unsecured claims in right of payment from the bankruptcy estate with respect to the assets securing the claim and up to the value of the assets. The omission of secured claims from the Bankruptcy Code's priority scheme is a vestige of pre-Code bankruptcy law, which allowed secured creditors to foreclose on their collateral without involvement in the bankruptcy proceeding. See Secured Transactions in California Commercial Law Practice §6.98 (2d ed Cal CEB 2001).

Whether or not a creditor's claim is secured depends on the rights the creditor holds against the debtor's property under applicable nonbankruptcy law. For example, a California bank lending to a buyer of residential real estate usually secures its loan with a deed of trust on the property purchased. If the deed of trust is in proper form and was properly executed and recorded under state law, the deed of trust will create a valid lien on the property and the lender will have the right to foreclose on the property if the borrower defaults. The lender's claim will qualify as a secured claim in a bankruptcy case filed by the borrower, and the lender will be entitled to receive the value of its interest in the property ahead of other creditors of the borrower. Therefore, it is important to determine whether the creditor had a valid lien or security interest under state law before commencement of the bankruptcy case.

NOTE: With some exceptions, security interests in personal property are governed by Division 9 of the California Uniform Commercial Code. See Com C §§9101-9709; Secured Transactions. The validity of liens on California real property is controlled by the Civil Code. See, *e.g.,* CC §§1214, 2897-2898, 2920-2923, 2925-2930. See California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009). The status of liens and security interests in bankruptcy cases is often litigated. See, *e.g., Aerocon Eng'g, Inc. v Silicon Valley Bank (In re World Auxiliary Power Co.)* (9th Cir 2002) 303 F3d 1120 (bank had perfected security interest in debtor's unregistered copyrights); *Diamant v Kasparian (In re Southern Cal. Plastics, Inc.)* (9th Cir 1999) 165 F3d 1243 (creditor with prejudgment attachment lien did not enjoy secured-creditor status in bankruptcy).

Even if the creditor held a valid lien or security interest prepetition, the lien or security interest may be voidable once the bankruptcy case is filed. Trustees (or debtors in possession in Chapter 11 cases), through their statutory avoiding powers, may be able to invalidate a creditor's lien or security interest if it was not properly perfected (see 11 USC §544), or if it was perfected within the 90-day period (1 year for insiders) before the date the bankruptcy petition was filed (see 11 USC §547(b)). *Loo v Martinson (In re Skywalkers, Inc.)* (9th Cir 1995) 49 F3d 546 (preferential transfer may be avoided if debt was not fully secured at time of transfer); *Hope v First Family Fin. Servs. (In re Harrison)* (Bankr MD Ga 2000) 259 BR 794 (allowance of creditor's secured claim did not immunize it from avoidance when lien was untimely perfected). See §§2.32-2.70 for further discussion of the avoiding powers.

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§3.5 2. Valuation of Collateral

If the creditor has a valid secured claim that is not subject to avoidance (see §3.4), the next step in the analysis is to determine the value of the collateral securing the claim. See 11 USC §506(a). In valuing collateral that is part of the bankruptcy estate, it is important to keep in mind the goal of the particular bankruptcy case. Greatly different valuations may result if the goal is to liquidate the property for the benefit of the creditors, as in a Chapter 7 case, instead of using the property as part of a going concern in a Chapter 11 case or to fund a payment plan in a Chapter 13 case. If the debtor (or trustee) and creditor cannot agree on the value of the collateral, the issue may be resolved through litigation in the bankruptcy court.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) introduced a new standard for valuation of personal property in Chapter 7 and 13 cases involving individual debtors. In such cases, the value of personal property securing an allowed claim will be determined based on the replacement value of the property as of the petition date without deduction for costs of sale or marketing. If the property in question was acquired for personal, family, or household purposes, replacement value is the price a retail merchant would charge for property of that kind, considering the age and condition of the property at the time value is determined. 11 USC §506(a)(2).

For business debtors in Chapter 11 proceedings, valuation of the business begins with an analysis of whether the debtor is a going concern or is on the brink of liquidation. *Wolkowitz v American Research Corp. (In re DAK Indus.)* (9th Cir 1999) 170 F3d 1197, 1199. The next step is to verify whether the debtor's balance sheet is positive or negative. In *Wolkowitz*, the bankruptcy court held that the debtor's business should be valued as a going concern because it continued to operate well into the bankruptcy case. 170 F3d at 1199.

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§3.6 3. Oversecured Claims; Interest; Attorney Fees

Sometimes, as a result of the original loan-to-value ratio or later appreciation, the creditor may be oversecured, because the value of the creditor's collateral is greater than the amount owed by the debtor. In addition to the principal amount owed, an oversecured creditor may also recover postpetition interest as long as the total recovery does not exceed the value of the collateral. 11 USC §506(b); *U.S. v Ron Pair Enters., Inc.* (1989) 489 US 235, 103 L Ed 2d 290, 109 S Ct 1026; *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 372, 98 L Ed 2d 740, 749, 108 S Ct 626. The applicable interest rate is either the rate specified in the contract, the market rate, or a default rate to be established by the bankruptcy court. *Bank of Honolulu v Anderson (In re Anderson)* (9th Cir 1987) 833 F2d 834, 836.

Further, an oversecured creditor can recover reasonable costs and attorney fees if provided for in the contract. 11 USC §506(b). *Kord Enters. II v California Commerce Bank (In re Kord Enters. II)* (9th Cir 1998) 139 F3d 684 (preempting state law on attorney fees); *Kamai v Long Beach Mortgage Co. (In re Kamai)* (BAP 9th Cir 2004) 316 BR 544 (junior lien not counted in determining whether creditor was oversecured and therefore entitled to attorney fees). The burden of proof concerning the reasonableness of the fees, costs, and charges remains with the creditor. *Atwood v Chase Manhattan Mortgage Co. (In re Atwood)* (BAP 9th Cir 2003) 293 BR 227. An oversecured creditor, however, is not entitled to attorney fees for defending against a preference action, because the action is a statutory proceeding independent of the contract provision for attorney fees. The creditor is entitled to fees only for actions enforcing or interpreting the agreement containing the attorney fee provision. *Williams v Official Unsecured Creditors' Comm. (In re Connolly)* (BAP 9th Cir 1999) 238 BR 475, 479.

NOTE: The trustee or the debtor in possession has a right to surcharge a creditor's collateral for "the reasonable, necessary costs and expenses of preserving, or disposing of, such property" including payment of ad valorem property taxes, to the extent that the trustee's or debtor's actions benefited the creditor. 11 USC §506(c). See generally *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890. The trustee or debtor, however, is permitted to surcharge only if the services rendered are necessary, reasonable, and confer a benefit to the secured lender. *Compton Impressions, Ltd. v Queen City Bank, N.A. (In re Compton Impressions, Ltd.)* (9th Cir 2000) 217 F3d 1256, 1260.

See additional discussion in §10.75.

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§3.7 4. Undersecured Claims; Lien-Stripping

During economic downturns, many creditors find themselves undersecured. Under 11 USC §506(a), in certain cases, the amount of a secured claim may be reduced or "stripped down" to the fair market value of the collateral as of the petition date. See also 11 USC §506(d). If the debtor is permitted to strip a secured creditor's claim down to the value of the collateral, the claim will be bifurcated into secured and unsecured portions. The creditor is treated as a secured creditor to the extent of the value of the collateral and as an unsecured creditor as to the remainder of the amount owed.

Despite the language of §506(a)(1), BAPCPA has significantly restricted lien-stripping as a strategy for personal property collateral in individual Chapter 7 and 13 cases. Section 506(a)(2) now requires the value of personal property securing an allowed claim to be determined based on the replacement value of the property as of the petition date without deduction for costs of sale or marketing. If the property was acquired for personal, family, or household purposes, the replacement value is its retail replacement value, taking into account its age and condition. Further, BAPCPA amended 11 USC §1325(a) to prohibit lien-stripping altogether in Chapter 13 cases with regard to purchase money security interests in (1) motor vehicles acquired for the debtor's personal use within 2½ years before the petition date, and (2) any other type of property acquired within 1 year before the petition date. Even before BAPCPA, in *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773, the U.S. Supreme Court held that 11 USC §506 was ambiguous and that a debtor in Chapter 7 could not strip a creditor's real estate lien down to the value of the real property collateral when the creditor's claim had already been allowed as a secured claim. *Dewsnup* is generally understood to prohibit lien-stripping in Chapter 7 cases only. See *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165; *In re Castro* (Bankr D Ariz 2002) 285 BR 703, 705. The prohibition against lien-stripping in Chapter 7 cases applies to nonconsensual as well as consensual liens. *Concannon v Imperial Capital Bank (In re Concannon)* (BAP 9th Cir 2006) 338 BR 90.

Lien-stripping is also prohibited in Chapter 11 and Chapter 13 cases for liens on a debtor's principal residence. 11 USC §§1123(b)(5), 1322(b)(2). See additional discussion of lien-stripping in chap 5.

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§3.8 B. Unsecured Claims

Creditors' claims that are not secured by collateral and claims secured by liens that have been avoided by the trustee or debtor in possession constitute unsecured claims under the Bankruptcy Code. Unsecured claims fall into two categories: priority claims and general unsecured claims.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.9 1. Priority Claims

§3.9 1. Priority Claims

Although general unsecured claims and priority claims are both unsecured, priority claims occupy a higher position in the distributional hierarchy than do general unsecured claims. The ten types of priority claims, in order of priority, are as follows (11 USC §507(a)):

- Domestic support obligations (see 11 USC §§101(14A), 503, 507; see also §2.52);
- Administrative expenses allowed under 11 USC §503(b) (see §3.10);
- Unsecured claims allowed under 11 USC §502(f) (see §3.11);
- Wages or commissions up to a maximum of $10,950 earned within 90 days before the petition was filed (see 11 USC §507(a)(4));
- Contributions to employee benefit plans for work performed within 180 days before the petition was filed or the debtor's business was closed (see 11 USC §507(a)(5)); claims under §507(a)(5) together with claims under §507(a)(4) in the aggregate cannot exceed $10,950 (see 11 USC §507(a)(5)(B)(ii));
- Claims by certain farmers or fishermen (see 11 USC §507(a)(6));
- Prepetition deposits with the debtor up to $2425 per individual claimant (see 11 USC §507(a)(7));
- Tax claims (see §§3.12-3.15);
- Claims of federal depositary agencies based on a commitment by the debtor to maintain the capital of an insured depository agency (see 11 USC §507(a)(9)); and
- Death or personal injury claims resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance. (see 11 USC §507(a)(10)).

NOTE: The dollar amounts stated in §507(a) are subject to adjustment every 3 years to reflect changes in the Consumer Price Index. 11 USC §104(a). They are scheduled to be amended on April 1, 2010.

NOTE: An entity that is subrogated to a priority claim is not always entitled to the original claimant's priority status. See 11 USC §507(d).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.10 a. Administrative Claims

§3.10 a. Administrative Claims

Administrative expenses are second priority claims under 11 USC §507(a)(2). Allowable administrative expenses are listed in 11 USC §503(b). There are two important characteristics of administrative expense claims:

- In most instances, they arise from expenses incurred by the estate after the bankruptcy petition has been filed; and
- Holders of administrative expense claims are not entitled to a priority in distribution from estate assets that constitute collateral for allowed secured claims.

Generally, administrative expense claims are of one or two types. Usually, they represent costs incurred postpetition to preserve the estate or operate the bankrupt business, such as professional fees, rent, and similar expenses. See 11 USC §503(b); *City of White Plains v A & S Galleria Real Estate, Inc. (In re Federated Dep't Stores)* (6th Cir 2001) 270 F3d 994 (property taxes); *Harvis Trien & Beck, P.C. v Federal Home Loan Mortgage Corp. (In re Blackwood Assocs.)* (2d Cir 1998) 153 F3d 61 (attorney fees); *Barakat v Life Ins. Co.* (*In re Barakat)* (9th Cir 1996) 99 F3d 1520 (tenant claims for security deposits under assumed leases); *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401 (rent); *Gonzalez v Gottlieb (In re Metro Fulfillment, Inc.)* (BAP 9th Cir 2003) 294 BR 306 (wages); *In re Service Merchandise Co.* (Bankr MD Tenn 1999) 256 BR 738 (accountant). Under 11 USC §503(b)(7), administrative expenses also include all amounts due under a nonresidential real property lease that was assumed under 11 USC §365 but later rejected for the 2-year period following the later of the date of rejection or the date of turnover of the premises. Under 11 USC §503(b)(9), administrative expenses further include the value of goods received by the debtor in the ordinary course of the debtor's business within 20 days before the petition date.

Administrative expense claims may also arise from tortious acts committed by the debtor during the postpetition operation of the debtor's business. *Alabama Surface Mining Comm'n v N. P. Mining Co. (In re N. P. Mining Co.)* (11th Cir 1992) 963 F2d 1449 (allowing administrative expense status for postpetition punitive and civil penalties incurred in debtor's mining operations); *United States Dep't of Interior v Elliot* (4th Cir 1985) 761 F2d 168 (granting administrative expense status to postpetition penalties for violations of federal mining reclamation law).

In general, except for the categories of administrative expenses added by BAPCPA (see 11 USC §§503(b)(7)-(9)), to be eligible for priority as an administrative expense, the claim must have arisen in a transaction with the trustee or debtor in possession, rather than a predecessor entity, or, alternatively, the claimant must have given consideration to the trustee or debtor in possession, and there must be a direct and substantial benefit to the estate. The claimant has the burden of proof that its claim qualifies for administrative expense priority. *Microsoft Corp. v DAK Indus., Inc. (In re DAK Indus., Inc.)* (9th Cir 1995) 66 F3d 1091.

Special rules are applicable to determine the allowable amount of administrative claims for postpetition rent under real estate leases. If the lease is for residential real estate, the administrative claim is limited to the rent for that portion of the leased property that is actually used or occupied. The amount of the administrative expense claim is not necessarily based on the rate specified in the rental agreement, but rather on an objective standard that measures the fair and reasonable value of the premises. There is a presumption that the contract rent constitutes a fair and reasonable value, but this presumption may be rebutted by showing that the reasonable value of the lease differs from the contract rate. This limitation is founded on the equitable principle of preventing unjust enrichment. *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700, 707. See also discussion of administrative expense in chap 7.

For nonresidential real estate leases, however, the trustee or debtor in possession is liable under 11 USC §365(d)(3) for the full amount of the contract rent due under the lease during the period before the lease is assumed or rejected, regardless of the fair and reasonable rental value of the premises. As noted above, the trustee or debtor in possession is also liable under 11 USC §503(b)(7) for 2 years' rent if the lease was assumed but later rejected. The amount of the landlord's administrative claim is calculated accordingly. *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401.

PRACTICE TIP: It is critical for the trustee or debtor in possession to act as soon as possible after the petition date to

assume or reject a lease. See generally §§7.35-7.59. In appropriate cases, courts will make the rejection effective retroactive to as early as the petition date. *Pacific Shores Dev., LLC v At Home Corp. (In re At Home Corp.)* (9th Cir 2004) 392 F3d 1064.

On lenders' superpriority administrative claims, see chap 10.

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§3.11 b. Claims Arising During Gap Period

Third in priority are claims for postpetition expenses incurred in the ordinary course of the debtor's business. See 11 USC §507(a)(3). These third priority claims are allowed only in involuntary bankruptcy cases after the involuntary petition has been filed and before entry of the order for relief. See 11 USC §502(f). This interim period is known as the "gap period." Examples of third priority claims are tax obligations incurred in the debtor's business postpetition.

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§3.12 c. Tax Claims

Tax claims on account of income or property taxes owed to the government have eighth priority. 11 USC §507(a)(8). Not all taxes are entitled to priority under §507(a)(8), however. A tax claim can be classified, in whole or in part, as a secured claim, a priority unsecured claim, or a general unsecured claim.

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§3.13 (1) Secured Tax Claims

Tax claims secured by liens on the debtor's property do not fall within 11 USC §507(a)(8). *Commissioner v TM Bldg. Prods.* (SD Fla 1998) 231 BR 364. If the Internal Revenue Service (IRS) or State of California Franchise Tax Board (FTB) has properly recorded a notice of tax lien, the taxing agency will have a secured claim to the extent of the value of the property to which the lien attached. See 11 USC §506(a); see also §§3.4-3.7. See generally IRC §§6321-6323; Rev & T C §38532; Govt C §§7170-7173.

For the IRS to perfect a tax lien on the debtor's real property for bankruptcy purposes, it must record its notice of federal tax lien before the petition date in the county where the real property is located. IRC §6323; CCP §2101(b). For personal property, the place of filing may be different. For a tax lien to be enforceable for bankruptcy purposes against a debtor's personal property, the IRS must file its notice of tax lien with the California Secretary of State before the petition date if the debtor is a corporation, a limited liability company, a partnership whose principal executive office is located in California, a trust, or a decedent's estate. In all other cases (including individuals), the IRS must record its tax lien notice with the county recorder where the person resides at the time the lien notice is recorded. IRC §6323; CCP §2101(c).

Similarly, the FTB's lien will be enforceable as a secured claim with respect to the debtor's real property if a notice of state tax lien is filed before the petition date in the office of the county recorder of the county in which the real property is located. Govt C §7170(b). For personal property, the FTB's notice must be filed with the California Secretary of State. Govt C §7170(c).

A tax lien cannot be voided as impairing an exemption under 11 USC §522(f). The homestead exemption will not affect the status of a federal tax lien; the federal tax lien has priority. *U.S. v Heffron* (9th Cir 1947) 158 F2d 657. Under IRC §6334(a), the IRS cannot seize certain property, but it can assert a lien on the same property for purposes of classification of a claim in a Chapter 13 plan. See *U.S. v Barbier* (9th Cir 1990) 896 F2d 377.

For secured tax claims, it is important to keep in mind the potential impact of a successful avoidance action under 11 USC §544. See generally §§2.32-2.33. If a tax lien on the debtor's property is successfully invalidated by the trustee (or the debtor in possession in Chapter 11 cases), the tax claim originally secured by the avoided lien will be classified either as an eighth priority unsecured tax claim or as a general unsecured tax claim.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.14 (2) Priority Unsecured Tax Claims

§3.14 (2) Priority Unsecured Tax Claims

To the extent the amount of a tax lien exceeds the value of the property to which the lien is attached, the tax claim becomes unsecured. 11 USC §506(a). For example, if the IRS is owed $10,000 and has recorded a notice of tax lien, and the debtor owns no real estate and has personal property worth $5000, the IRS's secured tax claim is only $5000. The question then becomes whether the remaining $5000 is a priority unsecured tax claim or a general unsecured claim.

The first step in the analysis is to identify the type of tax underlying the claim. Payroll taxes and "responsible person" penalties under IRC §6672 are taxes (1) "required to be collected or withheld and for which the debtor is liable in whatever capacity," and (2) entitled to priority status under 11 USC §507(a)(8)(C). Other types of taxes entitled to priority include certain property taxes (11 USC §507(a)(8)(B)), certain employment taxes (11 USC §507(a)(8)(D)), certain excise taxes (11 USC §507(a)(8)(E)), certain customs duties (11 USC §507(a)(8)(F)), and penalties related to priority tax claims (11 USC §507(a)(8)(G)).

Income tax claims are not entitled to priority status indefinitely. A three-prong test under 11 USC §507(a)(8)(A) is used to determine whether an income tax claim is entitled to priority. If any one of the following three conditions is met, the income tax claim in question will qualify as a priority tax claim. Note that 11 USC §507(a)(8)(A) includes a general requirement that, for priority status, the income tax claim must be for a taxable year ending on or before the petition date.

- The first condition is the "three-year rule." The tax year in question must be one "for which a return, if required, is last due, including any extensions, after three years before the date of the filing of the petition." See 11 USC §507(a)(8)(A)(i). Note that the key date is not the date that the return was actually filed; rather, it is the date that the return was due. See *Savaria v US (In re Savaria)* (BAP 9th Cir 2004) 317 BR 395 (postpetition filing of tax return due prepetition did not elevate tax debt to priority status). Thus, if the debtor did not file an extension, his or her tax return for 2003 was due April 15, 2004. If the bankruptcy petition was filed after April 15, 2007, the taxes due for the 2003 tax year will not meet the first test.
- The second condition is the "240 day rule." If the tax was assessed "within 240 days… before the date of the filing of the petition," the tax claim will be entitled to priority even if the tax return was due more than 3 years before the petition date. See 11 USC §507(a)(8)(A)(ii). The debtor may not know exactly the dates of assessment of taxes owed, but the assessment dates should be shown on the taxing authority's proof of claim, tax collection notices, debtor's copies of tax lien notices, or transcripts of account issued by the taxing authority. In addition, on request, the taxing agency will provide to the taxpayer or his or her attorney a transcript of account of the taxes due. If the debtor's counsel is working on a case with several years of back taxes due, a transcript of account should be obtained for each relevant tax year. The transcripts will allow counsel to identify the amount of the tax claim for each year and classify the amounts as either priority or general unsecured claims. Note that 11 USC §507(a)(8)(A)(ii) excludes from the 240-day calculation (1) any time during which an offer in compromise regarding the tax was pending or in effect during the 240-day period, plus 30 days; and (2) any time during which a stay of proceedings against collections was in effect in a prior bankruptcy case during the 240-day period, plus 90 days.
- The third condition is the "assessable but not assessed rule." If the tax claim is a tax other than the kind specified in 11 USC §523(a)(1)(B) or §523(a)(1)(C), the tax claim will be entitled to priority if it was assessable but not assessed after commencement of the case. See 11 USC §507(a)(8)(A)(iii). For example, if an audit was pending and the tax could have been assessed but was not because the audit was not completed by the time the petition was filed, the taxing agency is entitled to claim a priority without having actually made the assessment prepetition. This prevents a taxpayer from rushing to file a bankruptcy petition to prevent the tax from being classified as a priority claim because the debtor knows that an audit will lead to an assessment.

The time periods for determining the applicability of these conditions are subject to extension in certain

circumstances. Specifically, the time periods are tolled (11 USC §507(a)(8)):

- For any period during which the taxing authority was prohibited under nonbankruptcy law from collecting taxes based on a request by the debtor for a collection due process hearing and any appeal, plus 90 days; and
- For any time during which the collection of taxes was precluded by one or more confirmed bankruptcy plans or collection was prohibited due to the automatic stay in bankruptcy, plus 90 days.

Thus, counsel should note that the extension periods should be added to the time periods in the three conditions for determining priority status of income tax claims under 11 USC §507(a)(8)(A). In addition, the extension periods are applicable to the periods for determining the priority status of other taxes, such as employment taxes, property taxes, excise taxes, customs duties, and pecuniary loss penalties for these taxes under 11 USC §507(a)(8)(B), (a)(8)(D)-(G). The last clause of 11 USC §507(a)(8) apparently codifies and expands the holding in *Young v U.S.* (2002) 535 US 43, 152 L Ed 2d 79, 122 S Ct 1036, in which the U.S. Supreme Court held that the 3-year rule of 11 USC §507(a)(8)(A)(i) was equitably tolled during the pendency of a prior bankruptcy case in which the IRS was prohibited from collecting an income tax debt. A collection due process hearing (and appeal) is an administrative remedy to contest proposed collection actions by levy under IRC §6330 or similar procedures under state tax law.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.15 (3) Nonpriority Unsecured Tax Claims

§3.15 (3) Nonpriority Unsecured Tax Claims

Any income tax claims that do not meet one of the three conditions in 11 USC §507(a)(8)(A), and any other tax claims that do not fall into one of the other priority categories of 11 USC §507(a)(8), are classified as general unsecured claims and must share in any distributions in the case pro rata with other general unsecured creditors. See §3.16.

PRACTICE TIP: It sometimes is of strategic value to delay filing a petition so that tax claims age and cease to have priority. A debtor cannot discharge priority tax debt, but may be able to discharge nonpriority tax obligations that are not secured.

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§3.16 2. General Unsecured Claims

Claims that do not fit within any of the statutory definitions of priority claims (see §§3.9-3.15) fall in the category of general unsecured claims. Holders of general unsecured claims usually share pro rata in the distribution of estate assets (or in payments made under a confirmed Chapter 11 or Chapter 13 plan) after all secured creditors and priority claimants are paid or provided for. Prorata distribution means that a general unsecured creditor receives an amount from the bankruptcy estate that is proportional to the amount of its allowed claim compared with the total amount of the allowed claims of all general unsecured creditors. General unsecured creditors often receive only pennies on the dollar because the total amount of allowed claims against the debtor is usually substantially greater than the size of the debtor's estate, and the size of the estate may be greatly reduced after secured creditors and priority claimants receive their shares.

NOTE: Attorney fees accrued postpetition may be allowed as a general unsecured claim if authorized by a prepetition contract. See discussion of *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, and related cases in §§4.50, 10.91-10.92.

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§3.17 3. Postpetition Interest and Charges

In general, holders of unsecured claims are not entitled to postpetition interest, because the amount of their claims is determined as of the date of the bankruptcy filing. See §3.44. The sole exception to this rule is found in 11 USC §726(a)(5), which permits recovery of postpetition interest if there is excess property of the estate after all claims are paid. The interest is paid at the federal judgment rate specified in 28 USC §1961(a) (*Onink v Cardelucci (In re Cardelucci)* (9th Cir 2002) 285 F3d 1231; *Beguelin v Volcano Vision, Inc. (In re Beguelin)* (BAP 9th Cir 1998) 220 BR 94, 100), and is prorated among all unsecured claims. Interest properly payable under 11 USC §726(a)(5) usually begins to accrue on the date the bankruptcy petition is filed. In the Ninth Circuit, however, postpetition interest for holders of administrative claims in the form of attorney fees accrues from the date the court awards the fees, not the invoice date. *Boldt v Crake (In re Riverside-Linden Inv. Co.)* (9th Cir 1991) 945 F2d 320, 324.

NOTE: Holders of unsecured claims are treated equally for purposes of the payment of postpetition interest, when available, without regard to their statutory priority under 11 USC §507(a). Therefore, the priority scheme of §507(a) (see §3.9) will not affect an unsecured creditor's right to postpetition interest. See 11 USC §726(a)(5).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.18 4. Subordination of Claims

§3.18 4. Subordination of Claims

As discussed in §§3.4-3.16, the Bankruptcy Code sets forth the order in which creditors are to be paid in a bankruptcy case, and normally creditors are paid strictly in accordance with statutory priorities. If a claim is subordinated under 11 USC §510, however, the statutory priorities are altered. If a creditor successfully invokes §510 to obtain priority over other creditors, that creditor increases the likelihood of getting paid from the bankruptcy estate and potentially increases the amount the creditor will be able to recover. Conversely, a creditor whose claim is subordinated may be less likely to get paid from the bankruptcy estate and the amount recoverable by the creditor may be decreased.

There are three ways a claim can be subordinated under §510:

- Section 510(a) allows the subordination of claims when there is an enforceable subordination agreement between creditors of the debtor under state law. 11 USC §510(a).
- Section 510(b) subordinates claims stemming from the rescission of a purchase or sale of security of the debtor or damages arising from the purchase or sale of security of the debtor. 11 USC §510(b). See *American Broadcasting Sys., Inc. v Nugent (In re Betacom of Phoenix, Inc.)* (9th Cir 2001) 240 F3d 823 (subordination of damage claims of shareholders who had agreed to sell shares in transaction that did not close). Section 510(b) rescission claims are subordinated to all claims that are senior or of the same rank as claims represented by the security in question. If the security in question is common stock of the debtor, however, the rescission claim has the same priority as the claims of the debtor's common stockholders. In effect, §510(b) prevents a stockholder who successfully rescinds its stock purchase transaction under the federal securities laws from gaining a priority in bankruptcy to which it would not otherwise be entitled under state corporate law.

NOTE: Subordination of claims arising from the rescission of a purchase or sale of a security, or damages arising from the purchase or sale of a security, is mandatory, and does not depend on the creditor's inequitable conduct. *Audre Recognition Sys. v Casey (In re Audre, Inc.)* (Bankr SD Cal 1997) 210 BR 360, 365, aff'd (BAP 9th Cir 1997) 216 BR 19. When issuance of stock is simply the basis for calculating a consultant's compensation for services, however, §510(b) does not apply. *Racusin v American Wagering, Inc. (In re American Wagering, Inc.)* (9th Cir 2007) 493 F3d 1067.

- Section 510(c) permits a bankruptcy court to apply common law principles of equitable subordination. 11 USC §510(c). This section codifies the inherent equitable power of the bankruptcy court to subordinate claims as developed in case law. See, *e.g., Pepper v Litton* (1939) 308 US 295, 84 L Ed 281, 60 S Ct 238. Equitable subordination is a remedy that is rarely granted. The claimant must show that (1) the creditor sought to be subordinated engaged in some sort of inequitable conduct, (2) this misconduct injured other creditors or conferred an unfair advantage on the creditor in question, and (3) subordination would not be inconsistent with the Bankruptcy Code. *Feder v Lazar (In re Lazar)* (9th Cir 1996) 83 F3d 306, 309. See also *Paulman v Gateway Venture Partners III, L.P. (In re Filtercorp, Inc.)* (9th Cir 1998) 163 F3d 570 (equitable subordination requires inequitable conduct beyond initial undercapitalization); *Stroumbos v Kilimnik* (9th Cir 1993) 988 F2d 949.

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§3.19 IV. FILING PROOFS OF CLAIM

Filing a proof of claim (see §3.30) is usually a necessary step for the creditor to recover its share of the bankruptcy estate. With one exception (see §3.21), in a Chapter 7 or 13 case, a creditor's failure to file a proof of claim will prevent the creditor from participating in any distribution of property of the estate. Although creditors in Chapter 11 cases may not be required to file proofs of claim, it is generally good practice to do so. As a strategic matter, some creditors whose claims are nominal or are accurately scheduled as deemed allowed may not want to subject themselves to the jurisdiction of the bankruptcy court. See strategic considerations discussed in §3.20. On claims deemed allowed, see §3.22.

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§3.20 A. Proofs of Claim Filed by Creditors

The Bankruptcy Code provides that a creditor or a trustee "may" file a proof of claim. 11 USC §501(a). See Fed R Bankr P 3002(a). By filing a proof of claim, a creditor asserts its right to participate in the distribution of the bankruptcy estate. Unsecured creditors in Chapter 7 and 13 cases must file a proof of claim in order to be entitled to receive estate distributions. Fed R Bankr P 3002(a). It is not necessary, however, for secured creditors seeking to recover on their claim through the value of their collateral to file a proof of claim. *Meadowbrook Estates v McElvany (In re Meadowbrook)* (Bankr ED Cal 2000) 246 BR 898, 902.

NOTE: An unsecured creditor may be treated as having filed a proof of claim informally without having filed a proof of claim on Official Form 10. *Sambo's Restaurants, Inc. v Wheeler (In re Sambo's Restaurants, Inc.)* (9th Cir 1985) 754 F2d 811, 815. One situation in which a creditor is treated as filing an informal proof of claim occurs when the creditor has filed an adversary complaint with the bankruptcy court, making a demand on the debtor's estate that demonstrates an intent to hold the debtor liable. See generally *Nikoloutsos v Nikoloutsos (In re Nikoloutsos)* (5th Cir 2000) 199 F3d 233, 236 (five-part test to establish existence of informal proof of claim); *Electronic Sneak Preview, Inc. v Scott (In re Scott)* (Bankr SD Ind 1998) 227 BR 832. Counsel, however, should never rely on the validity of an informal proof of claim. The foregoing cases should be considered only if the filing deadline was missed.

Creditors face potential risks in filing proofs of claim, which should be considered in advance of the filing. These risks include (1) submitting the creditor to the jurisdiction of the bankruptcy court (including jurisdiction over the validity of any contract on which the claim is based), (2) giving the debtor and other creditors the right to conduct discovery regarding the creditor's claim, and (3) waiving the right to a jury trial. See *In re County of Orange* (Bankr CD Cal 1996) 203 BR 977 (creditor who files claim submits itself to summary jurisdiction of bankruptcy court and waives its right to jury trial); *In re Novak* (Bankr D Conn 1983) 37 BR 31 (debtor may compel discovery of creditor's business and knowledge for purposes of objecting to creditor's claim). See also §§1.56, 4.65.

PRACTICE TIP: If a creditor expects the trustee or debtor to commence litigation against it in a bankruptcy case, creditor's counsel should give careful thought to whether the creditor should file a proof of claim in the case. If distributions from the estate are expected to be minimal and preservation of a jury trial right is important, no proof of claim should be filed.

NOTE: Under 11 USC §502(b)(9), a proof of claim filed by a taxing agency in a Chapter 13 case with respect to a tax return filed under 11 USC §1308 will be deemed timely if it is filed within 60 days after the date on which the debtor filed the return.

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§3.21 B. Proofs of Claim Filed by Debtors

If an unsecured creditor in a Chapter 7 or 13 case neglects to file a proof of claim, the creditor's failure to file will not, in all circumstances, prevent a claim from being filed *for* the creditor. A debtor or the trustee may file a proof of claim if the creditor does not do so. 11 USC §501(c); Fed R Bankr P 3004. Further, an entity liable to the creditor along with the debtor, such as a guarantor or codebtor, may file a proof of claim if the creditor does not do so. 11 USC §501(b); Fed R Bankr P 3005.

When a Chapter 13 plan provides specifically for the treatment of a given claim, it should be unnecessary for the creditor to file a proof of claim in order to participate in distributions under the plan. Unless the creditor timely objects to the plan, confirmation of the plan will have a res judicata effect, binding both the creditor and the debtor to the plan's treatment of the claim. Under principles of judicial estoppel, the creditor's claim should be deemed allowed just as if the debtor had filed a timely claim on the creditor's behalf under 11 USC §501(c) and Fed R Bankr P 3004. See *Great Lakes Higher Educ. Corp. v Pardee (In re Pardee)* (BAP 9th Cir 1998) 218 BR 916, aff'd (9th Cir 1999) 187 F3d 648.

PRACTICE TIP: An attorney representing the debtor should consider filing a proof of claim on behalf of a creditor if the debts owed to the creditor cannot be discharged in the bankruptcy case. Failure of debtor's counsel to file a proof of claim in this situation forecloses the possibility that payments could be made on these claims from property of the estate. As a result, because the debts are nondischargeable, the debtor must pay them after the bankruptcy proceeding is over. The debtor's failure to file a proof of claim on the creditor's behalf can have the effect of defeating the "fresh start" the debtor hoped to achieve by declaring bankruptcy.

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§3.22 C. Claims Deemed Filed in Chapter 11 Cases

In Chapter 11 cases, a claim may be deemed filed under 11 USC §1111(a) even though neither the creditor nor the debtor filed a proof of claim. See Fed R Bankr P 3003. A claim is deemed filed when it has been listed by the debtor in possession (or the Chapter 11 trustee, if one has been appointed) in the schedules filed under 11 USC §521(a)(1) or §1106(a)(2). 11 USC §1111(a); Fed R Bankr P 3003. If the scheduled claim has been listed as disputed, contingent, or unliquidated, however, there is no "deemed" filing and the creditor must file a proof of claim in order to preserve its rights in the Chapter 11 case. See §§3.38-3.41. Moreover, proofs of claim that have actually been filed and not deemed filed in a Chapter 11, 12, or 13 case need not be filed for the second time on conversion to a Chapter 7 case. Fed R Bankr P 1019(3).

PRACTICE TIP: After reviewing the strategic considerations against filing a claim discussed in §3.20, creditor counsel may still decide to file a proof of claim even if the claim is deemed filed under 11 USC §1111(a). There are two reasons: first, to confirm the amount of the claim and the status of the claim as mature, liquidated, and not in dispute; and second, to eliminate any risk that the creditor's correct mailing address does not appear on the notice list provided by the debtor.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.23 D. Place of Filing

§3.23 D. Place of Filing

A proof of claim must be filed in accordance with the procedures in Fed R Bankr P 5005. Fed R Bankr P 3002(b). Under Rule 5005(a), proofs of claim must be filed with the clerk in the district where the bankruptcy case is pending. See §1.41 for a discussion of electronic case filing (ECF) systems in California bankruptcy courts.

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V. BAR DATES FOR FILING PROOFS OF CLAIM

A. Chapters 7 and 13

§3.24 1. 90-Day Rule

For bankruptcy petitions filed under Chapter 7 or Chapter 13, all proofs of claim must be filed within 90 days after the initial meeting of creditors under 11 USC §341(a). Fed R Bankr P 3002(c). (For discussion of §341(a) meetings, see §§4.27-4.34.) The deadline for filing is called the "bar date." There are five exceptions to the 90-day bar date in Chapter 7 or Chapter 13 cases. See §3.25.

The court has no equitable power to extend the time fixed by Fed R Bankr P 3002(c) unless one of the exceptions specified in the rule applies. *Zidell, Inc. v Forsch (In re Coastal Alaska Airlines, Inc.)* (9th Cir 1990) 920 F2d 1428, 1432. Thus, for example, the time period was not tolled or otherwise extended in the short time during which the case had been dismissed because of clerical error. *Gardenhire v Commissioner (In re Gardenhire)* (9th Cir 2000) 209 F3d 1145, 1148.

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§3.25 2. Exceptions to 90-Day Rule

The exceptions to the 90-day rule (see §3.24) are as follows:

- A government unit can file a proof of claim up to 180 days after the petition is filed. (The 180-day period can be extended for cause before the end of the period by motion to the court.) Fed R Bankr P 3002(c)(1). See *Gardenhire v Commissioner (In re Gardenhire)* (9th Cir 2000) 209 F3d 1145 (government claims must be filed within 180-day deadline). But see *IRS v Osborne (In re Osborne)* (9th Cir 1996) 76 F3d 306 (court does not have discretion under Fed R Bankr P 3002(c)(1) to allow IRS to file proof of claim late in Chapter 13 case).
- The court may extend the time for filing a proof of claim on behalf of an infant or incompetent person if doing so would not unduly delay administration of the case. Fed R Bankr P 3002(c)(2).
- A holder of an unsecured claim that arises or becomes allowable as a judgment may be filed within 30 days after the judgment becomes final, if the judgment is for the recovery of money or property from that entity or if the judgment denies or avoids the entity's interest in property. See Fed R Bankr P 3002(c)(3).

NOTE: This exception applies if an entity has been required to turn over property to the bankruptcy estate (*e.g.,* after a preferential transfer has been avoided) and as a result the entity acquires an unsecured claim against the estate.

- A creditor holding a claim arising from the rejection of an executory contract or unexpired lease may be filed after the 90-day period within such time as the court may direct. Fed R Bankr P 3002(c)(4).
- Creditors who received a notice in a Chapter 7 case that there are no assets to pay claims may file a proof of claim outside of the 90-day period if assets later become available for distribution. Creditors who initially received the notice of insufficient assets have 90 additional days to file proofs of claim after the clerk notifies them that distributions are possible. Fed R Bankr P 3002(c)(5). The court has discretion to extend the time for filing a proof of claim up to another 60 days for a creditor who received notice of the bar date at a foreign address if the court finds that the notice was insufficient under the particular circumstances to give the foreign creditor a reasonable time to file a proof of claim. Fed R Bankr P 3002(c)(6).

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§3.26 B. Bar Dates in Chapter 11 Cases

In general in Chapter 11 cases, the bar date for filing proofs of claim is set by the court, typically on motion by the debtor in possession, and may be extended by the court for cause. Fed R Bankr P 3003(c)(3). See also §3.28. In addition, extensions may be granted for infants or incompetent persons, for unsecured claims that arise in certain circumstances as the result of a judgment, and for claims arising from the rejection of an executory contract or unexpired lease. See Fed R Bankr P 3002(c)(2)-(4), discussed in §3.25. The Ninth Circuit recognized this distinction between Chapter 11 cases and Chapter 7 or 13 cases in *Levin v Maya Constr. (In re Maya Constr. Co.)* (9th Cir 1996) 78 F3d 1395. There is no bar date for filing claims for administrative expenses under 11 USC §503, unless one is set by the court. *Texas Comptroller of Pub. Accounts v Megafoods Stores, Inc. (In re Megafoods Stores, Inc.)* (9th Cir 1998) 163 F3d 1063, 1071.

NOTE: Rules on filing dates and specific language may differ in the local bankruptcy court; counsel should check the website of the appropriate court.

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§3.27 C. Bar Dates in Converted Cases

A new bar date for filing proofs of claim typically issues when a case is converted. A new bar date, however, will not issue if a Chapter 7 case had been converted to a Chapter 11, 12, or 13 case but thereafter converted back to a Chapter 7 case, and the time for filing claims expired in the original Chapter 7 case. Fed R Bankr P 1019(2). All claims actually filed by a creditor before conversion of the case are deemed filed in the Chapter 7 case. Fed R Bankr P 1019(3).

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§3.28 D. Late-Filed Claims

If a creditor fails to timely file a proof of claim, the creditor may make a motion requesting the bankruptcy court to permit the claim to be filed late. Under Fed R Bankr P 9006(b)(1), the bankruptcy court may grant such a motion if the creditor's failure to file the claim on time was the result of "excusable neglect." See *Pioneer Inv. Servs. Co. v Brunswick Assocs. LP* (1993) 507 US 380, 123 L Ed 2d 74, 113 S Ct 1489 (setting forth what sorts of neglect are excusable). But see *IRS v Osborne (In re Osborne)* (9th Cir 1996) 76 F3d 306 (court does not have discretion under Fed R Bankr P 3002(c)(1) to allow IRS to file proof of claim late in Chapter 13 case). Compare *Hi-Tech Communications Corp. v Poughkeepsie Bus. Park, LLC (In re Wheatfield Bus. Park, LLC)* (BAP 9th Cir 2004) 308 BR 463 (proof of claim erroneously delivered to bankruptcy court officials may be deemed timely).

The debtor or trustee may file a proof of claim on a creditor's behalf if the creditor fails to file one on a timely basis. 11 USC §501(c). To do so, the debtor or trustee must file a proof of claim within 30 days after the time period specified in Fed R Bankr P 3002(c) or 3003(c), whichever applies. Fed R Bankr P 3004. See §3.21.

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§3.29 VI. CONTENTS OF CLAIM

The requirements for preparation of a proof of claim are found in Fed R Bankr P 3001. A proof of claim is presumed valid if it is executed and filed with the bankruptcy court in accordance with Rule 3001. Fed R Bankr P 3001(f).

PRACTICE TIP: It is always preferable to have the client, rather than counsel, execute the proof of claim form, because of the risk of potential criminal liability for bankruptcy fraud. The form itself states that the penalty for presenting a fraudulent claim is a fine of up to $500,000 or imprisonment for up to 5 years, or both. 18 USC §§152, 3571.

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§3.30 A. Official Form

A proof of claim is a written statement setting forth a creditor's claim. Fed R Bankr P 3001(a). The proof of claim must be filed on or substantially conform to Official Form 10. See Directory for websites were the Official Forms may be found. A copy of the filed proof of claim should be served on the debtor and any trustee appointed in the case, to give them actual notice of the claim. Moreover, after filing the proof of claim, creditor's counsel should request a copy of the claims register maintained by the bankruptcy court, to verify that the claim was properly indexed by the bankruptcy court clerk.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.31 B. Prepetition Interest and Charges

§3.31 B. Prepetition Interest and Charges

If a creditor's claim includes prepetition interest or miscellaneous charges such as attorney fees, the creditor must provide a detailed breakdown of the interest and charges. If the claim is based on complex or extensive calculations, a summary sheet should be attached, demonstrating how the total amount was computed. See Official Form 10, Judicial Conference of the United States, Advisory Committee Note. See Directory for link to form.

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§3.32 C. Required Documentation

A creditor filing a proof of claim based on a writing must comply with Fed R Bankr P 3001(c). A creditor whose claim (or interest in the debtor's property securing the claim) is based on a writing must file the original or a duplicate of the writing along with the proof of claim. Fed R Bankr P 3001(c).

PRACTICE TIP: Although Fed R Bankr P 3001 permits a creditor to file an original of the writing, it is better practice to provide copies and retain the original writing because proofs of claim are occasionally lost or misfiled. Further, many courts, including the Central District of California, have gone "paperless" and destroy proofs of claims once they have been electronically imaged by the clerk.

If the original document or a copy of the document on which the claim is based is lost or missing, or if the documentation is voluminous, a creditor has the option of providing a summary of the documents along with the proof of claim. In this situation, the creditor must also file a statement describing the circumstances of the loss or destruction or indicating that the documentation is excessive. Fed R Bankr P 3001(c).

A creditor filing a proof of claim based on a lien or security interest in the debtor's property must provide evidence that the lien or security interest has been properly perfected. Fed R Bankr P 3001(d). For examples of acceptable evidence of perfection, see Fed R Bankr P 3001(d), Advisory Committee Note.

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§3.33 VII. AMENDMENT OR REPLACEMENT OF CLAIM

A creditor may seek to amend a claim if there is a defect in the claim as originally filed. Bankruptcy courts usually permit an amendment to a proof of claim if the creditor has provided adequate notice of the claim's existence as well as the nature and amount of the claim in the original proof of claim. *Sun Basin Lumber Co. v U.S.* (9th Cir 1970) 432 F2d 48. A creditor should also file an amendment to a proof of claim (and serve copies of the amendment on the debtor and the trustee) if the creditor's address or the address of the creditor's counsel has changed since the original filing.

PRACTICE TIP: A creditor who is submitting an amendment or a replacement to an earlier claim should make that clear by so stating on the Official Form as well as on the supporting documents. Official Form 10 includes a box to be checked if the form "replaces" or "amends" a previously filed claim. See Directory for websites where the Official Forms may be found. The filing date of the earlier proof of claim must be stated in the amendment.

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§3.34 VIII. WITHDRAWAL OF CLAIM

The right of a creditor to withdraw a proof of claim and the procedure for doing so are described in Fed R Bankr P 3006. Withdrawal is accomplished by filing a notice of withdrawal in the form of a pleading with the bankruptcy court. Unless the bankruptcy court orders otherwise after a properly noticed hearing, however, a creditor is not permitted to withdraw its claim once a party has objected to the creditor's claim, a complaint has been filed against the creditor in an adversary proceeding, or the creditor has accepted or rejected the plan or otherwise participated significantly in the case. Fed R Bankr P 3006.

A party objecting to the withdrawal of a creditor's claim has the burden of demonstrating that legal prejudice would result if the court allowed the creditor to withdraw its claim. *In re County of Orange* (Bankr CD Cal 1996) 203 BR 977, 982. A debtor objecting to a creditor's motion to withdraw a claim does not suffer prejudice on account of the debtor's time and resources spent in preparing for trial. *Resorts Int'l, Inc. v Lowenschuss (In re Lowenschuss)* (9th Cir 1995) 67 F3d 1394, 1401.

NOTE: Unless the court orders otherwise, an authorized withdrawal of a claim constitutes a withdrawal of any related acceptance or rejection of a plan. Fed R Bankr P 3006.

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IX. ALLOWANCE OF CLAIMS: PRESUMPTIONS AND BURDEN OF PROOF

§3.35 A. Presumption of Validity

A proof of claim, once filed, is deemed allowed unless the debtor or a party in interest objects to the claim. 11 USC §502(a). A properly executed and filed proof of claim constitutes prima facie evidence of the validity and amount of the claim. Thus, the party objecting to the claim has the burden of providing affirmative evidence to overcome the presumption of validity. Fed R Bankr P 3001(f); *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890; *Lundell v Anchor Constr. Specialists, Inc. (In re Lundell)* (9th Cir 2000) 223 F3d 1035; *Hardin v Gianni (In re King St. Invs.)* (BAP 9th Cir 1998) 219 BR 848, 858. The ultimate burden of persuasion, however, remains on the claimant. *Lundell v Anchor Constr. Specialists, Inc. (In re Lundell), supra*.

NOTE: In cases involving IRS tax claims, the government bears the initial burden of proof, but that burden is satisfied by the IRS's "deficiency determinations and assessments for unpaid taxes," which are presumed correct "so long as they are supported by a minimal factual foundation." *Neilson v U.S. (In re Olshan)* (9th Cir 2004) 356 F3d 1078, 1084. Only if the debtor can make a showing that the determination was arbitrary, excessive, or without foundation does the burden shift back to the IRS. 356 F3d at 1085.

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§3.36 B. Presumption of Validity in Chapter 11

The schedules of assets and liabilities filed by the debtor in a Chapter 11 case constitute prima facie evidence of the validity and amount of the creditors' claims. Fed R Bankr P 3003(b)(1). Therefore, a creditor need not file a proof of claim if its claim is listed accurately and is not listed as disputed, contingent, or unliquidated. See §3.22. This presumption does not apply, however, if its claim is listed in the schedules as disputed, contingent, or unliquidated. See §§3.38-3.41.

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§3.37 C. Heightened Proof for Insider's Claim

In *Brewer v Erwin & Erwin, P.C. (In re Marquam Inv. Corp.)* (9th Cir 1991) 942 F2d 1462, 1465, the Ninth Circuit held that, in dealing with a contested proof of claim of an insider (as defined in 11 USC §101(31)), the court may require the insider to prove both its good faith and the inherent fairness of the transaction from the viewpoint of the debtor and those interested in the transaction.

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X. CONTINGENT, UNLIQUIDATED, AND DISPUTED CLAIMS

§3.38 A. Generally

"Claim" is broadly defined in 11 USC §101(5). See §3.2. Even creditors with unliquidated, contingent, or disputed claims are permitted to participate in bankruptcy proceedings. See *Cool Fuel, Inc. v Board of Equalization (In re Cool Fuel, Inc.*) (9th Cir 2000) 210 F3d 999 (claim may be ripe and allowable even if cause of action has not yet accrued under state law).

The terms "disputed," "unliquidated," and "contingent" are often used loosely:

- "Disputed" claims are ones for which liability is truly at issue. Did the debtor do the deed that created the liability giving rise to the creditor's claim? Or, did the debtor's act give rise to any claim at all under substantive state or federal law?
- "Unliquidated" claims are debts for which liability is not usually at issue, but the amount of the claim (*e.g.,* the amount of tort damages) has not yet been fixed by agreement of the parties or by a court. Conversely, a claim is deemed to be "liquidated" if the amount is readily ascertainable, even if the issue of liability has not yet been finally decided. *Slack v Wilshire Ins. Co. (In re Slack)* (9th Cir 1999) 187 F3d 1070.
- "Contingent" claims are claims for which liability is not an issue, but a condition precedent to liability has not yet occurred. See *Mazzeo v U.S. (In re Mazzeo)* (2d Cir 1997) 131 F3d 295; *Fostvedt v Dow (In re Fostvedt)* (9th Cir 1987) 823 F2d 305. A typical contingent claim is a guarantor's obligation under a guaranty before the primary obligor's default on the guaranteed debt.

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§3.39 B. Scheduling Contingent, Unliquidated, or Disputed Claims

In Chapter 13, the debt limits of 11 USC §109(e) may tempt some debtors into underreporting the true amounts of their claims or disputing otherwise valid debts. See §§5.34, 5.53.

NOTE: The dollar amounts stated in §109(e) are subject to adjustment every 3 years to reflect changes in the Consumer Price Index. They are scheduled to be amended on April 1, 2010.

Similarly, a Chapter 11 debtor may be tempted to list one or more claims as contingent, unliquidated, or disputed, because doing so will force the creditor to take affirmative steps to file a proof of claim in order to preserve its rights in the case. An unsophisticated creditor may fail to do so, resulting in automatic disallowance of its claim. See Fed R Bankr P 3003(c)(2). In Chapter 11 cases, a proof of claim is "deemed filed" to the extent that the claim has been scheduled by the debtor, but this rule does not apply to claims that are listed as "disputed, contingent or unliquidated." See 11 USC §1111(a); see also §3.22.

A debtor is obligated to complete the bankruptcy schedules and list his or her assets and liabilities accurately for the benefit of the court and all parties in interest. 11 USC §521(a)(1). Failure to complete the schedules accurately by, for example, stating that all claims are disputed without a good faith basis for doing so might constitute a basis for denial of an individual debtor's discharge. See 11 USC §727(a)(4)(A) (making a false oath or account). Listing all debts as disputed might also be evidence of sufficient "bad faith" to support a motion for dismissal of the bankruptcy case for "cause." See 11 USC §§707(a), 1112(b), 1307(c) (all permit dismissal of a case for cause); see also §§4.79-4.91. A debtor who wants to file a Chapter 13 petition but is just over the debt limits should instead pay down one or more claims before bankruptcy to become eligible under 11 USC §109(e). See §5.27.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.40 C. Liquidating Contingent, Unliquidated, or Disputed Claims

§3.40 C. Liquidating Contingent, Unliquidated, or Disputed Claims

A creditor whose claim has been scheduled by the debtor as disputed, contingent, or unliquidated faces a choice. In most situations, the creditor will consent to bankruptcy court jurisdiction to resolve the claim in the debtor's case. If the trustee (or debtor in possession in a Chapter 11 case) objects to the creditor's proof of claim as filed, the objection will be resolved through a claims objection proceeding in the bankruptcy court. See §§3.51-3.53. Claims objection proceedings are "contested matters" under Fed R Bankr P 9014 (see generally §§3.52, 4.42-4.44). Claims are usually determined by the bankruptcy judge without a jury, and most evidence is submitted in the form of written declarations with an opportunity given for live cross-examination of the declarants. Claims objection proceedings in the bankruptcy court tend to be faster and less expensive than litigation in other forums, and bankruptcy judges are usually more conservative than are juries in calculating damages. See §3.52.

If the creditor would prefer to have the claim tried and liquidated in another forum, or if litigation regarding the claim was ongoing in another forum when the bankruptcy case was filed, the creditor must promptly file a motion for relief from the automatic stay to litigate the claim in the other forum. See §4.20. The bankruptcy court might grant the creditor's request if the factual basis of the claim or its legal foundation is complex or specialized (such as an antitrust, securities fraud, construction defect, or mass tort claim). Final distributions to creditors in the bankruptcy case will await the outcome of the proceedings in the other forum. The bankruptcy court, however, will generally not grant relief from stay if the creditor's claim is based on a contract or an open account.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.41 D. Estimation of Contingent or Unliquidated Claims

§3.41 D. Estimation of Contingent or Unliquidated Claims

The bankruptcy court, for purposes of allowance, must estimate any contingent or unliquidated claim if the fixing or liquidation of the claim would unduly delay administration of the case. 11 USC §502(c)(1). The bankruptcy court is also required to estimate payment rights arising from an equitable remedy for breach of performance. 11 USC §502(c)(2).

NOTE: The policy behind §502(c)(1) is to prevent undue delay in administration of the case. It follows that estimation may not be appropriate if awaiting the outcome of claims litigation would not delay case administration. *Swift v Bellucci (In re Bellucci)* (Bankr ED Cal 1990) 119 BR 763. For example, a bankruptcy court may grant relief from the automatic stay to allow a creditor to liquidate its claim in state court if doing so would expedite the bankruptcy proceedings.

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§3.42 XI. OBJECTIONS TO CLAIMS

Any party in interest may object to a proof of claim filed by a creditor. 11 USC §502(a). The trustee (or debtor in possession) is charged with the duty to review proofs of claim. 11 USC §§704(a)(5), 1106-1107. As a practical matter, a trustee will never review proofs of claims in a "no asset" Chapter 7 case. But, in "asset" cases, the trustee or debtor in possession will obtain copies and review all of the proofs of claim filed in the case. If a claim is incorrect or not supported by substantive law, the trustee or debtor in possession will usually file an objection to allowance of the claim.

PRACTICE TIP: It is important for the claim objection to affirmatively contest the debtor's liability or the amount of the debt (or both). An objection that does not do so will be insufficient to disallow the proof of claim, even if the proof of claim lacks the documentation required by Fed R Bankr P 3001(c). *Campbell v Verizon Wireless S-CA (In re Campbell)* (BAP 9th Cir 2005) 336 BR 430; *Heath v American Express (In re Heath)* (BAP 9th Cir 2005) 331 BR 424. See also *In re Lasky* (Bankr CD Cal 2007) 364 BR 385 (debtors may file objection to claim supported by declaration stating to what extent they believe they are liable, or not liable, on the claim and why).

If no party in interest objects to a creditor's claim, then the claim is deemed allowed. 11 USC §502(a). See 11 USC §502(b), (d), discussed in §§3.43-3.50. The deemed allowance is not final for purposes of res judicata, however, until the conclusion of the case. *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890, 894.

NOTE: In a Chapter 13 proceeding, a debtor cannot indirectly attack a claim by failing to object to it and later unilaterally reduce the amount of the claim in the Chapter 13 plan. *Fireman's Fund Mortgage Corp. v Hobdy (In re Hobdy)* (BAP 9th Cir 1991) 130 BR 318, 320.

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A. Grounds for Disallowance

§3.43 1. Unenforceable Claims

The most important ground for disallowance of a claim is that it is invalid under state law. A party in interest may object to a creditor's claim, to the extent that the claim is not enforceable against the debtor or the debtor's property under any agreement or any applicable law, for any reason other than the fact that the claim is contingent or unmatured. 11 USC §502(b)(1); *Durkin v Benedor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276 (trustee may raise any state law defense to proof of claim); *Diamant v Kasparian (In re Southern Cal. Plastics, Inc.)* (9th Cir 1999) 165 F3d 1243; *Johnson v Righetti (In re Johnson)* (9th Cir 1985) 756 F2d 738. In general, the validity of a claim is determined by state law in the judicial district where the bankruptcy is proceeding. *Arab Monetary Fund v Hashim (In re Hashim)* (9th Cir 2000) 213 F3d 1169. The Bankruptcy Code also provides a series of specific additional grounds for disallowance of claims, as discussed in §§3.44-3.50.

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§3.44 2. Unmatured Interest

Bankruptcy Code §502(b)(2) allows a party in interest to object to a creditor's claim for unmatured interest. In effect, §502(b)(2) prohibits a creditor from recovering postpetition interest on prepetition debts that are unsecured claims. *State Bd. of Equalization v Taxel (In re Del Mission, Ltd.*) (9th Cir 1993) 998 F2d 756, 757. See §3.17. Even though a creditor's claim for unmatured interest is subject to disallowance, that does not mean the creditor will never recover the interest. The Code's prohibition of claims for unmatured interest does not prevent (*Roa-Moreno v U.S. Dep't of Health & Human Servs. (In re Roa-Moreno)* (Bankr CD Cal 1997) 208 BR 488, 492):

- Interest from accruing;
- The creditor from collecting interest from a party other than the debtor, such as a guarantor;
- The creditor from collecting interest from the debtor if the debtor is denied a discharge or if the particular debt is excepted from discharge; or
- Payment of interest under 11 USC §726(a)(5) at the federal judgment rate if there is excess property in the estate (see §3.17).

See also discussion of interest and oversecured creditor in §10.91.

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§3.45 3. Property Tax Claims

Property tax claims will be disallowed to the extent that the claim exceeds the value of the estate's interest in the property subject to the tax. 11 USC §502(b)(3).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.46 4. Insider Claims

§3.46 4. Insider Claims

Claims for the services of an insider or attorney of the debtor will be disallowed to the extent that the claim exceeds the reasonable value of the services rendered. 11 USC §502(b)(4). See also 11 USC §330(a); Fed R Bankr P 2016.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.47 5. Unmatured Portion of Claim for Domestic Support Obligation

§3.47 5. Unmatured Portion of Claim for Domestic Support Obligation

A claim for a debt that is unmatured as of the date of the bankruptcy filing will be disallowed if the debt is excepted from discharge under Bankruptcy Code §523(a)(5), *i.e.,* domestic support obligations. 11 USC §502(b)(5).

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§3.48 6. Limitations on Landlord Claims

The amount of a lessor's claim for damages resulting from the termination of a real property lease is subject to the limitations of Bankruptcy Code §502(b)(6) (often referred to as the "landlord cap"). Under that section, the lessor's claim will be disallowed to the extent it exceeds the "rent reserved" by the lease (without acceleration) for the greater of 1 year or 15 percent (not to exceed 3 years) of the lease's remaining term, following the earlier of:

- The date of the filing of the bankruptcy petition, or
- The date the lessor repossessed or the lessee surrendered the property.

To determine whether and to what extent a claim will be disallowed under this section, counsel must analyze whether charges under a lease fall within the definition of "rent reserved." The Ninth Circuit has set forth a three-part test. To constitute "rent reserved," the charge under the lease must be (*Kuske v McSheridan (In re McSheridan)* (BAP 9th Cir 1995) 184 BR 91, 99, overruled on other grounds in *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978):

- Designated as rent or additional rent in the lease or be provided as the lessee's obligations under the lease;
- Related to the value of the property or the lease; and
- Properly classified as rent because it is a fixed, regular, or periodic charge.

WARNING: In *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978, the Ninth Circuit overruled *In re McSheridan* to the extent that it holds §502(b)(6) "to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant's failure to complete a lease term." In *Wall St. Plaza, LLC v JSJF Corp. (In re JSJF Corp.)* (BAP 9th Cir 2006) 344 BR 94, the BAP held that a landlord may add attorney fees awarded in state court in prepetition litigation to the cap under §502(b)(6). *Wall St. Plaza* was affirmed by the Ninth Circuit in an unpublished opinion in which the court cited the BAP's "explanation" that *In re McSheridan* has been read to be about claims allowance or disallowance, but that it instead "concerns which portions of a lessor's claim are limited by §502(b)(6)." See *JSJF Corp. v Wall St. Plaza, LLC (In re JSJF Corp.)* (9th Cir 2008) 277 Fed Appx 718.

For further discussion of landlords' claims and the landlord cap, see chap 7.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.49 7. Guarantor, Co-Obligor, or Surety Claims

§3.49 7. Guarantor, Co-Obligor, or Surety Claims

The court must disallow a claim for reimbursement or contribution of a guarantor, co-obligor, or surety on a claim to the extent that (11 USC §502(e)(1)):

- The creditor's claim on which the guarantor, co-obligor, or surety may be liable is disallowed;
- The guarantor's, co-obligor's, or surety's claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of the claim; or
- The guarantor, co-obligor, or surety asserts a right of subrogation to the rights of the creditor under 11 USC §509.

See generally *Potter v CNA Ins. Cos. (In re MEI Diversified, Inc.)* (8th Cir 1997) 106 F3d 829; *Dant & Russell, Inc. v Burlington N. R.R. Co. (In re Dant & Russell, Inc.)* (9th Cir 1991) 951 F2d 246.

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§3.50 8. Other Grounds for Objection

The following are also grounds for claims objections:

- **Claims under terminated employment contract.** An employee's claim for damages resulting from the termination of an employment contract may be disallowed to the extent that the claim exceeds the compensation provided for under the contract for 1 year plus any unpaid compensation due under the contract. 11 USC §502(b)(7). The 1-year period is measured from the earlier of the date the bankruptcy petition was filed or the date performance under the contract ceased. *Young v Condor Sys., Inc. (In re Condor Sys., Inc.)* (BAP 9th Cir 2003) 296 BR 5 (1-year cap under §502(b)(7) is calculated mechanically as of petition date and is not affected by any prepetition severance payments or pre- or postpetition payments by co-obligors or letter-of-credit issuers).
- **Late-filed claims.** A claim can be disallowed if not timely filed except to the extent it is permitted to be filed late under 11 USC §726(a)(1)-(3) or under the Federal Rules of Bankruptcy Procedure. 11 USC §502(b)(9). For further discussion of late-filed claims, see §§3.25, 3.28.
- **Claims of holders or transferees of estate property.** The court must disallow any claim of an entity for the value of property if (a) the property is recoverable by the estate under 11 USC §542, §543, §550, or §553; or (b) the entity is a transferee of a property transfer voidable under §522(f), §522(h), §544, §545, §547, §548, §549, or §724(a). 11 USC §502(d); see chap 2. At least one court has held that §502(d) also applies to administrative claims (see *Microage, Inc. v Viewsonic Corp. (In re Microage, Inc.)* (BAP 9th Cir 2002) 284 BR 914 amended (BAP 9th Cir 2002) 291 BR 503); however, a number of courts have ruled that it does not (see *Southern Polymer, Inc. v TI Acquisition, LLC (In re TI Acquisition, LLC)* (Bankr ND Ga 2009) 410 BR 742, 748). A creditor's claim subject to disallowance under §502(d) will nevertheless be allowed if the creditor pays the amount it owes or turns over the transferred property to the estate. Although §502(d) disallows claims of transferees who refuse to surrender voidable transfers, it does not compel the surrender of property and does not permit affirmative relief of any kind. *Parker N. Am. Corp. v Resolution Trust Corp. (In re Parker N. Am. Corp.)* (9th Cir 1994) 24 F3d 1145, 1155.
- **Claims of creditors that refused to negotiate a reasonable alternative repayment schedule.** Even if an unsecured consumer debt would normally be allowed in full, a debtor may reduce the claim by not more than 20 percent if (1) the claim was filed by a creditor who unreasonably refused to negotiate a reasonable alternative repayment schedule proposed on behalf of the debtor by an approved nonprofit budgeting and credit counseling agency described in 11 USC §111; (2) the debtor's offer was made at least 60 days before the petition date and provided for at least 60 percent of the debt over a period not to exceed the repayment period of the loan or a reasonable extension thereof; and (3) no part of the debt is nondischargeable. 11 USC §502(k). The debtor has the burden of proof of the applicability of this section by clear and convincing evidence. Note that §502(k) only applies to cases filed on or after October 17, 2005.
- **Claims without sufficient documentation.** Claims based on a writing must be supported with documentation sufficient to establish prima facie evidence of the existence of the claim. Fed R Bankr P 3001(c). See §3.35. Note, however, that an objection based on insufficient documentation must also affirmatively contest the debtor's liability or the amount of the debt (or both); otherwise, the claim will be allowed. *Campbell v Verizon Wireless S-CA (In re Campbell)* (BAP 9th Cir 2005) 336 BR 430; *Heath v American Express* (*In re Heath)* (BAP 9th Cir 2005) 331 BR 424.

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B. Claims Objection Proceedings

§3.51 1. Filing Procedures and Notice Requirements

In general, an objection to a proof of claim can be filed at any time. *Ashford v Consolidated Pioneer Mortgage (In re Consolidated Pioneer Mortgage)* (BAP 9th Cir 1995) 178 BR 222, 225, aff'd (9th Cir 1996) 91 F3d 151. The objection must be in writing and the objecting party must mail or deliver a copy along with notice of the hearing on the objection to the claimant, the debtor (or debtor in possession), and the trustee, at least 30 days before the hearing. Fed R Bankr P 3007. The 30-day notice requirement may be waived if a party fails to object at or before the time of the hearing. See *Trust Corp. v Patterson (In re Copper King Inn, Inc.)* (9th Cir 1990) 918 F2d 1404, 1406.

NOTE: The objecting party may not circumvent the objection procedures merely by including provisions in the Chapter 11 plan that reduce the amount of the claim. *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489.

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§3.52 2. Claims Objection Hearings

If an objection is filed, a hearing is set. A claims objection proceeding is a "contested matter" under Fed R Bankr P 9014. *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890; *Shook v CBIC (In re Shook)* (BAP 9th Cir 2002) 278 BR 815. See generally §§4.42-4.44. For simple objections, the matter is handled like a motion. The bankruptcy court reviews declarations and other evidence submitted in support of the objection and the creditor's response. A ruling is often made from the bench. For more complicated objections, the court will often treat the matter as an adversary proceeding. See generally §§4.45-4.50. The court will set a discovery cutoff date, a pretrial hearing, and a trial.

In bankruptcy court, almost all claims are decided in front of the bankruptcy judge without a jury. In many courts, most of the evidence comes in by way of declaration (with live testimony only on cross-examination and impeachment), which results in a less expensive and faster proceeding. Typically, bankruptcy judges tend to be more conservative in awarding damages and calculating claims than juries.

After the hearing (and trial, if any) on the objection, the court will either sustain the objection (disallow the claim), allow the claim in part, or overrule the objection. Under 11 USC §502, claims must be enforceable under substantive (state or federal) law. 11 USC §502(b)(1); *Siegel v Federal Home Loan Mortgage. Corp.* (9th Cir 1998) 143 F3d 525, 532 ("debt" is "coextensive" with definition of "claim"; court looks to state law to determine whether claim exists, but looks to federal law to determine when claim arises).

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§3.53 3. Special Procedures in Central District of California

The Bankruptcy Court for the Central District of California has a number of special procedures and rules relating to claims and objections to claims. For example, a claim objection must be set for hearing on notice of not less than 30 days. CD Cal Local Bankr R 3007-1(b)(1). Objections to claims are "contested matters" under Fed R Bankr P 9014 and must comply with the requirements of CD Cal Local Bankr R 9013-1(a)-(f) (except 9013-1(a)(6)(A)-(B)). See CD Cal Local Bankr R 3007-1(a)(1).

Counsel should carefully review and become familiar with local rules before making a filing in any bankruptcy court. See Directory.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/3 Claims/§3.54 XII. ASSIGNMENT OF CLAIMS

§3.54 XII. ASSIGNMENT OF CLAIMS

Absent some effect on the administration of the case or on property of the estate, the Bankruptcy Code does not prohibit or discourage creditors from selling their claims to third parties. *Unsecured Creditors' Comm. v Stern (In re SPM Mfg. Corp.)* (1st Cir 1993) 984 F2d 1305, 1314. A creditor may wish to sell its claim in order to realize an immediate cash payment, to dispose of unwanted collateral, or for other business reasons. If a claim is assigned by a creditor after the proof of claim is filed, evidence of the assignment must be filed with the bankruptcy court by the assignee. After the filing, the court clerk notifies the original creditor that the filing has occurred and that any objections to the assignment must be filed within 21 days after the date of the notice. If the original creditor does not make a timely objection, the assignee is substituted for the assignor on the court records. If a claim is assigned by a creditor before filing a proof of claim, the proof of claim is filed by the assignee. See generally Fed R Bankr P 3001(e).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/4 Bankruptcy Case Administration/ I. AUTOMATIC STAY/§4.1 A. General Scope

I. AUTOMATIC STAY

§4.1 A. General Scope

The automatic stay is one of the most powerful tools available to a debtor under the Bankruptcy Code. It is a statutory injunction implemented by 11 USC §362(a), effective in most cases immediately as of the date and time when the debtor files a voluntary bankruptcy petition or, in an involuntary case, when the order for relief is entered (see 11 USC §303(h); see also §1.8). The time indicated on the court stamp on the petition is presumed to be the "time of filing." *In re Schleier* (Bankr SD NY 2003) 290 BR 45. The stay prohibits creditors from taking any action whatsoever against the debtor or the debtor's property to collect sums owed to them, to enforce any judgment against the debtor, or to repossess or foreclose on any property of the debtor. See generally *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986; *Contractors' State License Bd. v Dunbar (In re Dunbar)* (9th Cir 2001) 245 F3d 1058. The protection afforded by the stay is at the core of the bankruptcy system and applies to all entities. See §1.12.

The debtor and all property of the estate benefit from the statutory protection of the stay unless or until the stay is lifted by court order under 11 USC §362(d); the stay terminates or is ineffective under 11 USC §362(c), (d), (e), (h), or (n); or the case is closed or dismissed. See 11 USC §362(c); *Spirtos v Moreno (In re Spirtos)* (9th Cir 2000) 221 F3d 1079 (stay remains in effect with respect to property as long as that property is in the estate). Actions stayed are enumerated in 11 USC §362(a), and include:

- Commencement or continuation of any judicial or other legal proceeding against the debtor that was (or could have been) commenced against the debtor prepetition, including any proceeding to recover a prepetition claim (11 USC §362(a)(1));
- Enforcement of any judgment obtained prepetition against the debtor or the debtor's property (11 USC §362(a)(2));
- Any act to obtain possession of, or to exercise control over, property of the estate (11 USC §362(a)(3));
- Creation, perfection, or enforcement of any lien against property of the estate (11 USC §362(a)(4)), or of any lien against the debtor's property that secures a prepetition claim (11 USC §362(a)(5));

NOTE: The term "lien" is defined broadly under 11 USC §101(36)-(37), (51), and (53) to include security interests, statutory liens, judicial liens, and other charges against, or interests in, property to secure payment of a debt.

- Any act to collect or recover a prepetition claim against the debtor (11 USC §362(a)(6));
- Setoff of any prepetition debt owed to the debtor against any claim against the debtor (11 USC §362(a)(7)); and
- Commencement or continuation of any U.S. Tax Court proceedings concerning a corporate debtor's tax liability for a taxable period determined by the bankruptcy court or concerning an individual debtor's tax liability for a period ending before the petition date (11 USC §362(a)(8)).

The automatic stay also benefits creditors generally by preventing any single creditor from taking a disproportionate share of estate property to the detriment of other creditors. The stay is, therefore, an important aspect of the fundamental bankruptcy policy to provide an equitable distribution of the estate among the debtor's creditors. See generally HR 95-595, 95th Cong, 1st Sess (1977), reprinted in 1978 US Code Cong & Ad News 5963, 6296.

NOTE: Whether or not the stay applies to a particular transaction or proceeding is a federal question, within the exclusive jurisdiction of the bankruptcy court. State courts have no jurisdiction to determine whether a matter violates the stay or to grant relief from stay. *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074. See also *Lockyer v Mirant Corp.* (9th Cir 2005) 398 F3d 1098 (federal district court has jurisdiction to decide whether stay arising from bankruptcy filing in another court is applicable to district court action).

Once the stay is terminated, it usually cannot be reinstated. *In re Flores* (Bankr ED Cal 2003) 293 BR 251.

NOTE: If an individual debtor files a Chapter 7 case without having first complied with the credit counseling

requirement under 11 USC §109(h), there is an issue as to whether the stay goes into effect at all. For further discussion of this issue, see §§4.86-4.88.

On the automatic stay and residential and commercial leases, see chap 7. On the automatic stay and mechanics' liens, see chap 9. On the automatic stay and real property secured loans, see chap 10.

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B. Protection of the Debtor

§4.2 1. Generally

The automatic stay generally applies to all debtors who seek bankruptcy relief, regardless of the Bankruptcy Code chapter under which relief is sought, except in certain cases involving serial bankruptcy filings, as described in §§4.3-4.4. In most cases, only the debtor is protected. There is an exception, however, in Chapter 13 proceedings, in which a "codebtor" stay applies to other persons (such as spouses or other cosigners) who are also liable on the debtor's debts. See 11 USC §1301.

The stay protects the debtor from many types of debt collection activity. See §4.10 for exceptions and limitations. For example, creditors are prohibited from contacting a debtor by phone, mail, or any other mode of communication in order to collect, assess, or recover a prepetition debt. See 11 USC §362(a)(6). Apart from the eventual discharge of most prepetition debts, this protection may be the most valuable relief provided to a Chapter 7 debtor. By the time a consumer debtor files a Chapter 7 petition, creditors may be hounding the debtor with demand letters and phone calls at work or at home or even to family members or neighbors. All such creditor collection activity must cease on commencement of the case.

The stay also enjoins the prosecution of any lawsuits against the debtor, including judicial actions to collect debts, as well as the enforcement of any judgment a creditor may have obtained, and even tax levies. See 11 USC §362(a)(1)-(2); *In re Richard B. Vance & Co*. (Bankr CD Ill 2003) 289 BR 692.

NOTE: The stay does not enjoin a lawsuit commenced against the debtor in the bankruptcy court where the debtor's bankruptcy case is pending. *Rein v Providian Fin. Corp.* (9th Cir 2001) 270 F3d 895; *Civic Ctr. Square, Inc. v Ford (In re Roxford Foods, Inc.)* (9th Cir 1993) 12 F3d 875.

The stay prevents the counterparty to an executory contract or lease in effect on the petition date from terminating or interfering with the debtor's rights under that contract or lease. See 11 USC §362(a)(3).

PRACTICE TIP: An attorney representing a Chapter 7 debtor should take steps to ensure that creditor actions cease, by notifying each creditor and applicable state court of the commencement of the case. For additional discussion of notices to creditors, see §4.8. If a levy is in process, the attorney should also notify the sheriff to make sure that the levy ceases immediately and, if the sheriff is holding money or property, to obtain its release. If the funds held by the sheriff will be insufficient for the trustee to administer, they may be released to the debtor with the trustee's consent. The sheriff may require a court order expressly authorizing release.

Decisional law limits the scope of the stay in situations not related to the underlying purpose of the bankruptcy laws. See *Rett v White Motor Sales Co.* (ND Cal 1989) 99 BR 12, 14. The U.S. Supreme Court, for example, held that an "administrative freeze" placed on a debtor's bank account by a depositary bank did not violate the stay because the freeze was temporary and the bank sought relief from stay to exercise its setoff rights. *Citizens Bank v Strumpf* (1995) 516 US 16, 133 L Ed 2d 258, 116 S Ct 286. A person is not prohibited by the stay from prosecuting a civil action under CCP §527.6 to enjoin the conduct of a debtor that "alarms, annoys, or harasses the person, and which serves no legitimate purpose." *Grant v Clampitt* (1997) 56 CA4th 586, 65 CR2d 727. An insurer does not violate the stay when it determines its obligations under a policy and acts to withdraw defense of a prepetition lawsuit. *Benz v DTRIC Ins. Co. (In re Benz)* (BAP 9th Cir 2007) 368 BR 861. A settlement negotiated in violation of the stay may nonetheless be enforceable if the bankruptcy is later dismissed, lifting the stay. *Valencia v Rodriguez* (2001) 87 CA4th 1222, 105 CR2d 281.

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2. Serial Filings

§4.3 a. Individual Debtors

Bankruptcy Code §362(c)(3) and (c)(4) were added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) to address the problem of serial filings. Section 362(c)(3) applies to individuals who have filed two cases within a 12-month period; §362(c)(4) applies to individuals who have filed three or more cases within a 12-month period.

Under §362(c)(3), if an individual debtor files a single or joint bankruptcy case within 1 year after a case involving the same debtor was pending and dismissed (other than a case filed under a different chapter after a dismissal pursuant to 11 USC §707(b)), the stay goes into effect on the filing of the case but terminates 30 days later unless the debtor or other party in interest moves to extend it. 11 USC §362(c)(3). The burden of proof and elements for extension under 11 USC §362(c)(3) are similar to those under §362(c)(4). See §4.14.

Under §362(c)(4), the automatic stay does not go into effect in a single or joint bankruptcy case filed by an individual debtor if two or more single or joint cases involving the same debtor were pending within the previous year but were dismissed (other than a case refiled under a different chapter after a dismissal pursuant to 11 USC §707(b)). 11 USC §362(c)(4)(A)(i). The bankruptcy court is required to enter an order, promptly on request of a party in interest, confirming that the stay is not in effect. 11 USC §362(c)(4)(A)(ii).

If a party in interest so requests within 30 days after the second case is filed, after notice and a hearing, the court may order the stay to take effect as to any or all creditors, subject to any conditions or limitations ordered by the court, provided that the party making the request demonstrates that the second case was filed in good faith with respect to the creditors to be stayed. 11 USC §362(c)(4)(B). There is a presumption, however—which may be rebutted only by clear and convincing evidence—that the later case was not filed in good faith in the following circumstances (11 USC §362(c)(4)(D)):

- As to all creditors:
- If two or more prior bankruptcy cases involving the same debtor were pending within the preceding year; or
- If a prior case involving the same debtor was dismissed within the preceding year after the debtor failed to file or amend the petition or other documents as required without "substantial excuse," failed to provide adequate protection as ordered by the court, or failed to perform the terms of a confirmed plan. For this purpose, "mere inadvertence or negligence" is not deemed to be "substantial excuse" unless the dismissal was caused by negligence of the debtor's attorney.
- If there has been no substantial change in the financial or personal affairs of the debtor since the last case was dismissed, or any other reason to conclude that the later case will not be concluded with a discharge (if Chapter 7) or a confirmed plan that will be fully performed (if Chapter 11 or 13).
- As to any creditor that had moved for relief from stay in the prior case if, as of the date of dismissal of the prior case, the creditor's motion was still pending or had been resolved by terminating, conditioning, or limiting the stay as to such creditor.

See also discussion of serial filings and real property foreclosures at §10.22.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/4 Bankruptcy Case Administration/§4.4 b. Small Business Debtors

§4.4 b. Small Business Debtors

Under 11 USC §362(n)(1), the automatic stay does not go into effect in a bankruptcy case in which the debtor:

- Is a debtor in another small business case pending at the time the petition is filed;
- Was a debtor in a small business case that was dismissed for any reason by an order that became final in the 2-year period ending on the petition date;
- Was a debtor in a small business case in which a plan was confirmed in the 2-year period ending on the petition date; or
- Is an entity that acquired substantially all of the assets or business of a small business debtor described above, unless the entity establishes by a preponderance of the evidence that it acquired the assets or business in good faith and not for the purpose of evading this exception to the stay.

The term "small business case" is defined in 11 USC §101(51C) to mean any Chapter 11 case filed by a "small business debtor." The term "small business debtor" generally refers to a Chapter 11 business debtor in a case without an unsecured creditors' committee and involving less than $2.19 million of debt. See the detailed definition in 11 USC §101(51D). Section 362(n)(1) does not apply (1) in involuntary cases if there is no collusion by the debtor with creditors, or (2) if the debtor can prove by a preponderance of the evidence that the filing resulted from circumstances beyond the debtor's control that were not foreseeable at the time the prior case was filed, and that it is more likely than not that the court will confirm a feasible plan (but not a liquidating plan) within a reasonable period of time. 11 USC §362(n)(2).

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§4.5 3. When Debtor Is a Plaintiff

For purposes of application of the automatic stay, it is important to distinguish situations in which the debtor is a plaintiff in ongoing litigation. Bankruptcy Code §362 does not stay proceedings in which the debtor is a plaintiff. *Gordon v Whitmore (In re Merrick)* (BAP 9th Cir 1994) 175 BR 333. As set forth in the statute, only actions "against" the debtor are stayed. 11 USC §362(a)(1). Generally, if the debtor is a plaintiff in an action at the time the petition is filed, the debtor's litigation claim becomes property of the estate. In a Chapter 7 case, the trustee will evaluate the claim, and if appropriate, continue with its prosecution if doing so would result in a return for creditors of the estate. In a Chapter 11 or 13 case, the debtor may continue to prosecute the action and incorporate the litigation (and any prospective recovery) into the debtor's plan of reorganization. If there is a counterclaim or cross-claim pending against the debtor in the litigation, that portion of the litigation will be stayed by operation of 11 USC §362(a)(1), at least until the defendant obtains relief from stay.

It is within the court's authority to annul the stay retroactively when no abuse is shown so as to validate the debtor's appeal. *Bunch v Hoffinger Indus., Inc. (In re Hoffinger Indus., Inc.)* (8th Cir 2003) 329 F3d 948. See also *Mataya v Kissinger (In re Kissinger)* (9th Cir 1995) 72 F3d 107; *Stinson v Bi-Rite Restaurant Supply, Inc. (In re Stinson)* (BAP 9th Cir 2003) 295 BR 109, aff'd in part and rev'd in part on other grounds in *Stinson v Cook Perkiss & Lew (In re Stinson)* (9th Cir 2005) 128 Fed Appx 30.

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§4.6 4. When Debtor Is One of Several Defendants

If the debtor is one of several defendants in a pending lawsuit, the automatic stay applies only to the debtor, not to the remaining defendants. *Wedgeworth v Fibreboard Corp.* (5th Cir 1983) 706 F2d 541. A common problem that may arise when the debtor is one of several defendants concerns pending discovery. Although litigation against the debtor is stayed, the stay does not prohibit a plaintiff from taking discovery from the debtor on matters relating to claims against other defendants. *Groner v Miller (In re Miller)* (BAP 9th Cir 2001) 262 BR 499.

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§4.7 C. Protection of Property

The automatic stay protects not only the debtor but also all "property of the estate" as defined in 11 USC §541(a). The stay remains in effect with respect to estate property as long as the property remains in the estate. *Spirtos v Moreno (In re Spirtos)* (9th Cir 2000) 221 F3d 1079. See §§2.1-2.23. No creditor or other party may take any of the actions against property of the estate enumerated in 11 USC §362(a)(2)-(5), including any action to repossess property or to enforce a security interest, mortgage, deed of trust, judgment lien, or tax lien. The protection of the stay extends to both tangible and intangible property rights. The stay prohibits a creditor from terminating any contract, lease, or other agreement with the debtor after the bankruptcy case is filed. *Johnston Envt'l Corp. v Knight (In re Goodman)* (9th Cir 1993) 991 F2d 613; *In re Carroll* (9th Cir 1990) 903 F2d 1266.

EXAMPLE: Although the debtor had only a possessory interest in a leasehold, the debtor's interest was an equitable interest and property of the estate subject to the stay. Therefore, relief from the stay was necessary to enforce an unlawful detainer judgment. *Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867.

The stay also prohibits a creditor from taking any action to perfect a lien or security interest in property of the estate after the bankruptcy case is filed, even if the lien or security interest is consensual. In certain circumstances, however, as provided in 11 USC §362(b)(3) by reference to 11 USC §§546(b) and 547(e)(2)(A), the lien or security interest may be perfected after bankruptcy without violating the stay (if state law deems the perfection to be effective at a date prior to the bankruptcy filing).

NOTE: Section 362(a) technically does not prohibit the *debtor* from voluntarily transferring property of the estate postpetition. Any such postpetition transfer by the debtor, however, may be voidable by the trustee under 11 USC §549. *Burkart v Coleman (In re Tippett)* (9th Cir 2008) 542 F3d 684, 691. See *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569.

The stay does not protect any property of the debtor that is excluded from the definition of "property of the estate." See 11 USC §541(b); see also §§2.14-2.23. In *Palm v Klapperman (In re Cady)* (BAP 9th Cir 2001) 266 BR 172, the BAP held that recordation of an abstract of judgment postpetition did not violate the stay when the judgment debt had been determined to be nondischargeable; the lien did not attach to any property of the estate. See also *Pintlar Corp. v Fidelity & Cas. Co. (In re Pintlar Corp.)* (9th Cir 1997) 124 F3d 1310. The BAP further refined *Palm v Klapperman (In re Cady), supra,* in *Arneson v Farmers Ins. Exch. (In re Arneson)* (BAP 9th Cir 2002) 282 BR 883, holding that stay relief to enforce a judgment of nondischargeability is not necessary when the judgment sought to be enforced was obtained in the same bankruptcy proceeding.

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§4.8 D. Notice to Creditors

After the petition is filed, all creditors listed in the debtor's schedules receive notice of the commencement of the bankruptcy case, including notice of the automatic stay, from the bankruptcy court clerk's office. Because creditors may not receive the court notice for several weeks after the case is filed, however, counsel for the debtor should also provide written notice of the filing to the debtor's creditors. Although the court will send notices only to creditors listed in the debtor's schedules, the stay is effective under 11 USC §362(a) even as to creditors who have not received notice of the case. Nevertheless, if a foreclosure sale is pending and the agent conducting the sale is unaware that the case has been filed, he or she will proceed to conduct the sale. See chap 10 for procedures to follow when dealing with foreclosure and bankruptcy.

NOTE: BAPCPA added detailed new requirements for the content of any notices required to be given to a creditor by the debtor or the court. See 11 USC §342(c)-(g). Although the automatic stay will be in effect, unless the creditor receives notice of the stay in accordance with these notice requirements, the creditor will not be subject to monetary penalties for violation of the stay unless the creditor's conduct continues after receipt of an effective notice. 11 USC §342(g)(2).

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§4.9 E. Potential for Abuse

The automatic stay is a powerful weapon for the debtor. Because it can be invoked relatively easily, with a "face-sheet" (incomplete) filing (see *e.g.,* CD Cal Local Bankr R 1002-1(g)(2)) and the cost of the filing fee, there is a significant potential for abuse, particularly in Chapter 11 or Chapter 13 cases when the filing does not result in a turnover of most of the debtor's assets to a trustee. The limitations on the scope of the stay introduced by BAPCPA were specifically intended to curb certain types of abuse.

With the filing of a voluntary petition, the debtor can obtain immediate relief from an array of creditor collection activities, including garnishments, bank account levies, repossessions, foreclosures, and unlawful detainer proceedings, unless an exception applies or until creditors obtain relief from stay from the bankruptcy court. A debtor operating in bad faith, who is unwilling to work out a feasible repayment plan, might attempt to dismiss the case voluntarily. Otherwise, the case may eventually be dismissed on request of a creditor, the Chapter 7 or Chapter 13 trustee, or the U.S. Trustee based on the debtor's noncooperation. See generally §§4.79-4.91. The bad faith debtor might then attempt to continue to frustrate creditors by filing another petition.

Bankruptcy Code §109(g) is intended to prevent serial, bad faith filings by individuals. It prohibits an individual debtor from refiling a case under any relief chapter of the Bankruptcy Code within 180 days if the debtor's prior case was dismissed by the court for the debtor's willful failure to abide by court orders or make proper court appearances, or if the debtor obtained a voluntary dismissal of the case after a request for relief from stay had been filed. 11 USC §109(g). A debtor's counsel should carefully investigate the circumstances of any previous bankruptcy case filed to verify that the debtor is proceeding in good faith and is eligible to refile. The stay may be retroactively annulled if a case is filed in violation of a refiling injunction (*e.g.,* the 180-day bar). *Umali v Dhanani (In re Umali)* (9th Cir 2004) 2004 US App Lexis 19186. This holding is reflected in 11 USC §362(b)(21). See §4.10. See also §4.3.

The good faith mandates and remedies found in Fed R Civ P 11 apply to bankruptcy proceedings. See Fed R Bankr P 9011. The rule requires a good faith, objective basis for signing and filing pleadings in federal court proceedings. See, *e.g., National Home Equity Corp. v Villareal (In re Villareal)* (Bankr CD Cal 1984) 46 BR 284 (filing for bankruptcy solely to avoid foreclosure when debtor has no unsecured debts subjects debtor and attorney to sanctions).

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§4.10 F. Exceptions to Application of Stay

Bankruptcy Code §362(b) lists 28 statutory exceptions to the automatic stay. At least historically, courts have read the statutory exceptions narrowly. See *Kir Temecula v LPM Corp. (In re LPM Corp.)* (9th Cir 2002) 300 F3d 1134. The exceptions include, for example, criminal proceedings, family court proceedings, suspension of driving or professional licenses, earnings withholdings, and government audits. The key exceptions relevant to real property transactions provide that the following creditor actions do not violate the stay:

- Certain actions to perfect a lien or security interest taken within 30 days after the bankruptcy petition was filed (11 USC §362(b)(3); see chaps 9-10);
- Audits by a governmental unit such as the IRS to determine tax liability, issuance of notices of tax deficiency, demands for tax returns, and assessments of any tax (11 USC §362(b)(9)), although tax collection activities are stayed under 11 USC §362(a);
- Actions by a lessor of nonresidential real estate to repossess property if the lease terminated before the lessee's bankruptcy filing (11 USC §362(b)(10); see chap 7);
- Presentment of negotiable instruments for payment (11 USC §362(b)(11));
- Creation or perfection of liens for ad valorem property taxes, or special taxes or assessments on real property (whether or not ad valorem) coming due postpetition (11 USC §362(b)(18));
- Any act to enforce a lien or security interest in real property if relief from stay was granted in a prior case under 11 USC §362(d)(4) within the past 2 years, although the debtor may move to have the stay reinstated on the basis of changed circumstances or for other good cause shown (11 USC §362(b)(20); see chaps 9-10);
- Any act to enforce a lien or security interest in real property if the debtor is not eligible to be a debtor under 11 USC §109(g), or if the case was filed in violation of a bankruptcy court order in a prior case prohibiting the debtor from refiling (11 USC §362(b)(21); see chaps 9-10);
- Subject to 11 USC §362(*l*), the continuation of any eviction, unlawful detainer, or similar action commenced prepetition by the lessor of residential real estate against a debtor-tenant, if the lessor obtained a judgment for possession prepetition (11 USC §362(b)(22); see chap 7); and
- Subject to 11 USC §362(m), any eviction action against a debtor-tenant by the lessor of residential real estate seeking possession based on endangerment of such property or the illegal use of controlled substances on the property, if the lessor certifies under penalty of perjury that the eviction action has been filed or that the debtor committed such acts within 30 days before the petition date (11 USC §362(b)(23); see chap 7).

Some exceptions in 11 USC §362(b) are fairly narrow and are relevant only in limited circumstances, such as certain actions by the Secretary of Housing and Urban Development. See, *e.g.,* 11 USC §362(b)(8). In *40235 Wash. St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, a postpetition county tax sale of the debtor's property was held to be void on grounds that tax sales do not fit within any of the exceptions in §362(b).

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§4.11 G. Violation of Stay

In the Ninth Circuit, an action taken in violation of the automatic stay, such as obtaining a judgment against the debtor or perfecting of a lien against property of the debtor, is void ab initio, rather than merely voidable. See *Burkart v Coleman (In re Tippett)* (9th Cir 2008) 542 F3d 684. This is true even if the bankruptcy petition is later dismissed as a bad faith filing. *40235 Wash. St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076. This is true whether or not the violation was willful. *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569. Thus, the debtor is protected from creditor action even if the creditor does not have notice of the commencement of the debtor's case. See §§4.12-4.13.

NOTE: On occasion, courts have recognized a very narrow equitable exception to strict enforcement of the stay, such as when a debtor participated extensively in a lawsuit that led to a default judgment prior to bankruptcy. *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986. Moreover, purely ministerial actions that do not affect the debtor's substantive rights, such as continuing the date of a foreclosure sale while the bankruptcy case is pending, will not violate the stay. *Mason-McDuffie Mortgage Corp. v Peters (In re Peters)* (9th Cir 1996) 101 F3d 618.

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§4.12 1. Unknowing Violations

If a creditor takes action in violation of the automatic stay without notice or actual knowledge of the debtor's bankruptcy filing, the creditor's actions are not willful and therefore are neither punishable by contempt nor sanctionable under 11 USC §362(k) (former 11 USC §362(h)). The creditor nonetheless has an affirmative obligation to the debtor to undo the act and restore the status quo, without the debtor's having to seek relief from the bankruptcy court. *In re Bennett* (Bankr SD Ohio 1992) 135 BR 72. If the creditor fails to remedy the violation, the court may find this lack of cooperation rising to the level of a willful violation, which is punishable by contempt and sanctions under 11 USC §362(k). See, *e.g., In re Taylor* (Bankr SD Fla 1995) 190 BR 459. An unknowing violation of the stay may occur if state court litigation against the debtor has been concluded but the debtor files bankruptcy before entry of final judgment. Entry of the judgment against the debtor constitutes a violation of the stay. Similarly, if a deed of trust is recorded or a UCC filing is made to perfect a lien on the debtor's property by a creditor without notice of the bankruptcy, the action is void and of no legal effect unless it occurs within the 30-day grace period of 11 USC §362(b)(3) and meets the other criteria listed in that section.

PRACTICE TIP: Debtor's counsel should consider recording a certified copy of the face page of the debtor's petition to give notice of the bankruptcy. The recording should preclude bona fide purchaser status for any transferees of the debtor's real property and preserve the trustee's rights to avoid the transfer under 11 USC §549(c).

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§4.13 2. Willful Violations

Title 11 USC §362(k)(1) provides that any individual injured by a willful violation of the automatic stay may recover actual damages (including attorney fees and costs) and in appropriate cases—except as provided in 11 USC §362(k)(2)—punitive damages. The limitation on recovery of punitive damages in §362(k)(2) applies to certain good faith actions by creditors under 11 USC §362(h) regarding personal property subject to a security interest or an unexpired lease. Attorney fees can include appellate attorney fees incurred in defending a nonfrivolous appeal of the damage award. *Beard v Walsh (In re Walsh)* (BAP 9th Cir 1998) 219 BR 873.

Under §362(k)(1), a "willful" violation does not require a specific intent to violate the stay. Instead, the debtor may recover damages based on a finding that the defendant knew of the stay and that the defendant's actions violating the stay were intentional. Unless the exception in 11 USC §362(k)(2) applies, whether or not the defendant believed in good faith that it had a right to the property is irrelevant to the question of whether the act was "willful" or whether the debtor is entitled to compensation. *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187; *Goichman v Bloom (In re Bloom)* (9th Cir 1989) 875 F2d 224. In *Kir Temecula v LPM Corp. (In re LPM Corp.)* (9th Cir 2002) 300 F3d 1134, the court held that a levy based on a writ of execution issued by the bankruptcy court violated the stay. Issuance of the writ was not equivalent to lifting the stay. In *Ozenne v Bendon (In re Ozenne) (*BAP 9th Cir 2006) 337 BR 214, the creditor claimed that its stay violation was not willful because state law was unclear regarding whether the debtor had any rights in the subject property. The BAP held the violation was willful because the creditor knew about the bankruptcy and intentionally sold the property. The creditor bore the risk and paid the price for guessing wrong about the debtor's state law rights in the property.

In *Dawson v Washington Mut. Bank, F.A. (In re Dawson)* (9th Cir 2004) 390 F3d 1139, the Ninth Circuit held that the "actual damages" recoverable by an individual injured by a willful violation of the stay include damages for emotional distress. See also *Fleet Mortgage Group, Inc. v Kaneb* (1st Cir 1999) 196 F3d 265 (emotional damages awarded due to lender's foreclosure action in violation of stay); *Sternberg v Johnston* (9th Cir, Oct. 1, 2009, Nos. 07-16870, 08-1572103-1234) 2009 US App Lexis 21532 (attorney liable for emotional distress damages for willfully violating stay by defending overly broad state court order on spousal support).

An important limitation on the debtor's ability to recover damages under 11 USC §362(k)(1) is that, in the Ninth Circuit, the debtor must be an individual; corporate debtors and trustees will not qualify for relief. See *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187; *Johnston Envt'l Corp. v Knight (In re Goodman)* (9th Cir 1993) 991 F2d 613. Creditors, however, as well as debtors have standing to recover damages under §362(k)(1) if they are seeking to protect the bankruptcy estate. *In re International Forex of Cal., Inc.* (Bankr SD Cal 2000) 247 BR 284 (creditors awarded attorney fees and punitive damages against debtor's officer and his attorney for willful violation of stay).

In addition to or in lieu of the remedy provided by 11 USC §362(k)(1), the bankruptcy court may hold a defendant in civil contempt for a stay violation under 11 USC §105(a). The bankruptcy court has inherent power to punish contempt. *Caldwell v Unified Capital Corp. (In re Rainbow Magazine, Inc.)* (9th Cir 1996) 77 F3d 278. Substantial damages may be awarded to punish violation of the stay as a civil contempt. See *Knupfer v Lindblade (In re Dyer)* (9th Cir 2003) 322 F3d 1178 (damages recoverable under contempt authority in 11 USC §105 and, for individual debtors, under predecessor to §362(k)). Unlike under §362(k)(1), "serious" punitive damages are not available under §105 or the court's inherent sanction authority. 322 F3d at 1192.

Another distinction is that actual damages under §362(k)(1) are mandatory, while damages for civil contempt under §105 are discretionary. See *Computer Communications, Inc. v Codex Corp*. *(In re Computer Communications, Inc.)* (9th Cir 1987) 824 F2d 725, 731 (contempt award of over $4 million affirmed in case filed before enactment of §362(k)). A sanction of contempt should not be issued for violating the stay without a finding of fact that the violation was made with actual knowledge of the stay. *ZiLog, Inc. v Corning (In re ZiLog)* (9th Cir 2006) 450 F3d 996.

Persons eligible for relief under §105(a) include bankruptcy trustees and corporations or other entities, as well as individuals. See *Havelock v Taxel (In re Pace)* (9th Cir 1995) 67 F3d 187. The contempt power of the bankruptcy court is limited by the doctrine of sovereign immunity (see §§1.52-1.53). *Lapin v Franchise Tax Bd. (In re Lapin)* (BAP 9th

Cir 1998) 226 BR 637, 642.

Contempt proceedings in the bankruptcy court are treated as "contested matters" (see §§4.43-4.44) under Fed R Bankr P 9020 and, by reference, Fed R Bankr P 9014, which permits relief to be granted by motion after "reasonable" notice and opportunity for hearing. For creditor guidance in doubtful situations, see Practice Tip in §7.6. See also *Eskanos & Adler, P.C. v Leetien* (9th Cir 2002) 309 F3d 1210 (creditor has affirmative duty to dismiss collection suit filed postpetition or seek relief from stay; sanctions appropriate for willful violation of stay); *Associated Credit Servs., Inc. v Campion (In re Campion)* (BAP 9th Cir 2003) 294 BR 313 (postpetition garnishment of debtor's wages due to creditor's "internal disorder" and computer problems violated stay). Even if a creditor is granted retroactive relief from stay (annulment), the debtor may be able to recover for damages suffered as a result of the violation of the stay. *Williams v Levi (In re Williams)* (BAP 9th Cir 2005) 323 BR 691.

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§4.14 II. AUTOMATIC TERMINATION OF STAY

BAPCPA added three subsections to the Bankruptcy Code that provide for automatic termination of the automatic stay on certain events after a specified period of time following the petition date in cases filed by individual debtors. See 11 USC §362(c)(3), (e)(2), (h).

Prior case dismissed in the past year. The first, 11 USC §362(c)(3), provides for automatic termination of the stay 30 days after the petition date in any single or joint case filed by an individual debtor under Chapter 7, 11, or 13 (except a case refiled under Chapter 11 or 13 after a dismissal under 11 USC §707(b)), if another single or joint case involving the same debtor was pending during the preceding year but was dismissed. 11 USC §362(c)(3)(A).

On motion of a party in interest, after notice and a hearing completed before expiration of the 30-day period, the court may continue the stay as to any or all creditors (subject to any conditions or limitations imposed by the court) only if the party in interest demonstrates that the later case was filed in good faith as to the creditors to be stayed. 11 USC §362(c)(3)(B). Unless rebutted by clear and convincing evidence, a case is presumed to have been filed in bad faith if it meets the criteria set forth in 11 USC §362(c)(3)(C). The presumption of bad faith does not apply if the prior case was dismissed due to the creation of a debt repayment plan. 11 USC §362(i).

Several recent cases have addressed the application of 11 USC §362(c)(3). For example, the court in *In re Paschal* (Bankr ED NC 2006) 337 BR 274 held that when the stay automatically terminates under §362(c)(3)(A), it expires only with respect to formal proceedings commenced before the second bankruptcy filing. The court reasoned that the words "action taken" must be narrowly construed to apply only to formal actions filed in a court or other tribunal. But see *In re James* (Bankr SD Ga 2007) 358 BR 816, 819 (rejecting debtor's argument that stay expires "only as to creditors who have taken action prior to the filing of the second petition" and finding "no temporal qualification on 'action taken' that limits its application to past action").

Further, the words "with respect to the debtor" indicate that the stay only terminates with respect to actions against the debtor and not with respect to actions involving property of the estate. See *Jumpp v Chase Home Fin., LLC (In re Jumpp)* (BAP 1st Cir 2006) 356 BR 789 (stay remained in effect to extent debtor's home was property of estate); *In re Johnson* (Bankr WD Tenn 2006) 335 BR 805 (termination of stay under §362(c)(3)(A) applies only to property of debtor, not property of estate); *In re Wilson* (Bankr ED Tenn 2005) 336 BR 338 (although motion under §362(c)(3) must be made and completed within 30 days and supported by admissible written evidence, court not required to render ruling within 30 days of filing of petition).

Because "good faith" is not defined in the Bankruptcy Code, courts have adopted a "totality of the circumstances" approach to determine whether the stay should be imposed or extended under 11 USC §362(c)(3) and (c)(4). A list of factors to be considered and allocation of the burden of proof are addressed in *In re Charles* (Bankr SD Tex 2005) 334 BR 207, *In re Collins* (Bankr SD Tex 2005) 335 BR 646, *In re Galanis* (Bankr D Utah 2005) 334 BR 685, and *In re Phillips* (Bankr ED Okla 2006) 336 BR 818. At least one unpublished case from the Central District of California has adopted the same approach. *In re Morgan* (Bankr CD Cal, Mar. 16, 2006, No. SV06-10312 MT) 2006 Bankr Lexis 2452.

NOTE: Several courts have disagreed as to whether a case filed without compliance with the credit counseling requirement of 11 USC §109(h) and subsequently terminated should be counted as a case dismissed for purposes of §362(c)(3)-(4). See *In re Falcone* (Bankr D Mass 2007) 370 BR 177 (reviewing majority and minority views of debtor noncompliance with §109(h)); *In re Rios* (Bankr SD NY 2005) 336 BR 177 and *In re Elmendorf* (Bankr SD NY 2006) 345 BR 486 (petition filed without compliance with §109(h) is void ab initio and does not count as prior dismissed case); *In re Ross* (Bankr ND Ga 2006) 338 BR 134 (agreeing with majority of other courts that case is commenced despite debtor's noncompliance with §109(h)); *In re Burch* (Bankr ND NY, Oct. 23, 2006, No. 06-10228) 2006 Bankr Lexis 3551 (taking intermediate position of dismissing petition as distinct from dismissing case; dismissal of petition does not count as a prior dismissed case for purposes of §362(c)(3)-(4)).

60 days after motion for relief from stay. The second BAPCPA provision for automatic termination of the stay—

under 11 USC §362(e)(2), in individual Chapter 7, 11, or 13 cases 60 days after a motion for relief from stay is filed—is discussed in §4.25.

Personal property security or unexpired personal property lease. The third BAPCPA provision for automatic termination of the stay concerns personal property securing an obligation or subject to an unexpired lease in cases in which the debtor is an individual. Title 11 USC §362(h)(1) provides that the stay is terminated, and the property is no longer property of the estate if the debtor fails, within the time specified by 11 USC §521(a)(2):

- To timely file the statement of intention required by §521(a)(2) with respect to the property, or to indicate in the statement that the debtor will, as applicable, either surrender or retain the property, and if retaining it, either redeem it under 11 USC §722, enter into a reaffirmation agreement as provided in 11 USC §524(c), or assume the lease under 11 USC §365(p) if the trustee does not do so; and
- To timely carry out the action specified in such statement (unless the debtor intends to reaffirm the debt but the creditor refuses to agree to the reaffirmation).

Title 11 USC §362(h)(2) provides that the stay will not be terminated if, after notice and a hearing, the court determines, on a motion filed by the trustee before expiration of the applicable time period under 11 USC §521(a)(2), that the personal property is of consequential value or benefit to the estate, and the court orders appropriate adequate protection of the creditor's interest, and orders the debtor to deliver any collateral in the debtor's possession to the trustee. If the court does not so determine, the stay terminates at the conclusion of the hearing on the motion.

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III. RELIEF FROM STAY

A. Procedures

§4.15 1. Types of Relief Available

Bankruptcy Code §362(d) provides that the bankruptcy court may grant relief from the automatic stay "[o]n request of a party in interest and after notice and a hearing." 11 USC §362(d). Under §362(d), the bankruptcy court has considerable latitude in crafting relief from stay. "Relief" may take the form of termination of the stay, but the court may also modify or condition the stay without terminating it, and further has power to grant relief retroactively or to annul the stay. *National Envt'l Waste Corp. v City of Riverside (In re National Envt'l Waste Corp.)* (9th Cir 1997) 129 F3d 1052; *Aheong v Mellon Mortgage Co. (In re Aheong)* (BAP 9th Cir 2002) 276 BR 233.

Decisions of the Ninth Circuit and its lower courts indicate some confusion regarding the standard to be applied in a proceeding to annul the stay. The Ninth Circuit stated that "[a]ny equitable exception to the automatic stay should be narrow and applied only in extreme circumstances." *Phoenix Bond & Indem. Co. v Shamblin (In re Shamblin)* (9th Cir 1989) 890 F2d 123, 126. In *Fjeldsted v Lien (In re Fjeldsted)* (BAP 9th Cir 2003) 293 BR 12, 15, however, a Ninth Circuit Bankruptcy Appellate Panel stated that a court should balance the equities to determine whether retroactive annulment is justified, citing the test set forth in *National Envt'l Waste Corp. v City of Riverside (In re National Envt'l Waste Corp.), supra*.

The *Fjeldsted* opinion's reliance on *National Envt'l Waste Corp.* is somewhat curious because, although *National Envt'l Waste Corp.* discusses balancing equities, it does not explicitly reject the statement in *Phoenix Bond & Indem. Co. v Shamblin (In re Shamblin), supra,* that annulment should apply only in extreme circumstances. Ultimately, the two concepts can be harmonized by recognizing that balancing the equities is not necessarily inconsistent with granting an annulment only under extreme circumstances. The question is where to place the fulcrum. In addition to harming the debtor, retroactive annulment of the stay may also harm the bankruptcy system itself. See, *e.g., In re Murray* (Bankr ED Cal 1996) 193 BR 20, 22 ("balancing the equities here, the court finds that, irrespective of any harm to debtors, retroactively lifting the automatic stay in the instant case would *unjustly harm the integrity of the bankruptcy process*"). (Emphasis in original.)

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§4.16 2. Enforceability of Prebankruptcy Waivers

Prebankruptcy agreements by debtors waiving the automatic stay if a bankruptcy case is filed are usually invalid as a violation of public policy. See *In re Jenkins Court Assocs. Ltd. Partnership* (Bankr ED Pa 1995) 181 BR 33. There is, however, some authority for enforcing prepetition "lift stay" agreements in single asset real estate cases (see §4.22). See *In re University Commons, LP* (Bankr MD Fla 1996) 200 BR 255. Any such agreement will be scrutinized carefully by the bankruptcy court. For further discussion, see §10.18.

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§4.17 3. Motion Procedures

An action for relief from the automatic stay is a "core proceeding" over which the bankruptcy court has subject matter jurisdiction under 28 USC §157(b)(2)(G) and is classified as a "contested matter" under the Federal Rules of Bankruptcy Procedure. See Fed R Bankr P 9014; see also §§4.40-4.44. To obtain stay relief, a creditor or other party in interest generally must file a motion for relief from the stay with the bankruptcy court, although the motion may be heard on shortened time or ex parte in limited circumstances. Fed R Bankr P 4001(a). A motion for stay relief can be filed at any time postpetition, and, in Chapter 11 and 13 cases, before or after confirmation of the debtor's plan. On form and supporting documentation for the motion, see §7.25. On creditor pleadings and detailed discussion of motion procedures, see §§10.30-10.38.

Because stay relief motions are very common bankruptcy court proceedings, most districts have special local rules and forms governing this type of motion practice, which are intended to facilitate case administration. If required to file electronically, attorneys should register online at the local court website (see Directory) in advance of the date that they need to file pleadings. If the motion is not filed on the appropriate court-approved form, then, at a minimum, the motion may not be considered on the merits and must be refiled and set for hearing at a later date. See, *e.g.*, CD Cal Local Bankr R 9013-1(a)(5), which also provides that the motion may be denied and the bankruptcy judge may impose monetary or other sanctions. All motions for relief from stay must be supported by admissible evidence establishing one or more of the grounds for relief set forth in 11 USC §362(d)(1)-(3).

On serving motion for relief from stay, see §7.27. For stay relief procedures in each local bankruptcy district in California, check the website of the local court. See Directory for information.

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§4.18 4. Stipulations for Relief From Stay

Creditors or other parties in interest may be able to negotiate a stipulation with the trustee or debtor in possession for relief from the automatic stay. Any such stipulation must be approved by the bankruptcy court and is subject to other special procedures as set forth in Fed R Bankr P 4001(d). The type of creditor and its interest will determine the special conditions and the terms of the stipulation. The stipulation will be more easily approved by the court if it contains a recitation of facts sufficient to enable the court to determine whether:

- The property against which the creditor intends to take action is property of the debtor, the bankruptcy estate, or neither;
- There is a statutory or equitable basis for the relief requested;
- The terms imposed on the debtor are reasonable under the circumstances; and
- Any other creditor's rights or rights of the trustee are affected by the terms of the stipulation.

For discussion of stipulations for stay relief in specific creditor relationships, see §§7.32, 10.39-10.42.

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§4.19 B. Grounds for Relief From Stay

The most common reasons that creditors seek relief from the automatic stay are to foreclose on real estate (see chap 10), execute construction-related liens (*i.e.*, mechanics' liens, see chap 9), obtain possession of real property from a debtor-lessee (see chap 7), or continue litigation pending in another forum when the bankruptcy was filed. Motions for stay relief are sometimes coupled with objections to a debtor's plan of reorganization (Chapter 11) or debt adjustment plan (Chapter 13), so that the court is in a position to grant stay relief immediately if it denies plan confirmation. A creditor may also file a motion for relief from stay if the debtor is in default under a confirmed plan.

NOTE: An important precondition to stay relief with respect to particular property is that the creditor seeking relief must have an interest in that property. A creditor with an unperfected security interest is not entitled to stay relief with respect to a particular property, because, by operation of 11 USC §544(a) (the "strong arm" power; see §2.33), the creditor's interest is subordinate to the interests of the trustee (or debtor in possession) in the property and thus effectively wiped out. See *Omega Envt'l Inc. v Valley Bank NA (In re Omega Envt'l Inc.)* (9th Cir 2000) 219 F3d 984, 986 n1. The unsecured creditor can get stay relief to, *e.g.,* proceed with pending nonbankruptcy litigation or to pursue an insurance policy.

Relief from stay may be granted by the bankruptcy court based on one or more of the following grounds:

- "[C]ause, including the lack of adequate protection of an interest in property" of the moving party (11 USC §362(d)(1));
- If the stay concerns property of the estate in which the debtor has no equity, and the property "is not necessary for an effective reorganization" (11 USC §362(d)(2));
- If the stay concerns "single asset real estate" (as defined in 11 USC §101(51B)) and relief is sought by a creditor with a claim secured by a lien on that real estate, unless the debtor has filed a plan of reorganization with a reasonable possibility of being confirmed within a reasonable time, or the debtor is making adequate debt service payments (11 USC §362(d)(3)); or
- If the stay affects an action against real property by a creditor with a claim secured by a lien on that property, and the court finds that the bankruptcy filing was part of a scheme by the debtor to delay, hinder, and defraud creditors that involved either a transfer of the property without the lienholder's consent or court approval, or multiple bankruptcy filings affecting the property (11 USC §362(d)(4)).

Each of these grounds is discussed more fully in §§4.20-4.23. See also discussion of grounds for relief in context of residential and commercial leases in §§7.20-7.28.

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§4.20 1. Cause

The first statutory basis for relief from the automatic stay is "cause" under 11 USC §362(d)(1). Section 362(d)(1) applies both to relief from stay of actions against the debtor and to relief from stay of actions against property of the estate. Any request for relief from stay of litigation pending against the debtor must be brought under this section, but the court will not grant relief to enable an unsecured creditor to pursue a "garden-variety" debt collection lawsuit against the debtor in state court. If the unsecured creditor's claim is liquidated and not disputed or contingent, the creditor's principal remedy is to file a proof of claim with the bankruptcy court and seek payment from the assets (if any) of the bankruptcy estate. See §§3.19-3.32. If the creditor's claim is disputed or is not liquidated, it will typically be liquidated through claims objection proceedings in the bankruptcy court (see §§3.38-3.41), although a bankruptcy court may grant relief from stay for "cause" so that litigation against the debtor can proceed in another forum if the litigation is complex and the subject matter of the litigation is highly specialized. Multiparty environmental or securities fraud suits are examples of litigation matters for which the bankruptcy court may grant relief from stay for "cause" under 11 USC §362(d)(1). The bankruptcy court may also grant relief from stay so that an unliquidated claim can be liquidated in another forum if doing so would save the estate attorney fees and costs. The court will not, however, permit the liquidated claim to be enforced to the extent that the claim may be paid, in whole or in part, from the bankruptcy estate.

"Cause" is a flexible concept that must be interpreted on a case-by-case basis. *Christensen v Tucson Estates, Inc. (In re Tucson Estates, Inc.)* (9th Cir 1990) 912 F2d 1162, 1166; *Beguelin v Volcano Vision, Inc. (In re Beguelin)* (BAP 9th Cir 1998) 220 BR 94. Some courts have used a balancing test for cause, weighing the potential prejudice to the debtor's estate if the stay is lifted against the potential harm to the party seeking relief if the stay continues. See *Robbins v Robbins (In re Robbins)* (4th Cir 1992) 964 F2d 342. Cause includes bad faith in filing a Chapter 11 reorganization case. *Trident Assocs. Ltd. Partnership v Metropolitan Life Ins. Co. (In re Trident Assocs. Ltd. Partnership)* (6th Cir 1995) 52 F3d 127 (bankruptcy filing on eve of foreclosure sale by newly formed debtor after losing state court motion to enjoin foreclosure was made in bad faith); *Can-Alta Props., Ltd. v State Sav. Mortgage Co. (In re Can-Alta Props., Ltd.)* (BAP 9th Cir 1988) 87 BR 89; *In re Kinney* (Bankr CD Cal 1985) 51 BR 840. To determine whether a case has been filed in bad faith, the court should not focus solely on the debtor's intent but should review the totality of the circumstances, including:

- Whether the debtor misrepresented facts in the bankruptcy petition or a plan, unfairly manipulated the Bankruptcy Code, or otherwise filed the case in an inequitable manner;
- The debtor's history of filings and dismissals;
- Whether the case was filed solely to defeat state court litigation; and
- Whether egregious behavior was present.

A finding of bad faith does not depend on the existence of malice or actual fraud. *Leavitt v Soto (In re Leavitt)* (9th Cir 1999) 171 F3d 1219, 1224 (Chapter 13 case). For additional discussion of the concept of bad faith as cause for stay relief, see §§10.21-10.24.

Cause may also include lack of "adequate protection" to a secured creditor. See 11 USC §§361, 362(d)(1). The concept of adequate protection embodies the secured creditor's constitutional right to receive the value of its collateral, regardless of the debtor's bankruptcy filing. *Sumitomo Trust & Banking Co. v Holly's, Inc. (In re Holly's, Inc.*) (Bankr WD Mich 1992) 140 BR 643, 686. If the estate cannot provide the secured creditor with adequate protection of its interest, then cause exists for stay relief. For discussion of the ways in which the estate may give a creditor adequate protection to avoid stay relief, see chaps 7, 10.

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§4.21 2. Lack of Equity and Property Not Necessary for Reorganization

The second statutory basis for stay relief, 11 USC §362(d)(2), applies only to relief from stay of actions against property of the estate. This section requires a showing that (a) there is no equity in the property at issue and (b) the property is not necessary to an effective reorganization of the debtor. 11 USC §362(d)(2). For further discussion, see §§10.26-10.28.

Lack of equity is established by taking the current market value of the property and deducting the allowed liens, the estimated costs of sale of the property, and if applicable the debtor's homestead exemption. See §10.27. The remainder, if any, constitutes the equity that could be used to pay unsecured creditors. See generally *Stewart v Gurley* (9th Cir 1984) 745 F2d 1194; *Pistole v Mellor (In re Mellor)* (9th Cir 1984) 734 F2d 1396. For example, if a debtor owns an apartment building with a current market value of $450,000, first and second mortgages total $400,000, and costs of sale are reasonably calculated at 8 percent of the price (or $36,000), the remaining value in the property is $14,000.

The current market value of the property is normally established by a properly authenticated appraisal from a qualified professional appraiser. Bankruptcy courts will usually not accept a broker's or agent's informal evaluation or even a "drive-by" appraisal by a professional appraiser as persuasive. For real property appraisals, counsel should contact a local real estate broker and ask for recommendations.

Calculation of equity under 11 USC §362(d)(2)(A) is a separate and distinct analysis from calculation of the amount of the equity or value "cushion" that will be deemed sufficient to afford a secured creditor "adequate protection" of its interest under 11 USC §363(e) if relief from stay is not granted. See §10.67. The relative priority of the lienholder moving for stay relief is not relevant to the former analysis, but it is relevant to the latter. If a senior lienholder is seeking stay relief, junior liens are normally not considered in evaluating the senior lienholder's equity or value cushion. *Nantucket Investors II v California Fed. Bank (In re Indian Palms Assocs.)* (3d Cir 1995) 61 F3d 197; *Stewart v Gurley, supra*; *Pistole v Mellor, supra*. Property values are often hotly contested in stay relief proceedings, with the secured creditor and the debtor submitting conflicting appraisals.

The second element of 11 USC §362(d)(2), that the property is not necessary to an effective reorganization, is easily established in Chapter 7 cases, where there is no reorganization. If there is equity in the property, however, relief will not be granted if the Chapter 7 trustee opposes it, because the trustee may sell the property and monetize the equity, thereby making it available to satisfy unsecured creditors' claims. For further discussion, see §10.28.

In Chapter 11 or 13 cases, the moving party must establish that the property is not necessary for the success of the debtor's reorganization plan. The U.S. Supreme Court in *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 375, 98 L Ed 2d 740, 750, 108 S Ct 626, interpreted the language "necessary to an effective reorganization" in §362(d)(2) as requiring "a reasonable possibility of a successful reorganization within a reasonable time." To satisfy this test, the debtor must present evidence of the contents of the plan, when it will be proposed and brought to fruition, and that there is a realistic chance that the plan will be confirmed. See *Western Farm Credit Bank v Teresi (In re Teresi)* (Bankr ED Cal 1991) 134 BR 392. In general, the longer that a debtor's Chapter 11 case has been pending, the more difficult it may be for the debtor to prove that it has a reasonable prospect of reorganizing successfully.

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§4.22 3. Single Asset Real Estate Cases

The third statutory basis for relief from the automatic stay, in 11 USC §362(d)(3), is limited to cases involving "single asset real estate," as defined in 11 USC §101(51B):

> The term "single asset real estate" means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.

Because real estate developers commonly isolate ownership of separate pieces of commercial real property in separate legal entities for liability and tax reasons, many commercial real estate projects will fall within this definition.

Under 11 USC §362(d)(3), the bankruptcy court will grant a creditor, whose claim is secured by the single asset real estate, relief from stay after notice and a hearing, unless, within 90 days after the order for relief (normally, the petition date, see §1.8) or 30 days after the court determines that the debtor is subject to the single asset real estate rules (if more than 90 days after entry of order for relief), the debtor files a Chapter 11 plan of reorganization "that has a reasonable possibility of being confirmed within a reasonable time," or the debtor has initiated monthly payments to each creditor whose claim is secured by the property in an amount equal to interest at the then-applicable nondefault contract rate on the value of the creditor's interest in the property. 11 USC §362(d)(3). Under §362(d)(3) as amended, the monthly payments can be made from rents pledged to the creditor to secure the loan.

For further discussion of single asset real estate cases, see §§1.64, 10.29.

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§4.23 4. In Rem Relief

Bankruptcy Code §362(d)(4) authorizes in rem relief from the automatic stay in cases involving either (1) a transfer of real property without court approval or consent of the secured creditor, or (2) multiple bankruptcy filings affecting the same real property, if the court finds that the bankruptcy filing was part of a scheme to delay, hinder, and defraud creditors. If properly recorded under applicable state law, the court's order granting relief from stay will be binding on all successive owners of the property for 2 years from the date of entry, although a debtor in a later bankruptcy case may move for relief from the order based on changed circumstances or for good cause shown. 11 USC §362(d)(4). Once in rem relief is granted, 11 USC §362(b)(20) creates an exception to application of the stay in any bankruptcy case filed within the next 2 years for any lien enforcement actions against the property.

See also discussion in §§10.8, 10.22.

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§4.24 C. Notice and Hearing

The requirements for service of notice of a motion for relief from the automatic stay are set forth in Fed R Bankr P 4001 and applicable local rules. Notice requirements vary with the particular relief chapter of the Bankruptcy Code involved. In Chapter 7 and 13 cases, the trustee must be served along with the debtor and debtor's counsel, if any. In a Chapter 11 case, notice should be given to the debtor, debtor's counsel, and the Chapter 11 trustee if one has been appointed; the U.S. Trustee for the district and division in which the case is pending; and the committee of unsecured creditors (if one has been appointed) and its counsel. If a committee has not been appointed, notice should be given to the 20 largest unsecured creditors. The identities of all these parties can be obtained from the court files. Fed R Bankr P 4001(a)(1).

PRACTICE TIP: Counsel should review the court's docket before any motion is filed to obtain copies of any change of address notices and any requests for special notice filed by parties in interest, to ensure that notices are served correctly. Too often, motions for relief from stay are denied or continued because of a notice problem such as the debtor's change of address.

Local bankruptcy rules and the procedures established by individual bankruptcy judges will govern the setting of the hearing. In the Central District of California, many judges require the moving party to "self-calendar" motions for relief from stay, and instructions for doing so are given telephonically by recorded messages from the judges' calendar clerks.

The initial hearing on a motion for relief may be only preliminary. See 11 USC §362(e)(1). If the debtor files an opposition, the bankruptcy court may continue the proceedings and set the matter for a final evidentiary hearing on the elements of 11 USC §362(d)(1), (d)(2), or (d)(3). The final hearing is normally set within 30 days after the preliminary hearing, and the court normally continues the stay in effect during this time. See 11 USC §362(e)(1); see also §4.25. For additional discussion of procedures and practical considerations for obtaining stay relief, including checklists, see chap 10 on real property secured loans.

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§4.25 D. Termination of Stay After Motion for Relief Filed

Under 11 USC §362(e)(1), the automatic stay terminates with respect to a creditor who files a motion for relief from the stay as it affects actions against property of the estate, 30 days after the motion is filed, unless the court, after notice and a hearing, orders the stay continued in effect pending a final hearing and final determination of the matter. The court is required to continue the stay in effect if there is a "reasonable likelihood" that the party opposing relief will prevail at the final hearing. 11 USC §362(e)(1). The court is required to conclude the final hearing no later than 30 days after the preliminary hearing, unless the 30-day period is extended with consent of the moving parties or for a specific time that the court finds is required by "compelling circumstances." 11 USC §362(e)(1).

Under 11 USC §362(e)(2), in any Chapter 7, 11, or 13 case with an individual debtor, the stay terminates altogether —not merely with respect to particular property or a particular creditor—60 days after a motion for relief from stay is filed, unless (1) the court renders a final decision during the 60-day period, or (2) the 60-day period is extended by agreement of all parties in interest, or by the court for a specific period of time that the court finds is required for good cause as described in findings made by the court.

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§4.26 E. Appeals

Appeals of bankruptcy court orders in respect of motions for relief from the automatic stay are subject to the same procedures applicable to appeals of other types of bankruptcy court orders. As noted in §4.68, unless otherwise ordered by the bankruptcy court, orders granting stay relief are stayed automatically for 14 days under Fed R Bankr P 4001(a)(3). This means that, if a secured creditor obtains relief from stay and the debtor does not waive the 14-day period, unless the order granting relief from stay provides otherwise, the creditor's foreclosure sale must be postponed until the 14-day period has passed.

If the debtor obtains a further stay pending appeal under Fed R Bankr P 8005, the foreclosure sale must be postponed until the appeal is resolved. If the debtor fails to obtain a further stay, however, and the foreclosure sale proceeds and the property is sold to a third party, the debtor's appeal will be rendered moot. *National Mass Media Telecommunication Sys. v Stanley (In re National Mass Media Telecommunication Sys.)* (9th Cir 1998) 152 F3d 1178.

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IV. §341(a) MEETING OF CREDITORS

§4.27 A. Meeting Scope and Procedures

Under 11 USC §341(a), except as provided in 11 USC §341(e), the U.S. Trustee is required to hold a meeting of creditors in all cases filed under the Bankruptcy Code, regardless of chapter, within a reasonable period of time after the case is filed. (This meeting is referred to throughout this book as the "§341(a) meeting.") The debtor is required to appear at the §341(a) meeting and submit to examination under oath. 11 USC §343. Under 11 USC §341(e), on request of a party in interest after notice and a hearing, the court may order, for cause, that the U.S. Trustee not convene a §341(a) meeting if the debtor has filed a plan and obtained creditor acceptances before commencement of the case. Section 341(e) is intended to streamline the confirmation of "prepackaged" Chapter 11 plans. See §5.4.

The §341(a) meeting gives the debtor an opportunity to meet with creditors to explain why the bankruptcy was filed. All creditors and other parties in interest (including stockholders and employees of a business debtor) are permitted to attend the meeting and ask specific questions about the debtor's assets and liabilities. Creditors (including corporate creditors) need not be represented by an attorney. 11 USC §341(c). Depending on the relief chapter under which the case was filed, the hearing will actually be conducted by the Chapter 7 trustee, the Chapter 13 trustee, or, in Chapter 11 cases, a representative of the U.S. Trustee's office. Under Fed R Bankr P 2004(b), the scope of the debtor's examination can be as broad as is permitted for Rule 2004 examinations. See §§4.35-4.37. Section 341(a) meetings are recorded on audiotape, and copies of the tapes may be ordered from the U.S. Trustee's office. See Fed R Bankr P 2003(c).

The officer conducting the §341(a) meeting is not authorized to make any formal rulings. He or she cannot rule on evidentiary objections or compel the debtor to answer a question. Indeed, although the debtor is sworn in and the meeting is recorded, there is an issue as to whether the proceedings are subject to the Federal Rules of Evidence.

PRACTICE TIP: It is questionable whether debtor's counsel can preserve evidentiary objections at a §341(a) meeting simply by objecting and allowing the response to be stated on the record. Therefore, although this is not common, it may be prudent for debtor's counsel to instruct the debtor not to answer a question deemed improper. Debtors, however, have a duty to cooperate in the administration of their cases (see 11 USC §521(a)(3)), and unresponsive debtors take their chances if they appear uncooperative or unresponsive to creditor questions.

In all bankruptcy cases, the bankruptcy court clerk will give notice of the §341(a) meeting to all creditors and other parties in interest listed in the schedules and the master mailing matrix filed by the debtor under local bankruptcy court rules. This notice also contains some basic information for creditors on the pendency of the case and the automatic stay. Under Fed R Bankr P 2003(a), §341(a) meetings in Chapter 7 and 11 cases must be held within 20 to 40 days after the petition date, and §341(a) meetings in Chapter 13 cases must be held within 20 to 50 days after the petition date. In Chapter 7 cases involving individual debtors, the actual date of the §341(a) meeting is very important for purposes of case administration because it starts the running of the 60-day time period within which a complaint to determine the dischargeability of certain debts under 11 USC §523(c) or to object to the debtor's discharge under 11 USC §727(a) must be filed. See Fed R Bankr P 4004(a), 4007(c). The conclusion of the §341(a) meeting generally triggers the general 30-day period for objecting to a debtor's claimed exemptions. See Fed R Bankr P 4003(b). But see (1) Fed R Bankr P 4003(b)(2), extending the period to 1 year when the exemption claim has been fraudulently made; and (2) Fed R Bankr P 4003(b)(3), addressing objections based on 11 USC §522(q) limiting state homestead exemptions under certain conditions.

If the debtor misses two or more scheduled §341(a) meetings without adequate excuse or explanation, the debtor's case is subject to conversion or dismissal. See §§4.72-4.91. In some districts, Chapter 7 cases are subject to automatic dismissal if the debtor fails to appear at two hearings. See CD Cal Local Bankr R 1017-2(b). If the case is an "asset" Chapter 7 case, however, the Chapter 7 trustee may allow the case to remain open regardless of the debtor's conduct, but may take action to deny the debtor a discharge. If a Chapter 11 debtor fails to appear at the §341(a) meeting (or other initial meeting with the U.S. Trustee), the U.S. Trustee will normally move to convert the case to Chapter 7, rather

than seek a dismissal. Counsel should always consult local rules. See Directory for website information.

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§4.28 B. Document Production

Federal Rules of Bankruptcy Procedure 4002(b) requires each individual debtor to bring to the §341(a) meeting specified identity and financial documentation.

In addition to the foregoing requirements, an individual Chapter 7 or 13 debtor is required to provide the trustee, no later than 7 days before the date first set for the §341(a) meeting, a copy of his or her federal income tax return (or a transcript thereof) for the most recent tax year ending immediately before the commencement of the case and for which a return was filed. 11 USC §521(e)(2)(A)(i). Copies are also required to be provided to creditors on request. 11 USC §521(e)(2)(A)(ii).

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§4.29 C. Scope of Examination

In all cases, the debtor will be examined for the purpose of verifying the information stated in the bankruptcy schedules, the Statement of Financial Affairs, and any other documents produced at or before the §341(a) meeting. Once this is accomplished, however, the examinations differ somewhat, depending on the relief chapter under which the debtor's case was filed. See §§4.30-4.32.

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§4.30 1. Chapter 7

Although 11 USC §341(a) and Fed R Bankr P 2003(b)(1) state that the U.S. Trustee presides at the §341(a) meeting of creditors, in most districts the Chapter 7 trustee actually conducts the meeting. Under Fed R Bankr P 2003(b), creditors have the right to elect a trustee in a Chapter 7 case, but such an event is rare. The Chapter 7 trustee invariably remains the one designated by the U.S. Trustee from the panel of trustees in the district as of the petition date.

The Chapter 7 trustee's principal goal at the §341(a) meeting is to find out whether the debtor has any nonexempt assets that may be liquidated for the benefit of creditors. The trustee's examination typically includes questions about real estate valuations and the existence and valuation of other assets that may or may not have been accurately scheduled by the debtor. The trustee will also seek to determine whether the debtor's filing represents a "substantial abuse" of Chapter 7 under 11 USC §707(b) (see §4.81) and whether the debtor is aware of the consequences of a bankruptcy filing (see 11 USC §341(d)).

In most Chapter 7 cases, creditor questioning is usually limited because of time constraints. Although local practice varies, a §341(a) meeting calendar may consist of about 20 Chapter 7 cases per hour and, to get through the calendar, the Chapter 7 trustee must restrict the time for creditor questions. National creditors, such as credit card issuers, auto lenders, mortgage companies, and student loan creditors, seldom attend §341(a) meetings in Chapter 7 cases although they have a right to do so. The creditors most likely to attend are local ones, such as local tradespeople. If a number of creditors attend the meeting and the trustee believes that the case merits further examination of the debtor, the trustee may continue the meeting and request the debtor to provide additional information or documents. See Fed R Bankr P 2003(e); see also §4.33. In addition, the trustee may schedule a separate examination of the debtor under Fed R Bankr P 2004(a) (see §4.35) if the case involves complex or detailed issues that merit further inquiry. Creditors may also invoke Fed R Bankr P 2004(a) as a way of obtaining detailed information that the time constraints of §341(a) meetings prevent.

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§4.31 2. Chapter 13

In Chapter 13 cases, the trustee's focus is not only on the assets scheduled by the debtor but also on the debtor's current income and expenses. The Chapter 13 trustee will seek to determine whether the debtor's plan is feasible and whether the debtor is proceeding in good faith. The Chapter 13 trustee also typically collects initial plan payments at the §341(a) meeting.

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§4.32 3. Chapter 11

Although the general purpose and scope of the §341(a) meeting in Chapter 11 cases is the same as for other relief chapters, certain districts require the debtor to submit additional documentation prior to the meeting so that the U.S. Trustee's representative will be better equipped to conduct a meaningful examination. For example, in the Central District of California, within 7 days after filing the petition, a Chapter 11 debtor must submit to the U.S. Trustee, among other things, a real property questionnaire, proof of insurance, proof of closing and opening bank accounts, financial statements, and copies of tax returns (see U.S. Trustee, Central District of California, *Notice of Requirements for Chapter 11 Debtors in Possession* (rev Apr. 2008); for article, see Directory). The debtor's representatives should expect to be examined regarding these documents at the §341(a) meeting. One of the main objectives of the U.S. Trustee's representative and creditors at the §341(a) meeting in a Chapter 11 case is to evaluate whether there is a realistic possibility that the debtor can reorganize successfully by implementing a feasible plan.

In Chapter 11 cases, the U.S. Trustee's representative will allow more calendar time for the §341(a) meeting, based on his or her assessment of the complexity of the case and the number of creditors likely to attend the meeting. A §341(a) meeting in a Chapter 11 case may run for a hour or two, or an entire morning or afternoon in larger cases with many creditors in attendance. As noted in §4.27, on request of a party in interest after notice and a hearing, the court may dispense with a §341(a) hearing in cases in which a prepackaged plan has been approved prepetition.

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§4.33 D. Continuances

When questioning has been completed, the officer will conclude the §341(a) meeting, and the debtor is free to leave. Occasionally, if questioning reveals an avenue of inquiry that the officer believes should be explored further or if the debtor did not furnish requested documents to the officer's satisfaction, the officer will continue the meeting to a future date. See Fed R Bankr P 2003(e). Such a continuance has the effect of extending the 30-day period within which a trustee or other party in interest may file an objection to the list of property claimed by an individual debtor as exempt. See Fed R Bankr P 4003(b).

If the meeting is continued without fixing a specific date for the continued meeting at the initial meeting or within 30 days thereafter, the meeting is deemed concluded at the time the initial meeting is adjourned, thus fixing the 30-day period for purposes of Rule 4003(b). *Smith v Kennedy (In re Smith)* (9th Cir 2000) 235 F3d 472. See also *Chubb & Son, Inc. v Clark (In re Clark)* (BAP 9th Cir 2001) 262 BR 508. Courts outside of the Ninth Circuit may take a different approach. See *In re Steffen* (Bankr MD Fla 2008) 391 BR 874 (applying "minority view" that when §341(a) meeting is deemed concluded must be decided on case-by-case basis); *Peres v Sherman (In re Peres)* (5th Cir 2008) 530 F3d 375, 377 (stating that "majority of courts reject… bright-line approach" of *Smith*); *Logan v Williams (In re Williams)* (D Md 2008) 400 BR 479 (rejecting *Smith* and citing third line of cases holding that meeting is never concluded until trustee or court declares it so).

A continuance does not extend the time for filing a complaint to determine the dischargeability of a debt under 11 USC §523(c) or a complaint to object to a Chapter 7 debtor's discharge under 11 USC §727(c)(1). Federal Rules of Bankruptcy Procedure 4007(c) and 4004(a), respectively, fix the deadline for doing so at "no later than 60 days after the first date set for the meeting of creditors."

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§4.34 E. Practical Considerations

Debtor's counsel should advise the debtor to review the petition, schedules, Statement of Financial Affairs, and all other documents filed in the case prior to the §341(a) meeting and to be prepared to answer questions about them. Many times, only the officer conducting the meeting, the debtor, and debtor's counsel are present, but any creditor has the right to appear and question the debtor. 11 USC §343. Prior to the meeting, the officer and creditors will have reviewed the petition and accompanying schedules in some detail. The officer will ask questions intended to verify the information provided by the debtor, and then may ask specific questions about the particular facts and circumstances of the debtor's case.

Regardless of which relief chapter is involved, all creditor questioning must comply with Fed R Bankr P 2004(b) concerning the permitted scope of the examination. See §4.35. Further, the officer conducting the meeting will not permit creditors to harass the debtor or to conduct discovery pertaining to a particular actual or anticipated adversary proceeding. If a creditor believes that it did not have sufficient time to examine the debtor at the §341(a) meeting, it has the right to conduct its own examination under Fed R Bankr P 2004 to seek further information relevant to its claim. See §§4.35-4.37.

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V. RULE 2004 EXAMINATIONS

§4.35 A. Purpose and Scope of Fed R Bankr P 2004

Used correctly, an examination under Fed R Bankr P 2004 (referred to throughout this book as a "Rule 2004 examination") can be a very powerful discovery tool for creditors in advance of litigation. The general purpose of Rule 2004 is to allow trustees, creditors, and other parties in interest in a bankruptcy case to obtain relevant information concerning the debtor, property of the estate, and claims against the estate. It is often used to obtain information that the debtor failed or was unable to provide at the §341(a) meeting. See generally §§4.27-4.33.

Rule 2004 applies in cases under all relief chapters of the Bankruptcy Code. Persons who can be examined under Rule 2004 include the debtor and any parties with contacts or dealings with the debtor or who may have information about the debtor or the administration of the debtor's estate. See *In re Dinubilo* (ED Cal 1993) 177 BR 932 ("range of discoverable subject matter in a Rule 2004 examination is 'unfettered and broad' and… is often termed a 'quick fishing expedition'"). Subpoenas under Fed R Bankr P 2004(c) and 9016 may be used to compel attendance of third parties. Rule 2004 is also frequently used for the production of documents from third parties and other discovery before commencement of an adversary proceeding, with a subpoena accompanying the order. See Fed R Bankr P 2004(c).

Rule 2004 examinations are usually conducted like depositions and reported by a court reporter, but, unlike depositions, they may take place *before* a complaint is filed. Rule 2004 examinations are often used by creditors before filing nondischargeability actions (see §5.58). Indeed, it is normally advisable for a creditor to conduct a Rule 2004 examination of the debtor before filing a nondischargeability action under 11 USC §523(a)(2), to ensure that there is adequate evidentiary support for the complaint under Fed R Bankr P 9011(b). A creditor's failure to conduct a Rule 2004 examination before filing a nondischargeability complaint could make it difficult for the creditor to avoid the mandatory attorney fees sanction under 11 USC §523(d) if the creditor does not prevail. See *First Card v Hunt (In re Hunt)* (9th Cir 2001) 238 F3d 1098; *People's Bank v Poirer (In re Poirer)* (Bankr D Conn 1997) 214 BR 53.

Once an adversary proceeding or a contested matter is pending, discovery as to that matter or proceeding through Rule 2004 is normally not permitted, although counsel may still conduct a Rule 2004 examination as to other subject matters. Discovery takes place under Part VII of the Federal Rules of Bankruptcy Procedure (Fed R Bankr P 7026-7037). *In re Dinubilo, supra*. But see *In re International Fibercon, Inc.* (Bankr D Ariz 2002) 283 BR 290 (allowing Rule 2004 examination to go forward although litigation was pending in another jurisdiction, because litigation was unrelated to bankruptcy case).

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§4.36 B. Motion for Rule 2004 Examination

To conduct a Rule 2004 examination, a party in interest must first obtain an order on motion to the bankruptcy court authorizing the examination. Fed R Bankr P 2004(a). Local bankruptcy rules should be consulted for specific requirements. The court may order that the examination will take place at any time and place, either within or outside the district in which the bankruptcy case is pending. Fed R Bankr P 2004(d). If the motion is unopposed, the court will normally issue an order for a Rule 2004 examination without the need for a hearing.

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§4.37 C. Failure to Comply With Rule 2004 Order

A debtor or other person who fails to appear for a Rule 2004 examination or to furnish documents as ordered may be held in contempt. See Fed R Bankr P 2004(c), 9016(e); *Stasz v Gonzalez (In re Stasz)* (BAP 9th Cir 2008) 387 BR 271. In addition, the debtor's attendance at a Rule 2004 examination may be compelled under Fed R Bankr P 2005, which permits the court to order a federal Marshal to take the debtor into physical custody. To obtain an order under Rule 2005, the moving party must show that the debtor has evaded service or willfully disobeyed a subpoena or is about to leave the area. See Fed R Bankr P 2005(a).

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VI. BANKRUPTCY COURT LITIGATION

§4.38 A. Introduction

Bankruptcy litigation is a specialized type of federal civil litigation. Experienced federal court litigators will recognize most procedures applicable in the bankruptcy setting. One key difference is that bankruptcy judges and practitioners tend to be more practical than technical in their approach to litigation, because of the economic constraints inherent in the insolvency context. For example, the estate may have a claim for recovery of property from a third party, but the assets of the estate may not support protracted litigation to recover the property. The Chapter 7 trustee, as the representative of the estate, may therefore be more amenable to an early settlement than would a private litigant. Similarly, bankruptcy judges tend to favor mediation when possible as an alternative, cost-effective method for dispute resolution. See §§4.69-4.70 for a discussion of bankruptcy court mediation programs.

Of necessity as a result of overcrowded bankruptcy court dockets, bankruptcy judges tend to be efficient case administrators with little tolerance for delaying tactics, and favor prompt resolution of contested matters and adversary proceedings. As a consequence, litigation matters are typically concluded more quickly in bankruptcy court than in other forums. The summary nature of most bankruptcy proceedings may be beneficial or detrimental to the parties, depending on their respective interests in the case.

Finally, because of the bankruptcy court's role in the liquidation or restructuring of troubled businesses, bankruptcy judges tend to be sophisticated in their analysis and rulings on business and commercial law matters.

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B. Bankruptcy Court Jurisdiction

§4.39 1. Generally

For a general discussion of the jurisdiction of the federal bankruptcy courts, see §§1.44-1.56. The federal district courts have original and exclusive jurisdiction over "all cases under [T]itle 11" (28 USC §1334(a)) and matters involving bankruptcy professionals (28 USC §1334(e)(2)), and original but nonexclusive jurisdiction over "all civil proceedings *arising under* [T]itle 11, or *arising in* or *related to* cases under [T]itle 11." (Emphasis added.) (28 USC §1334(b)). This jurisdiction is exercised by the federal bankruptcy courts through automatic referral under general orders of the federal district courts. See 28 USC §157(a). See, *e.g.,* U.S. Dist Ct CD Cal General Order 266 (Oct. 9, 1984); U.S. Dist Ct ED Cal General Order 182 (May 14, 1993); U.S. Dist Ct ND Cal General Order 24 (May 20, 1985). See generally *Security Farms v International Bhd. of Teamster*s (9th Cir 1997) 124 F3d 999.

The U.S. Supreme Court has recognized a probate exception in 28 USC §1334, but in *Marshall v Marshall* (2006) 547 US 293, 164 L Ed 2d 480, 126 S Ct 1735, the Court ruled that the probate exception does not prevent bankruptcy courts from taking jurisdiction over suits involving creditors, heirs, and other claimants against a decedent's estate to establish their claims, as long as the bankruptcy court does not interfere with the probate proceedings or assume general jurisdiction of the probate or control of the property in the custody of the state court.

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§4.40 2. "Core" Proceedings

In addition to bankruptcy cases, bankruptcy courts have jurisdiction to hear and determine, and issue final orders or judgments in, so-called core proceedings. Core proceedings are those "*arising under* [T]itle 11, or *arising in* a case under [T]itle 11." (Emphasis added.) 28 USC §157(b)(1). See 28 USC §1334(b). In general, core proceedings include matters involving substantive rights, created under the Bankruptcy Code, that have no existence outside of bankruptcy. *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074; *Eastport Assocs. v City of Los Angeles (In re Eastport Assocs.)* (9th Cir 1991) 935 F2d 1071. See 28 USC §157(b)(2) for a nonexclusive list of core proceedings. The first and penultimate items on the list, "administration of the estate" (28 USC §157(b)(2)(A)) and "other proceedings" (28 USC §157(b)(2)(O)), are sometimes referred to as the "catch-all" provisions of §157(b)(2). See *Taxel v Electronic Sports Research (In re Cinematronics, Inc.)* (9th Cir 1990) 916 F2d 1444. The Ninth Circuit has restricted use of the catch-all provisions, ruling that state law claims should not be categorized as core proceedings if doing so would raise constitutional issues, even if the claims arguably fall within the language of 28 USC §157(b)(2)(A) or §157(b)(2)(O). 916 F2d at 1450. See also *Piombo v Castlerock Props. (In re Castlerock Props.)* (9th Cir 1986) 781 F2d 159.

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§4.41 3. "Noncore" Matters

Bankruptcy courts also have jurisdiction to hear so-called noncore proceedings that are otherwise "*related to* a case under [T]itle 11." (Emphasis added.) 28 USC §157(c). See 28 USC §1334(b). Unless all parties consent, however, the bankruptcy court can conduct or supervise all aspects of the proceeding, but is jurisdictionally constrained to submit proposed findings of fact and conclusions of law to the federal district court. Final orders or judgments in noncore proceedings are issued by the district court, after consideration of the bankruptcy court's findings and conclusions. 28 USC §157(c); *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074; *Piombo v Castlerock Props. (In re Castlerock Props.)* (9th Cir 1986) 781 F2d 159, 161

Most jurisdictional disputes in the bankruptcy court concern noncore matters and their degree of relatedness to the debtor's bankruptcy case, and arise in connection with motions for abstention or remand. See §§4.55-4.63. As stated in *Fietz v Great W. Sav. (In re Fietz)* (9th Cir 1988) 852 F2d 455, the test in the Ninth Circuit for determining "*related to*" jurisdiction is:

> whether the outcome of [the] proceeding could conceivably have any effect on the estate being administered in bankruptcy.... [T]he proceeding need not necessarily be against the debtor or against the debtor's property. An action is related to bankruptcy if the outcome could alter the debtor's rights, liabilities, options, or freedom of action (either positively or negatively) and... in any way impacts upon the handling and administration of the bankrupt estate.

A common example of a noncore matter that is "related to" a bankruptcy case within 28 USC §157(c)(1) is a state-law breach-of-contract action if the outcome will be crucial to the debtor's ability to reorganize. Another example involving both a core and a noncore, related-to matter is a complaint to determine the dischargeability of a debt (a core proceeding) that also involves a dispute regarding the existence or validity of the debt under state law (a noncore, related-to matter). Typically, the bankruptcy court wishes to retain jurisdiction over actions that could have a serious financial impact on the overall bankruptcy case, and often, because of that connection, the bankruptcy court will be better equipped to handle and expeditiously resolve the issues at hand.

Federal Rules of Bankruptcy Procedure 7008 requires claimants in adversary proceedings to state in their pleadings whether the proceeding is core or noncore, and whether the pleader consents to entry of final orders or judgment by the bankruptcy court. A corresponding rule requires each respondent in an adversary proceeding to state its position on whether the proceeding is core or noncore. Fed R Bankr P 7012(b). If the respondent believes that the proceeding is noncore, the rule requires the respondent to indicate whether the respondent does or does not consent to entry of final orders or judgment by the bankruptcy judge. Fed R Bankr P 7012(b). See *Dunmore v U.S.* (9th Cir 2004) 358 F3d 1107 (district court erred in affirming bankruptcy court's final judgment on taxpayer's noncore refund-related claims because taxpayer did not consent to entry of judgment). These rules combine to present any issues or disputes over jurisdiction to the bankruptcy court at the outset of the litigation.

NOTE: If neither the debtor nor the trustee is a party to litigation commenced in the bankruptcy court, it may be difficult to convince the bankruptcy court to retain jurisdiction over the matter. Moreover, once a plan of reorganization is confirmed, the court's jurisdiction may be limited on matters determined to be peripheral to the plan. *Penthouse Media Group v Guccione (In re General Media, Inc.)* (Bankr SD NY 2005) 335 BR 66. See §§4.55-4.58.

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C. Contested Matters and Adversary Proceedings

§4.42 1. Introduction

There are two basic categories of litigation in the bankruptcy court: contested matters and adversary proceedings. Contested matters usually relate to case administration and involve resolution of evidentiary disputes. Every opposed motion is a contested matter. Although procedures are streamlined in contested matters, the Federal Rules of Evidence, discovery, and many other procedural rules apply. See Fed R Bankr P 9014; see also §§4.43, 4.49. BAPCPA did not significantly alter the procedures for litigating matters in bankruptcy court, although the appellate process was materially altered. See §4.68.

Most bankruptcy court orders are issued in motion proceedings. Federal Rules of Bankruptcy Procedure 9013 generally requires that any request for a bankruptcy court order be made by written motion, unless the request is made at a bankruptcy court hearing. (In some districts, counsel may style a motion as an "application," particularly requests for compensation by a professional employed in a case; thus, the caption on the pleading is not definitive.) Motions may be unopposed and, if so, are usually not "contested matters" unless the court challenges the request for relief sua sponte. Both uncontested motions and contested matters are usually subject to the same general procedural framework for motion practice as established in local bankruptcy court rules. See §4.43. Both national and local bankruptcy rules set forth procedures applicable to motion practice.

Adversary proceedings in the bankruptcy court are substantially identical to federal district court litigation. Adversary proceedings are commenced by the filing of a complaint under Fed R Bankr P 7003 (the bankruptcy analogue of Fed R Civ P 3), and there are subject matter jurisdictional restrictions on the bankruptcy court's authority to hear and decide certain types of actions. See generally §§1.47-1.53, 4.39-4.41. Typically, an adversary proceeding must be filed if the defendant is not already a party in the debtor's bankruptcy case or if relief of a type described in Fed R Bankr P 7001 is sought against the defendant, who may be a party in interest (*e.g.,* a creditor) or just a third party obligor of the estate or the plaintiff. See Fed R Bankr P 7001; *Feld v Zale Corp. (In re Zale Corp.)* (5th Cir 1995) 62 F3d 746. Any nonparty defendant must be properly served with a summons in accordance with Fed R Bankr P 7004 in order for the bankruptcy court to gain personal jurisdiction over that defendant. See Fed R Bankr P 7004(f). Local bankruptcy rules impose many specific procedural requirements for the conduct of adversary proceedings in the bankruptcy court. It is essential for counsel to review and comply with applicable local rules because they were created by and for the benefit of the judges who will hear and decide the litigation. See generally §4.52. For discussion of adversary proceedings, see §§4.45-4.49. For discussion of the jury trial right in bankruptcy court adversary proceedings, see §§4.65-4.66. The term "case" refers to the main bankruptcy proceeding commenced by the debtor's filing of a petition under a particular relief chapter of the Bankruptcy Code, within which the contested matter or adversary proceeding occurs. See §1.14. Adversary proceedings and contested matters are docketed in different ways by bankruptcy court clerks. The clerk will docket all contested matters under the general case number and caption and file all papers relating to a contested matter in the general bankruptcy court file for that case. Adversary proceedings, however, are assigned separate numbers for docketing purposes and are designated with separate captions identifying the plaintiff(s) and defendant(s). The clerk will create a new bankruptcy court file for adversary proceedings when the summons and complaint are filed with the court. The docketing of an adversary proceeding corresponds to the docketing of litigation in a federal district court lawsuit.

Usually, the bankruptcy judge presiding over the underlying bankruptcy case hears all related adversary proceedings, but the judge is not required to do so. In some districts, adversary proceedings may be assigned to a bankruptcy judge other than the one sitting in the main bankruptcy case, and that judge may even be a visiting bankruptcy judge from outside California.

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2. Contested Matters

§4.43 a. Procedures; Parties

Contested matters include, at least potentially, every bankruptcy court request for relief that is actually or potentially contested and that is not included on the list of adversary proceedings in Fed R Bankr P 7001. Common examples are motions for relief from stay, professional fee applications, motions for assumption or rejection of executory contracts and leases, motions to authorize the sale of estate property, motions governing the debtor's use of cash collateral, motions for approval of litigation settlements, motions relating to plan confirmation, and objections to claims. See §4.44.

Because bankruptcy court proceedings are traditionally summary proceedings with the overall goal of expediting the debtor's "fresh start," bankruptcy courts have been receptive to the creative use of motion practice to address matters that might also be dealt with in an adversary proceeding. Federal Rules of Bankruptcy Procedure 9014 states that matters not otherwise governed by the Federal Rules of Bankruptcy Procedure must be brought before the court by motion. Thus, only when a party seeks to recover money or property from a nondebtor (see Fed R Bankr P 7001(1)), or seeks any of the other nine forms of relief set out in Rule 7001 (see generally §4.45), is an adversary proceeding absolutely required as a matter of law. At other times, the parties should proceed by motion unless the bankruptcy court orders otherwise.

Motion practice is distinguished from trial practice in the bankruptcy court in that relief is sought solely by a written motion, supported by a detailed memorandum of points and authorities and evidentiary declarations. The Federal Rules of Evidence apply in contested matters as well as adversary proceedings. Fed R Bankr P 9017. See §4.54. Exhibits to motions are introduced into evidence through authentication under the Federal Rules of Evidence. Pleadings in contested matters must be served in accordance with Fed R Bankr P 7004, which authorizes service by first-class mail, but requires that the appropriate person be designated in the service. Although the discovery rules in adversary proceedings (see Fed R Bankr P 7026, 7028-7037) also apply in contested matters under Rule 9014, motions are usually considered by the bankruptcy court based on the evidence presented in the declarations, and live testimony is not usually required. Bankruptcy court motion practice is governed by national and local bankruptcy court rules. Outside of the Ninth Circuit, procedures can be very different; some courts do not require filing of evidence with the motion and may take all evidence in the form of live testimony.

The number of parties to a contested matter may vary widely. Usually, there will be two disputants. In some instances, however, there may be only one. For example, if the court has a duty to make specific findings to support its order, the court itself may challenge an unopposed motion or application and require further proceedings. This is common in the fee application process. See *In re Garcia* (Bankr SD Cal 2004) 317 BR 810, aff'd in part and rev'd in part sub nom *Ferette & Slatter v U.S. Trustee (In re Garcia)* (BAP 9th Cir 2005) 335 BR 717. If numerous individuals or entities have an interest in the outcome, however, many parties may appear and participate in the hearings leading to a decision by the bankruptcy court. Usually, each party in a contested matter is already a party to the debtor's bankruptcy case, *i.e.,* is either a debtor, a creditor, an equity security holder of the debtor, the U.S. Trustee, or a trustee administering the case. See generally §§1.66-1.72. However, very intrusive forms of relief may be granted by the court against creditors through motions. For example, a trustee's motion for assumption and assignment of a lease or executory contract under 11 USC §365(a) may saddle the nondebtor party with a new tenant or contracting party against the nondebtor party's will. Further, secured creditors may be forced to accept replacement collateral after their original collateral has been sold free and clear of liens under 11 USC §363(f).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/4 Bankruptcy Case Administration/§4.44 b. Types of Contested Matters

§4.44 b. Types of Contested Matters

Numerous specific motions, objections, and applications are defined or referred to in the Federal Rules of Bankruptcy Procedure as contested matters:

- A motion to dismiss the bankruptcy case or to convert the bankruptcy case to a different chapter of the Bankruptcy Code, other than (1) conversion by debtors as of right under 11 USC §§706(a), 1112(a), and 1307(a); and (2) dismissal as of right by the debtor under 11 USC §1307(b). Fed R Bankr P 1017(d). See §§4.72-4.91.
- A motion to appoint a trustee or an examiner in a Chapter 11 case under 11 USC §1104. Fed R Bankr P 2007.1.
- An application for compensation of a professional, if opposed. Fed R Bankr P 2016, 9014, Advisory Comm. Note.
- A motion to examine the debtor's transactions with an attorney. Fed R Bankr P 2017, Advisory Comm. Note.
- A proceeding to contest any act or failure to act by the U.S. Trustee. Fed R Bankr P 2020.
- An objection to a proof of claim, except that a counterclaim necessitates an adversary proceeding. Fed R Bankr P 3007, Advisory Comm. Note. See generally §§3.42-3.53.
- An objection to the confirmation of a Chapter 12 or Chapter 13 plan. Fed R Bankr P 3015(f).
- An objection to the modification of a Chapter 12 or Chapter 13 plan. Fed R Bankr P 3015(g).
- An objection to the disclosure statement in a Chapter 11 case. Fed R Bankr P 3017, 9014, Advisory Comm. Note.
- An objection to the confirmation of a Chapter 9 or Chapter 11 plan. Fed R Bankr P 3020(b)(1).
- A motion for relief from the automatic stay. Fed R Bankr P 4001(a). See §§4.15-4.26.
- A motion to prohibit or condition the use, sale, or lease of property under 11 USC §363(e). See §§2.72-2.82.
- A motion for authorization for the debtor to use cash collateral. Fed R Bankr P 4001(b). See §§10.64-10.66.
- A motion for authority to obtain credit under 11 USC §364. Fed R Bankr P 4001(c). See §§10.57-10.62.
- An objection to the debtor's claim of exemption under 11 USC §522. Fed R Bankr P 4003(b), 9014, Advisory Comm. Note. See §4.27.
- A motion to avoid a lien that impairs an exemption under 11 USC §522(f). Fed R Bankr P 4003(d). See §§3.13, 3.50.
- A motion for abstention under 28 USC §1334(c). Fed R Bankr P 5011(b). See §§4.55-4.58.
- A motion to review an accounting by a custodian who turns over property under 11 USC §543. Fed R Bankr P 6002, Advisory Comm. Note. See §§2.24, 2.31.
- An objection to the proposed use, sale, or lease of property under 11 USC §363. Fed R Bankr P 6004(b). See §§2.72-2.82.
- A motion for authority to sell property free and clear of liens or other interests (except interests of co-owners) under 11 USC §363(f). Fed R Bankr P 6004(c). See §§2.79-2.81.
- An objection to a notice of intent to sell nonexempt property of an aggregate gross value of less than $2500. Fed R Bankr P 6004(d).
- A motion to assume, assume and assign, or reject an executory contract, unexpired lease, or timeshare interest (other than as part of a plan). Fed R Bankr P 6006(a). See generally chaps 6-7.
- A motion to require the trustee, debtor in possession, or debtor to determine whether to assume or reject an executory contract, unexpired lease, or timeshare interest. Fed R Bankr P 6006(b). See chaps 6-7.
- An objection to the proposed disposition or abandonment of property. Fed R Bankr P 6007, Advisory Comm. Note. See §§2.83-2.84.
- A motion to authorize the redemption of property from a lien or from a sale to enforce a lien. Fed R Bankr P 6008. See chaps 9-10.
- A motion to remand a removed claim or cause of action. Fed R Bankr P 9027(d). See §4.63.

Whether other motions made outside of adversary proceedings are to be treated as contested matters depends on the context. The operative principle is that "[w]henever there is an actual dispute, other than an adversary proceeding, before the bankruptcy court, the litigation to resolve that dispute is a contested matter." Fed R Bankr P 9014, Advisory Comm. Note. See §4.43.

BAPCPA added many new requirements—particularly the ones involving administration of consumer bankruptcy cases—that will likely give rise to contested matters. For example, 11 USC §521(i)(1) provides for automatic dismissal of a consumer case, apparently without notice to the debtor, if the debtor fails to file specified information within 45 days after the petition date. Some trustees are filing ex parte motions to trigger such dismissals, although not all bankruptcy courts appear willing to act without notice to the debtor.

PRACTICE TIP: Local bankruptcy court rules address procedures for such dismissals. Counsel should monitor bankruptcy court websites regularly to stay abreast of new rules, which are developed by each court in response to the district's actual experiences and needs. See Directory for website information.

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§4.45 3. Adversary Proceedings

Adversary proceedings are lawsuits in federal bankruptcy court. They must arise in or under a bankruptcy case or the Bankruptcy Code or be "related to" a pending bankruptcy case within 28 USC §1334(b) in order for the bankruptcy court to have subject matter jurisdiction. *Feld v Zale Corp. (In re Zale Corp.)* (5th Cir 1995) 62 F3d 746. See §§4.39-4.41. Usually, the debtor or a trustee administering the estate must be a party in order for subject matter jurisdiction to exist.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/4 Bankruptcy Case Administration/§4.46 a. When Required

§4.46 a. When Required

Federal Rules of Bankruptcy Procedure 7001 requires an adversary proceeding for the following categories of bankruptcy litigation. Because the following list is nonexclusive, the bankruptcy court may require that other matters be handled as adversary proceedings, although such a requirement is rare.

- Determination of the nondischargeability of a debt. Fed R Bankr P 7001(6). See, *e.g., Ung v Boni (In re Boni)* (BAP 9th Cir 1999) 240 BR 381. This type of litigation arises under 11 USC §523; the defendant is an individual debtor. See 11 USC §523(c)(1); see also §§5.57-5.59.
- Denial of an individual's discharge under 11 USC §727(a). Fed R Bankr P 7001(4). See §§5.57, 5.60-5.63.
- Contesting the validity, priority, or extent of a lien (Fed R Bankr P 7001(2); *Brady v Andrew (In re Commercial W. Fin. Corp.)* (9th Cir 1985) 761 F2d 1329; see §2.33), except for lien avoidance by the debtor under 11 USC §522(f) (see §10.85).
- Sale of the interest of a co-owner of property of the estate under 11 USC §363(h). Fed R Bankr P 7001(3). (Sale of the interest of the *debtor* in property of the estate can be handled by motion, as a contested matter.) See *Applewood Chair Co. v Three Rivers Planning & Dev. Dist. (In re Applewood Chair Co.)* (5th Cir 2000) 203 F3d 914; see also §2.81.
- Avoidance litigation (classified as proceedings to recover money or property). See Fed R Bankr P 7001(1); see also §§2.32-2.70. These are the most common lawsuits in bankruptcy court and are usually based on one of the following sections of the Bankruptcy Code:
- 11 USC §544 (avoidance of property transfers under the "strong-arm" power and state law theories; see §2.33);
- 11 USC §547 (preference litigation; see §§2.37-2.55);
- 11 USC §548 (fraudulent conveyance litigation; see §§2.56-2.67); or
- 11 USC §549 (avoidance of postpetition property transfers; see §§2.68-2.70).
- Turnover of property of the estate under 11 USC §§542-543, with limited exceptions. Fed R Bankr P 7001(1). See §§2.24-2.31.
- A proceeding to revoke confirmation of a Chapter 11, 12, or 13 plan. Fed R Bankr P 7001(5). See, *e.g.,* 11 USC §1144; see also chap 5.
- Subordination of a claim or interest (see 11 USC §510), except under a Chapter 11, 12, or 13 plan. Fed R Bankr P 7001(8). See §3.18.
- Declaratory or injunctive relief generally. Fed R Bankr P 7001(7), (9). See 11 USC §105(a). See, *e.g., Ung v Boni (In re Boni), supra*.

NOTE: Requests for relief from stay (itself a statutory injunction) or for sanctions for violation of the stay are contested matters and not adversary proceedings under specific procedures found in 11 USC §362(d)-(h). Plans confirmed under Chapter 11 or 13 may also provide for injunctive relief outside of the context of an adversary proceeding. See Fed R Bankr P 7001(7).

- Suits for damages (classified as suits to recover money). See Fed R Bankr P 7001(1); *Village Mobile Homes, Inc. v First Gibraltar Bank (In re Village Mobile Homes, Inc.)* (5th Cir 1991) 947 F2d 1282.
- Proceedings to determine claims or causes of action removed under 28 USC §1452. Fed R Bankr P 7001(10).

PRACTICE TIP: The bankruptcy court has discretion to incorporate the adversary proceeding rules into the conduct of a contested matter. How counsel titles the request for relief may have a significant impact on whether the court permits the matter to be handled as a contested matter, requires the contested matter to proceed using the adversary rules, or compels the parties to move forward with a full-blown adversary proceeding (which can only be commenced with service of a summons and complaint). In general, the more complex and contentious the matter, the more likely the court will apply all of the adversary proceeding rules. In *Ruvacalba v Munoz (In re*

Munoz) (BAP 9th Cir 2002) 287 BR 546, the BAP held that the bankruptcy court's failure to treat a motion styled "Motion for Relief from Stay/Modification for Relief From Discharge Injunction" as an adversary proceeding was harmless error, because the material facts were undisputed, the critical questions were purely issues of law, and the record below would not have been materially different had there been an adversary proceeding.

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§4.47 b. Typical Characteristics

Adversary proceedings are more expensive and considerably slower to produce a result for the litigants than are contested matters. As a consequence, a party requesting relief from the bankruptcy court typically prefers to use the motion procedure to obtain relief quickly, while the opposing party typically prefers an adversary proceeding, which will be slower. Resolution of the matters at issue in an adversary proceeding generally does not occur except following a motion for summary judgment or a full trial. All of the rules in Part VII and many in Part IX of the Federal Rules of Bankruptcy Procedure apply in adversary proceedings. In 2004, Fed R Bankr P 9014 was amended to clarify that the disclosure rules set forth in Fed R Civ P 26(a)(1)-(3) and (f) do not apply to contested matters. In addition, local rules impose many specific procedural requirements for the conduct of adversary proceedings in the bankruptcy court. For a discussion of the jury trial right in bankruptcy court adversary proceedings, see §§4.65-4.66.

NOTE: Any corporation (other than the debtor or a governmental unit) that is a party to an adversary proceeding must file two copies of a statement disclosing any other corporation that directly or indirectly owns 10 percent or more of any class of shares in the corporation, or else stating that there are no other corporations to report. The statement must be filed along with the first pleading filed by the corporation in the proceeding, and must be supplemented if there are any subsequent changes in the corporation's affiliations. Fed R Bankr P 7007.1.

Although most of the Federal Rules of Civil Procedure are applicable in bankruptcy court trials of adversary proceedings (see §4.51), bankruptcy court trial procedures often differ markedly from trial procedures in federal district court. Trial procedures vary widely from bankruptcy judge to bankruptcy judge and from district to district. Moreover, adversary proceedings are sometimes assigned to visiting judges, who may follow procedures that are customary in the district where they normally sit but are unusual in the district where they are visiting. Therefore, it is essential for counsel to be thoroughly familiar with all applicable local and "local-local" rules (see §§1.36-1.38, 4.52), as well as with the Federal Rules of Evidence and the Federal Rules of Civil Procedure as incorporated into the Federal Rules of Bankruptcy Procedure, and to consult in advance with the calendar clerk of the judge assigned to the adversary proceeding to ensure that counsel understands and observes all relevant trial procedures. The Federal Rules of Evidence are not abrogated despite the expeditious nature of bankruptcy proceedings. *American Express Travel Related Servs. Co. v Vinhnee (In re Vinhnee)* (BAP 9th Cir 2005) 336 BR 437 (creditor precluded from having computer-generated records admitted without proper authentication).

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§4.48 c. Trials Based on Written Declarations

Many (but not all) bankruptcy judges in California conduct trials in adversary proceedings primarily on the basis of written evidentiary declarations. If this procedure is not used, the bankruptcy judge will conduct the trial in the traditional manner with live testimony of witnesses.

If the judge does permit a trial using written declarations, the trial will typically proceed as follows: The plaintiff will present its case in chief by filing a trial brief and written declarations of its witnesses. The defendant will then file its trial brief and written declarations of its witnesses and may also file evidentiary objections to the plaintiff's declarations. Some, but not all, judges will allow the plaintiff to file a reply or rebuttal declarations as well as evidentiary objections to the defendant's declarations. On trial day, each party must have all of its witnesses present in the courtroom for possible cross-examination; otherwise, their declarations may be stricken. The court will first rule on the parties' evidentiary objections. The defendant will then call the plaintiff's witnesses for cross-examination. At the conclusion of all cross-examination, rehabilitation, and recross-examination, the plaintiff's case is concluded. The same procedure applies to the defendant's case.

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§4.49 4. Similarities and Differences

If a matter is categorized as an adversary proceeding, all of the procedural rules in Part VII and many in Part IX of the Federal Rules of Bankruptcy Procedure apply (see §§1.29-1.34). In contested matters, however, unless the bankruptcy court orders otherwise, the rules in Part VII are only partially applicable. See Fed R Bankr P 9014. The major similarities and differences in the rules applicable to the two types of bankruptcy litigation are summarized below:

- The most dramatic difference is the speed with which a contested matter can be decided. The court may require that only 15 to 28 days' notice be given before the court holds a hearing and makes a definitive ruling. An adversary proceeding will have barely begun in that time frame. Thus, when speed is essential, structuring bankruptcy court litigation as a contested matter (if at all possible) will accelerate the judicial decision process.
- Classic pleading rules for complaints and answers do not apply to contested matters. Contested matters are commenced by motion, with procedures relating to format and timing covered in local bankruptcy court rules.
- Service of process requirements for contested matters and adversary proceedings are set forth in Fed R Bankr P 7004-7005, 9014, and local bankruptcy court rules. Note that in contested matters, service of the initial motion is governed by Fed R Bankr P 7004 (the same as for adversary proceedings) and not Fed R Bankr P 2002 (the notice provisions). Other papers served after the initial motion are served as provided in Fed R Civ P 5(b) (Fed R Bankr P 7005(b)). See Fed R Bankr P 9014(b).
- An order granting a motion in a contested matter may be obtained only "after notice and a hearing." This phrase is a term of art in bankruptcy practice. See §1.30. It is defined in 11 USC §102(1) to include several procedural variations. The bankruptcy court has substantial discretion to decide what kind of notice and opportunity for hearing may be appropriate under the circumstances; therefore, a court hearing is not required in all contested matters. Commonly, local bankruptcy court rules set out the appropriate notice procedure in each instance.
- Discovery in contested matters is fully available, with the exception of taking depositions to perpetuate testimony. This exception is likely due to the presence of a specific bankruptcy case procedure to serve the same need. See Fed R Bankr P 2004; see also §§4.35-4.37. Examinations under this rule may take place outside the district where the bankruptcy is pending through issuance and service of a subpoena in the manner prescribed by Fed R Civ P 45. See Fed R Bankr P 2004(c), 9016.
- Discovery in a contested matter is useful and widely underemployed. If a motion is opposed, serving a notice of deposition or request for production of documents requires no advance approval from the bankruptcy court (unlike examinations under Rule 2004). One key benefit is that the lack of a formal discovery phase means that contested matters are usually much less costly than adversary proceedings.
- Most procedural rules concerning entry and enforcement of orders apply to contested matters. In fact, orders issued in many contested matters can be as prejudicial and irreparable to the losing party as any relief ordered in an adversary proceeding.
- Formal pretrial procedures do not usually apply in contested matters. However, in contested matters involving large sums of money or having a major impact on the direction of the case, such as plan confirmation or Chapter 11 trustee appointment hearings, the court may establish certain pre-trial procedures (such as discovery cutoff dates) by order for the purpose of organizing the evidentiary presentations.
- In an adversary proceeding, unlike a contested matter, the plaintiff has the ability to limit the number of entities involved in the proceeding. An adversary proceeding usually involves only the parties named by the plaintiff at the outset of the lawsuit. In contrast, a contested matter usually requires notice to the entire creditor body, thus giving any creditor an opportunity to appear in court and comment on or contest the relief sought.

Counsel who wish to import into a contested matter some of the procedures normally applicable only in adversary proceedings may make a motion to that effect to the bankruptcy court. See Fed R Bankr P 9014 (the court "may at any stage in a particular matter direct that one or more of the other rules in Part VII shall apply"). An important revision to Rule 9014 provides that, if a contested matter cannot be decided without resolving a disputed factual issue, an

evidentiary hearing must be held at which the testimony of witnesses will be taken in the same manner as at a trial in an adversary proceeding. Further, the court must provide a procedure to enable parties to learn in advance whether or not the hearing will be evidentiary.

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§4.50 5. Attorney Fees

The right of a creditor or a debtor to recover attorney fees in either contested matters or adversary proceedings as part of an unsecured claim is determined based on the underlying contract and state law. In *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, the U.S. Supreme Court held that an unsecured claim for attorney fees authorized by a prepetition contract with the debtor and incurred in postpetition litigation may not be categorically disallowed solely because the postpetition litigation involves issues of federal bankruptcy law. The Court's analysis was based on 11 USC §502, which describes what damages elements should be allowed as part of an unsecured claim.

Inquiry into whether the fees would be recoverable outside of a bankruptcy proceeding will now be required in California because the bankruptcy court will need to apply CC §1717. In *Travelers,* the U.S. Supreme Court overruled *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, in which the Ninth Circuit had stated that attorney fees are not recoverable in bankruptcy when the litigated issues are peculiar to federal bankruptcy law, absent the losing party's bad faith or harassment.

Applying *Travelers,* the Bankruptcy Appellate Panel for the Ninth Circuit in *Hoopai v Countrywide Home Loans, Inc. (In re Hoopai)* (BAP 9th Cir 2007) 369 BR 506 vacated the bankruptcy court's award of attorney fees to the secured creditor and remanded the case for the court to determine whether the debtor was entitled to attorney fees from the creditor as the prevailing party on several contested matters concerning relief from stay and Chapter 13 plan challenges. See also *SNTL Corp. v Center Ins. Co. (In re SNTL Corp.)* (9th Cir 2009) 571 F3d 826, 838 (creditor whose claim revived postpetition entitled to attorney fees); *Chinese Yellow Pages Co. v Chinese Overseas Mktg. Serv. Corp.* (2008) 170 CA4th 868, 88 CR3d 250 (state court may award contractual attorney fees after automatic stay expires).

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D. Rules of Procedure

§4.51 1. Federal Rules of Bankruptcy Procedure

For an overview of the Federal Rules of Bankruptcy Procedure, see §§1.29-1.34. The Federal Rules of Civil Procedure are largely incorporated intact into Parts VII and IX of the Federal Rules of Bankruptcy Procedure. As discussed in §§4.42-4.49, the Part VII rules apply differently to contested matters and adversary proceedings. Some key differences between the Federal Rules of Civil Procedure and the Federal Rules of Bankruptcy Procedures are as follows:

- Some federal civil procedural rules, such as Fed R Civ P 2-3, do not apply at all in bankruptcy court proceedings.
- Certain bankruptcy procedural rules have no counterpart in the Federal Rules of Civil Procedure. For example, Fed R Bankr P 7087 allows for transfers of adversary proceedings to other districts.
- Service by first-class mail, as distinct from personal service generally required under Fed R Civ P 4, is permitted in bankruptcy court. Fed R Bankr P 7004(b).
- Complaints objecting to a debtor's discharge under 11 USC §727 may not be dismissed without notice to the U.S. Trustee. Fed R Bankr P 7041. This rule differs from Fed R Civ P 41, which permits a voluntary dismissal by the plaintiff before an answer is filed or by stipulation without notice.
- Trustees need not comply with the bonding requirements of Fed R Civ P 65(c) for injunctions. See Fed R Bankr P 7065.

Amendments to Fed R Civ P 16, 26, 33, 34, 37, and 45 in 2007 addressed issues of preservation, production, and privilege related to electronically stored information (ESI). The following are among the changes applicable to bankruptcy litigation under Fed R Bankr P 7016, 7026, 7033, 7034 and 9016:

- Rule 16(b)(6)(3)(b)(iii) allows the court to include provisions for disclosure or discovery of ESI in the scheduling order.
- Rule 26(f)(3)(C) requires parties to discuss any issues relating to discovering and preserving discoverable ESI at the Rule 26(f) conference.
- Rule 33(d) allows a responding party to provide the propounding party with "reasonable opportunity to examine, audit or inspect such records and to make copies, compilations, abstracts, or summaries" from which the answer may be derived.
- Rule 34(a)(1)(A), like Rule 33(d), provides that a party may request an opportunity to test or sample ESI material sought under the rule in addition to inspecting and copying it.
- Rule 26(b)(5)(B) addresses claims of privilege or protection asserted after production.

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§4.52 2. Local Bankruptcy Rules; General Orders

Each federal judicial district in California has local bankruptcy rules governing procedures for adversary proceedings and contested matters. In addition, the bankruptcy court may have issued general orders, and individual bankruptcy judges may have instituted special procedures, affecting litigation or other proceedings in the bankruptcy court. See generally §§1.36-1.38. Local bankruptcy rules and procedures may address the form of papers filed with the court, service of process, status conferences, early meetings of counsel, pre-trial orders, discovery, and other litigation matters. It is essential for counsel to review all applicable local court rules, which vary substantially from district to district in California, before taking any action in bankruptcy court. Any local rules that conflict with the Bankruptcy Code or the Federal Rules of Bankruptcy Procedure, however, may be invalid. See *Steinacher v Rojas (In re Steinacher)* (BAP 9th Cir 2002) 283 BR 768. See Directory for website information of individual local bankruptcy districts.

PRACTICE TIP: Bankruptcy courts in California have been active in crafting rules to adopt new technologies. In all judicial districts, faxed documents may be acceptable for court filings in place of documents bearing original signatures, although counsel should check the applicable local rule for specific procedures. All bankruptcy courts in California have rules regarding electronic filing of bankruptcy cases, adversary proceedings, and pleadings, although some courts still require parties to deliver courtesy copies of documents to the applicable judge's chambers. Electronic filing options offer counsel 24/7 access to the bankruptcy court for filings, reduced paper flow from the law office to the court, easier case monitoring, and lower office overhead from savings in supplies, messenger services, and staff time preparing papers for court filings. Counsel regularly involved with bankruptcy courts in California should review the electronic filing rules and create a plan to maximize use of electronic tools. See §1.41.

The bankruptcy courts have authority to enforce their rules by levying sanctions against counsel who violate them. *Spacone v Burke (In re Truck-A-Way)* (ED Cal 2003) 300 BR 31, 35. The appellate courts defer to the trial court's interpretation of its local rules. *Guam Sasaki Corp. v Diana's, Inc*. (9th Cir 1989) 881 F2d 713. It is perilous for counsel not to be conversant with the local rules of any court in which counsel appears.

NOTE: Title 18 USC §158 requires the bankruptcy courts to establish procedures for the referral of cases involving materially fraudulent statements in bankruptcy schedules to federal criminal prosecutors.

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§4.53 3. Notice and Service of Process

Notices of proceedings in bankruptcy cases other than contested matters and adversary proceedings are governed by 11 USC §342, the detailed provisions of Fed R Bankr P 2002, Fed R Bankr P 3007 (for claims objections), and local bankruptcy rules. Section 342 addresses the requirements for notice of the case itself, notice to be given by the court clerk to consumer debtors, notice by the clerk or the debtor to creditors, and notice by a creditor to the court and the debtor of its address.

NOTE: Under 11 USC §342, a creditor can file a notice of address to be used during a particular case (11 USC §342(e)) or to be used on a national basis (11 USC §342(f)). Notices that are not given as required may not be effective. See 11 USC §342(g).

Among other things, Fed R Bankr P 2002 addresses notices of §341(a) meetings; notices of any proposed use, sale, or lease of property of the estate; notices of a hearing on approval of a compromise or settlement of a controversy; notices of a hearing on dismissal of a case or conversion to another chapter; notices of the time within which a proposed plan modification must be accepted or rejected; notices of a hearing on requests for compensation exceeding $1000; notices of the time for filing proofs of claim; and notices of the time fixed for filing objections and the hearing on Chapter 11 or 13 plans and disclosure statements. Counsel should refer directly to Fed R Bankr P 2002 for other detailed requirements. Federal Rule of Bankruptcy Procedure 3007 sets forth the requirements for notices in claims objection proceedings.

Service of process requirements for contested matters and adversary proceedings are subject to different rules, set forth in Fed R Bankr P 7004-7005, 9014, and local bankruptcy court rules. Note that, in contested matters, service of the initial motion is governed by Fed R Bankr P 9014, which incorporates parts of Rule 7004 (the same as for adversary proceedings), and not Fed R Bankr P 2002 (the general bankruptcy notice provisions). Other papers served after the initial motion are served as provided in Fed R Civ P 5(b) (Fed R Bankr P 7005(b)). See Fed R Bankr P 9014(b).

Service by first-class mail, as distinct from personal service generally required under Fed R Civ P 4, is permitted in bankruptcy court. Fed R Bankr P 7004(b).

Issues regarding service of process have generated a rash of appellate decisions. See *Rubin v Pringle (In re Focus Media, Inc.)* (9th Cir 2004) 387 F3d 1077 (service of complaint on counsel may be sufficient to qualify as service on party); *Beneficial Cal., Inc. v Villar (In re Villar)* (BAP 9th Cir 2004) 317 BR 88 (strict adherence to Fed R Bankr P 7004(b) required in serving motion to avoid lien). *Villar* may provide a standard defense in cases in which improper service preceded the granting of relief. Counsel should now be aware that failure to strictly observe Fed R Bankr P 7004's service requirements may result in the disapproval of an otherwise credible motion.

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§4.54 E. Federal Rules of Evidence

The Federal Rules of Evidence apply in all proceedings in the bankruptcy court, including both adversary proceedings and contested matters. Fed R Evid 101. Typically, motions in contested matters and adversary proceedings are resolved based on written declarations of witnesses submitted at a hearing at which counsel argue the law and the facts as presented in the declarations. In contested matters, the court may provide an opportunity for live cross-examination of the declarants. See generally §§4.43-4.49. These procedures have survived due process challenges and are permitted under Fed R Evid 611, which allows the court to "exercise reasonable control over the mode and order of interrogating witnesses and presenting evidence so as to (1) make the interrogation and presentation effective for the ascertainment of the truth, [and] (2) avoid needless consumption of time." Fed R Evid 611(a); *Adair v Sunwest Bank (In re Adair)* (9th Cir 1992) 965 F2d 777, 779.

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F. Abstention

§4.55 1. Case Abstention

The bankruptcy code provides that, after notice and a hearing, the court may dismiss a bankruptcy case or may suspend all proceedings in a bankruptcy case at any time. 11 USC §305(a). This section recognizes that there are cases for which it would be appropriate for the court to decline jurisdiction by dismissing the bankruptcy petition altogether. *In re Walter* (Bankr CD Cal 1989) 108 BR 244. A court's abstention under 11 USC §305(a) is from exercise of jurisdiction over the entire bankruptcy case. Abstention from jurisdiction over a particular proceeding within a case is governed by 28 USC §1334(c), discussed below. The usual standard for dismissal under 11 USC §305 is whether the interests of creditors and the debtor would be better served by dismissal of the case or suspension of *all* proceedings in the case. 11 USC §305(a)(1). The purpose of abstention from the entire case is to provide for the most efficient and economic administration of the estate. *In re Michael S. Starbuck, Inc.* (Bankr SD NY 1981) 14 BR 134.

The decision to abstain from hearing a case is discretionary and based on equitable concerns. *Cash Currency Exch. v Shine (In re Cash Currency Exch.)* (7th Cir 1985) 762 F2d 542. The court is likely to abstain from hearing a case when the interests of creditors and the debtor would be better served by such dismissal or suspension, or when there is a pending foreign proceeding under 11 USC §1515. *Eastman v Eastman (In re Eastman)* (BAP 9th Cir 1995) 188 BR 621; 11 USC §305(a). An abstention order under §305 is not reviewable by appeal or otherwise. 11 USC §305(c).

Local bankruptcy court rules may specify procedures for motions to abstain under §305. There is no specific time requirement for filing a motion to abstain from a case. However, because efficiency and economy of administration are the goals of such a motion, it should be filed early.

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§4.56 2. Adversary Proceeding Abstention

Short of abstaining from an entire case, federal district courts and, by reference, the bankruptcy courts, may also decline to hear a particular proceeding arising under the Bankruptcy Code or arising in or related to a case under the Bankruptcy Code. 28 USC §1334(c). Common circumstances that may lead a bankruptcy court to abstain from a proceeding include:

- Pending litigation in another forum involving nonbankruptcy issues;
- Complex litigation matters;
- Pending litigation in another forum on the eve of trial when substantial work has been done for trial in the other forum;
- Matters involving an area of law in which another court may have greater expertise than the bankruptcy court, such as family or tax law; and
- Concurrent consideration of the Bankruptcy Code and another federal statute.

Generally, the party seeking abstention has the burden of proof. *In re Condominium Ass'n of Plaza Towers South* (Bankr SD Fla 1984) 43 BR 18.

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§4.57 a. Discretionary Abstention

Abstention from particular proceedings may be discretionary or mandatory. A court *may* abstain from hearing a particular proceeding arising under the Bankruptcy Code or arising in or related to a case under the Bankruptcy Code. 28 USC §1334(c)(1). Abstention under §1334(c)(1) is not mandatory. Rather, it gives the district court (and by reference, the bankruptcy court) discretion to abstain from a particular proceeding "in the interest of justice, or in the interest of comity with State courts or respect for State law." 28 USC §1334(c)(1). See *Security Farms v International Bhd. of Teamster*s (9th Cir 1997) 124 F3d 999; *Taxel v Commerce Bank (In re World Fin. Servs. Ctr.)* (Bankr SD Cal 1986) 64 BR 980.

Factors bearing on whether discretionary abstention should be invoked include (*Moses H. Cone Mem. Hosp. v Mercury Constr. Corp.* (1983) 460 US 1, 74 L Ed 2d 765, 103 S Ct 927; *Christensen v Tucson Estates, Inc. (In re Tucson Estates, Inc.)* (9th Cir 1990) 912 F2d 1162):

- Concurrent state and federal court proceedings;
- Convenience of the federal forum;
- Avoidance of piecemeal litigation;
- The order in which the courts obtained jurisdiction;
- Whether either court has assumed jurisdiction over property;
- The source of legal precedent; and
- Whether the state court can adequately protect the rights of the parties seeking federal jurisdiction.

Other factors relevant to discretionary abstention include:

- The federal court's duty to decide matters properly before it;
- The plaintiff's choice of forum between state and federal court;
- The nature of the claims: whether purely state law matters are better addressed by a state court;
- Prejudice to involuntarily removed parties;
- Comity considerations;
- Economical or duplicative use of judicial resources; and
- The effect that the decision would have on the efficient and economic administration of the bankruptcy estate.

No single factor is necessarily decisive. See *Swift v Bellucci (In re Bellucci)* (Bankr ED Cal 1990) 119 BR 763.

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§4.58 b. Mandatory Abstention

A court *must* abstain from hearing a noncore proceeding based on a state law claim or cause of action *related to* a case under the Bankruptcy Code, but not *arising under* the Bankruptcy Code or *arising in* a case under the Bankruptcy Code, if the proceeding can be timely adjudicated in a state forum and the only basis for jurisdiction is that the debtor is in bankruptcy. 28 USC §1334(c)(2). For mandatory abstention to apply, all statutory requirements must be met. See *World Solar Corp. v Stinbaum (In re World Solar Corp.)* (Bankr SD Cal 1988) 81 BR 603.

Abstention under 28 USC §1334(c)(2) does not limit the applicability of the stay under 11 USC §362(a) with respect to actions against property of the estate. Thus, a state court action against the debtor cannot proceed without the bankruptcy court first granting relief from stay under §362(d). 28 USC §1334(c)(2); *Benedor Corp. v Conejo Enters. (In re Conejo Enters.)* (9th Cir 1996) 96 F3d 346. But if the bankruptcy court may or must abstain from a proceeding, "cause" may exist for granting stay relief under 11 USC §362(d)(1) to allow the state court action to proceed. *Christensen v Tucson Estates, Inc. (In re Tucson Estates, Inc.)* (9th Cir 1990) 912 F2d 1162.

There is some conflict as to whether mandatory abstention is applicable only if there is a pending case for the abstaining court to defer to. Compare *Taxel v Commerce Bank (In re World Fin. Servs. Ctr.)* (Bankr SD Cal 1986) 64 BR 980 (pending state court action is prerequisite for mandatory abstention) with *World Solar Corp. v Stinbaum (In re World Solar Corp.*) (Bankr SD Cal 1988) 81 BR 603 (pending state court action is not prerequisite for mandatory abstention if action can be timely filed in state forum).

Any bankruptcy court decision to abstain or not to abstain made under 28 USC §1334(c) (except a decision not to abstain under §1334(c)(2)) is appealable to the district court but not to the court of appeals or the U.S. Supreme Court. See 28 USC §1334(d).

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G. Removal

§4.59 1. Generally

In the context of bankruptcy litigation, removal means the transfer of a pending claim or cause of action from another court to the bankruptcy court. A party can remove any claim or cause of action in a civil action (except U.S. Tax Court proceedings or certain governmental enforcement actions) from either state or federal court to a bankruptcy court if the bankruptcy court has jurisdiction under 28 USC §1334. 28 USC §1452(a). Removal can occur even when the case has been suspended, dismissed, or closed. Fed R Bankr P 9027. In addition, a defendant can transfer an entire case from state court to bankruptcy court if there is jurisdiction under §1334. 28 USC §1441. See *Things Remembered, Inc. v Petrarca* (1995) 516 US 124, 133 L Ed 2d 461, 116 S Ct 494. The bankruptcy court's "related to" jurisdiction under 28 USC §1334(b) is very broad, and this jurisdictional requirement is usually not difficult to meet. *TIG Ins. Co. v Smolker (In re TIG Ins. Co.)* (Bankr CD Cal 2001) 264 BR 661. See also *Stratosphere Litig. LLC v Grand Casinos, Inc.* (9th Cir 2002) 298 F3d 1137 (litigation between nondebtor parties fell under "related to" jurisdiction when dispute involved executory contract). For discussion of bankruptcy court jurisdiction, see §§4.39-4.41.

Removal is intended to facilitate bankruptcy litigation and resolution of all claims against the debtor by permitting all matters relating to the debtor's bankruptcy case to be removed easily to the same forum. No judicial authorization is needed to remove a matter; the trial court immediately loses all jurisdiction over it.

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§4.60 2. Procedures for Removal

Detailed procedures for removal are set forth in Fed R Bankr P 9027. First, a notice of removal is filed with the federal district court for the district within which is located the state or federal court where the action is pending. Fed R Bankr P 9027(a)(1). Although Rule 9027(a)(1) refers to the "district court," it should be read to mean the bankruptcy court to which the applicable federal district court has referred all bankruptcy matters under 28 USC §157(a). See §1.44. The notice must also be filed with the court from which the action is being removed. On filing the notice in the court from which the action is removed, the proceedings in that forum are stayed. See Fed R Bankr P 9027(c).

NOTE: Under Fed R Bankr P 9027(a)(1), the initial destination of the removed proceeding is the bankruptcy court for the district in which the *litigation* was originally pending—not the district in which the *bankruptcy case* is pending. If the litigation matter and the bankruptcy case are in the same federal judicial district, then the removed action will rest in the bankruptcy court in which the underlying bankruptcy case is pending. If the litigation is pending in a federal judicial district that is different from the one in which the bankruptcy case was filed, the litigation can be further transferred to the district in which the bankruptcy is pending. See 28 USC §1412; Fed R Bankr P 7087. If the litigation is pending in a federal district court and the bankruptcy case is in the same district, the district court must be requested to refer the pending litigation to the bankruptcy court within its district.

The notice of removal is required to state (1) the facts justifying removal (*i.e.,* why bankruptcy jurisdiction exists), (2) whether the action is a core or noncore matter under 28 USC §157 (see §§4.39-4.41), and (3) if noncore, whether the party filing the notice consents to bankruptcy court jurisdiction. The notice of removal must be accompanied by copies of all pleadings and process (Fed R Bankr P 9027(a)(1)), but including only the summons, complaint, answer, any cross-complaints, and any motions for failure to state a claim, not the entire file. After removal, the bankruptcy judge may require the party filing the notice of removal to file in the bankruptcy court copies of all related records and papers filed in the court. Fed R Bankr P 9027(e). Counsel should review Fed R Bankr P 9027 carefully to ensure compliance with all of its requirements.

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§4.61 3. Timing

There are strict deadlines for removal. If litigation is pending at the time the bankruptcy petition is filed, a notice of removal can be filed only within the longest of (Fed R Bankr P 9027(a)(2)):

- 90 days postpetition if the pending action is not stayed by the bankruptcy filing;
- 30 days after entry of an order terminating a stay, if the pending action was stayed under 11 USC §362(a); or
- 30 days after a trustee is appointed in a Chapter 11 case, if less than 180 days after the case was filed.

If litigation is commenced after the filing of the bankruptcy case, a notice of removal can be filed only within the earlier of 30 days after the party seeking removal receives a copy of the initial pleading stating the claim to be removed, or 30 days after the party seeking removal receives a summons if the initial pleading was not served.

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§4.62 4. Practical Considerations

At times, removal may be a tempting strategy to derail litigation. In considering this tactic, however, counsel should be aware that, if the case is not likely to be retained by the bankruptcy court if the opponent seeks remand, removal may be deemed to be in bad faith and result in sanctions against the debtor and its counsel. See, *e.g., Miller v Cardinale (In re DeVille)* (BAP 9th Cir 2002) 280 BR 483, aff'd (9th Cir 2004) 361 F3d 539 (removal improper when its purpose was to delay state court trial; court properly awarded sanctions sua sponte). If removal to the bankruptcy court operates primarily for the benefit of insiders rather than the debtor's creditors, the matter is not likely to remain in bankruptcy court and will likely be returned to its original forum.

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§4.63 H. Remand

Once removed, a claim or cause of action may be remanded and sent back to the court from which it was removed. 28 USC §1452(b); Fed R Bankr P 9027(d). Remand serves as a judicial check on removal. Although a party may desire removal, a judge may remand on equitable grounds, including judicial economy, comity with other courts, relative expertise of the involved courts, and whether the action would or could be bifurcated. *TIG Ins. Co. v Smolker (In re TIG Ins. Co.)* (Bankr CD Cal 2001) 264 BR 661. A party seeking remand must do so by motion served on the parties to the removed claim or cause of action. Fed R Bankr P 9014, 9027(d). Remand orders are generally not appealable. 28 USC §§1447(d), 1452(b); *Benedor Corp. v Conejo Enters. (In re Conejo Enters.)* (9th Cir 1996) 96 F3d 346.

Forum shopping is against public policy; it is a misuse of judicial resources. *Canter Family Trust v Canter (In re Canter)* (9th Cir 2002) 299 F3d 1150, 1154. The bankruptcy court may exercise its discretion to abstain or remand if it believes that removal was undertaken solely to change the venue of the litigation.

PRACTICE TIP: In the authors' experience, bankruptcy judges may be inclined to grant remand motions in order to avoid protracted litigation proceedings in the bankruptcy court and to manage their caseload efficiently. Counsel should expect bankruptcy judges to be deferential to other judges, regardless of counsel's arguments that the bankruptcy court would be a fairer forum. Counsel may persuade a bankruptcy judge to deny a remand motion if counsel can demonstrate a risk of conflicting rulings or a possible material adverse effect on the bankruptcy estate.

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§4.64 I. Default Judgments

Default judgments are ordinarily disfavored, and the general rule is that cases should be decided on their merits whenever reasonably possible. If counsel has suffered a default judgment as the result of failure to timely perform an obligation imposed on counsel or client, Fed R Bankr P 9024 makes Fed R Civ P 60 (Relief From Judgment or Order) applicable in cases under the Bankruptcy Code, and Fed R Bankr P 7055 makes Fed R Civ P 55 applicable to default judgments. The standard for setting aside a default judgment under Fed R Civ P 55(c) is "good cause shown," which is more lenient than the "excusable neglect" standard of Fed R Civ P 60(b). *Educational Credit Mgmt. Corp. v Bernal (In re Bernal)* (BAP 9th Cir 1998) 223 BR 542, aff'd (9th Cir 2000) 207 F3d 595.

Good practice may require a default prove-up hearing, at least when the bankruptcy court is asked to enter a money judgment. *Liu v Liu (In re Liu)* (Bankr CD Cal 2002) 282 BR 904 (plaintiff creditor must prove up prima facie case when seeking default judgment against defendant debtor who failed to answer §523 nondischargeability claim). In determining whether to award a default, the court may consider (282 BR at 908):

> (1) the possibility of prejudice to the plaintiff, (2) the merits of plaintiff's substantive claim, (3) the sufficiency of the complaint, (4) the sum of money at stake in the action, (5) the possibility of a dispute on the material facts, (6) whether the default was due to excusable neglect, and (7) the strong policy favoring decisions on the merits.

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J. Jury Trials

§4.65 1. Jury Trials in Bankruptcy Court

Bankruptcy court adversary proceedings are not usually tried to a jury, and the bankruptcy court's right to conduct jury trials is limited. Title 28 USC §157(e) permits a bankruptcy judge to conduct a jury trial if there is a right to a jury trial in a proceeding that may be heard by the bankruptcy judge, the district court has specially designated the bankruptcy court to conduct the jury trial, and all parties consent. 28 USC §157(e). See generally *Malone v Norwest Fin. Cal.* (ED Cal 2000) 245 BR 389.

The U.S. Supreme Court has also considered the role of jury trials in bankruptcy court proceedings. In *Granfinanciera, S.A. v Nordberg* (1989) 492 US 33, 106 L Ed 2d 26, 109 S Ct 2782, the Court held that, in an action brought by a bankruptcy trustee to recover money subject to a fraudulent conveyance, the defendant who had *not* filed a proof of claim was entitled to a jury trial under the Seventh Amendment. In a later decision, *Langenkamp v Culp* (1990) 498 US 42, 112 L Ed 2d 343, 111 S Ct 330, the Court held that a creditor who *had* filed a proof of claim waived the right to a jury trial on counterclaims concerning the trustee's avoidance powers. Taken together, the two cases hold "that by filing a claim against a bankruptcy estate the creditor triggers the process of 'allowance and disallowance of claims,' thereby subjecting himself to the bankruptcy court's equitable power," for which there is no Seventh Amendment right to a jury trial. 498 US at 44, 112 L Ed 2d at 347 (citing *Katchen v Landy* (1966) 382 US 323, 336, 15 L Ed 2d 391, 400, 86 S Ct 467). See also *Sigma Micro Corp v Healthcentral.com (In re Healthcentral.com)* (9th Cir 2007) 504 F3d 775 (even when right to jury trial exists, bankruptcy court retains jurisdiction over pre-trial matters, including summary judgment motions); *Benedor Corp. v Conejo Enters. (In re Conejo Enters.)* (9th Cir 1996) 96 F3d 346; *Leslie Salt Co. v Marshland Dev. (In re Marshland Dev.)* (Bankr ND Cal 1991) 129 BR 626. The Federal Rules of Bankruptcy Procedure and some local court rules address jury trials in bankruptcy court. See Fed R Bankr P 9015. See also §1.56.

PRACTICE TIP: If a creditor expects the trustee or debtor to commence litigation against it in a bankruptcy case, creditor's counsel should give careful thought to whether the creditor should file a proof of claim in the case. If distributions from the estate are expected to be minimal and preservation of a jury trial right is important, no proof of claim should be filed. See generally §§3.19-3.32.

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§4.66 2. Jury Trials in Federal District Court

If a party to a bankruptcy court adversary proceeding wishes to have the matter tried to a jury, but the other party does not consent under 28 USC §157(e) (see §4.65), the party desiring the jury trial may make a motion in the applicable federal district court requesting the district court to withdraw the reference of the case from the bankruptcy court. See generally 28 USC §157(d); see also §1.49. For the reference of the proceeding to be withdrawn, the moving party must show cause. "Whether cause exists is a multi-factored determination. Among the proper considerations are the efficient use of judicial resources, delay and costs to the parties, uniformity of bankruptcy administration, the prevention of forum shopping, and other similar issues." *Malone v Norwest Fin. Cal.* (ED Cal 2000) 245 BR 389, 393. See also *Security Farms v International Bhd. of Teamsters* (9th Cir 1997) 124 F3d 999, 1008. Even if the district court conducts the jury trial, pre-trial proceedings and discovery matters may continue to be handled in the bankruptcy court.

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§4.67 K. Bankruptcy Settlements

Settlements of contested matters or adversary proceedings in bankruptcy cases require bankruptcy court approval on motion by the trustee (or debtor in possession in Chapter 11 cases) and after notice and a hearing. See Fed R Bankr P 9019. The bankruptcy court may approve the settlement only if it is "fair and equitable" to the creditors of the estate. *Protective Comm. for Independent Stockholders of TMT Trailer Ferry, Inc. v Anderson* (1968) 390 US 414, 424, 20 L Ed 2d 1, 88 S Ct 1157, 1163. The standards for bankruptcy court approval of settlements or compromises are well settled in the Ninth Circuit. The two leading cases are *Martin v Kane (In re A & C Props.)* (9th Cir 1986) 784 F2d 1377, followed by *Woodson v Fireman's Fund Ins. Co. (In re Woodson)* (9th Cir 1988) 839 F2d 610, both of which set forth four factors that the bankruptcy court is obliged to consider in evaluating the fairness and reasonableness of settlement agreements (*A & C Props.,* 784 F2d at 1381; *Woodson,* 839 F2d at 620):

- The probability of success in the litigation;
- The difficulties, if any, to be encountered in the matter of collection;
- The complexity of the litigation involved, and the expense, inconvenience, and delay necessarily attending it; and
- The paramount interest of the creditors and a proper deference to their reasonable views in the premises.

See also *Arden v Motel Partners (In re Arden)* (9th Cir 1999) 176 F3d 1226; *Goodwin v Mickey Thompson Entertainment Group, Inc. (In re Mickey Thompson Entertainment Group, Inc.)* (BAP 9th Cir 2003) 292 BR 415. The trustee or debtor in possession has the burden of proof on these issues, and the bankruptcy court usually accords deference to the business judgment of the trustee or debtor in possession that the settlement is in the best interests of the estate. 292 BR at 420.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/4 Bankruptcy Case Administration/§4.68 L. Appeals

§4.68 L. Appeals

Appeals are governed by Part VIII of the Federal Rules of Bankruptcy Procedure (Fed R Bankr P 8001-8020). In addition, some bankruptcy court districts have local rules relating to appeals. Any appeal from a judgment, order, or decree of the bankruptcy court, whether entered in an adversary proceeding or contested matter, is taken by filing a notice of appeal with the bankruptcy court no later than 14 calendar days after the date of the entry of the contested order or judgment. Fed R Bankr P 8001, 8002(a). See 28 USC §158(a). In *Brown v Wilshire Credit Corp. (In re Brown)* (9th Cir 2007) 484 F3d 1116, the Ninth Circuit clarified that a minute order, as a "memorialization of a ruling, not a judgment," did not trigger the time period for filing an appeal. A minute order, the court held, does not suffice as a judgment or order unless it contains "unequivocal judgment-granting language."

If the appeal is from an interlocutory order under 28 USC §158(a)(3), the notice must be accompanied by a motion for leave to appeal. Fed R Bankr P 8001(b), 8003. It is more common for interlocutory appeals to be heard in bankruptcy cases because the interlocutory order may resolve with finality an aspect of the case.

Under 28 USC §158(d), an appeal can be taken directly from the bankruptcy court to the Ninth Circuit Court of Appeals if the bankruptcy court, the district court, or the U.S. Bankruptcy Appellate Panel of the Ninth Circuit (BAP) (acting on the court's own motion or on request of a party to the appeal), or if all parties to the appeal acting jointly, certify that:

- The appeal involves an issue of law with respect to which there is no controlling authority or involves a matter of public importance;
- The appeal involves a question of law requiring resolution of conflicting decisions; or
- An immediate appeal to the court of appeals may materially advance the progress of the case or the proceeding.

Federal Rules of Bankruptcy Procedure 8001(f) includes additional detailed requirements for submitting a request for certification for a direct appeal.

NOTE: The BAP declined to certify the debtor's appeal of a bankruptcy court's dismissal for direct appeal because the case was filed before October 17, 2005, the effective date of BAPCPA. See *Berman v Maney (In re Berman)* (BAP 9th Cir 2006) 344 BR 612.

If 28 USC §158(d) is not invoked, bankruptcy appeals in the Ninth Circuit are routed first to the BAP for hearing (unless one or both parties have elected to have the applicable federal district court hear the appeal instead). The BAP hears appeals by consent of the parties. 28 USC §158(b)(1). The appellate panel consists of three sitting bankruptcy judges who hear bankruptcy appeals from federal judicial districts other than the panel members' home districts. 28 USC §158(b)(5). Because the jurisdiction of the BAP is consensual, any party to the appeal has an absolute right to have the appeal heard by the federal district court for the district in which the bankruptcy court sits. See 28 USC §158(c). A request to be heard by the district court must be filed concurrently by the appellee as a separate document with the notice of appeal or by the appellant within 30 days after service of the notice of appeal. 28 USC §158(c)(1).

NOTE: The BAP has its own set of local rules, which counsel must review in connection with any appeal. The BAP rules are available for downloading at the court's website listed in the Directory. Further, the BAP has recently published an attorneys' handbook concerning BAP appeals, also available from the court's website. See *Appeals Before the Bankruptcy Appellate Panel of the Ninth Circuit: A Manual for Litigants* (rev. Apr. 2009); see Directory for link to article.

In general, stays of bankruptcy court orders and judgments pending appeal are not automatic but require a separate motion by the appellant to the bankruptcy court. See Fed R Bankr P 8005. Certain bankruptcy court orders, however, are stayed for a period of 14 days after entry, unless the court orders otherwise, to allow the appellant time to request a stay pending appeal. See Fed R Bankr P 3020(e) (plan confirmation orders), 4001(a)(3) (orders granting relief from stay), 6004(h) (orders authorizing use, sale, or lease of property other than cash collateral), 6006(d) (orders authorizing assignment of executory contract or lease). An appeal of an order authorizing a sale or lease of property of the estate

will be rendered moot if the property is sold or leased to a bona fide third party purchaser or lessee, even if the purchaser or lessee had actual knowledge of the appeal, unless the order and the sale or lease were stayed pending appeal. 11 USC §363(m).

Among bankruptcy practitioners, folklore persists that a factually based appeal is better presented to the federal district court. As a trial court, the federal district court is thought to be more receptive to arguments regarding trial procedure or evidentiary errors. If the issue on appeal is unique to bankruptcy law and requires specialized bankruptcy expertise, however, the issue may find a better reception at the BAP.

For purposes of appeal to the Ninth Circuit Court of Appeals, a BAP order is final if it affirms or reverses a final bankruptcy court order. If a BAP order reverses and remands a matter for further fact-finding by the bankruptcy court, the Ninth Circuit applies a four-factor test to determine whether the BAP order is final. The factors are (*Scovis v Henrichsen (In re Scovis)* (9th Cir 2001) 249 F3d 975):

(1) The need to avoid piecemeal litigation;

(2) Judicial efficiency;

(3) The systemic interest in preserving the bankruptcy court's role as the finder of fact; and

(4) Whether delaying review would cause either party irreparable harm.

The Ninth Circuit may take jurisdiction even though the BAP has remanded a matter if the issue on appeal is legal and its resolution could dispose of the case or the proceeding and obviate the need for fact-finding, or would materially assist the bankruptcy court in disposing of the matter on remand. See *Scovis v Henrichsen (In re Scovis)*, *supra*.

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VII. BANKRUPTCY MEDIATION OR DISPUTE RESOLUTION PROGRAMS

§4.69 A. Generally

Counsel should be aware of mediation as a potential cost-effective alternative to bankruptcy court litigation. The bankruptcy courts in each federal judicial district in California have adopted alternative dispute resolution programs, which are called either mediation or dispute resolution programs. Information on each district's program can be found on the bankruptcy court's website (see Directory), in the local bankruptcy court rules, or both. Federal Rules of Bankruptcy Procedure 9019(a) provides that, on stipulation of the parties, the bankruptcy court may authorize any controversy affecting the estate to be submitted to final and binding arbitration.

Mediation is made possible because of the efforts of volunteer mediators, usually practicing bankruptcy lawyers, in each district. Generally, mediators are approved by the bankruptcy court, must complete a formal training program, and must agree to accept appointment to the panel of approved mediators for a given term. Mediation is usually voluntary by all parties, but judges in some districts may, either sua sponte or on request of a party, order a matter assigned to mediation over the objections of one or more parties.

Voluntary mediation is usually initiated by stipulation of the parties and a request to the bankruptcy court for an order assigning the matter to mediation. Once a case is assigned to mediation, the parties choose a mediator from the panel, who then communicates with counsel to schedule submission of mediation briefs and the actual mediation sessions. Each district has different rules concerning fees and costs for mediations. Certain consumer mediations may be handled by mediators on a pro bono basis, but mediators are generally paid for their services in protracted mediations of complex business disputes. In general, all mediation proceedings are confidential and may not be disclosed to any nonparty or to any court.

PRACTICE TIP: It is essential for counsel to consult and adhere to the local rules and formal guidelines for mediation programs in their district. The Central District of California in particular has highly structured procedures, prescribed forms, and specific filing requirements for the conduct of mediations in the district. See the Directory for court website information.

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§4.70 B. What Types of Cases May Be Mediated

Many types of disputes in the bankruptcy court are candidates for mediation, including adversary proceedings, contested matters, and other issues that may arise over the course of a bankruptcy case. Mediation is commonly used in nondischargeability litigation and some claims objection proceedings. Bankruptcy courts have found the process very useful in managing the onslaught of nondischargeability actions brought by credit card companies against consumer debtors without counsel. Mediation also may be quite productive and effective in bankruptcy cases involving spouses in the process of dissolving their marriage or business partners dissolving their partnership. A skilled mediator will recognize the emotional component in the dispute, help the parties set this aside, and find an objective, practical solution. Because of the litigation cost-savings it affords, mediation is particularly attractive to debtors.

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§4.71 C. Arbitration

Arbitration is required under many contracts in business transactions today. State and federal courts generally respect arbitration clauses. See generally *Kipperman v Kidder Peabody & Co. (In re Tre Scalini)* (Bankr CD Cal 1995) 178 BR 237, 239. See also *MBNA Am. Bank, N.A. v Hill* (2d Cir 2006) 436 F3d 104 (class action litigation over stay violation commenced after administration of bankruptcy estate subject to arbitration). See also §1.51.

PRACTICE TIP: Arbitration may be a useful tactical option for one party, especially in an adversary proceeding. Counsel should reflect on whether seeking mandatory arbitration offers advantages not present in a resolution by the bankruptcy court.

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VIII. CONVERSION OF CASE TO ANOTHER RELIEF CHAPTER OF BANKRUPTCY CODE

§4.72 A. Effect of Conversion

The legal effect of conversion of a bankruptcy case, regardless of the relief chapter under which it was filed, is governed by 11 USC §348. Although conversion will result in an order for relief under the new chapter, conversion does not affect the date of filing the case, commencement of the case, or the initial order for relief. 11 USC §348(a). The debtor's conversion rights are governed by 11 USC §706 in Chapter 7 cases, 11 USC §1112 in Chapter 11 cases, and 11 USC §1307 in Chapter 13 cases. In general, a debtor has a right to convert his or her case once to another relief chapter, as long as he or she would qualify for bankruptcy relief under that chapter pursuant to 11 USC §109. The debtor's conversion rights are limited to prevent the debtor from bouncing from chapter to chapter to avoid a pending issue or claim in a particular case. The bankruptcy court has authority under 11 USC §105 to deny a debtor's motion to convert based on a finding of bad faith. *Marrama v Citizens Bank (In re Marrama)* (2007) 549 US 365, 166 L Ed 2d 956, 127 S Ct 1105.

Conversion of a bankruptcy case is governed by Fed R Bankr P 1017, and may also be subject to local bankruptcy rules.

NOTE: BAPCPA added a number of provisions concerning conversion or dismissal of Chapter 7, 11, and 13 cases. In general, the amendments expand the grounds on which the court may convert or dismiss cases involving debtor bad faith, abuse, or violations of requirements of the Bankruptcy Code or court orders. See Fed R Bankr P 1017; 11 USC §707; see also §5.3

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§4.73 B. Chapter 7

As long as he or she otherwise qualifies under Chapter 11, 12, or 13 (see 11 USC §109), a debtor in Chapter 7 may convert to any of the other relief chapters at any time if the case has not previously been converted from one of those chapters to Chapter 7. 11 USC §706(a); see also §5.64. For example, if a debtor in Chapter 7 is an individual with secured debt of less than $1,010,650 and unsecured debt of less than $336,900, and the debtor has regular income, he or she will qualify to convert to Chapter 13. See 11 USC §109(e). This is probably the most common type of conversion, and is accomplished by motion to the bankruptcy court. The motion is usually granted immediately, without a hearing. Counsel should consult local bankruptcy court rules for specific procedures and forms. If the court believes that the conversion is in bad faith, however, the debtor has no absolute right to convert and the motion may be denied. *Marrama v Citizens Bank (In re Marrama)* (2007) 549 US 365, 166 L Ed 2d 956, 127 S Ct 1105, overruling *Croston v Davis (In re Croston)* (BAP 9th Cir 2004) 313 BR 447; *Rosson v Fitzgerald (In re Rosson)* (9th Cir 2008) 545 F3d 764.

Because the Bankruptcy Code does not provide for involuntary Chapter 13 cases, only the debtor can seek to convert a Chapter 7 case to Chapter 13, and not the court, the trustee, a creditor, or other party in interest, unless the debtor consents to such conversion. See 11 USC §706(c). There are several common situations in which a Chapter 7 debtor will seek to convert his or her case to Chapter 13, including situations in which:

- Cases are filed on or after the effective date of BAPCPA (October 17, 2005), when the debtor is subject to a presumption of abuse and his or her Chapter 7 case would otherwise be subject to dismissal under 11 USC §707(b)(1) based on his or her income levels (see 11 USC §707(b)(2));
- Property that the debtor believed would be exempt is ruled not to be exempt, and the Chapter 7 trustee begins taking steps to seize and liquidate that property;
- A complaint challenging the discharge of a debt is imminent or has been filed; or
- A transfer of money or property to friends or family members occurred before the filing and the Chapter 7 trustee is seeking to rescind the transfer.

Chapter 7 debtors also have the right to convert to Chapter 11 if facing these issues, although conversion to Chapter 11 is not common because of the expense and complexity of Chapter 11 cases. Chapter 11 is the only alternative, however, if the Chapter 7 debtor exceeds the asset and debt limits for Chapter 13, or if a party in interest other than the debtor is seeking to convert the Chapter 7 case without the debtor's consent. See 11 USC §706(b).

A Chapter 7 case filed by an individual debtor whose debts are primarily consumer debts may also be converted, with the debtor's consent, to Chapter 11 or 13 or dismissed by the court on its own motion or on a motion by the U.S. Trustee, the bankruptcy trustee, a creditor, or any other party in interest, after notice and a hearing, if the court finds that granting a discharge would be an abuse of the provisions of Chapter 7. 11 USC §707(b)(1).

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§4.74 C. Chapter 11

A debtor in Chapter 11 may voluntarily convert its case to Chapter 7 as long as a Chapter 11 trustee has not been appointed in the case, the case was not filed as an involuntary Chapter 11 case, and the case has not previously been converted. 11 USC §1112(a). Unless the court finds that appointment of a Chapter 11 trustee would better serve the interests of the estate (see 11 USC §1104(a)(3)) or the circumstances described in 11 USC §1112(b)(2) apply, a Chapter 11 case may also be converted or dismissed (whichever is in the best interests of creditors) on request of a creditor or other party in interest, after notice and a hearing, for "cause." 11 USC §1112(b)(1). See *Pioneer Liquidating Corp. v U.S. (In re Consol. Pioneer Mortgage Entities)* (BAP 9th Cir 2000) 248 BR 368, aff'd (9th Cir 2001) 264 F3d 803. Cause for purposes of 11 USC §1112(b)(1) are numerous, and are set forth in 11 USC §1112(b)(4).

The court cannot convert or dismiss the case if there are unusual circumstances specifically identified by the court that establish that conversion or dismissal is not in the best interests of the creditors and the estate. 11 USC §1112(b)(1). Further, under 11 USC §1112(b)(2), the court cannot convert or dismiss the case if the debtor or another party in interest objects and can establish that there is a reasonable likelihood that a plan can be confirmed within the time frames established by Chapter 11 or otherwise within a reasonable period of time, and that the grounds for relief include an act or omission (other than one amounting to "cause" under 11 USC §1112(b)(4)) for which there is reasonable justification and which will be cured within a reasonable time fixed by the court.

Because Chapter 12 and 13 cases are strictly voluntary, creditors and other parties in interest may not seek conversion of a Chapter 11 case to Chapter 12 or 13. Only a debtor may do so. See 11 USC §1112(d). Most of the conversions (or dismissals) in Chapter 11 cases are the result of a debtor's inability to timely propose, confirm, and implement a plan of reorganization. Bankruptcy courts will generally not allow a Chapter 11 debtor to sit idle in the case, to the detriment of creditors. Often, debtors will seek protection under Chapter 11 to maintain control over their assets and protect them from creditors, but are then unable to generate sufficient cash flow or asset sale proceeds to fund a plan of reorganization. Before BAPCPA, this situation usually resulted in conversion to Chapter 7, rather than dismissal, for the creditors' protection. On conversion, a Chapter 7 trustee will be appointed, just as if the case had been originally filed under Chapter 7, and the trustee will proceed to liquidate the available estate assets for the benefit of all creditors. After BAPCPA, conversion to Chapter 7 will require that an individual debtor meet the new eligibility requirements.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/4 Bankruptcy Case Administration/§4.75 D. Chapter 13

§4.75 D. Chapter 13

Conversion of Chapter 13 cases is governed by 11 USC §1307. Under 11 USC §1307(a), a debtor may convert a Chapter 13 case to Chapter 7 at any time with or without cause (assuming the debtor can meet the eligibility requirements). Any waiver of the debtor's right to convert is unenforceable. 11 USC §1307(a). A Chapter 13 debtor may wish to convert the case to Chapter 7 in the following situations:

- If the debtor is unable to make the plan payments, but still needs debt relief and a discharge, the debtor may convert to Chapter 7 rather than have the Chapter 13 case dismissed, assuming that the debtor qualifies for Chapter 7 relief;
- If all nonexempt property has been sold or otherwise transferred pursuant to the plan, Chapter 13 protection is no longer necessary; the case can be converted to Chapter 7 and proceed to a speedier discharge; or
- If the debtor has been unable to cure a default in a loan secured by a home or car under the plan and the property has been lost to foreclosure, there may be no other reason to maintain the case in Chapter 13.

The debtor may convert a Chapter 13 case to Chapter 7, at any time during the Chapter 13 proceedings, by filing a motion for conversion. See 11 USC §1307(a). Like a conversion motion in Chapter 7, the motion is usually granted immediately, without a hearing. Counsel should consult local bankruptcy court rules for specific procedures and forms.

The bankruptcy court may convert a Chapter 13 case to a Chapter 7 case, or may dismiss the Chapter 13 case, whichever is in the best interests of creditors and the estate, on request of the U.S. Trustee or a party in interest, after notice and a hearing, for cause. See 11 USC §1307(c), (e) for examples of cause.

Further, on motion of the U.S. Trustee or a party in interest, the bankruptcy court is required to convert or dismiss the debtor's Chapter 13 case, whichever is in the best interests of creditors, if the debtor fails to file tax returns as required by 11 USC §1308. 11 USC §1307(e).

A debtor (or the U.S. Trustee, a creditor, or any other party in interest) may convert a Chapter 13 case to Chapter 11 or 12 at any time before confirmation of the Chapter 13 plan, if the debtor meets the eligibility requirements for the other chapter. 11 USC §1307(d). Conversion from Chapter 13 to Chapter 11 or 12 requires prior notice and a hearing. A common example of a case that a Chapter 13 debtor would seek to convert to Chapter 11 is one in which the allowed claims in the case exceed the debt limits stated in 11 USC §109. Another example is a situation in which the debtor proposes, but the court is unwilling to confirm, a type of debt restructuring plan commonly referred to as a "pot plan." A pot plan is one in which payments to creditors will come from a single source, such as the sales proceeds from a piece of property to be sold under the plan. Because Chapter 13 plans are usually designed for monthly payments based on regular income, many bankruptcy courts before BAPCPA would not confirm a pot plan in Chapter 13. A pot plan can be confirmed under Chapter 11.

BAPCPA amended 11 USC §348(f) regarding the effect of converting a Chapter 13 case to a case under another relief chapter of the Bankruptcy Code. Under §348(f) as amended, on conversion from Chapter 13:

- Property of the estate in the converted case consists of that property of the estate as of the petition date of the Chapter 13 case that remains in the debtor's possession or control on the date of conversion, unless the case is converted in bad faith. In that situation, property of the estate in the converted case consists of the property of the estate in the Chapter 13 case as of the date of conversion. 11 USC §348(f)(1)(A), (f)(2).
- Valuations of property and of allowed secured claims in the Chapter 13 case continue to apply if the case is converted to Chapter 11 or 12, but not if the case is converted to Chapter 7. Allowed secured claims are reduced to the extent that they have been paid under the Chapter 13 plan. 11 USC §348(f)(1)(B).
- A secured creditor's claim continues to be secured unless the full amount of the claim (as determined under applicable nonbankruptcy law) has been paid in full as of the conversion date, regardless of any valuation of the claim made in the Chapter 13 case. 11 USC §348(f)(1)(C)(i).
- Unless a prebankruptcy default has been fully cured under the plan at the time of conversion, the default will have the same effect as it has under applicable nonbankruptcy law. 11 USC §348(f)(1)(C)(ii).

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§4.76 E. Time-Sensitive Issues Relating to Conversion

What if the debtor incurs a debt after the commencement of a Chapter 13 case, but before conversion of the case to Chapter 7? This issue may be of significant importance to creditors doing business with a Chapter 13 debtor postpetition. Bankruptcy Code §348(d) provides that such a claim is treated as if it had arisen just before the filing of the original bankruptcy petition, unless the claim is classified as an administrative expense or priority tax claim under 11 USC §503. If the debt was incurred for an expense that the creditor can establish provided a benefit to the estate and helped to preserve estate assets, it may qualify as an administrative claim with a higher priority than a general unsecured claim in Chapter 7.

As set forth in 11 USC §348(f), the determination of "property of the estate" under 11 USC §541 on conversion from Chapter 13 to Chapter 7 is based on the property that the debtor owned as of the date of the original Chapter 13 filing, not the date of conversion. For example, if a Chapter 13 debtor acquires an interest in real estate after the filing of the petition and then converts his or her case to Chapter 7, that real estate will not become property of the Chapter 7 estate available for liquidation by the Chapter 7 trustee. Moreover, only property that remains in the debtor's possession is considered property of the estate (11 USC §348(f)(1)(A)), so any preconversion transfers of property by the debtor cannot be avoided by the Chapter 7 trustee absent a finding of bad faith.

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§4.77 F. Valuation Issues; Status of Security

Under 11 USC §348(f)(1), valuations of property and allowed secured claims in a Chapter 13 case are carried over only after conversion to Chapter 11 or 12, but not in a conversion to Chapter 7. Secured claims are reduced to the extent they have been paid under the Chapter 13 plan. 11 USC §348(f)(1)(B). Secured claims continue to be secured by the same collateral after conversion unless the full amount of the claim (determined under applicable nonbankruptcy law) has been paid in full as of the conversion date, notwithstanding any valuation of the claim in the Chapter 13 case. Any prebankruptcy default continues to have the effect given by applicable nonbankruptcy law, unless the default has been fully cured by the conversion date. 11 USC §348(f)(1)(C).

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§4.78 G. Bad Faith Conversion

If the conversion of the case is found to have been in bad faith as provided in 11 USC §348(f)(2), property of the estate will include all property acquired postpetition but preconversion. Bad faith conversion is most often found when there have been multiple filings and conversions or dismissals, and the debtor has made little or no effort to comply with Chapter 13 requirements.

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IX. DISMISSAL OF BANKRUPTCY CASE

§4.79 A. Generally

Bankruptcy Code §349 governs the legal effect of dismissal of cases under all relief chapters of the Bankruptcy Code. If a case is dismissed, unless the bankruptcy court orders otherwise, the debtor steps back into his or her legal position just before filing the bankruptcy petition. The automatic stay is no longer in effect, any discharge is revoked, all debt collection activities by creditors may resume, all legal actions or proceedings against the debtor or the debtor's property may proceed, and all property of the estate revests in the debtor. See 11 USC §349. The grounds for dismissal of cases vary depending on the specific relief chapter under which the case was filed, and are described in §§4.80-4.91.

Dismissal will not prevent the debtor from refiling a bankruptcy petition later, except as provided in 11 USC §109(g) (prohibition on refiling for 180 days if case dismissed for the debtor's willful failure to obey court orders or to make required court appearances, or case dismissed at debtor's request after motion for relief from stay granted). 11 USC §349. Frequently, the court entering the dismissal order will prohibit the debtor from refiling for a certain period of time if it is clear that the debtor is abusing the bankruptcy process through, *e.g.*, serial filings, avoiding court appearances, or failing to comply with deadlines for filing documents.

NOTE: BAPCPA introduced a number of provisions intended to prevent debtors from making serial bankruptcy filings by removing the protection of the automatic stay in the refiled case(s). See §§4.3-4.4, 4.14, 4.23.

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B. Dismissal of Chapter 7 Case

§4.80 1. Dismissal for "Cause" Under §707(a)

Bankruptcy Code §707 governs dismissal of Chapter 7 cases. Under 11 USC §707(a), the bankruptcy court may dismiss a Chapter 7 case after notice and a hearing, but only for "cause." Cause may include concealment of assets, unreasonable delay by the debtor that is prejudicial to creditors, nonpayment of court fees, or the debtor's general failure to comply with his or her statutory duties outlined in 11 USC §521. See 11 USC §707(a); *Neary v Padilla (In re Padilla)* (9th Cir 2000) 222 F3d 1184. For example, if all documents required to be filed under 11 USC §521 are not filed on a timely basis, or if the debtor fails to attend the §341(a) meeting of creditors on two successive occasions, the case will usually be dismissed automatically on motion of the U.S. Trustee. Chapter 7 trustees often bring motions to dismiss under 11 USC §707(a) if the trustee was unable to object to the debtor's discharge on a timely basis, yet the debtor continues to abuse the bankruptcy system, fails to cooperate, and continues with other bad acts. If the trustee is successful, the debtor's discharge would be revoked once the case is dismissed. The Ninth Circuit has ruled, however, that the debtor's bad faith alone does not constitute grounds for dismissal under 11 USC §707(a). Instead, the debtor's acts must be redressed under more specific provisions of the Bankruptcy Code, such as the "abuse" provisions of 11 USC §707(b). *Neary v Padilla (In re Padilla), supra*. See §§4.81-4.84.

A Chapter 7 debtor may bring a motion under 11 USC §707(a) to dismiss the case for cause, but he or she must demonstrate that the dismissal will not be prejudicial to the creditors in the case. *In re Stephenson* (Bankr WD Okla 2001) 262 BR 871. For example, if the debtor has nonexempt assets that became property of the estate on filing, the debtor will not normally be able to dismiss the case unless he or she can prove that all creditors consent to the dismissal or that all creditors' claims have been paid. To protect the creditors' rights to share proportionately in the assets of the estate, the court will require the Chapter 7 trustee to administer the case. See *In re Eichelberger* (Bankr ED Mo 1998) 225 BR 437.

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2. Dismissal for "Abuse" Under §707(b)

§4.81 a. Generally

Bankruptcy Code §707(b) provides that the bankruptcy court, after notice and a hearing, may dismiss a Chapter 7 case filed by an individual debtor whose debts are "primarily consumer debts" (or, with the debtor's consent, convert the case to Chapter 11 or 13) on the court's own motion or a motion of the U.S. Trustee, the bankruptcy trustee, or any party in interest, if the court finds that granting the debtor Chapter 7 relief would constitute "abuse" of the provisions of Chapter 7. 11 USC §707(b)(1). (BAPCPA replaced the previous "substantial abuse" threshold for §707(b) dismissals with a simple "abuse" standard.) The term "consumer debts" is defined in 11 USC §101(8) as debts incurred by an individual primarily for personal, family, or household purposes. The court may take into account home mortgage debt when determining the extent of consumer debt. *Price v U.S. Trustee (In re Price)* (9th Cir 2004) 353 F3d 1135.

Because Chapter 13 cases are strictly voluntary (see 11 USC §303(a)), the court cannot compel a debtor to convert a Chapter 7 case to Chapter 13. If a motion to dismiss is brought under §707(b), however, the debtor may voluntarily convert the case to Chapter 13 in response.

NOTE: Charitable contributions are in a protected category under 11 USC §707(b). The court may not take into consideration a debtor's contributions to a qualified religious or charitable organization to the extent the contributions do not exceed 15 percent of the debtor's gross income. 11 USC §707(b)(1). See *Drummond v Cavanagh (In re Cavanagh)* (BAP 9th Cir 2000) 250 BR 107.

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§4.82 b. Presumption of Abuse; Means Test

Abuse is presumed to exist under 11 USC §707(b)(2)(A) if the debtor does not qualify under the "means test," as follows: The presumption is triggered if the debtor's current monthly income (as defined in 11 USC §101(10)(A)), reduced by allowable monthly expenses (see 11 USC §707(b)(2)(A)(ii)-(iv)), and multiplied by 60 is not less than the lesser of:

- The greater of (1) 25 percent of the debtor's nonpriority unsecured claims in the case, or (2) $6575; or
- $10,950.

See 11 USC §707(b)(2)(A)(i). The bankruptcy courts provide an official form to be used in calculating the means test for Chapter 7. See Official Form B22A (Chapter 7 Statement of Current Monthly Income and Means-Test Calculation), which is available to download. See Directory for website information.

The presumption of abuse can be rebutted under 11 USC §707(b)(2)(B)(i) only if the debtor can establish special circumstances, such as a serious medical condition or a call to active duty in the Armed Forces, to the extent that the circumstances justify additional expenses or adjustments of current monthly income for which there is no reasonable alternative. There are extensive documentation requirements for special circumstances, and the additional expenses must cause the debtor's net income to dip below a formula specified in the statute. See 11 USC §707(b)(2)(B)(ii)-(iv).

The means test does not apply, and the court may not dismiss or convert a case based on the means test, if the debtor is a disabled veteran and his or her indebtedness occurred primarily during a period when he or she was on active duty or performing a homeland defense activity. 11 USC §707(b)(2)(D).

If the presumption of abuse does not arise, or the presumption is rebutted, 11 USC §707(b)(3) nevertheless requires the court to consider whether the debtor filed the petition in bad faith or whether the totality of the circumstances of the debtor's financial situation demonstrates abuse (*e.g.,* whether the debtor seeks to reject a personal services contract and what is the debtor's financial need for such rejection).

The presumption of bad faith will not arise in a case in which the debtor's current income falls below the median in the state in which the debtor files. "Current monthly income" is defined as the debtor's average monthly income for the 6 calendar months prior to the filing of the bankruptcy case. 11 USC §101(10A). Nevertheless, for a debtor whose income fell below the median during the 6 months prior to the bankruptcy, but whose income has increased substantially after it, the court may still consider the increased income in determining whether the case was filed in bad faith and should be dismissed. *In re Pak* (Bankr ND Cal 2006) 343 BR 239.

See additional discussion of means test in §§4.83-4.84, 5.54.

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§4.83 c. Standing; Attorney Fees

The impact of the means test on potential Chapter 7 debtors has been ameliorated somewhat by new standing requirements for dismissal motions under 11 USC §707(b). If the current monthly income of the debtor and the debtor's spouse combined, multiplied by 12, as of the petition date, is *equal to or less than* the applicable state median family income (as defined in 11 USC §101(39)(A)) based on the number of persons in the debtor's household (see 11 USC §707(b)(7)(A)), the means test does not apply and neither the court, the U.S. Trustee, the bankruptcy trustee, nor any party in interest has standing to bring a motion under 11 USC §707(b)(2) based on the "means test" presumption of abuse. If, however, the debtor's income (along with the income of the debtor's spouse in a joint case) is at or below the applicable state median, a §707(b) motion to dismiss may nevertheless be brought under general grounds of abuse (see 11 USC §707(b)(3); see also §4.82), but only the court, the U.S. Trustee, or a bankruptcy administrator has standing to bring the motion. If the debtor's income exceeds the applicable state median income figures, all parties in interest have standing to bring a §707(b) motion.

If the court denies a §707(b) motion filed by the creditor and finds that the creditor violated Fed R Bankr P 9011, or that the creditor's counsel violated 11 USC §707(b)(4)(C) and that the motion was made solely to coerce the debtor into waiving a right guaranteed under the Bankruptcy Code, then the court may award the debtor its reasonable attorney fees and costs in contesting the motion. 11 USC §707(b)(5).

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§4.84 d. Notice of Presumption of Abuse; United States Trustee Review

Under 11 USC §342(d), the clerk of the bankruptcy court is required to give notice to all creditors within 10 days after the petition date that the presumption of abuse has arisen in the debtor's case. To facilitate this requirement, the Judicial Conference of the United States has issued Official Form B22A (Chapter 7 Statement of Current Monthly Income and Means-Test Calculation), which is available to download. Local bankruptcy courts may provide their own version on their local website. See Directory for additional information. The form is to be filed by the debtor with the bankruptcy court along with the debtor's bankruptcy schedules. This form can and should be used as a worksheet in preliminary means-test calculations.

Under 11 USC §704(b)(1), the U.S. Trustee (or bankruptcy administrator) is required to review all papers filed by the debtor and, no more than 10 days after the date of the first §341(a) meeting, file a statement with the court concerning whether the debtor's case involves a presumption of abuse under 11 USC §707(b). The court, in turn, is required to provide a copy of the U.S. Trustee's statement to all creditors. Within 30 days after filing this statement, the U.S. Trustee is required to file either a motion to dismiss or convert under 11 USC §707(b) or a statement setting forth the reasons why the U.S. Trustee does not believe such a motion is appropriate.

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§4.85 3. Dismissal for Bad Faith

Bankruptcy Code §707(b)(3) contains two tests to determine whether an abuse of Chapter 7 has occurred, even if the presumption of abuse (see §§4.82-4.84) has not arisen or has been rebutted: (1) whether the debtor filed the petition in bad faith (11 USC §707(b)(3)(A)), or (2) whether "the totality of the circumstances… of the debtor's financial situation demonstrates abuse" (11 USC §707(b)(3)(B)). These tests apply even if the debtor's income is below the state median.

In *In re Mitchell* (Bankr CD Cal 2006) 357 BR 142, the bankruptcy court granted a motion of the U.S. Trustee to dismiss a Chapter 7 case for bad faith under 11 USC §707(b)(3)(A). Under §707(b)(3)(A), the bankruptcy court has discretion to dismiss the case even if the Bankruptcy Code provides another remedy for a debtor's bad faith acts.

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4. Dismissal for Failure to Obtain Credit Counseling

§4.86 a. Generally

A controversy has arisen among several bankruptcy courts regarding the effect of a bankruptcy case filed by an individual debtor who has not first obtained credit counseling in accordance with 11 USC §109(h). Section 109(h) allows a waiver of this requirement only in a few limited circumstances.

Most courts treat the failure to comply with §109(h) as incurable and conclude that the debtor cannot remain in bankruptcy, no matter how good the debtor's excuse or reason for noncompliance. If the debtor does not qualify for one of the specific statutory waivers, that is the end of the matter. *In re Mingueta* (Bankr CD Cal 2006) 338 BR 833; *In re Taylor* (Bankr ND Cal, Mar. 9, 2006, No. 05-35381DM) 2006 Bankr Lexis 689. See also *Dixon v LaBarge (In re Dixon)* (BAP 8th Cir 2006) 338 BR 383; *In re Elmendorf* (Bankr SD NY 2006) 345 BR 486.

The minority approach, which appears to be gaining momentum, is that the court has jurisdiction to allow the case to continue even absent compliance with §109(h) or qualification for one of the statutory waivers. *In re Manalad* (Bankr CD Cal 2007) 360 BR 288; *In re Hess* (Bankr Vt 2006) 347 BR 489. See also *Mendez v Salven (In re Mendez)* (BAP 9th Cir 2007) 367 BR 109 (refusing to dismiss voluntary Chapter 7 case at debtor's request for her failure to comply with §109(h)); *In re Parker* (Bankr ND Ga 2006) 351 BR 790.

In *Manalad,* Chief Judge Zurzolo, joined by several but not all of his colleagues on the Central District of California bench, held that the court has discretion to determine whether a bankruptcy case should be dismissed based on ineligibility under §109(h). *Manalad* sets out a three-part test: The court need not dismiss the case if the debtor (1) has a reasonable explanation for noncompliance, (2) participates in budget and credit counseling once the debtor learns it is required, and (3) the counseling session concludes that the individual's debts could not have been repaid outside of bankruptcy.

Courts that have concluded that noncompliance with §109(h) is incurable have come up with three distinct ways of disposing of the noncompliant cases. Most courts simply dismiss the case. This procedure was followed in *Mingueta* and *Taylor*. Alternatively, the courts in *In re Rios* (Bankr SD NY 2005) 336 BR 177 and *In re Elmendorf, supra,* held that a petition filed without compliance with §109(h) is void ab initio, and therefore the petition must be stricken. Lastly, *In re Burch* (Bankr ND NY, Oct. 23, 2006, No. 06-10228) 2006 Bankr Lexis 3551 stakes out an intermediate position. In *Burch,* the court decided to dismiss the petition as distinct from dismissing the case. See also *In re Falcone* (Bankr D Mass 2007) 370 BR 462 (discussing dismissing case versus striking petition). See §4.87 for discussion of the status of the automatic stay.

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§4.87 b. Impact on Automatic Stay

Each of the three methods of disposing of noncompliant bankruptcy cases discussed in §4.86 has led to different results concerning the status of the automatic stay, both in the noncomplying bankruptcy case and in any subsequent bankruptcy case.

The courts in *In re Rios* (Bankr SD NY 2005) 336 BR 177 and *In re Elmendorf* (Bankr SD NY 2006) 345 BR 486 held that a petition filed without compliance with 11 USC §109(h) is void ab initio, and as a result, the stay never goes into effect. Following this reasoning, the court in *In re Salazar* (Bankr SD TX 2006) 339 BR 622 refused to invalidate a foreclosure sale that took place after a bankruptcy was filed without compliance with §109(h).

The court in *In re Brown* (Bankr D Md 2006) 342 BR 248 reached the opposite conclusion, holding that a petition filed without compliance with §109(h) nevertheless commenced a case under the Bankruptcy Code and invoked the automatic stay. Notwithstanding the subsequent dismissal of the case, any creditor actions taken in violation of the stay while it was operative were void. In *Brown,* the court even awarded consequential damages to the debtor, but stopped short of awarding punitive damages.

In *In re Burch* (Bankr ND NY, Oct. 23, 2006, No. 06-10228) 2006 Bankr Lexis 3551, the court decided to dismiss the petition as distinct from dismissing the case. Under this approach, the stay did go into effect while the petition was pending.

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§4.88 c. Involuntary Petitions

An individual debtor against whom an involuntary Chapter 7 petition has been filed typically would not have obtained credit counseling within 180 days prior to the filing of the involuntary petition or qualify for any of the statutory or judicially created exceptions. BAPCPA left open the issue of the effect of noncompliance with 11 USC §109(h) on an involuntary case.

PRACTICE TIP: Counsel representing a debtor in an involuntary case should consider the possibility of moving for dismissal if the debtor has not completed credit counseling and does not wish to remain in bankruptcy. The credit counseling issue should be timely raised by the debtor or else it might be deemed waived. See *Marlar v Williams (In re Williams)* (8th Cir 2005) 432 F3d 813, 814; *McCloy v Silverthorne (In re McCloy)* (5th Cir 2002) 296 F3d 370, 375. But see *Mendez v Salven (In re Mendez)* (BAP 9th Cir 2007) 367 BR 109 (refusing to dismiss voluntary case for noncompliance with credit counseling requirement).

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§4.89 5. Dismissal for Failure to File Required Information or Provide Copy of Tax Return

If an individual debtor in a Chapter 7 or 13 case fails to file the information required to be filed under 11 USC §521(a) within 45 days after the petition date, the case is subject to automatic dismissal on the 46th day after the petition date. 11 USC §521(i)(1). Further, if an individual debtor in a Chapter 7 or 13 case fails to provide a copy of his or her most recent federal income tax return to a creditor on request at the same time that the debtor provides a copy of such return to the trustee, the case is subject to automatic dismissal unless the debtor can demonstrate that the failure to provide the copy is due to circumstances beyond the debtor's control. 11 USC §521(e)(2)(C). Finally, if the debtor fails to file a tax return that comes due after the petition date (or fails to obtain an extension of the due date for the return), the IRS may seek dismissal under 11 USC §521(j).

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§4.90 C. Chapter 11

Dismissal of a Chapter 11 case is governed by 11 USC §1112(b), the same statute governing conversion of a Chapter 11 case to Chapter 7 on request of a party in interest or the U.S. Trustee for cause. See §4.74. Under 11 USC §1112(b), the court has discretion either to convert or dismiss the case, whichever is in the best interests of creditors. The court will generally not dismiss the case if there is any possible recovery for creditors. Typically, the U.S. Trustee will bring a motion under §1112(b) if the debtor in possession has failed to comply with Chapter 11 procedural requirements or has failed to file and confirm a plan of reorganization by the deadline set by the bankruptcy court. The bankruptcy court itself may also issue an order to show cause why the case should not be dismissed or converted under 11 USC §1112, and is likely to do so if the case seems to be languishing. Finally, creditors or other parties in interest may seek to dismiss or convert the debtor's Chapter 11 case under §1112 in an attempt to protect assets from being dissipated over the course of the Chapter 11.

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§4.91 D. Chapter 13

A Chapter 13 debtor has a nearly absolute right to dismiss his or her case at any time under 11 USC §1307(b) on motion to the bankruptcy court. See *Nash v Kester (In re Nash)* (9th Cir 1985) 765 F2d 1410. The concept of "best interests of creditors" is not relevant to the debtor's rights under §1307(b). If the debtor is abusing Chapter 13, however, the U.S. Trustee, the Chapter 13 trustee, a creditor, or any other party in interest can bring a dismissal motion under 11 USC §1307(c), which permits the court to convert or dismiss the case (whichever is in the best interests of creditors and the estate) for "cause." See §4.75. Moreover, the court may prohibit the debtor from refiling under any Bankruptcy Code chapter for a period of 180 days. See 11 USC §109(g).

"Cause" under 11 USC §1307(c) may include (1) unreasonable delay by the debtor that is prejudicial to creditors, (2) nonpayment of administrative fees, (3) failure to file a Chapter 13 plan on a timely basis, (4) failure to pay any domestic support obligation due postpetition, or (5) failure to make plan payments or other material default under the plan. See §4.75. A Chapter 13 case may also be dismissed for bad faith. See *Leavitt v Soto (In re Leavitt)* (9th Cir 1999) 171 F3d 1219 (dismissal with prejudice under totality of circumstances test); *Eisen v Curry (In re Eisen)* (9th Cir 1994) 14 F3d 469. On motion of the U.S. Trustee or a party in interest, the bankruptcy court is required to convert or dismiss the debtor's Chapter 13 case, whichever is in the best interests of creditors, if the debtor fails to file tax returns as required by 11 USC §1308. 11 USC §1307(e). See §4.85. The U.S. Trustee may seek a dismissal if the debtor fails to appear at the §341(a) meeting or fails to file the required schedules and Statement of Financial Affairs. The Chapter 13 trustee routinely brings motions to dismiss if the debtor fails to make plan payments, or if the plan becomes infeasible. See generally 11 USC §1307(c). For example, if a debtor misses a few monthly plan payments, the Chapter 13 trustee is likely to file a motion to dismiss, whereupon the debtor has an opportunity to cure the deficiency. Cure may include modification of the plan to extend the term and to adjust the payment amounts. In a Chapter 13 case, a discharge is issued only after all plan payments have been made (see 11 USC §1328(a)) or in hardship cases (see 11 USC §1328(b)). If a dismissal motion is made toward the end of the plan term, the debtor may lose the right to a discharge, which can be quite difficult and frustrating. Counsel should monitor the debtor's compliance throughout the term of the plan to avoid any complications at the end.

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X. CLOSING A BANKRUPTCY CASE

§4.92 A. Generally

Once a bankruptcy estate has been fully administered, that is, once all claims have been resolved and all property of the estate has been distributed to creditors or others entitled to receive distributions, the case can be formally closed pursuant to 11 USC §350(a). In Chapter 7 and 13 cases, the actual closing of the case is a clerical task, which is completed once the bankruptcy court has received the final report and accounting from the trustee. See Fed R Bankr P 5009. In Chapter 11, a case is closed by court order on motion of a party in interest or on the court's own motion. Fed R Bankr P 3022.

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§4.93 B. Chapter 7 "Asset" Case

In Chapter 7 "asset" cases, after the Chapter 7 trustee has sold all nonexempt property and has reviewed and resolved all claims filed in the case, the closing process can begin. First, the trustee will file a final tax return for the bankruptcy estate. The IRS then has 60 days, under the prompt determination rules of 11 USC §505(b)(1)(A), to decide whether to audit the return. If the IRS elects to examine the return, it has 180 days within which to complete its examination, unless this deadline is extended by the bankruptcy court. See 11 USC §505(b)(1)(B). After all tax issues are resolved, the trustee prepares a final report, summarizing what took place during the administration of the case and estimating the amounts to be distributed to creditors, including the amounts of administrative claims of attorneys and other professionals and the trustee. See Fed R Bankr P 5009. The final report is reviewed by the U.S. Trustee and then forwarded to the bankruptcy court. The court usually sets the matter for a final hearing so that any objections to the report can be heard and resolved, all administrative claims can be approved or adjusted, and the proposed distributions and case closing can be approved. Once the judge has signed the order on the final report, the trustee is authorized to issue checks for payments to creditors. The entire process may be quite lengthy, extending over months or even years if there is protracted claims litigation.

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§4.94 C. Chapter 7 "No Asset" Case

The closing process for "no asset" Chapter 7 cases, which constitute the majority of all bankruptcy cases filed, is much more streamlined. After the Chapter 7 trustee concludes the §341(a) meeting of creditors, he or she submits a memorandum to the bankruptcy court clerk indicating that the debtor has no assets available for distribution to creditors. Thereafter, the trustee files a "no asset" report, indicating that he or she does not intend to administer any assets in the case. Once the 60-day deadline for a creditor to file a nondischargeability complaint has passed (see 11 USC §§523, 727; Fed R Bankr P 4004(a)), the clerk will issue the debtor's discharge and shortly thereafter will close the case. Closing involves the clerical task of placing a document in the case file, indicating that the case is closed, and noting the same on the court docket.

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§4.95 D. Chapter 13 Case

In a Chapter 13 case, after all payments under the confirmed Chapter 13 plan are made, the Chapter 13 trustee will begin a review of the file for closing. If all allowed claims have been paid in accordance with the plan terms, the trustee will submit a final report and accounting to the bankruptcy court requesting that the case be closed. See Fed R Bankr P 5009. If no party in interest objects, the bankruptcy court clerk will then issue the debtor's discharge and close the case.

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§4.96 E. Chapter 11 Case

A Chapter 11 case may be closed after the plan is confirmed, substantially all distributions under the confirmed plan have been made, and other substantive terms of the plan are implemented. See Fed R Bankr P 3022. Quarterly fees due to the U.S. Trustee under 28 USC §1930(a) in a Chapter 11 case must continue to be paid even after confirmation of the plan, until the case is formally closed. *Tighe v Celebrity Home Entertainment, Inc. (In re Celebrity Home Entertainment, Inc.)* (9th Cir 2000) 210 F3d 995. To initiate the closing of the case, the debtor files a motion for entry of a final decree. The court may then find that the Chapter 11 estate has been fully administered and issue the final decree closing the case under 11 USC §350(a). See Fed R Bankr P 3022.

PRACTICE TIP: Because entry of a final decree will cut off the obligation to pay the U.S. Trustee's quarterly fees, it is becoming customary to include in Chapter 11 reorganization plans a provision that the final decree can be issued after substantial consummation of the plan, subject to a broad right to reopen the case if necessary.

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§4.97 F. Reopening Bankruptcy Case

Bankruptcy Code §350(b) permits the court to reopen a previously closed case "to administer assets, accord relief to the debtor, or for other cause." 11 USC §350(b). Section 350(b) applies only to cases formally closed under 11 USC §350(a), not to cases that have been dismissed by the bankruptcy court. *Armel Laminates, Inc. v Lomas & Nettleton Co. (In re Income Prop. Bldg.)* (9th Cir 1982) 699 F2d 963. A Chapter 7 case can be reopened under 11 USC §350(b) so that the debtor may add a prepetition creditor previously omitted from the schedules, and the debtor will be entitled to a discharge of liability on that creditor's claim under 11 USC §727(b). See *In re Hendricks* (Bankr CD Cal 1988) 87 BR 114. See *Goswami v MTC Distrib. (In re Goswami)* (BAP 9th Cir 2003) 304 BR 386, in which the court allowed a debtor to reopen the case to amend Schedule C, which the court found could be amended up until the case was closed again (after reopening). The decision of whether to reopen a case is discretionary with the bankruptcy court. *Elias v U.S. Trustee (In re Elias)* (9th Cir 1999) 188 F3d 1160. See also *Curry v Castillo (In re Castillo)* (9th Cir 2002) 297 F3d 940; *McGhan v Rutz (In re McGhan)* (9th Cir 2002) 288 F3d 1172. In *Lopez v Speciality Restaurants Corp. (In re Lopez)* (BAP 9th Cir 2002) 283 BR 22, the court ruled that a debtor's bad faith in failing to schedule an asset (such as a lawsuit) is irrelevant to the reopening of a case if the reopening will benefit the creditors in the case. Some local bankruptcy courts have posted guidelines for reopening cases on their websites. See Directory for website information.

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Reorganization and Liquidation

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I. OVERVIEW OF PLANS

§5.1 A. Reorganization Plans

The reorganization plan is the key feature differentiating bankruptcy cases under Chapters 11, 12, and 13 from a straight liquidation under Chapter 7. The title of Chapter 11, "Reorganization," explicitly refers to the financial reorganization objective of a Chapter 11 case. The title of Chapter 13, "Adjustment of Debts of an Individual With Regular Income," implies the personal rehabilitation focus of a Chapter 13 case, but many Chapter 13 plan concepts are similar to Chapter 11. Chapter 12, titled "Adjustment of Debts of a Family Farmer or Fisherman With Regular Annual Income," is modeled after Chapter 13 and shares most of the same features.

In cases commenced under Chapters 11, 12, and 13, as in Chapter 7 cases, property of the debtor becomes property of the estate at the commencement of the case. Similarly, property acquired by the debtor during the case is also property of the estate. Under Chapters 11, 12, and 13, unlike Chapter 7, property of the estate is revested in the debtor when a plan is confirmed unless the plan provides otherwise. 11 USC §§1141(b), 1227(b), 1327(b). Plans confirmed under Chapters 11, 12, and 13 allow a debtor to restructure its finances by modifying the rights of creditors and equity holders subject to the requirements of the Bankruptcy Code. Chapter 12 and 13 plans typically have a simplified structure providing for payments over a period of 3-5 years. On completion of the plan payment schedule, the debtor receives a discharge of debts (other than certain nondischargeable debts) that were treated by the plan. 11 USC §§1228(a), 1328(a). Chapter 11 plans may be in the form of a true reorganization under which the debtor emerges as a reorganized going concern. In that event, a discharge of debts treated under the plan is granted on confirmation of the plan. 11 USC §1141(d). No discharge is granted in a Chapter 11 case filed by an individual debtor until all plan payments are made. 11 USC §1141(d)(5). Chapter 11 plans may also provide for liquidation of substantially all property of the estate, with no ongoing business after consummation of the plan. In that scenario, a discharge is not granted. 11 USC §1141(d)(3).

Chapter 9 governs bankruptcy of municipalities and other local governmental units, such as school districts and land use commissions. Chapter 9 cases are somewhat rare and are not treated in this book.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/5 Reorganization and Liquidation/§5.2 B. Liquidation Plans

§5.2 B. Liquidation Plans

In a Chapter 7 case, a trustee liquidates assets of the bankruptcy estate and distributes the proceeds of encumbered assets to repay secured creditors to the extent of their "allowed secured claims" and the proceeds of unencumbered assets plus any surplus value remaining after payment of secured creditors to unsecured creditors in accordance with the priority scheme of 11 USC §507. 11 USC §§704(a)(1), 725-726. In most Chapter 7 cases, issues involving secured claims are resolved well before the case is completed.

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§5.3 C. Confirmation or Conversion

If a reorganization plan is confirmed and the debtor is unable to substantially consummate the plan or materially defaults under the plan, a creditor may request that the case be dismissed or converted to Chapter 7. 11 USC §§1112(b) (Chapter 11), 1208(c) (Chapter 12—dismissal only remedy for plan default), 1307(c) (Chapter 13). Note that stay relief granted because of defaults under a confirmed plan does not void the plan. In *Carvalho v Federal Nat'l Mortgage Ass'n (In re Carvalho)* (1st Cir 2003) 335 F3d 45, the court confirmed a debtor's plan that bifurcated a nonresidential mortgage into secured and unsecured portions. The secured lender obtained stay relief after the debtor defaulted on plan payments. Before the lender foreclosed, the debtor made all plan payments, but the lender refused payments tendered to it. The court rejected the lender's argument that stay relief nullified the plan's bifurcation of its claim, concluding that the lender had other remedies such as specific performance and expectation damages to put it in the same position as the plan provided. See also discussion of conversion at §§4.72-4.78.

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II. CHAPTER 11 PLANS

A. Parties and Claims

§5.4 1. Who May Propose Plan

For the first 120 days after the date of the order for Chapter 11 relief, *i.e.,* after the commencement of the case, only the debtor may file a plan. See 11 USC §1121(b). If the debtor files a plan in that time, the "exclusivity period" continues for another 60 days to allow the debtor the opportunity to confirm its proposed plan. 11 USC §1121(c). The court may enlarge or reduce any of the above time periods for cause shown. 11 USC §1121(d). However, the appointment of a Chapter 11 trustee automatically terminates the exclusivity period. 11 USC §1121(c)(1). The 120-day and 180-day periods can be extended, respectively, no later than 18 and 20 months after the petition date. In a similar vein, 11 USC §105(d)(1) has been changed to require (as opposed to allow) the court, on request of a party in interest or its own motion, to conduct "such status conferences as are necessary to further the expeditious and economical resolution of the case."

After the exclusivity period expires, any party in interest, including a creditor, may file a plan. In commercial real estate cases, a secured lender sometimes proposes its own plan, after the exclusivity period ends, if its claims are predominant, if there is an extended delay by the debtor in proposing a plan, or if the debtor proposes an unrealistic plan.

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§5.5 2. Small Business and Single Asset Real Estate Cases

Under the "small business" provisions of Chapter 11 (debtors with liquidated noncontingent debts not exceeding $2.19 million, see 11 USC §101(51C)-(51D)), only the debtor may file a plan during the first 180 days after the date for the order of relief. The court may enlarge or reduce any of the above time periods for cause shown. 11 USC §1121(e). For further discussion of small business Chapter 11 cases, see §§1.63, 4.4.

Strict deadlines are imposed on Chapter 11 debtors with assets consisting solely of a single parcel of real estate (so called "single asset real estate" cases, see 11 USC §101(51B)). These debtors must file a Chapter 11 plan and disclosure statement within 90 days of the order of relief or within 30 days of the bankruptcy court's determination that the case is a single asset case. Secured creditors may be granted relief from stay in single asset real estate cases unless the debtor is making current interest payments at the nondefault contract rate or has filed a feasible plan of reorganization within 90 days. 11 USC §362(d)(3). See §§1.64, 4.22, 10.29 for further discussion of single asset real estate cases.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/5 Reorganization and Liquidation/§5.6 3. Contents of Chapter 11 Plan

§5.6 3. Contents of Chapter 11 Plan

Bankruptcy Code §1123(a)-(b) sets forth, respectively, the mandatory and permissive requirements for a Chapter 11 plan. All Chapter 11 plans must do the following (11 USC §1123(a)):

- Designate classes of claims;
- Designate which classes are impaired;
- Specify the treatment of such classes of claims;
- Provide for the same treatment for each claim in a class of claims;
- Provide adequate means for the plan's implementation;
- Provide that the charter of the debtor, if the debtor is a corporation, will be amended to prohibit the issuance of nonvoting stock; and
- Contain provisions consistent with the interest of creditors and equity security holders and with public policy with respect to the selection of management of the reorganized debtor.

The plan of an individual debtor must also provide for payment to creditors of income received after the commencement of the case, to the extent needed to execute the plan. Section 1123(b) also lists several permissive provisions, but there are no other restrictions on the contents of a plan, leaving a plan proponent with significant flexibility, except that it must satisfy 11 USC §1129 requirements on plan confirmation. See §§5.12-5.23.

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§5.7 4. Classification of Claims

Creditor claims and the interests of equity holders are placed into classes with other substantially similar claims or interests. 11 USC §1122. The debate over whether a mortgagee's deficiency claim can be classified separately from other general unsecured claims continues. If the deficiency claim is large and it is classified with general unsecured claims, the lender may be able to control voting in that class and whether the plan can be confirmed. As a result, debtors often attempt to classify the deficiency claim separately. In grappling with the classification issue, the courts reject gerrymandering classes of creditors under a plan to increase the likelihood of confirmation. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 656.

In the Ninth Circuit, determining whether claims are similar enough to preclude separate classification is a question of fact, reviewable under the clearly erroneous standard. *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323. Absent "legitimate business or economic justification," a debtor may not separately classify a lender's deficiency claim from those of general unsecured creditors. *Barakat v Life Ins. Co. (In re Barakat)* (9th Cir 1996) 99 F3d 1520, 1526. The mere fact that a lender has the right to make an 11 USC §1111(b) election (see §10.90) does not amount to such justification. 99 F3d at 1526. Nor is it appropriate to separately classify unsecured trade creditors with whom the debtor continues to do business. 99 F3d at 1528. See *Oxford Life Ins. Co. v Tucson Self-Storage, Inc. (In re Tucson Self-Storage, Inc.)* (BAP 9th Cir 1994) 166 BR 892 (separate classification based solely on undersecured mortgagee's right to make §1111(b) election is impermissible); *Montclair Retail Ctr., LP v Bank of the W. (In re Montclair Retail Ctr., LP)* (BAP 9th Cir 1995) 177 BR 663 (plan classifying deficiency claim and trade debt separately but treating each the same is not confirmable, because equal treatment negates business or economic justification for separate classes). In addition to the substantial similarity requirement of §1122, claims classification may also implicate the "fair and equitable" requirement of 11 USC §1129(b). Without reference to its earlier decisions in *Johnston* and *Barakat,* the Ninth Circuit has stated, in what may be dicta, that discrimination between classes must satisfy four criteria to be considered fair under 11 USC §1129(b): "(1) the discrimination must be supported by a reasonable basis; (2) the debtor could not confirm or consummate the Plan without the discrimination; (3) the discrimination is proposed in good faith; and (4) the degree of the discrimination is directly related to the basis or rationale for the discrimination." *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 656.

Outside the Ninth Circuit, the appellate courts have disagreed widely about the proper standard for classification. The First Circuit had held that, as a matter of law, claims of equal priority must be placed in the same class. *Granada Wines, Inc. v New England Teamsters & Trucking Indus. Pension Fund* (1st Cir 1984) 748 F2d 42. At the other extreme, the Seventh Circuit has held that 11 USC §1111(b) requires that a deficiency claim be classified separately from general unsecured claims. *In re Woodbrook Assocs.* (7th Cir 1994) 19 F3d 312. Without reference to its *Woodbrook* decision, the Seventh Circuit approved a partnership debtor's plan that separately classified a lender's nonrecourse deficiency claim and general trade creditors. It provided for a 16-percent payout on the deficiency claim and a 100-percent payout to the trade creditors. *In re 203 N. LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd on other grounds sub nom *Bank of America v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411. This discrimination, which recognized that the trade would be paid in full in a Chapter 7 case (presumably by recourse against the general partner) and that the lender's deficiency claim would receive nothing, was found to be legitimately and narrowly tailored to satisfy the "best interests" test of 11 USC §1129(a)(7).

The Second, Third, Fourth, Fifth, and Eighth Circuits have each adopted more flexible, intermediate approaches. *Boston Post Rd. Ltd. Partnership v FDIC (In re Boston Post Rd. Ltd. Partnership)* (2d Cir 1994) 21 F3d 477 (different origins of unsecured deficiency claims and general unsecured claims do not alone justify separate classification; debtor must produce evidence of legitimate reason for segregating claims); *John Hancock Mut. Life Ins. Co. v Route 37 Bus. Park Assocs.* (3d Cir 1993) 987 F2d 154 (separate classification allowable only when reasonable); *Travelers Ins. Co. v Bryson Prop., XVIII (In re Bryson Prop., XVIII)* (4th Cir 1992) 961 F2d 496 (separate classification not per se prohibited, but plan could not separately classify claims for purpose of manipulating voting); *Phoenix Mut. Life Ins. Co. v Greystone*

III Joint Venture (In re Greystone III Joint Venture) (5th Cir 1991) 995 F2d 1274, 1279 (separate classification is presumptively impermissible but can be allowed for reasons independent of debtor's motivation to secure vote of impaired, assenting class of claims); *Lumber Exchange Bldg. Ltd. Partnership v Mutual Life Ins. Co. (In re Lumber Exchange Bldg. Ltd. Partnership)* (8th Cir 1992) 968 F2d 647 (same).

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§5.8 5. Impaired Classes

A Chapter 11 plan may, and often does, modify the rights of at least some classes of claims or equity interests in order to effect the proposed reorganization. Those classes of creditors and equity holders whose rights are modified are generally considered "impaired" by the plan. This distinction is critical because, to confirm the plan, all impaired classes must vote for the plan or the plan must be "fair and equitable" for an impaired class that votes against the plan. 11 USC §1129(a)(8), (b). Preliminary identification of impaired classes is facilitated by the requirement that a plan specify whether a class of claims or interests is impaired or unimpaired. See 11 USC §1123(a)(2)-(3). Impairment status is determined under 11 USC §1124, which provides that a class of claims or equity interests is impaired unless the plan does one of two things:

- The plan "leaves unaltered the legal, equitable, and contractual rights" of each claim in the class (*e.g.,* the lender would be free to foreclose a defaulted real property loan). 11 USC §1124(1). See *L&J Anaheim Assocs. v Kawasaki Leasing Int'l, Inc. (In re L&J Anaheim Assocs.)* (9th Cir 1993) 995 F2d 940 (secured creditor proposed plan that favorably modified its own remedies, thereby making itself impaired class). But see *Barakat v Life Ins. Co. (In re Barakat)* (9th Cir 1996) 99 F3d 1520 (security deposit claims not impaired when treated in accordance with state law); or
- The plan merely de-accelerates an accelerated obligation and does not otherwise modify it. 11 USC §1124(2).

The following conditions are also necessary in order for a claim to be deemed not impaired:

- The default must be cured in full in cash (if the plan proposes to cure the default over a period of time, the class is impaired);
- The original maturity of the obligation must be reinstated;
- The creditor must be compensated for damages incurred by reasonable reliance on the right to accelerate; and
- The plan may not otherwise alter the obligation.

A cure of defaults under a plan will generally nullify all consequences of default, including default penalties such as higher interest (see §10.91), and will render lenders unimpaired. *Florida Partners Corp. v Southeast Co. (In re Southeast Co.)* (9th Cir 1989) 868 F2d 335; *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338; *CityBank v Udhus (In re Udhus)* (BAP 9th Cir 1998) 218 BR 513. The *Entz-White* decision was not overruled by the 1994 addition of 11 USC §1123(d). *In re Phoenix Bus. Park Ltd. Partnership* (Bankr D Ariz 2001) 257 BR 517 (cure under §1123 need not include default interest but only contract rate of interest due absent default). A cure of defaults outside the context of a plan, however (*e.g.,* in connection with a sale of assets under 11 USC §363), will not nullify the secured parties' right to recover default-rate interest. *General Elec. Capital Corp. v Future Media Prods., Inc.* (9th Cir 2008) 536 F3d 969.

The Bankruptcy Reform Act of 1994 deleted former 11 USC §1124(3), which had provided that a claim is unimpaired if it is paid in full as of the effective date of the plan. Prior to the amendment, the cases were divided on whether the plan proponent could "artificially" impair the class merely by delaying payment for a short period after confirmation. Compare *Connecticut Gen. Life Ins. Co. v Hotel Assocs. (In re Hotel Assocs.)* (BAP 9th Cir 1994) 165 BR 470 (30-day delay impaired class; however, delay could be considered in deciding if plan was proposed in good faith) with *Windsor on the River Assocs., Ltd. v Balcor Real Estate Fin., Inc. (In re Windsor on the River Assocs., Ltd.)* (8th Cir 1993) 7 F3d 127, 132 (class not paid for 60 days not impaired because "the alteration of rights in question arises solely from the debtor's exercise of discretion"). Given the change in the Bankruptcy Code, it appears that a class will be impaired even if paid in full on the plan's effective date unless such payment is consistent with the legal, equitable, and contractual rights of the creditors in the class.

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§5.9 6. Modification of Secured Claims

A Chapter 11 plan may modify the terms for payment of a secured claim other than a claim secured only by the debtor's primary residence. 11 USC §1123(b)(5). (The home mortgage exception is discussed in §5.10.) If the plan proposes to modify a secured lender's claim, the lender's claim will be impaired. See §5.8. A debtor seeking to modify a lender's claim generally focuses on one or more of the following aspects of the secured claim:

(1) Showing that the lender is undersecured in order to reduce the lender's secured claim down to the value of the collateral (also known as "lien-stripping"; see §10.89);

(2) Lowering the interest rate payable to the lender; or

(3) Stretching the maturity of payments due to the lender.

On whether the proposed modification is permissible over the lender's objection, see §5.17.

Note, however, that the debtor may not use a Chapter 11 plan to unilaterally reduce a creditor's allowed secured claim without the consent of the creditor or compliance with the claim objection procedures under Fed R Bankr P 3007. See *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489, in which the secured creditor's claim had been scheduled by the debtor as undisputed and was deemed allowed under 11 USC §1111(a) and Fed R Bankr P 3003(b)(1). The bankruptcy appellate panel concluded that the debtor's attempt to unilaterally reduce the claim in its plan was not a modification of the claim. The issue highlights the tension between the preclusive effect of plan confirmation (see §5.24) and the due process rights afforded creditors under the Bankruptcy Code's claim allowance provisions.

Similarly, in the Chapter 13 context, the Ninth Circuit bankruptcy appellate panel held that "a plan can effectively determine value and/or avoid a lien only if the creditor receives clear notice that the plan will do so. A plan that is silent about the fate of a secured claim provides no notice of what will happen to the secured claim and therefore cannot effectively avoid a lien or determine its value." *Shook v CBIC (In re Shook)* (BAP 9th Cir 2002) 278 BR 815, 824. See *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856 (plan did not provide adequate notice of debtors' intent to strip down tax lien). See also *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113, cert granted (2009) 174 L Ed 2d 289, 129 S Ct 2791 (court of appeals allowed discharge of student loan without finding of undue hardship in adversary proceeding because lender did not object after receiving adequate notice of Chapter 13 plan required by Fed R Bankr P 7004); *In re Rascon* (ND Cal 2005) 321 BR 48 (plan that unambiguously provided for modification of secured lender's claim did not violate due process). See §5.30. The concurring opinion in *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.), supra,* also underscores the problems that may be created by a plan that fails to note a lien reduction or explain it so that the creditor understands that its claim is challenged and will be reduced unless the creditor takes action. 293 BR at 500.

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§5.10 7. Modification of Claims Secured Only by Principal Residence

A Chapter 11 plan cannot modify the terms of a claim secured only by a security interest in real property that is the debtor's principal residence. 11 USC §1123(b)(5). This provision, which was enacted as part of the Bankruptcy Reform Act of 1984, parallels the treatment of home mortgages in a Chapter 13 case and blocks "lien-stripping" of an undersecured home mortgage. See 11 USC §1322(b)(2), discussed in §§5.29-5.35. However, in enacting 11 USC §1123(b)(5), Congress did not enact a provision in Chapter 11 that is analogous to 11 USC §1322(b)(5), which allows the debtor to cure any arrearages on his or her home mortgage under a Chapter 13 plan within a reasonable period. Read literally, this difference could require an individual debtor in a Chapter 11 case to cure any defaults on the home mortgage in full on the effective date of the plan.

Holding collateral incidental to the debtor's principal residence should not defeat application of §1123(b)(5). *Lee v Home Savs. (In re Lee)* (BAP 9th Cir 1997) 215 BR 22 (principal residence exception applies to mortgage that includes lien on personal property, such as washer, that is made component of real property by agreement and that has little or no independent value); *Lievsay v Western Fin. Sav. Bank (In re Lievsay)* (BAP 9th Cir 1996) 199 BR 705 (same result even if debtor maintains home office). However, in the Chapter 13 context, some courts have found certain types of relatively minor, supplemental collateral sufficient to disqualify the antimodification under §1322(b)(5). See §5.31. Courts have also held that §1322(b)(5) does not apply if the lender is completely unsecured. See §5.34. The logic of these cases should also apply in the Chapter 11 context.

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§5.11 B. Voting on Plan; Disclosure Statement

Not all classes of creditors or equity interest holders vote for or against a plan. Unimpaired classes are deemed to accept the plan. 11 USC §1126(f). Similarly, classes that receive nothing under the plan are deemed to reject the plan. 11 USC §1126(g). Hence, only those classes impaired by the plan (see §5.8) and receiving consideration under the plan are entitled to vote (see §5.15). For a class of creditors (secured or unsecured) to accept a plan, two-thirds in amount and a simple majority in number of the allowed claims held by creditors in the class who actually vote to accept or reject the plan must vote for (*i.e.,* accept) the plan. 11 USC §1126(c).

To reach the voting stage, the plan proponent must first obtain court approval of a disclosure statement, which is akin to a prospectus, that describes the plan and background information sufficiently to allow a hypothetical reasonable creditor or equity holder to make an informed judgment about the plan. See 11 USC §1125; *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177 (determination of adequate information is subjective and made on case-by-case basis according to court's discretion). The disclosure statement must also include a discussion of material federal tax consequences and the court must consider the complexity of the case, the benefit of additional information to creditors, and the cost of providing additional information in determining the sufficiency of the disclosure statement. 11 USC §1125(a)(1). In a small business case, the court may conditionally find that a disclosure statement is not required if a plan contains adequate information. Fed R Bankr P 3017.1(a). For information required in the plan, see Fed R Bankr P 3016 and 11 USC §1125(f)(1).

The plan proponent must give at least 28 days' notice to parties of the time fixed for filing objections to the disclosure statement and for the hearing to consider the statement's approval or, under §1125(f), to make a final determination of whether the plan provides adequate information so that a separate disclosure statement is not necessary. Fed R Bankr P 2002(b).

PRACTICE TIP: Counsel should check for local rules establishing court-specific and judge-specific procedures for approval of a disclosure statement. Some judges have mandatory plan and disclosure statement forms that are not the same as official or local forms. See Directory for local bankruptcy court website information.

If the plan is unconfirmable on its face, a creditor might consider objecting to the disclosure statement on that ground. Once approved, the disclosure statement is delivered along with a copy of the plan and a ballot to creditors and equity holders entitled to vote. 11 USC §1125; Fed R Bankr P 3017(d). See *Computer Task Group, Inc. v Brotby (In re Brotby), supra* (immaterial misleading statement in disclosure statement will not block confirmation nor will providing corrected financial projections at confirmation hearing, but reballoting may be appropriate if voting process is tainted by misinformation). Parties are not allowed to solicit votes for or against a plan until the disclosure statement is approved. 11 USC §1125(b). Parties who do not follow the procedures for plan solicitation may be subject to sanctions. *Duff v U.S. Trustee (In re California Fid., Inc.)* (BAP 9th Cir 1996) 198 BR 567 (debtor's president sanctioned for improperly soliciting votes against confirmation of trustee's plan before approval of disclosure statement by sending letter to 300 unsecured creditors).

At the conclusion of the voting period, returned ballots are tabulated and a report of the voting is given to the court. A hearing is then set for confirmation of the plan, at which the plan proponent must show that all confirmation requirements have been satisfied and creditors or equity holders may object to confirmation.

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§5.12 C. Confirmation of Chapter 11 Plan

A plan may be confirmed if it satisfies the requirements set forth in 11 USC §1129. The bankruptcy court has "an affirmative duty" to ensure that a plan satisfies all §1129 requirements. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, 653. See *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177, 197 (cursory finding that requirements for confirmation have been satisfied under §1129 is insufficient if specific objection has been raised to confirmation).

The plan proponent must give at least 28 days' notice of the time fixed for filing objections to the plan and for the hearing to consider the plan's confirmation. Fed R Bankr P 2002(b).

In 2000, a bankruptcy appellate panel held that if the debtor prevails on an objection to confirmation, the debtor is not entitled to an award of prevailing party attorney fees under CC §1717. See *Hassen Imports Partnership v KWP Fin. VI (In re Hassen Imports Partnership)* (BAP 9th Cir 2000) 256 BR 916, 922. However, the effect of this holding is doubtful under *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, which overruled *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149 and related Ninth Circuit precedents that prohibited recovery of contract-based attorney fees incurred in litigating matters peculiar to bankruptcy law. Under *Travelers,* a claim for reasonable attorney fees incurred by a creditor prevailing in litigation involving issues peculiar to bankruptcy law must be allowed as part of a creditor's claim if the right to recover attorney fees is enforceable under state law, unless "other principles of bankruptcy law" provide "an independent basis for disallowing" the attorney fee award. *Travelers Cas. & Sur. Co. of Am.,* 549 US at 456, 167 L Ed 2d at 189. Unresolved is the issue of whether an award in favor of the trustee or debtor may be offset by the losing creditor's prepetition claim. If not, creditors may be far more reluctant to seek relief or challenge debtor or trustee actions in a case.

PRACTICE TIP: Counsel involved in a confirmation proceeding should be familiar with applicable federal and local rules of procedure. See, *e.g.,* Fed R Bankr P 2002, 3015-3020. At the confirmation hearing, the plan proponent should be prepared to present evidence that shows that all 11 USC §1129 requirements are satisfied. The proponent will often submit a declaration in advance of the confirmation hearing for this purpose. If the plan is uncontested, it may be sufficient to make an offer of proof that each requirement has been satisfied, with a witness available to provide testimony if necessary.

If the debtor files a plan for which it has already solicited acceptances at the time it files the petition, the plan is referred to as a "prepackaged" Chapter 11 plan. In a prepackaged Chapter 11 case, the debtor can use the exclusivity period to continue to move toward a prompt plan confirmation, thus reducing its time in bankruptcy and the overall cost of the case. See §4.27 on prepackaged plans and meeting of creditors. Some local bankruptcy courts have issued guidelines for prepackaged plans; counsel should check the website of the local court. See Directory for information.

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§5.13 1. Other Bankruptcy Code Requirements

The first two requirements of 11 USC §1129 are that the plan and the plan proponent comply with the applicable provisions of the Bankruptcy Code. 11 USC §1129(a)(1)-(2). Thus, a plan must include the mandatory provisions set forth in 11 USC §1123(a) (see §5.6). Moreover, the plan proponent must be qualified to submit a plan and must abide by the Bankruptcy Code's limits on plan solicitation and use of an approved disclosure statement. See §5.11.

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§5.14 2. Plan Proposed in Good Faith

The plan must be proposed in good faith and not by any means forbidden by law. 11 USC §1129(a)(3). A plan has been proposed in good faith when it is intended to achieve a result consistent with the objectives of the Bankruptcy Code. *In re Corey* (9th Cir 1989) 892 F2d 829, 835, cert denied (1990) 498 US 815, 112 L Ed 2d 31, 111 S Ct 56. Whether the plan meets the "good faith" requirement is a question of fact that is reviewed on appeal under the "clearly erroneous" standard. *Pacific First Bank v Boulders on the River, Inc. (In re Boulders on the River, Inc.)* (BAP 9th Cir 1994) 164 BR 99. See *Platinum Capital, Inc. v Sylmar Plaza, LP (In re Sylmar Plaza, LP)* (9th Cir 2002) 314 F3d 1070 (plan filed to reinstate loan's lower, nondefault interest rate through cure of default not proposed in bad faith); *In re 203 N. LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd on other grounds sub nom *Bank of America v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411 (plan motivated in significant part by desire to defer $20 million tax liability that would arise from foreclosure not proposed in bad faith).

The second prong of §1129(a)(3)—that the plan has not been proposed by means forbidden by law—may be satisfied when it is established that the plan complies with the Bankruptcy Code and state law, to the extent state law is applicable and has not been superseded by the Bankruptcy Code. *Acequia, Inc. v Clinton (In re Acequia, Inc.)* (9th Cir 1986) 787 F2d 1352, 1360, aff'd in part, rev'd in part, remanded (9th Cir 1994) 34 F3d 800.

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§5.15 3. Plan Acceptance by Impaired Classes

When a plan impairs any class of claims or interests, the general rule is that all impaired classes are required to accept the plan. 11 USC §1129(a)(8). On impairment, see §5.8. However, the plan may still be confirmed even if less than all impaired classes vote for the plan when (1) at least one impaired class of claims accepts the plan, excluding the votes of insiders (11 USC §1129(a)(10)), and (2) the plan satisfies the requirements for confirmation of a "cramdown plan" (11 USC §1129(b)). On cramdown, see §§5.17-5.20. If none of the members of an impaired class vote on the plan, the class is treated as not having voted for the plan. *Bell Rd. Inv. Co. v M. Long Arabians (In re M. Long Arabians)* (BAP 9th Cir 1989) 103 BR 211.

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§5.16 4. "Best Interests" of Impaired Creditors

Unless every member of an impaired class votes for the plan, holders of impaired claims or equity interests must receive or retain under the plan, on account of such claim or interest, property of a value as of the effective date of the plan that is not less than the amount that such holder would receive or retain if the debtor were liquidated under Chapter 7 as of the effective date of the plan. 11 USC §1129(a)(7)(A). This treatment has been dubbed the "best interests" test because it requires that impaired creditors and shareholders do at least as well under the plan as they would in a hypothetical straight liquidation under Chapter 7. If impaired creditors and shareholders would do worse under the plan, the plan would not be in their best interests. Generally, secured lenders will receive as much under a Chapter 11 plan as they would in a Chapter 7 case because of the restriction on modification of the rights of secured creditors. On cramdown, see §§5.17-5.20. See also *In re Patrician St. Joseph Partners, LP* (D Ariz 1994) 169 BR 669, 680 (oversecured creditor lacked standing to object on "best interest" grounds because it was adequately protected).

Section 1129(a)(7) requires the plan proponent to show both the present value of the property projected to be received by the impaired class under the plan, as of the plan effective date, and the expected value of such property if liquidated in a Chapter 7 case. See *M&I Thunderbird Bank v Birmingham (In re Consolidated Water Utils., Inc.)* (BAP 9th Cir 1998) 217 BR 588, 591 (best interests test satisfied when creditor received more than it would have in Chapter 7, according to liquidation analysis as of effective date of plan). In determining liquidation value, a plan proponent should consider the potential impact of Chapter 7 provisions concerning the following:

- Claims subordination;
- Allowance of tardily filed claims;
- Allowance of claims for fines, penalties, or punitive damages not in compensation for actual pecuniary loss;
- Treatment of certain liens;
- The rights of a partnership trustee against general partners; and
- Distributions of community property.

See H Rep No. 95-595, 95th Cong, 1st Sess 412 (1977); *Bell Rd. Inv. Co. v M. Long Arabians (In re M. Long Arabians)* (BAP 9th Cir 1989) 103 BR 211, 216 (reversing confirmation order and remanding for consideration of net worth of debtor's general partner because Chapter 7 trustee would have cause of action against partner to recover any obligations to creditors unpaid after liquidation of debtor's asset); *In re Sierra-Cal* (Bankr ED Cal 1997) 210 BR 168 (denying confirmation, in part, because insider creditor would be subject to preference avoidance action, and such insider's claim would be subject to disallowance under 11 USC §502(d) in Chapter 7 case).

The best interests test is modified for impaired, secured creditors who elect to treat their claim as fully secured under 11 USC §1111(b)(2) (see §10.90). For such creditors, the best interests test is satisfied if the creditors will receive or retain property having a present value at least equal to the value of the collateral as of the effective date of the plan. 11 USC §1129(a)(7)(B).

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§5.17 5. "Cramdown" of Impaired, Dissenting Classes; Absolute Priority Rule

If at least one class of impaired claims votes for a plan, 11 USC §1129(b) permits the cramdown of the plan on other impaired classes of claims or equity interests. 11 USC §1129(a)(8), (a)(10), (b)(1). A cramdown, however, is allowed only "if the plan does not discriminate unfairly, and is fair and equitable" for each impaired class that has not accepted the plan. 11 USC §1129(b)(1). The "fair and equitable" standard derives from the Bankruptcy Act of 1898 and is a term of art. Whether a plan is "fair and equitable" depends on whether the class is a class of (1) secured creditors, (2) unsecured creditors, or (3) equity interests. See 11 USC §1129(b)(2).

Section 1129(b)(2) establishes the "absolute priority rule," which in essence requires that a cramdown plan provide for the following:

- Full payment of any dissenting secured creditors' claims ahead of those of unsecured creditors; and
- Full payment of any dissenting unsecured creditors' claims ahead of those of the debtor's equity holders.

See *Norwest Bank Worthington v Ahlers* (1988) 485 US 197, 99 L Ed 2d 169, 108 S Ct 963. Implementation of the rule, however, does not require that a class of creditors actually be paid in full before any distributions can be made to junior classes; rather, it requires only that the senior class of creditors be provided full present payment, or its equivalent, under the plan. The debtor must demonstrate at the time of confirmation, however, that the senior class of creditors will actually receive the payments promised under the plan, *i.e.,* that the plan is "feasible." *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323. There are three alternatives for "fair and equitable" treatment of a class of dissenting secured creditors. See §§5.18-5.20.

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§5.18 a. Make Deferred Cash Payments

The first alternative is for the plan to provide that the secured creditor (1) retains its lien to the extent of the allowed amount of its claim and (2) receives deferred cash payments totaling at least the allowed amount of the claim and of a value, as of the effective date of the plan, of at least the value of the creditor's secured interest in the collateral. 11 USC §1129(b)(2)(A)(i). These provisions, read in conjunction with 11 USC §§506(a) and 1111(b), permit a plan proponent to propose reducing the lender's claim to the value of its collateral (also known as "lien-stripping"; see §10.89) as long as the required payments are to be made to the secured creditor under the plan. *Wade v Bradford* (10th Cir 1994) 39 F3d 1126; *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284, 292. Recall, however, that a plan may not modify the rights of a lender secured only by the debtor's principal residence. See §5.10.

At first glance, determining the required amount of deferred payments to the secured creditor may seem confusing. More directly stated, the present value of the payments to the secured creditor must total at least the amount of the allowed secured claim. In addition, the total payments to be made must have a value, on the effective date of the plan, equal to the secured claim. This requires a present value calculation using an appropriate interest rate. The correct application of these parameters requires determining whether a creditor is oversecured or undersecured and, if the creditor is undersecured, knowing whether the lender has elected to be treated as fully secured under §1111(b)(2) (see §10.90). For an oversecured lender, the total deferred cash payments must have a present value equal to the full amount of the lender's allowed claim. This requires the plan to correctly value the collateral and to use a proper interest rate.

Assume a $5 million debt secured by property worth $3 million. If the §1111(b)(2) election is not made, the allowed secured claim is $3 million, and the present value of the total deferred payments must equal $3 million. Treatment of the allowed unsecured claim of $2 million is a different subject. It is possible that the class in which the unsecured claim is placed will accept the plan; if not, an entirely different definition of "fair and equitable" will govern cramdown for that unsecured class.

On the other hand, if the lender makes the §1111(b)(2) election, the allowed secured claim is $5 million, and there is no unsecured deficiency claim. The deferred cash payments to the lender must total at least $5 million. But because the value of the collateral is $3 million, the present value of the deferred cash payments need only equal $3 million. Unless the proper interest rate is very high or the difference between the claim amount and the collateral value is small, in most cases when the lender makes the §1111(b)(2) election, the deferred payments on account of the allowed secured claim ($5 million in the example) will exceed the amount of payments needed to provide the lender with a present value equal to the collateral value ($3 million in the example). In sum, to calculate the necessary payments under 11 USC §1129(b)(2)(A)(i), the plan must correctly value the secured lender's collateral and select the proper interest rate.

PRACTICE TIP: Section 1111 and the related rules do not specify a deadline for making the election, although some local bankruptcy rules may do so. Accordingly, debtors often seek a bar date that is the last day of the hearing on approval of the disclosure statement.

The two recurring disputes in a cramdown fight are determination of the value of the lender's collateral and determination of the interest rate to be used to calculate present value. The starting point for collateral valuation is 11 USC §506(a), which provides that "value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." If the debtor proposes to retain the collateral, the court must use the property's fair market value (rather than its forced-sale liquidation value) without deduction of hypothetical sale costs. *Taffi v U.S. (In re Taffi)* (9th Cir 1996) 96 F3d 1190 (en banc). See *Associates Commercial Corp. v Rash* (1997) 520 US 953, 959 n2, 138 L Ed 2d 148, 156 n2, 117 S Ct 1879 (citing *Taffi* in ruling that proper valuation standard in Chapter 13 case for collateral being retained by debtor under cramdown plan is "replacement value" of that collateral rather than liquidation

value secured creditor would realize after foreclosure sale); *In re Young* (Bankr ND Cal 2007) 367 BR 183 (in retaining mobilehome, debtor must pay secured creditor its replacement value, excluding value of its location); *Ardmor Vending Co. v Kim (In re Kim)* (9th Cir 1997) 130 F3d 863 (when debtor's plan proposed retaining real estate lease and equipment used for dry cleaning business, those assets must be valued together as turnkey operation).

In *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650, the plan proposed to fix the lender's secured claim as the value of the collateral (an apartment complex) less accumulated net rents already paid to the lender and in which the lender had a security interest. Cramdown was rejected because the plan, though providing for postconfirmation interest, undervalued the lender's claim by improperly deducting the rents paid to the lender.

For further discussion of valuation and appraisal standards, see §§5.34, 5.37, 10.38, 10.88.

NOTE: The value established at a failed plan confirmation hearing is not binding on the lender in subsequent litigation. *Gold Coast Asset Acquisition, LP v 1441 Veteran St. Co.* (*In re 1441 Veteran St. Co.)* (9th Cir 1998) 144 F3d 1288, modified and rehearing denied (9th Cir 1998) 154 F3d 1103.

The U.S. Supreme Court, in a plurality decision, held that the cramdown interest rate in a Chapter 13 case should be determined by use of the "prime-plus" approach (also known as the "formula rate"). *Till v SCS Credit Corp. (In re Till)* (2004) 541 US 465, 158 L Ed 2d 787, 124 S Ct 1951. The formula-rate calculation starts with the national prime rate charged to creditworthy borrowers. That rate is then adjusted to reflect the greater risk of nonpayment by the debtor, which depends on factors such as "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." 541 US at 479, 158 L Ed 2d at 800. *Till* will likely be treated as determinative in the Chapter 11 context because the Chapter 11 cramdown requirements parallel those of Chapter 13.

Earlier precedent in the Ninth Circuit and other circuits that adopted the formula-rate approach should continue to be persuasive. See, *e.g., Farm Credit Bank v Fowler (In re Fowler)* (9th Cir 1990) 903 F2d 694 (determining interest rate by looking to prevailing market rate for loans having similar terms, collateral, and risk of default); *Pacific First Bank v Boulders on the River, Inc. (In re Boulders on the River, Inc.)* (BAP 9th Cir 1994) 164 BR 99 (blended-rate analysis; oversecured lender entitled to one rate for funds up to 70-percent loan-to-value ratio and higher rate for funds that would take loan above 70-percent loan-to-value ratio); *In re Duval Manor Assocs.* (Bankr ED Pa 1996) 191 BR 622 (proper interest rate determined on case-by-case basis, taking into account risks associated with debtor, collateral, and plan); *In re Gramercy Twins Assocs.* (Bankr SD NY 1995) 187 BR 112 (rejecting proposed market-rate standard based on "workout loans"); *In re HRC Joint Venture* (Bankr SD Ohio 1995) 187 BR 202 (good discussion of proper discount rate for 100-percent loan-to-value ratio case; plan confirmed); *In re Villa Diablo Assocs.* (Bankr ND Cal 1993) 156 BR 650 (applying formula to specify interest required for Chapter 11 plan note by adjusting typical market rate in light of loan-to-value ratio, quality of security, debt coverage ratio and cash reserves, and risk reduction inherent in confirmation process).

Most cramdown plans propose payment of a secured claim with a regular amortization schedule or with interest only and a balloon payment at maturity. However, it is also possible to propose a negative amortization plan. Negative amortization plans are strongly disfavored because of the potential lack of adequate protection of the lender and the lack of evidence of feasibility of the plan. See, *e.g., Great W. Bank v Sierra Woods Group* (9th Cir 1992) 953 F2d 1174. There is no fixed limit on the length of the repayment term in a Chapter 11 case. See *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489 (20-year term approved). In any event, however, the plan must be feasible. See §5.22.

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§5.19 b. Sell Collateral Free and Clear of Lien

A cramdown plan is fair and equitable to a dissenting secured creditor (see §5.17) if it provides for a sale of the collateral free and clear of the lender's security interest, with an opportunity for the lender to credit-bid at the sale (see §10.73) and with the security interest transferred to the proceeds of sale and treated under either of the other two alternatives (see §§5.18, 5.20). 11 USC §1129(b)(2)(A)(ii).

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§5.20 c. Provide Indubitable Equivalent

The fair and equitable standard (see §5.17) will be satisfied if the dissenting secured creditor class receives "the indubitable equivalent" of its claims. 11 USC §1129(b)(2)(A)(iii). The legislative history of this section indicates the language is intended to follow the strict approach taken by Judge Learned Hand in *In re Murel Holding Corp.* (2d Cir 1935) 75 F2d 941 and gives two examples: abandonment of the collateral to the secured creditors and replacement liens on similar collateral. If the plan started out with the alternative described in §5.19 (sale of collateral free and clear), application of this third alternative to the sale proceeds would presumably mean that the secured creditor would be paid or given a lien on the cash proceeds.

Consistent with the legislative history, a secured creditor that receives its real estate collateral back under a plan has received the indubitable equivalent of its secured claim. *Arnold & Baker Farms v U.S. (In re Arnold & Baker Farms)* (BAP 9th Cir 1994) 177 BR 648, aff'd (9th Cir 1996) 85 F3d 1415, 1423; *Sandy Ridge Dev. Corp. v Louisiana Nat'l Bank (In re Sandy Ridge Dev. Corp.)* (5th Cir 1989) 881 F2d 1346. Attempted variations of the straightforward "dirt for debt" plan have not fared well. Partial "dirt for debt" plans involve the transfer of only a portion of the secured creditor's collateral in proposed full satisfaction of the lender's claim. This treatment is not the "indubitable equivalent" of the lender's secured claim unless the plan also ensures the safety of, or prevents possible jeopardy to, the principal amount of the claim, though the determination of property value alone is not necessarily determinative of "indubitable equivalence." See *Arnold & Baker Farms v U.S (In re Arnold & Baker Farms), supra* (adopting panel's decision). See also *In re Sparks* (Bankr ND Ill 1994) 171 BR 860 (rejecting plan that proposed conversion of apartment complex to condominiums and required partial releases of lender's lien as units were sold; converted condominium project was not "indubitable equivalent" of lender's original collateral). Moreover, a plan proposing to surrender real estate collateral in full satisfaction of both a lender's secured and unsecured claims should not be confirmable over the lender's objection. See *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, overruled on other grounds in *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199 (Chapter 12 plan).

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§5.21 6. "New Value" Exception to Absolute Priority Rule

Under the former Bankruptcy Act, courts had recognized a "new value" exception or corollary to the absolute priority rule permitting equity holders of a debtor to retain their ownership interest, even though creditors would not be paid in full, if they contributed new money under a reorganization plan. *Case v Los Angeles Lumber Prods. Co.* (1939) 308 US 106, 84 L Ed 110, 60 S Ct 1; *Stegall v Federal Land Bank of St. Louis (In re Stegall)* (7th Cir 1989) 865 F2d 140. After the decision in *Norwest Bank Worthington v Ahlers* (1988) 485 US 197, 99 L Ed 2d 169, 108 S Ct 963 (holding that under plan no junior class can be paid unless all dissenting senior classes are paid in full; see §5.17), courts are divided on the question of whether the new value exception continues to exist under the Bankruptcy Code and, if it does, what standards govern the exception.

The U.S. Supreme Court's decision in *Bank of America v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411, did little to relieve the confusion. The Court acknowledged that the statutory language could support the new value exception but declined to decide whether the exception actually exists. Instead, the Court held that a new value plan cannot be confirmed in any event during the debtor's exclusive period to propose a reorganization plan under 11 USC §1121. It also concluded that, if the existing owners have an exclusive opportunity to acquire the equity in the reorganized debtor (*i.e.,* to put up new value), those owners are receiving value "on account of" their old interests in violation of the absolute priority rule. To test the proposed new value, the property must be exposed to the market. This holding appears to overrule the Ninth Circuit's decision in *Bonner Mall Partnership v U.S. Bancorp Mortgage Co. (In re Bonner Mall Partnership)* (9th Cir 1993) 2 F3d 899, motion to vacate denied, appeal dismissed (1994) 513 US 18, 130 L Ed 2d 233, 115 S Ct 386.

NOTE: The court in *203 N. LaSalle* declined to indicate whether the market testing would be satisfied by allowing other parties to (1) propose competing plans or (2) bid against the new value offered by the existing owners under the debtor's plan. Thus, case law regarding the new value exception that is not inconsistent with the narrow holding in *203 N. LaSalle* should continue to have precedential value.

In the Ninth Circuit, subject to the additional requirement of market testing under the *203 N. LaSalle* decision, satisfaction of the new value exception requires the debtor's equity holders to offer value under the proposed plan that is:

(1) New;
(2) Substantial;
(3) In money or money's worth;
(4) Necessary for successful reorganization; and
(5) Reasonably equivalent to the value or interest received.

Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership) (9th Cir 1997) 115 F3d 650, 654. What constitutes adequate new value depends on the circumstances of each case, but *Ambanc* provides some guidance. In that case, a partnership debtor owned an apartment complex. The plan proposed that existing equity contribute cash of $32,000 and make nine annual contributions of $32,000. The lender's secured claim was $4.4 million, its separately classified deficiency claim was $4,044,920, and other unsecured creditors held claims of about $950,000. The Ninth Circuit determined that the proposed new value contribution was insufficient. Only the initial up-front contribution of $32,000 could be considered "money or money's worth." This sum, being less than 0.5 percent of the total unsecured debt and even less of the debt being discharged under the plan, was de minimis and failed the "substantiality" requirement as a matter of law (though the court expressly noted that it was not defining a bright-line rule). The court also commented that if a new value plan is proposed, the bankruptcy court must take care that its analysis of "equivalence" (the fifth component of new value) "only compares what the partners put in to what they get." 115 F3d at 656. See *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177 (trial court must make factual findings to support conclusion that plan provides new value).

In contrast to *Ambanc,* the court in *In re 203 N. LaSalle St. Partnership* (7th Cir 1997) 126 F3d 955, rev'd on other

grounds sub nom *Bank of America v 203 N. LaSalle St. Partnership* (1999) 526 US 434, 143 L Ed 2d 607, 119 S Ct 1411, held that the proposed new value contribution was adequate. In that case, a partnership debtor owned part of a Chicago office building. The lender's secured claim was $56 million, and its unsecured claim was $37 million; property taxes of $2.3 million were outstanding; a general partner had a secured claim; and the partnership owed some $90,000 of trade debt. The plan proposed that existing equity holders contribute cash of $3 million and make five annual contributions of $625,000. Not balking at the fact that some of the contribution was coming in the future, the Seventh Circuit accepted the finding that the new capital had a "present value" of $4.1 million and affirmed the bankruptcy court's finding that this amount satisfied the substantiality requirement both in absolute terms and in relation to the lender's unsecured claim. Whether the Seventh Circuit would accept a contribution consisting solely of future contributions remains an open issue.

PRACTICE TIP: Reliance on future contributions will increase scrutiny of plan feasibility, thus attempting to add new value could potentially result in the plan being found to be unfeasible. Debtor counsel must carefully weigh this risk before proceeding.

A number of lower court decisions also provide insights on what contribution suffices as new value. See *In re Duval Manor Assocs.* (Bankr ED Pa 1996) 191 BR 622 ($100,000 contribution was acceptable new value in case with secured debt of $3.45 million and unsecured debt of $2 million); *In re HRC Joint Venture* (Bankr SD Ohio 1995) 187 BR 202 ($1.3 million contribution constituted acceptable new value in case with $23.4 million of secured debt and $25 million of unsecured debt, given "riskiness" of investment); *In re Gramercy Twins Assocs.* (Bankr SD NY 1995) 187 BR 112 ($250,000 contribution by old partners to retain 70 percent of equity was insufficient to be new value in case with secured debt of $7.6 million and over $13 million of unsecured debt; $1 million contribution by new participant for 30 percent of equity not counted toward old equity's contribution); *In re Dollar Assocs.* (Bankr ND Cal 1994) 172 BR 945 (plan technically complying with new value requirements but involving overencumbered single asset real estate not confirmable because plan was not fair and equitable to secured creditor); *In re Rocha* (Bankr MD Fla 1995) 179 BR 305 (income from debtor's existing rental property is not new value from outside source); *In re Short* (Bankr ED Okla 1994) 173 BR 946 (same); *In re Davis* (Bankr D Ariz 2001) 262 BR 791 (new value plan did not satisfy *203 N. LaSalle* requirements because it did not disclose source of new value or provide market testing approach to new value).

NOTE: The absolute priority rule (see §5.17) requires only that the senior class of creditors be provided full present payment, or its equivalent, under the plan. *Steelcase, Inc. v Johnston (In re Johnston)* (9th Cir 1994) 21 F3d 323 (confirmed plan provided that dissenting unsecured creditors would be paid in full, with interest, on deferred basis, but permitted debtor to retain all of his rights to estate's property and to use estate funds to pay living expenses before he made any payments to objecting class). To satisfy the absolute priority rule, a new value plan proposing to pay creditors over time must also provide for postconfirmation interest to those creditors to compensate them for the time value of their money. *Everett v Perez (In re Perez)* (9th Cir 1994) 30 F3d 1209, 1214.

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§5.22 7. Feasibility Requirement

Before a bankruptcy reorganization plan can be confirmed, the Bankruptcy Code requires the debtor to show that plan confirmation "is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the plan, unless such liquidation or reorganization is proposed in the plan." 11 USC §1129(a)(11). Commonly referred to as the "feasibility requirement," this requires, in essence, that the proposed plan be realistic. To demonstrate that a plan is feasible, the debtor need show only a reasonable probability of success. *Computer Task Group, Inc. v Brotby (In re Brotby)* (BAP 9th Cir 2003) 303 BR 177. Some plans involving deferred payments to a secured lender propose that, in the event of default in making the plan payments, the secured lender be allowed to foreclose. The Eighth Circuit has held that such a foreclosure provision does not satisfy the feasibility requirement. *Danny Thomas Props. II LP v Beal Bank SSB (In re Danny Thomas Props. II LP)* (8th Cir 2001) 241 F3d 959.

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§5.23 8. Other Plan Confirmation Requirements

A plan must provide for cash payment to holders of administrative and priority claims unless the claimant agrees to other treatment, with the exception of priority tax claims, which may be paid over a period not exceeding 5 years from the date of entry of the order of relief. 11 USC §1129(a)(9). In addition, all fees due to the U.S. Trustee must be paid by the effective date of the plan. 11 USC §1129(a)(12).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/5 Reorganization and Liquidation/§5.24 D. Preclusive Effect of Plan Confirmation

§5.24 D. Preclusive Effect of Plan Confirmation

Confirmation of a Chapter 11 plan can result in the preclusion of claims by or against the debtor as well as issue preclusion. Older reported cases discuss these principles in terms of a bar, estoppel, or waiver of claims stemming from plan confirmation. An excellent overview is provided in *Alary Corp. v Sims (In re Assoc. Vintage Group)* (BAP 9th Cir 2002) 283 BR 549. In essence, two primary types of preclusion questions arise from the cases:

- When should the debtor (or its successor) be prohibited from bringing claims against lenders or others?
- When should creditors be prohibited from asserting claims against the debtor or its successor?

With respect to the debtor's claims against others, the difficulty facing the debtor (especially larger businesses) is how to preserve potential claims that have been identified but not yet initiated or that have yet to be identified. This problem is especially acute if a plan is proposed early in the case.

PRACTICE TIP: To avoid an unintentional waiver of claims, a plan and disclosure statement should describe and reserve known claims; include a broad general reservation of unknown, potential claims and defenses; and reserve jurisdiction of the bankruptcy court to decide such claims if that is desired.

More recent decisions validate blanket reservation of potential claims. See *Alary Corp. v Sims (In re Assoc. Vintage Group)* (BAP 9th Cir 2002) 283 BR 549; *National Envt'l Waste Corp. v Stephens, Berg & Lasaster (In re National Envt'l Waste Corp.)* (9th Cir 2000) 200 F3d 1266. See also *Peltz v Worldnet Corp.* (*In re USN Communications, Inc.*) (Bankr D Del 2002) 280 BR 573; *Cohen v TIC Fin. Sys. (In re Ampace Corp)* (Bankr D Del 2002) 279 BR 145. The reservation language should be as clear and as broad as possible. See *D&K Props. Crystal Lake v Mutual Life Ins. Co.* (7th Cir 1997) 112 F3d 257 (ambiguous statement did not suffice to reserve claims regarding interest-rate dispute with lender). A blanket reservation of claims has been held to include the right to seek subordination under 11 USC §510(b); however, the right to subordinate a claim under 11 USC §510(c) may require a detailed summary of the claim being reserved. *In re Worldwide Direct, Inc.* (Bankr D Del 2002) 280 BR 819, 823.

PRACTICE TIP: Claimants should be specific as to the known claims (*i.e.,* contract disputes, claims objections, and recovery actions) and should describe broader reservations both generally ("all claims of any kind") and specifically by type ("all claims arising under §§544, 545, 546, 547, etc." or "all claims to set aside and/or recover preferences, fraudulent conveyances, other avoidable transfers, etc.").

Absent a broadly inclusive claim reservation (with specific known claims actually identified), the debtor may be precluded from raising claims that existed as of the plan confirmation date. *Kelley v South Bay Bank (In re Kelley)* (BAP 9th Cir 1996) 199 BR 698 (failure to specifically identify and reserve known claims against lender barred claims); *In re County of Orange* (Bankr CD Cal 1997) 219 BR 543 (Chapter 9 plan confirmation barred equitable subordination action because plan and disclosure statement retained only defenses, counterclaims, and rights to setoff or recoupment regarding subject creditor). Several courts have dismissed postconfirmation lender-liability actions because the plan and disclosure statement failed to reference the claims. *Hay v First Interstate Bank* (9th Cir 1992) 978 F2d 555 (equitable estoppel based on failure to mention claims in debtor's schedules, disclosure statement, or plan); *Eubanks v FDIC* (5th Cir 1992) 977 F2d 166 (res judicata); *Heritage Hotel Ltd. Partnership I v Valley Bank (In re Heritage Hotel Ltd. Partnership I)* (BAP 9th Cir 1993) 160 BR 374, aff'd (9th Cir 1995) 59 F3d 175 (unpublished opinion) (equitable estoppel and res judicata). Courts have dismissed other claims, including claims by persons affiliated with the debtor, on the same basis. *Harstad v First Am. Bank* (8th Cir 1994) 39 F3d 898 (preference claims barred); *Payless Wholesale Distribs., Inc. v Alberto Culver (P.R.), Inc.* (1st Cir 1993) 989 F2d 570 (antitrust claims judicially estopped); *Sanders Confectionary Prods., Inc. v Heller Fin., Inc.* (6th Cir 1992) 973 F2d 474 (res judicata barred claims by debtor's corporate parent and officer against debtor's lender and Chapter 7 trustee). But res judicata will not bar claims against parties who are not creditors of the estate because the essential element of privity is missing. *CLC Creditors' Grantor Trust v Sonnenschein Nath & Rosenthal LLP (In re Commercial Loan Corp.)* (Bankr ND Ill 2007) 363 BR 559, 569, rev'd in part on other grounds (Bankr ND Ill 2008) 396 BR 730.

Plan confirmation has also been held to bar a debtor's efforts to amend its schedules to add a homestead exemption. *Knupfer v Wolfberg (In re Wolfberg)* (BAP 9th Cir 2000) 255 BR 879. Courts may not apply preclusion theories as stringently in a Chapter 7 case. Compare *Haley v Dow Lewis Motors, Inc.* (1999) 72 CA4th 497, 85 CR2d 352 (judicial estoppel rarely appropriate in Chapter 7 cases against debtors who fail to schedule claim unless intentional self-contradiction is used to obtain unfair advantage), with *Browning Mfg. v Mims (In re Coastal Plains, Inc.)* (5th Cir 1999) 179 F3d 197 (inadvertent nondisclosure of claims in debtor's schedule of assets precludes judicial estoppel only when debtor lacks knowledge of undisclosed claim or has no motive for its concealment).

Claims by lenders and other creditors inconsistent with their treatment under a confirmed plan can also be barred. *Trulis v Barton* (9th Cir 1995) 107 F3d 685 (plan provided that creditors who elected to become members of reorganized country club were deemed to have released managers and confirmation of plan was res judicata; prepetition Racketeer Influenced and Corrupt Organizations Act (RICO) lawsuit by various creditors who voted for plan was dismissed); *M&I Thunderbird Bank v Birmingham (In re Consolidated Water Utils., Inc.)* (BAP 9th Cir 1998) 217 BR 588 (plan that did not provide for interest was binding on creditors, notwithstanding fact that estate funds were available to pay interest). But see *Carolco Television, Inc. v National Broad. Co. (In re De Laurentiis Entertainment Group)* (9th Cir 1992) 963 F2d 1269 (confirmation did not bar creditor's right to setoff).

A creditor's unsuccessful objection to plan confirmation may also have preclusive impact. *CoreStates Bank, N.A. v Huls Am., Inc.* (3d Cir 1999) 176 F3d 187 (bank's claim in subordination action against another secured creditor barred by claim preclusion because bank's prior objection to plan confirmation was held to be same claim). Similarly, a party may not collaterally attack plan provisions that were not objected to at the time the plan was confirmed. *Stratosphere Litig. LLC v Grand Casinos, Inc.* (9th Cir 2002) 298 F3d 1137 (confirmed plan that discharged claims asserted in litigation was res judicata even if discharge was illegal third party release that could not have been approved over objection).

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§5.25 E. Interpretation and Modification of Plan

The proponent of a Chapter 11 plan may be allowed to modify the plan at any time before confirmation, but not if the modification causes the plan to fail to meet the 11 USC §§1122-1123 requirements (see §§5.6-5.10). See 11 USC §1127. See also *National Loan Investors, LP v Brewster (In re Brewster)* (BAP 9th Cir 1999) 243 BR 51 (abuse of discretion to not allow creditor continuance to obtain evidence to rebut proposed plan modification received 6 days before hearing). However, after a plan is substantially consummated, it cannot be modified. See 11 USC §§1101(2), 1127(b); *Antiquities, Inc. v Bala Cynwyd Corp. (In re Antiquities, Inc.)* (BAP 9th Cir 1994) 173 BR 926 (following cases that segregate cash from other property to determine substantial consummation). But see *Beal Bank v Jack's Marine, Inc.* (ED Pa 1996) 201 BR 376 (bankruptcy court properly enforced consent agreement regarding plan payment to secured lender; court may clarify or interpret confirmed plan under 11 USC §§105 and 1142 without modifying plan).

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) modified this rule in cases filed by individuals. At any time after confirmation and before completion of plan payments, an individual Chapter 11 debtor's plan can be modified to (1) increase or decrease payments of claims in a particular class, (2) extend or reduce the time for payments, or (3) alter the amount of a distribution to a creditor to take account of any nonplan payments to that creditor. 11 USC §1127(e). A motion to make a modification may be made by the debtor, a trustee, the U.S. Trustee, or the holder of an allowed unsecured claim. These BAPCPA rules for Chapter 11 cases are similar to existing modification provisions in 11 USC §1329 governing modification of Chapter 13 plans, and thus case law interpreting §1329 may be influential. See §5.40. In any event, changes in the individual debtor's postconfirmation financial circumstances may lead to considerable plan modification disputes.

A confirmed plan is treated as a contract that is binding on the debtor and its creditors and, unless the plan provides otherwise, should be interpreted consistently with state law. *Hillis Motors, Inc. v Hawaii Auto. Dealers' Ass'n* (9th Cir 1993) 997 F2d 581.

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§5.26 F. Appeals From Confirmation Orders

An order confirming a plan is automatically stayed for 14 days unless the court orders otherwise. Fed R Bankr P 3020(e). Absent a stay during the pendency of the appeal, the appeal may be mooted by consummation of the plan. See §§10.95-10.101 on appeals generally and on mootness rules regarding appeals from confirmation orders.

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III. CHAPTER 13 PLANS

§5.27 A. Individual Debt Adjustment; Qualifying Debtors

Chapter 13 is designed to provide financially troubled consumers with an alternative to a straight liquidation of assets under Chapter 7. Under a Chapter 13 plan, debtors retain most if not all of their assets and pledge future wages to what is essentially a court-supervised debt consolidation and deferred payment scheme. See 11 USC §1322(a). Unless the plan or confirmation order provides otherwise, a standing trustee makes distributions to creditors, and the debtor makes plan payments to the trustee. 11 USC §1326. It is not unusual for a plan to provide that the debtor will make mortgage payments directly to a lender.

Chapter 13 is available to individuals, or to individuals and their spouses, with regular sources of income and limited indebtedness. 11 USC §109(e). One feature distinguishing Chapter 13 from Chapter 7 is the discharge. A debtor who files a Chapter 7 case may still find that a number of debts are not dischargeable. See 11 USC §523(a). Under BAPCPA, exceptions to discharge under 11 USC §523(a) were expanded. In addition, a discharge is available under Chapter 7 only once every 8 years (6 years after a prior discharge in Chapter 13). 11 USC §727(a).

Prior to BAPCPA, individuals were encouraged to file under Chapter 13 because nondischargeable debts were primarily limited to the tax, fraud, and other exceptions under the pre-BAPCPA 11 USC §523(a); child and spousal support; student loans; restitution or fines resulting from criminal convictions; and drunk driving wrongful death claims. 11 USC §1328(a). BAPCPA also added a number of additional limits to Chapter 13 discharge, the most significant of which are the following:

- No discharge of debts arising from claims of wrongful death or injury caused by the debtor's drunk driving (also not dischargeable under Chapter 7, 11, or 12) (see 11 USC §§523(a)(9), 1328(a));
- No discharge of debts owed to pension, profit-sharing, stock bonus, or similar plans (also not dischargeable under Chapter 7, 11, or 12) (see 11 USC §§523(a)(18), 1328(a));
- No discharge of debts in the form of restitution or damages resulting from civil actions against the debtor for willful or malicious acts causing personal injury or death (see 11 USC §1328(a)(4));
- No discharge of debts if the debtor received a discharge in a prior Chapter 7, 11, or 12 case during the 4 years preceding the filing of the Chapter 13 case (see 11 USC §1328(f)(1)); and
- No discharge of debts if the debtor received a discharge in a prior Chapter 13 case during the 2 preceding years (see 11 USC §1328(f)(2)).

In a Chapter 13 case, the debtor generally does not receive a discharge until all payments provided for in the plan are made and until the debtor completes an instructional course on personal financial management. 11 USC §1328(a), (g).

Several features of Chapter 11 plans do not apply to Chapter 13 cases. Chapter 13 has no concept of impaired classes, no voting on plans (other than by secured creditors), no period of exclusivity for filing plans (only the debtor may ever file a plan (11 USC §1321)), no option for nonrecourse lenders to have recourse, and nothing resembling the 11 USC §1111(b)(2) election. Cramdown is available, but without the "fair and equitable" standard. 11 USC §1325. See §§5.6-5.9, 5.17-5.20, 10.90.

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§5.28 B. Contents of Chapter 13 Plan

Bankruptcy Code §1322 governs the contents, both mandatory and optional, of a Chapter 13 plan. The payout period under a Chapter 13 plan is usually 3 years but may be extended by the court for cause to a maximum of 5 years. 11 USC §1322(d). Debtors with higher income (based on a median income standard) may propose plans up to 5 years in length and debtors with lower income may propose plans up to 3 years.

A Chapter 13 plan may modify unsecured debt. 11 USC §1322(b)(2). A Chapter 13 plan may also modify secured debt other than loans secured only by the debtor's primary residence and cure defaults on secured debt. See §§5.29-5.35.

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§5.29 1. Modification of Secured Debt

Modifications of secured debt in Chapter 13 plans are governed by 11 USC §§1322 and 1325 and are similar in many respects to modifications permitted in Chapter 11 plans. They consist of lien-stripping (either completely or down to the value of the collateral, to the limited extent still allowed after BAPCPA) (see §§5.9, 5.30-5.34, 10.89); curing defaults (see §5.35); or altering loan terms (such as lowering the interest rate or extending the repayment period, with or without a corresponding reduction in the monthly payment) (see, *e.g.,* §5.9), subject to the limitations on plan periods under 11 USC §1322(d) (see §5.28).

In general, in Chapter 13, any property acquired with purchase money financing within 12 months before a bankruptcy case cannot be the subject of a strip-down motion. See clause following 11 USC §1325(a)(9). Further, when lien-stripping is allowed, the lien will not be released until all plan payments have been made and the debtor receives a discharge. 11 USC §1325(a)(5)(B)(i). If the case is converted to Chapter 7, the creditor retains the full amount of its original lien. 11 USC §348(f)(1)(C).

NOTE: Bankruptcy Code §506(a)(2) specifically requires that property acquired for "personal, family or household purposes" be valued at its "replacement value," being the price a retail merchant would charge for that property considering its age and condition at the time of valuation. This protects creditors who finance consumer merchandise by requiring significantly higher valuations of their collateral when lien-stripping is allowed. Furthermore, costs of sale and marketing may *not* be deducted when calculating value for lien-stripping purposes. On valuation and appraisal standards, see §§5.18, 5.34, 5.37, 10.38, 10.88.

As in Chapter 11, a Chapter 13 plan may not modify the rights of a secured creditor whose claim is secured only by the debtor's principal residence. See 11 USC §1322(b)(2). See also §5.31.

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§5.30 a. Due Process Issues

The circumstances under which a Chapter 13 plan may modify a secured creditor's claim without initiation of a claim objection have been the subject of considerable dispute. The issue highlights the tension between the preclusive effect of plan confirmation (see §5.39) and the due process rights afforded creditors under the Bankruptcy Code's claim allowance provisions. The Ninth Circuit bankruptcy appellate panel held that "a plan can effectively determine value and/or avoid a lien only if the creditor receives clear notice that the plan will do so." *Shook v CBIC (In re Shook)* (BAP 9th Cir 2002) 278 BR 815, 824. A plan that is silent or ambiguous about a secured claim provides no notice of what will happen to the secured claim and therefore cannot effectively avoid the lien or determine its value. *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856. Compare *Shook* and *Brawders* with *Universal Am. Mortgage Co. v Bateman (In re Bateman)* (11th Cir 2003) 331 F3d 821 (confirmed plan that unilaterally cut secured lender's arrearage claim by half did not preclude lender from recovering full arrears under mortgage to extent not paid in full by plan payments). See §5.9 on modification of secured claims in context of Chapter 11.

The plan in *Brawders* was found to be ambiguous and therefore provided insufficient notice to effectively strip the tax agency's lien. In an analogous case involving student loans (which require an adversary proceeding to discharge), the Ninth Circuit found that a creditor need only get ordinary notice of a Chapter 13 plan to be bound by its terms. *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113, cert granted (2009) 174 L Ed 2d 289, 129 S Ct 2791. Thus, if the plan unambiguously proposes to affect a secured residential mortgage lien, it may be found to effectively strip the lien despite the prohibition under 11 USC §1322(b)(2). See §5.34.

PRACTICE TIP: Although an adversary proceeding may not always be required to strip off an unsecured lien, due process requires that a plan make a clear statement of intention and be served on the affected creditor in accordance with Fed R Bankr P 7004(b)(3) not merely by mailing under Fed R Bankr P 2002 (*i.e.,* it must be addressed to an officer or agent of the creditor). *In re Pereira* (Bankr SD Cal 2008) 394 BR 501. The best practice is for the debtor to be explicit in its filings and for creditors to be attentive to those filings.

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§5.31 b. Home Mortgages

In Chapter 13 cases, the debtor's encumbered property typically consists of a car and a home, although a debtor may sometimes own income-producing real property. As in Chapter 11 plans (see §5.10), the Bankruptcy Code draws a distinct line between the treatment of home mortgages and other secured debt by providing that a Chapter 13 plan may modify the rights of secured creditors, but not if the creditor's claim is secured only by the debtor's principal residence. See 11 USC §1322(b)(2). Consequently, the incidence of secured debt modification in Chapter 13 cases is low. If modifiable debt exists, a debtor may modify such debt (*e.g.,* by lien-stripping) only under a plan that provides for full payment of the secured portion of the claim over the life of the plan. *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165 (nonresidential mortgage).

There are only two statutory exceptions to the prohibition on modifying a home mortgage. The first exception allows a plan to provide for the cure of home mortgage defaults. See 11 USC §1322(b)(5), (c)(1), discussed in §5.35. The second exception permits a debtor to stretch out the repayment period for a home loan that would otherwise mature prior to the completion of the debtor's 3- to 5-year payment plan. See 11 USC §1322(c)(2), (d). See also *In re Hussain* (Bankr D NJ 2000) 250 BR 502; *In re Lobue* (Bankr SD Fla 1995) 189 BR 216. The courts are divided on whether the second exception allows only an extension of the loan (subject to the requirements for cramdown under 11 USC §1325(a)(5), discussed in §5.37) or authorizes additional modifications such as lien-stripping of an undersecured loan. Compare *Witt v United Cos. Lending Corp. (In re Witt)* (4th Cir 1997) 113 F3d 508 (lien-stripping *not* allowed) with *First Union Mortgage Corp. v Eubanks (In re Eubanks)* (BAP 6th Cir 1998) 219 BR 468 (lien-stripping and payment modification permitted) and *Magnolia Mortgage v Arnett (In re Arnett)* (SD Ala 2002) 278 BR 239 (lien-strip permitted if plan provides for full payment of secured portion of loan with balloon payment at end of plan).

Most deeds of trust grant the beneficiary a security interest in the impound escrow accounts used for payment of taxes or insurance, and these accounts may be used to offset a payment default. Bankruptcy courts outside California are split on whether the grant of such "incidental security interests" strips creditors of the protection provided to a claim secured solely by the debtor's principal residence under 11 USC §1322(b)(2). Such claims may not be modified by the debtor's bankruptcy plan, while a claim that is secured by the principal residence and something more may be modified. See, *e.g., Brown v Master Fin., Inc. (In re Brown)* (Bankr MD Fla 2004) 311 BR 282 (mortgagee with security interest in tax and insurance escrow account forfeits protection from modification in §1322(b)(2)); *Reed v Norwest Mortgage, Inc. (In re Reed)* (Bankr ED Pa 2000) 247 BR 618 (creditor's security interest in impound accounts allows debtor to bifurcate claim into secured and unsecured portions under plan). See also *Rodriguez v Mellon Bank, N.A. (In re Rodriguez)* (Bankr ED Pa 1998) 218 BR 764 (escrow accounts are "typical feature" in every mortgage; to hold that they remove mortgage from antimodification clause emasculates §1322(b)(2)). To date, the California bankruptcy courts do not appear to have weighed in on this issue.

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§5.32 c. Multiunit Properties

Not surprisingly, there has been substantial litigation about whether certain mortgages held by secured lenders can be modified. If the home mortgage prohibition applies, the lender's secured claim cannot be stripped down to the value of its collateral or otherwise varied. *Nobelman v American Sav. Bank* (1993) 508 US 324, 124 L Ed 2d 228, 113 S Ct 2106 (no strip down); *Smith v Reeves (In re Reeves)* (BAP 9th Cir 1994) 164 BR 766 (short-term, non-purchase money loan could not be modified); *In re Martin* (Bankr D Conn 1995) 176 BR 675 (due-on-sale clause could not be modified).

The majority view is that the prohibition does not apply if the debtor occupies one unit of a multiunit property. Compare *Scarborough v Chase Manhattan Mortgage Corp. (In re Scarborough)* (3rd Cir 2006) 461 F3d 406 (prohibition inapplicable to income-producing units; bifurcation of secured claim allowed), *Lomas Mortgage, Inc. v Louis* (1st Cir 1996) 82 F3d 1 (same), *In re Kimbell* (Bankr WD NY 2000) 247 BR 35 (same), and *In re Del Valle* (Bankr D Conn 1995) 186 BR 347 (debtor's home with income unit is not "only" debtor's personal residence) with *In re Macaluso* (WD NY 2000) 254 BR 799 (prohibition applicable even though property contained both duplex and barbershop) and *Litton Loan Servicing, LP v Beamon* (ND NY 2003) 298 BR 508 (prohibition applicable if facts and circumstances show that parties intended to enter into consumer-residential rather than commercial transaction).

NOTE: California law generally treats 1- to 4-unit properties as residential property. See, *e.g.,* CC §2924.6. It is not clear how a California bankruptcy court would treat a duplex, triplex, or fourplex with an owner-occupied unit. In addition, the value and debt of most of these properties will exceed Chapter 13 limits.

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§5.33 d. Personal Property

Considerably more litigation has arisen because many home mortgages contain boilerplate language adding miscellaneous personal property to a lender's collateral. These cases mostly involve attempts by the debtor to confirm a plan that modifies a mortgage by stripping the lien of an undersecured lender down to the lower value of the debtor's residence. The courts have split in their analysis of the problem.

Some courts have allowed lien-stripping when additional personal property collateral such as appliances, machinery, furniture, equipment, or escrow accounts exists. See, *e.g., Hammond v Commonwealth Mortgage Corp. (In re Hammond)* (3d Cir 1994) 27 F3d 52, 56 (lien on personal property including common areas of condominium complex, escrow funds, proceeds of hazard insurance, and rents); *Johns v Rousseau Mortgage Corp. (In re Johns)* (3d Cir 1994) 37 F3d 1021; *In re Lara* (Bankr SD Tex, Apr. 8, 2008, No. 07-60188) 2008 Bankr Lexis 1158 (lien on mobilehome residence was lien on personal property under Texas law and therefore could be stripped down); *In re Libby* (Bankr D NJ 1996) 200 BR 562 (unpledged tax escrow account not additional collateral, but pledge of deposit accounts, though none existed, was); *Mellon Bank v Crystian (In re Crystian)* (Bankr WD Pa 1996) 197 BR 803 (security interest in checking account and pledged escrow account); *In re Escue* (Bankr MD Tenn 1995) 184 BR 287 (collecting earlier cases).

Other courts have rejected the argument that items typically listed in boilerplate mortgage forms—such as rents, royalties, profits, and fixtures—constitute additional collateral, because those items are inextricably bound to the real property. See, *e.g., Allied Credit Corp. v Davis (In re Davis)* (6th Cir 1993) 989 F2d 208; *RTC v Washington (In re Washington)* (5th Cir 1992) 967 F2d 173 (credit life and disability insurance not additional collateral); *In re Rosen* (D NJ 1997) 208 BR 345 ("rents and profits" and "taxes and hazard insurance" escrows not additional collateral). See also *Lievsay v Western Fin. Sav. Bank (In re Lievsay)* (BAP 9th Cir 1996) 199 BR 705 (analyzing 11 USC §1123(b)(5), Chapter 11 counterpart of 11 USC §1322(b)(2); also rejecting argument that home office use justified modification).

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§5.34 e. Junior Liens; Creditor Strategies

One of the most important issues in Chapter 13 cases arises when debtors attempt to strip junior liens from their home. Bankruptcy Code §1322(b)(2) states that Chapter 13 plans can modify the rights of holders of secured claims "other than a claim secured only by a security interest in real property that is the debtor's residence." 11 USC §1322(b)(2). Despite §1322(b)(2), the bankruptcy appellate panel of the Ninth Circuit ruled in *Lam v Investors Thrift (In re Lam)* (BAP 9th Cir 1997) 211 BR 36 that the liens of junior deed of trust holders can be stripped by Chapter 13 debtors if the value of the debtor's home is less than the amount owed to senior deed of trust holders. In other words, if there is no equity in the debtor's home to support any part of the junior lienholder's position, the entire junior's claim can be converted to unsecured debt. See §§10.42, 10.59. The *Lam* holding was confirmed by the Ninth Circuit in *Zimmer v PSB Lending Corp. (In re Zimmer)* (9th Cir 2002) 313 F3d 1220, and the rule has been followed in many other circuit courts addressing the issue. See, *e.g., Griffey v U.S. Bank (In re Griffey)* (BAP 10th Cir 2005) 335 BR 166; *Obeid v SunTrust Bank (In re Obeid)* (Bankr D Md, Dec. 12, 2008, No. 08-19917PM) 2008 Bankr Lexis 3395.

Lam and *Zimmer* have profound implications for lenders in the state of California. It is now routine for Chapter 13 debtors to strip junior deeds of trust, depending on their home values and the dollar amounts of senior claims, and it may be difficult for creditors' counsel to be able to avoid application of these cases. In a Chapter 13 proceeding to strip a junior deed of trust, counsel for the junior trust deed holder should consider the following possible strategies:

- **Valuation.** If creditor's counsel can prove that there is sufficient value in the property to support any portion of the client's secured claim, the entire claim survives. Retaining an appraiser as an expert witness is therefore crucial. See §10.38. The proper standard for valuing property the debtor intends to keep as a residence is fair market value, not replacement value or foreclosure value, because the property is not being replaced or foreclosed under the plan. "Fair market value" means the price that "a willing seller under no compulsion to sell and a willing buyer under no compulsion to buy would agree upon after the property has been exposed to the market for a reasonable time." *Taffi v U.S. (In re Taffi)* (9th Cir 1996) 96 F3d 1190, 1192. Appraisals based on comparable properties sold by banks can be unreliable indicators of fair market value because, absent evidence to the contrary, banks selling distressed property are not willing sellers under no compulsion to sell. *In re Serda* (Bankr ED Cal 2008) 395 BR 450. For further discussion of valuation, see §§5.18, 5.37, 10.38, 10.88.
- **Bad faith.** Look for evidence of bad faith. Perhaps the debtor intentionally failed to pay property taxes and mortgage payments prepetition in order to reduce the equity in the property available for the junior lienholder's claim. Evidence of this type of conduct will exist if payments to mortgage holders ceased after the debtor first consulted a bankruptcy attorney. Other evidence of bad faith exists if sufficient funds were on hand on or shortly before the petition date to make mortgage and property tax payments, the implication being that the debtor intentionally stopped making the payments in order to further a lien-stripping action.
- **Procedural objection.** Some debtors attempt to strip a junior lien by filing a motion. Under Fed R Bankr P 7001, proceedings to determine the validity, priority, or extent of a lien must be brought by an adversary proceeding. The junior lienholder should insist that the debtor comply with the more time-consuming and costly requirements for an adversary proceeding.
- **Debtor eligibility.** Look for problems in the debtor's Chapter 13 case that are unrelated to the lien-stripping proceeding. This is another way of saying that the best defense is a good offense. Perhaps the debtor is ineligible for Chapter 13, or perhaps insufficient income is being dedicated to repay unsecured creditors. Lien-stripping (based on the *Lam* case) is clearly not available in the Ninth Circuit in Chapter 7 cases. *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773; *Laskin v First Nat'l Bank (In re Laskin)* (BAP 9th Cir 1998) 222 BR 872. If a debtor's entire Chapter 13 case can be attacked successfully, the lien-stripping issue will become moot. To the extent that the debtor is successful in stripping a creditor's junior deed of trust, the creditor will hold an unsecured claim. If that will push the debtor over the eligibility limitation stated in 11 USC §109(e) on unsecured claims (currently $336,900), the entire Chapter 13 case must be dismissed.

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§5.35 2. Cure of Defaults and De-Acceleration

A Chapter 13 plan may provide for the cure of defaults, including a defaulted loan secured by the debtor's principal residence, within a "reasonable period of time" and for the maintenance of payments to the lender while the case is pending. 11 USC §1322(b)(3), (b)(5). A Chapter 13 plan cannot cure defaults on a loan secured by the debtor's principal residence after the residence is actually sold at a foreclosure sale that complies with applicable nonbankruptcy law. 11 USC §1322(c)(1). See *Litton v Wachovia Bank (In re Litton)* (4th Cir 2003) 330 F3d 636 (cure includes defaults under settlement agreement which secured lender agreed to in prior bankruptcy case); *Oregon v Hurt (In re Hurt)* (BAP 9th Cir 1993) 158 BR 154 (cure permissible after entry of judgment of foreclosure if no foreclosure sale had been conducted); *Oregon v Braker (In re Braker)* (BAP 9th Cir 1991) 125 BR 798.

A cure of defaults effectively "de-accelerates" an obligation, even if the acceleration occurred prior to the filing of the Chapter 13 case. See *In re Nelson* (BAP 9th Cir 1985) 59 BR 417; *DiPierro v Taddeo (In re Taddeo)* (2d Cir 1982) 685 F2d 24. Chapter 13 does not have a provision parallel to 11 USC §1124(2), which specifically authorizes de-acceleration. Most courts, however, have held that de-acceleration of a fully accelerated obligation under 11 USC §1322(b)(3) and (b)(5) does not trigger the home mortgage antimodification provisions of §1322(b)(2). See *In re Nelson* (BAP 9th Cir 1985) 59 BR 417; *Mid-State Homes, Inc. v Cheeks (In re Cheeks)* (Bankr MD Ala 1982) 24 BR 477 (collecting cases reaching both similar and contrary results). The Chapter 13 cure provisions are in marked contrast with those in Chapter 11, which require a cure to be made in cash at plan confirmation for de-acceleration to occur without impairment of the claim. 11 USC §1124(2).

The amount necessary to cure a default is calculated according to the underlying loan agreement and applicable state law. 11 USC §1322(e). These may require interest to be paid on arrearages. *In re Mendez* (Bankr D NJ 2000) 255 BR 143 (interest on entire arrears allowable whether claim is oversecured or not). But see *In re Arvelo* (Bankr D NJ 1995) 176 BR 349 (undersecured lender not entitled to postpetition interest before plan confirmation and entitled to postconfirmation interest on arrearages only to extent arrearages are secured). For cases involving loan agreements made before October 24, 1994, the effective date of §1322(e), confirmation of a plan curing a defaulted mortgage may require interest on arrears whether the loan is undersecured or oversecured. *In re Rita Hardware* (Bankr ED NY 1995) 189 BR 273.

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C. Confirmation and Cramdown in Chapter 13

§5.36 1. Plan Confirmation Requirements

The confirmation standards for Chapter 13 plans share many features with those for confirmation of plans in Chapter 11 cases. A Chapter 13 plan must include the provisions required by 11 USC §1322 and be proposed in good faith. 11 USC §1325(a)(1), (a)(3), (a)(7). See §5.14. On what constitutes bad faith and statutory and case law responses to bad faith, see §§10.2, 10.21-10.24.

The plan must also be feasible. 11 USC §1325(a)(6). See §5.22. See also *First Nat'l Bank of Boston v Fantasia (In re Fantasia)* (BAP 1st Cir 1997) 211 BR 420 (plan proposing payment on 15-year amortization schedule with interest and balloon payment after 60 months permissible but not shown to be feasible); *In re Harris* (Bankr D NH 1996) 199 BR 434 (plan proposing mortgage modification with substantial balloon payment at end of 5 years rejected because debtor's ability to make balloon payment too speculative).

One notable distinction from Chapter 11 is the limitation on acceptance of the plan by secured creditors. See 11 USC §1325(a)(5)(A). See also §§5.11, 5.15. As discussed in §5.37, a Chapter 13 plan may still be crammed down on a dissenting secured creditor. Solicitation of acceptance or rejection of a Chapter 13 plan from unsecured creditors is not required, but the plan's treatment of unsecured creditors must satisfy the "best interests" test. See §5.16. In other words, unsecured creditors must receive payments under the plan that are not less than the distribution they would receive in a Chapter 7 case. 11 USC §1325(a)(4).

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§5.37 2. Cramdown of Secured Creditors

If a secured creditor does not accept the proposed plan, it may still be crammed down on the creditor. Cramdown is only available to modify a loan secured by the debtor's primary residence if an exception to the modification prohibition of 11 USC §1322(b)(2) exists. See §§5.10, 5.29-5.35. Chapter 13 trustees have standing to object to a plan that fails to treat secured creditors properly despite the lack of any objection by secured creditors. *Andrews v Loheit (In re Andrews)* (9th Cir 1995) 49 F3d 1404.

Assuming §1322(b)(2) does not apply, the debtor has two cramdown alternatives. One option is to surrender the collateral to the secured creditor. 11 USC §1325(a)(5)(C). If the property is overencumbered, the surrender option will only satisfy the secured portion of the creditor's claim.

PRACTICE TIP: If the debtor intends to surrender real property collateral to the secured creditor, the debtor should do so early in the case (or even before the case) when a deed in lieu of foreclosure, an agreement to foreclose by power of sale, or an outright release, any of which would bar liability for a deficiency claim, can usually be negotiated with no difficulty.

The second option requires the secured creditor to retain its lien on the collateral and to receive property (*i.e.,* payments) having a present value, as of the effective date of the plan, of at least the amount of the allowed secured claim. 11 USC §1325(a)(5)(B). Such payments must be made over the life of the plan. See *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165. See §5.29. Periodic payments must be "in equal monthly amounts," and the plan must provide that the lender retain its lien until the earlier of (1) payment of the underlying debt determined under nonbankruptcy law or (2) the debtor's discharge under the plan. 11 USC §1325(a)(5)(B).

This second option requires determination of the value of the collateral and an appropriate interest rate to determine present value. As in a Chapter 11 case, the allowed amount of a secured claim is governed by 11 USC §506(a). Chapter 13, however, does not contain an analog to 11 USC §1111(b)(2) allowing an undersecured creditor to elect to be treated as fully secured. See §10.90. Thus, the undersecured creditor's allowed secured claim will equal the value of its collateral, and the creditor will have an allowed unsecured claim for the deficiency, assuming the debt is a recourse obligation. In a Chapter 13 case, the proper valuation standard for collateral being retained by a debtor under a cramdown plan is the "replacement value" of that collateral (as defined in *Associates Commercial Corp. v Rash* (1997) 520 US 953, 959 n2, 138 L Ed 2d 148, 156 n2, 117 S Ct 1879) rather than the liquidation value the secured creditor would realize at a foreclosure sale. The U.S. Supreme Court, in a plurality decision, held that the cramdown interest rate should be determined by use of the "prime-plus" approach (also known as the "formula rate"). This approach is in contrast to others, variously called the "similar-loan" and "presumptive-contract-rate" approaches. *Till v SCS Credit Corp. (In re Till)* (2004) 541 US 465, 158 L Ed 2d 787, 124 S Ct 1951. The formula-rate calculation starts with the national prime rate charged to creditworthy borrowers. That rate is then adjusted to reflect the greater risk of nonpayment by the debtor, which depends on factors such as "the circumstances of the estate, the nature of the security, and the duration and feasibility of the reorganization plan." 541 US at 479, 158 L Ed 2d at 800. See *In re Pluma (Tax Collector for the County of San Diego v Pluma)* (BAP 9th Cir 2003) 303 BR 444, aff'd, (9th Cir 2005) 427 F3d 1163 (formula approach incorrectly applied if trial court fails to consider risk of default). On valuation and interest rates in cramdown under Chapter 11, see §5.18.

NOTE: A confirmed plan purporting to avoid all liens unless a proof of claim is filed did not terminate the lien held by a secured creditor that failed to file a claim. *Cen-Pen Corp. v Hanson* (4th Cir 1995) 58 F3d 89 (rejecting such avoidance without due process safeguards of adversary proceeding).

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§5.38 3. Cramdown of Unsecured Creditors

The unfortunate secured lender may find itself with an unsecured deficiency claim either because the lender is undersecured or completely unsecured due to low collateral value or senior liens or both. Although unsecured creditors do not vote to accept or reject a Chapter 13 plan, an unsecured creditor may voice its dissent by objecting to confirmation. In that case, the debtor must satisfy the requirements for cramdown of the unsecured creditor's claim. 11 USC §1325(b)(1). Cramdown is allowed if the plan provides for total payment to the creditor of not less than the amount of the creditor's claim. 11 USC §1325(b)(1)(A). Alternatively, all of the debtor's projected disposable income for the 3-5 years following confirmation must be applied to making payments under the plan. 11 USC §1325(b)(1)(B). BAPCPA significantly revised the definition of "disposable income" primarily by incorporating the means test standards under 11 USC §707(b)(2)(A)-(B) for determining what amount will be deemed "reasonably necessary" for certain expenses. See 11 USC §1325(b)(2)-(3). On means test, see §§4.82, 5.54.

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§5.39 D. Preclusive Effect of Plan Confirmation

A confirmed Chapter 13 plan is binding on the debtor and each creditor, whether or not the claim of a creditor is provided for by the plan and regardless of whether a creditor objected to, accepted, or rejected the plan. 11 USC §1327(a). Except as otherwise provided in the plan or confirmation order, confirmation of a plan also vests all property of the bankruptcy estate in the debtor free and clear of any claim or interest of any creditor provided for by the plan. 11 USC §1327(b)-(c). It follows that confirmation of a Chapter 13 plan, as with a Chapter 11 plan, has a claim-preclusive and issue-preclusive effect for all justiciable issues that were or could have been decided at the confirmation hearing. On Chapter 11 preclusion, see §5.24. However, plan confirmation does not preclude a challenge to treatment of secured debt under a plan if that treatment was subject to a pending adversary proceeding. *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165.

Preclusion may compromise a creditor's rights that are inconsistent with the plan. *Great Lakes Higher Educ. Corp. v Pardee (In re Pardee)* (9th Cir 1999) 193 F3d 1083 (plan confirmation is res judicata even if provision at issue might otherwise have violated Bankruptcy Code); *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113, cert granted (2009) 174 L Ed 2d 289, 129 S Ct 2791 (court of appeals allowed student loan to be discharged by inclusion in plan because creditor failed to object after notice of proposed plan); *Multnomah County v Ivory (In re Ivory)* (9th Cir 1995) 70 F3d 73 (rejecting county's claim that tax foreclosure and expiration of redemption period preconfirmation deprived bankruptcy court of jurisdiction); *In re Chappell* (7th Cir 1993) 984 F2d 775 (court denied lender's request for additional interest after payments under confirmed Chapter 13 plan were completed consistent with lender's proof of claim—waiver and res judicata); *In re Rascon* (ND Cal 2005) 321 BR 48 (plan modification of secured claim allowed). However, the debtor has the burden of proving that claim preclusion applies and, in particular, of showing that the plan clearly stated the intended effect on the issue in dispute. *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856 (model plan treatment of tax lien not sufficiently clear to modify lien rights or claim amount).

Preclusion may also block claims by a debtor. *Sure-Snap Corp. v State St. Bank & Trust Co.* (2d Cir 1991) 948 F2d 869 (lender liability claims barred). But preconfirmation claims omitted from the debtor's plan are not barred by res judicata if they lie against parties who are not creditors in the case. *Air Cargo, Inc. Litig. Trust v i2 Technol., Inc. (In re Air Cargo, Inc.)* (Bankr D Md 2008) 401 BR 178. See also *Donato v Metropolitan Life Ins. Co.* (Bankr ND Cal 1999) 230 BR 418 (debtor's failure to include wrongful termination claim in schedules was not grounds for judicial estoppel, because debtor's plan provided for 100-percent payout to creditors; former employer was not creditor and thus had no right to vote on plan; and there was no prejudice to creditors).

An action to revoke an order confirming a plan on the basis of fraud must be filed within 180 days after entry of the order. 11 USC §1330(a). This time limit is generally not subject to exception and reinforces the intertwined policies of finality and claim preclusion. See *In re Valenti* (BAP 9th Cir 2004) 310 BR 138.

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§5.40 E. Modification of Chapter 13 Plan

Before confirmation, a Chapter 13 plan may be modified at any time as long as the modified plan satisfies the requirements of 11 USC §1322. 11 USC §1323(a). A secured creditor is deemed to continue its acceptance or rejection of the modified plan unless the modification changes the rights of the secured creditor and the creditor then changes its prior acceptance or rejection. 11 USC §1323(c).

After confirmation and at any time before payments under the plan are completed, a plan may be modified at the request of the debtor, the Chapter 13 standing trustee, or an unsecured creditor to (1) increase or reduce payments to a particular class, (2) extend or reduce the time for payments, or (3) alter the distribution amount to a creditor as needed to take account of any payment on the claim outside of the plan. 11 USC §1329(a). The modified plan must still comply with the requirements for a Chapter 13 plan. 11 USC §1329(b)-(c). In the Ninth Circuit, if the trustee seeks modification but the debtor or a creditor objects, the trustee must show that there has been a substantial change in the debtor's ability to pay since the confirmation hearing and that the change had not been anticipated at the time of confirmation. *Anderson v Satterlee (In re Anderson)* (9th Cir 1994) 21 F3d 355. In certain circumstances, the Bankruptcy Code also allows modification to reduce plan payments by the amount the debtor pays for health insurance. 11 USC §1329(a)(4).

The Sixth Circuit held that §1329(a) does not allow a debtor to "alter, reduce, or reclassify" a previously allowed secured claim, except to alter the amount or timing of specific payments. See *Chrysler Fin. Corp. v Nolan (In re Nolan)* (6th Cir 2000) 232 F3d 528, 533. See also *In re Cruz & Santiago* (Bankr D NJ 2000) 253 BR 638 (Chapter 13 debtors could not modify payments being made to mortgagee to zero). For cases reaching a contrary conclusion, see *In re Zeider* (Bankr D Ariz 2001) 263 BR 114 (creditor's liquidation of motor vehicle securing its claim constituted cause for allowing modification of plan, reducing schedule payments on creditor's secured claim to zero); *In re Mason* (Bankr ND Cal 2004) 315 BR 759 (rejecting reasoning of *In re Nolan* in favor of *In re Zeider*). See summary of more recent cases in *In re Davis* (Bankr SD Tex 2009) 404 BR 183.

If a debtor realizes a windfall from collateral appreciation after confirmation, it may be possible to amend the plan to increase payments to creditors, although the debtor is entitled to object to the motion to amend. See *Fridley v Forsythe (In re Fridley)* (BAP 9th Cir 2007) 380 BR 538, 543. In *Barbosa v Soloman* (1st Cir 2000) 235 F3d 31, the debtor later sold for $137,500 property securing a creditor's claim that had been "stripped down" in value from $114,000 to $64,000 under the plan. The Chapter 13 trustee was allowed to amend the plan. 235 F3d at 41. It may also be possible to modify a plan to provide for payment over less than 3 years and without payment of allowed claims in full. *Sunahara v Burchard (In re Sunahara)* (BAP 9th Cir 2005) 326 BR 768 (debtor allowed to modify confirmed model plan by later refinancing to fund 50-percent payments to unsecured creditors as plan provided, but paying them off in single lump sum to receive early discharge). But see *In re Keller* (Bankr ED Cal 2005) 329 BR 697. If the plan is not formally modified by the court, however, the plan will not be deemed to have been completed early so as to qualify the debtor for an early discharge. *Fridley v Forsythe (In re Fridley), supra*.

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IV. CHAPTER 12 PLANS

§5.41 A. Overview of Chapter 12

Prior to the enactment of Chapter 12 in 1986, most individual farmers filed cases under Chapter 11 because they carried debts that exceeded the limits for a Chapter 13 case. The enabling legislation establishing Chapter 12 was subject to a sunset provision. However, BAPCPA permanently enacted Chapter 12 and included "family fisherman" under those who may seek relief under Chapter 12. 11 USC §§101(19A), 109(f).

Chapter 12 is patterned extensively after Chapter 13. However, in addition to individuals, corporate or partnership entities in which more than 50 percent of the outstanding equity is controlled by one family are also eligible for Chapter 12. See 11 USC §§101(18), 109(f). The majority of the requirements of a Chapter 12 plan are based on Chapter 13. Some provisions of Chapter 12, which deviate significantly from Chapter 13, relate directly to the claims of creditors secured by real property. Those differences are discussed in §§5.42-5.51.

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§5.42 B. Special Definition of "Adequate Protection"

Bankruptcy Code §1205(b) contains a special definition of "adequate protection" for purposes of Chapter 12. That definition parallels the definition of "adequate protection" in 11 USC §361, which applies in Chapter 7, 11, and 13 cases, with one additional method of providing adequate protection beyond the three stated in §361. See §§10.20, 10.67. Section 1205(b)(1)-(2) states that adequate protection can be provided by making periodic cash payments or providing an additional or replacement lien to the extent of the decrease in the value of the secured creditor's interest in property. Similarly, §1205(b)(4) authorizes the debtor to provide adequate protection by providing the secured creditor with such other protection "as will adequately protect the value of property securing a claim"—a provision similar to §361(3), which states that adequate protection includes any other relief providing the creditor with "the indubitable equivalent of such entity's interest in such property."

The additional method of providing adequate protection is in §1205(b)(3), which provides that adequate protection may be supplied by "paying to such entity for the use of farmland the reasonable rent customary in the community where the property is located, based upon the rental value, net income, and earning capacity of the property." This provision was intended to circumvent a line of court decisions that required a debtor to pay interest to an undersecured creditor, but because the U.S. Supreme Court subsequently held that nothing in the Bankruptcy Code entitles an undersecured creditor to postpetition interest (see *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626), the special method of providing adequate protection in §1205(b)(3) is meaningless.

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§5.43 C. Power to Sell Property Free and Clear

Chapter 12 grants a trustee (or debtor in possession) the unique authority to sell farmland, farm equipment, or property used in a commercial fishing operation free and clear of any interest (such as a secured claim) in the property, with the proceeds automatically subject to the interest. 11 USC §1206. This allows a debtor farmer to sell such property without the consent of the lender even if the total proceeds are less than the secured claim. This power supplements the general power to sell free and clear of liens in 11 USC §363(f), which authorizes a sale free and clear when the proceeds are greater than the liens against the property or when the secured lender consents to the sale. See §10.70.

In jurisdictions where lenders may seek massive deficiency judgments, §1206 is designed to enable farmers to maximize the value of the collateral and thereby minimize their liability for any deficiency. While this consideration may be relevant with respect to personal property in California, the state's antideficiency statutes will limit the applicability of §1206. There is little likelihood that a farmer will suffer a deficiency judgment in favor of a lender whose collateral is real property, because a lender would be required to conduct a judicial foreclosure sale to obtain such a judgment; nevertheless, in extreme cases, when there is a good prospect of recovery against a guarantor, some lenders will do so. See CCP §580d.

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§5.44 D. Contents of Chapter 12 Plan

Bankruptcy Code §1222 governs the contents, both mandatory and optional, of a Chapter 12 plan. The payout period under a Chapter 12 plan, like a Chapter 13 plan, is usually 3 years but may be extended by the court for cause to a maximum of 5 years. 11 USC §1222(c). A Chapter 12 plan may modify both secured and unsecured debt. 11 USC §1222(b)(2).

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§5.45 1. Modification of Secured Debt

Unlike in Chapter 13, there is no limit on the right of a Chapter 12 debtor to modify the rights of secured creditors under a Chapter 12 plan, as long as the plan complies with the pertinent provisions of 11 USC §§1222 and 1225. 11 USC §1222(b)(2). In particular, there is no counterpart to the 11 USC §1322(b)(2) prohibition on modification of a claim secured only by a debtor's principal residence. See §5.31. Although payments under a Chapter 12 plan are usually limited to a period of 3-5 years (11 USC §1222(c)), payments to secured creditors may be made over a longer period consistent with a permissible cramdown of a secured creditor. See 11 USC §1222(c). See also §§1222(b)(9), 1225(a)(5).

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§5.46 2. Cure of Defaults and De-Acceleration

A Chapter 12 plan may provide for the cure of defaults within a "reasonable period of time" and for the maintenance of payments to the lender while the case is pending. 11 USC §1222(b)(5). Based on precedent interpreting a parallel provision in Chapter 13 cases, a cure of defaults under §1222(b)(5) arguably should "de-accelerate" an obligation, even if the acceleration occurred before the filing of the Chapter 12 case. See *DiPierro v Taddeo (In re Taddeo)* (2d Cir 1982) 685 F2d 24; *In re Nelson* (BAP 9th Cir 1985) 59 BR 417. The amount necessary to cure a default is calculated according to the underlying loan agreement and applicable state law. 11 USC §1222(d). These may require interest to be paid on arrearages. See §5.35 for cases interpreting the parallel provision in Chapter 13.

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E. Confirmation and Cramdown in Chapter 12

§5.47 1. Plan Confirmation Requirements

The confirmation standards for plans under Chapter 12 share many of the same features as those for Chapter 11 and 13 plans. A Chapter 12 plan must be proposed in good faith and satisfy the provisions of 11 USC §1222 and other applicable provisions. 11 USC §1225(a)(1), (a)(3). See §§5.13-5.14, 5.36. The plan must also be feasible. 11 USC §1225(a)(6). See §5.22. See also *In re Gough* (Bankr MD Fla 1995) 190 BR 455 (plan not feasible because debtor's crop yield projections underlying proposed plan payments were overly optimistic). Like Chapter 13, only secured creditors must accept the plan. 11 USC §1225(a)(5)(A). A Chapter 12 plan may still be crammed down on a dissenting secured creditor. See §5.48. Solicitation of acceptance or rejection of a Chapter 12 plan from unsecured creditors is not required, but the plan's treatment of unsecured creditors must satisfy the "best interests" test. In other words, unsecured creditors must receive payments under the plan that are not less than the distribution they would receive in a Chapter 7 case. 11 USC §1225(a)(4). See §5.16.

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§5.48 2. Cramdown of Secured Creditors

If a secured creditor does not accept the proposed plan, the plan may still be crammed down on the creditor. The debtor's two cramdown alternatives are as follows:

- Surrender the collateral to the secured creditor (11 USC §1225(a)(5)(C)); or
- Make payments having a present value in the amount of the secured claim to the creditor (11 USC §1225(a)(5)(B)).

A plan calling for the debtor to surrender real property collateral to the lienholder in full satisfaction of both the secured and the unsecured claim of the lender does not comply with 11 USC §1225(a)(5)(C) and cannot be confirmed over the objection of the lienholder. *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149, overruled on other grounds in *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199. If the property is overencumbered, the surrender option will only satisfy the secured portion of the creditor's claim.

PRACTICE TIP: As in Chapter 13, if the debtor intends to surrender real property collateral to the secured creditor, the debtor should act promptly. See Practice Tip in §5.37.

The second option requires the secured creditor to retain its lien on the collateral and to receive property (*i.e.,* payments) having a present value, as of the effective date of the plan, of at least the amount of the allowed secured claim. 11 USC §1225(a)(5)(B). The debtor can propose a plan that pays a secured claim over a period of longer than 3 years, up to 5 years, as long as the present value of all payments is equal to the allowed amount of the secured claim. 11 USC §1222(b)(9). This option requires determination of the value of the collateral and an appropriate interest rate to determine present value. See §5.18. See also *Wells Fargo Bank Northwest, N.A. v Yett (In re Yett)* (BAP 9th Cir 2004) 306 BR 287 (no error in confirming plan that used contract rate if sole evidence of proper interest rate was contract that contained nondefault and default rates). As in Chapter 11 and 13 cases, the allowed amount of a secured claim is governed by 11 USC §506(a). Chapter 12, however, does not contain an analog to 11 USC §1111(b)(2), allowing an undersecured creditor to elect to be treated as fully secured. See §10.90. Thus, the undersecured creditor's allowed secured claim may be stripped to equal the value of its collateral, and the creditor will have an allowed unsecured claim for the deficiency, assuming that the debt is a recourse obligation. See *Harmon v U.S.* (8th Cir 1996) 101 F3d 574 (debtor received benefit of postconfirmation increase in property value); *Zabel v Schroeder Oil, Inc. (In re Zabel)* (Bankr ED Wis 2000) 249 BR 764. The proper valuation standard in a Chapter 12 case for collateral being retained by a debtor under a cramdown plan arguably should be, as it is in a Chapter 13 case, the "replacement value" of that collateral rather than the liquidation value the secured creditor would realize at a foreclosure sale. See §§5.18, 5.37.

The debtor can propose a plan that pays a secured claim over a period of longer than the 3- to 5-year period allowed for other claims, as long as the present value of all payments is equal to the allowed amount of the secured claim. 11 USC §1222(b)(9). In *Travelers Ins. Co. v Bullington* (11th Cir 1989) 878 F2d 354, the Eleventh Circuit approved a 30-year plan, rejecting the argument that the value of the payments made during the administration of the plan (4 years) must equal the value of the secured claim.

PRACTICE TIP: Because it is clear that Congress intended to allow a debtor to pay off a claim secured by farmland over a period longer than the short life of a Chapter 12 plan, the alternative method for challenging such a payment scheme is to attack the feasibility of the plan under 11 USC §1225(a)(6).

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§5.49 3. Cramdown of Unsecured Creditors

The unfortunate secured lender may find itself with an unsecured deficiency claim in a Chapter 12 case. Although unsecured creditors do not vote to accept or reject a Chapter 12 plan, an unsecured creditor may voice its dissent by objecting to confirmation. In that case, the debtor must satisfy the requirements for cramdown of the unsecured creditor's claim. 11 USC §1225(b)(1). Cramdown is allowed if the plan provides for total payment to the creditor of not less than the amount of the creditor's claim. 11 USC §1225(b)(1)(A). Alternatively, all of the debtor's projected disposable income for the duration of the plan must be applied to making payments under the plan. 11 USC §1225(b)(1)(B). A third alternative was created under BAPCPA, which approved cramdown by a plan that distributes property of a value over the plan life that is not less than the debtor's projected disposable income for the same period. 11 USC §1225(b)(1)(C). The definition of "disposable income" was also amended in 11 USC §1225(b)(2).

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§5.50 F. Preclusive Effect of Plan Confirmation

A confirmed Chapter 12 plan is binding on the debtor and each creditor whether or not the claim of a creditor is provided for by the plan and regardless of whether a creditor objected to, accepted, or rejected the plan. 11 USC §1227(a). Except as otherwise provided in the plan or confirmation order, confirmation of a plan also vests all property of the bankruptcy estate in the debtor free and clear of any claim or interest of any creditor provided for by the plan. 11 USC §1227(b)-(c). Thus, confirmation of a Chapter 12 plan, as with Chapter 11 and Chapter 13 plans, has a claim-preclusive and issue-preclusive effect. See, *e.g., First Nat'l Bank v Allen* (8th Cir 1997) 118 F3d 1289, 1295 (undersecured lenders who participated in negotiation of and voted for plan that failed to provide for payment on unsecured portion of lenders' claims waived right to seek recognition of unsecured claims). For extensive discussion of preclusion, see §§5.24 (Chapter 11), 5.39 (Chapter 13).

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§5.51 G. Modification of Chapter 12 Plan

Before confirmation, a Chapter 12 plan may be modified at any time as long as the modified plan satisfies the requirements of 11 USC §1222. 11 USC §1223(a). A secured creditor is deemed to continue its acceptance or rejection of the modified plan unless the modification changes the rights of the secured creditor and the creditor then changes its prior acceptance or rejection. 11 USC §1223(c).

After confirmation, and at any time before payments under the plan are completed, a plan may be modified at the request of the debtor, the Chapter 12 standing trustee, or an unsecured creditor to (1) increase or reduce payments to a particular class, (2) extend or reduce the time for payments, or (3) alter the distribution amount to a creditor as needed to take account of any payment on the claim outside the plan. 11 USC §1229(a). The modified plan must still comply with the requirements for a Chapter 12 plan stated in 11 USC §1229(b)-(c). Additionally, a modification cannot (1) increase payments due before the modification is effective; (2) except as requested by the debtor, increase payments to unsecured creditors beyond the debtor's disposable income based on an increase in disposable income; or (3) in the last year of the plan, except as requested by the debtor, require payments that would leave the debtor with insufficient capital to carry on the farming (or presumably, although not expressly stated, the fishing) operation after completion of the plan. 11 USC §1229(d).

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§5.52 V. CHAPTER 7 PLANS

Chapter 7 is the primary liquidation chapter of the Bankruptcy Code. Although it is possible to liquidate under the reorganization chapters (Chapters 9, 11, 12, and 13), one cannot reorganize under Chapter 7; its principal purpose is to provide for the liquidation of nonexempt assets of the debtor for the benefit of creditors. A collateral purpose is to provide the individual debtor with a discharge of debts, but only if and to the extent that the debtor qualifies for a discharge.

Unlike Chapters 12 and 13, Chapter 7 is a one-way ticket to bankruptcy relief that does not allow the debtor the option of unilateral dismissal. Title 11 USC §707(a) allows dismissal of a Chapter 7 case "only for cause." *Bartee v Ainsworth (In re Bartee)* (BAP 9th Cir 2004) 317 BR 362. Once filed, the debtor must live with the consequences of the filing decision, including any unintended and unforeseen consequences of haste in filing or a lack of prefiling analysis. Although many Chapter 7 cases hardly receive a second look by the trustee or creditors, proper analysis and preparation will go a long way toward ensuring that there will be no surprises when the case file is scrutinized by the U.S. Trustee, the Chapter 7 trustee, or a creditor.

Seeing a Chapter 7 case through to a satisfactory conclusion begins at the time of counsel's initial contact with the prospective client. Chapter 7 cases often qualify as consumer bankruptcies, in which case provisions relating to debt relief agencies may apply to attorneys and bankruptcy preparers assisting such debtors. See §1.65. Chapter 7 counsel should become thoroughly familiar with the requirements attendant to being a "debt relief agency" (11 USC §101(12A)) and the requirements for means testing (11 USC §707(b); see §§4.82, 5.54) to avoid having the debtor's Chapter 7 case subject to dismissal after it is filed.

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§5.53 A. Eligibility and Sustainability

Bankruptcy Code §109(a)-(b) governs most eligibility requirements for Chapter 7 individual debtors. Individuals are disqualified if they do not have a domicile, a place of business, or property in the United States. Note that citizenship is not required. Conversely, it appears from the statutory language that a citizen who has neither a domicile, place of business, or property in the United States may not be a debtor. It is significant that the statute does not require any degree of financial distress. A prospective debtor need not be insolvent nor have any threshold level of debt to become a debtor under Chapter 7. An additional requirement is that an individual debtor complete a credit counseling course within 180 days before the bankruptcy petition is filed.

Once filed, a Chapter 7 petition may be dismissed for cause (11 USC §707(a); see §4.80) or for abuse, or converted to a Chapter 11 or 13 case (11 USC §707(b); see §§4.81-4.84, 5.54). It also may be subject to dismissal if the debtor has not met the credit counseling requirement.

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§5.54 1. Chapter 7 Means Test

Perhaps the most significant feature of Chapter 7 is the "means test" applicable in consumer cases. If the debtor does not qualify under the means test, his or her Chapter 7 case is subject to dismissal or, with the debtor's consent, conversion to Chapter 11 or 13. See 11 USC §707(b)(1); Official Form B22A (Chapter 7 Statement of Current Monthly Income and Means-Test Calculation), which is available to download from the U.S. Courts' website. See Directory. See also §§4.82-4.85.

The means test and related dismissal provisions of 11 USC §707(b) only apply to a debtor whose debts are primarily consumer debts. The term "consumer debt" is defined with reference to the purpose for which the debt was incurred—as a "debt incurred by an individual primarily for a personal, family, or household purpose." 11 USC §101(8). Thus, the means test does not affect entities such as partnerships, corporations, and limited liability companies. Further, if a sole proprietor incurred most of his or her debt for business purposes (*e.g.,* debts to suppliers or vendors), the means test does not apply. In the case of a small business person who operates his or her business through an entity, debts personally incurred to fund the business would likely not be considered consumer debts. Debts incurred to fund shortfalls in personal income caused by a business failure, however, would almost certainly be considered "consumer" in nature. Further, the means test may be applicable to sole proprietors with home mortgages that materially exceed the amount of their business debts. See *Price v U.S. Trustee (In re Price)* (9th Cir 2004) 353 F3d 1135. Some debtors may alter their behavior in anticipation of bankruptcy by taking advances on personal loans, contributing the loan proceeds to their business entity, and then taking funds out in the form of salary. This strategy should not alter the character of the debt as "consumer," however, if the borrowed funds are simply returned to the debtor in the form of salary.

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§5.55 2. Credit Counseling Requirement

An individual cannot file a Chapter 7 case unless, during the 180-day period before filing, he or she has received an individual or group briefing from an approved nonprofit budget and credit counseling agency that outlined the opportunities for available credit counseling and assisted the individual in performing a budget analysis. 11 USC §109(h)(1). Individuals who operate businesses as sole proprietorships are also required to comply with 11 USC §109(h). See *In re Watson* (ED Va 2005) 332 BR 740.

NOTE: Approved credit counseling agencies are listed on the website of the U.S. Trustee Program; see Directory for information. Credit counseling is available by telephone, in person, and over the Internet.

PRACTICE TIP: Counsel should not underestimate the significance or ignore the nuances of opinions on the credit counseling requirement. Much BAPCPA litigation to date has been related to credit counseling issues.

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B. Risks Connected With Chapter 7

§5.56 1. Loss of Control Over Assets

Once a Chapter 7 case is filed, control over all of the debtor' assets that constitute "property of the estate" under 11 USC §541 (see chap 2) and that the debtor does not claim as exempt under 11 USC §522 (see §1.9) passes to the Chapter 7 trustee. See generally 11 USC §704. As the representative of the unsecured creditors in the case, the trustee will make all decisions concerning the disposition of those assets, independent of the debtor. The trustee may sell any property of the estate with court approval, after notice and a hearing. 11 USC §363(b). See generally §§2.72-2.82. Although the debtor remains a party in interest for purposes of questioning or objecting to any asset sale, the bankruptcy court is likely to follow the trustee's business judgment instead of the debtor's wishes.

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§5.57 2. Discharge and Dischargeability

Newcomers to bankruptcy practice frequently confuse "discharge," which is governed by 11 USC §727, and "dischargeability," which is governed by 11 USC §523. Simply stated, §727 is directed at the acts and conduct of the debtor before and during the Chapter 7 case, and provides for denial of the entire Chapter 7 discharge if the debtor has committed any of the acts specified in §727. See §§5.60-5.62. Section 523 is directed at the conduct of the debtor or the type of debt as it relates to a particular creditor before the filing of the Chapter 7 case and provides a mechanism for determining whether or not the debt owed to that creditor may be excepted from discharge, even though the debtor's other debts may be discharged. See §§5.58-5.59. Thus, a successful exception to discharge under §523 results in all debts but the excepted one being discharged, while a denial of discharge under §727 results in no debt being discharged. For further discussion of discharge under §727, see §1.10.

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a. Nondischargeable Debts

§5.58 (1) Debts Requiring Nondischargeability Action

Bankruptcy Code §523(a) lists 19 types of debts that are excepted from discharge for individuals in Chapter 7 cases (and also individuals in Chapter 11, 12, and 13 cases), but the discharge exception is not necessarily automatic for each type of debt. Different procedures apply in determining nondischargeability. The following debts are discharged unless a creditor takes timely action, by filing a complaint in the bankruptcy court, to determine nondischargeability:

- Claims for money, property, services, or credit if obtained by false pretenses, a false representation, actual fraud, or use of a materially false written financial statement on which the creditor relied in extending credit to the debtor. 11 USC §523(a)(2).
- Claims for fraud or defalcation of a fiduciary, embezzlement, or larceny. 11 USC §523(a)(4).
- Claims for willful and malicious injury by the debtor to another person or entity or the person or entity's property. 11 USC §523(a)(6).

With minor exceptions, any complaint to determine nondischargeability under 11 USC §523(a)(2), (a)(4), or (a)(6) in a Chapter 7 or Chapter 11 case must be filed within 60 days after the first date set for the debtor's meeting of creditors. See 11 USC §523(c)(1); Fed R Bankr P 4007(c). The 60-day period may be extended, but only on motion of a party in interest filed within the 60-day period. See Fed R Bankr P 4007(c). An action to determine the nondischargeability of a debt in the bankruptcy court is an adversary proceeding. See Fed R Bankr P 4007(e); see also §§4.45-4.48.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/5 Reorganization and Liquidation/§5.59 (2) Debts Automatically Nondischargeable

§5.59 (2) Debts Automatically Nondischargeable

The remaining debts listed in 11 USC §523(a) are excepted from discharge without the need for action by any party to the case. These debts include:

- Certain taxes or customs duties as specified in 11 USC §507(a)(3) or §507(a)(8) (11 USC §523(a)(1)(A)), and certain liabilities incurred to pay taxes that are nondischargeable (11 USC §523(a)(14)).
- Certain debts not listed or scheduled by the debtor in the bankruptcy filing, unless the creditor had actual knowledge of the bankruptcy case in time to permit timely filing of a proof of claim (11 USC §523(a)(3)(A)) or to permit timely filing of a proof of claim and request for dischargeability (11 USC §523(a)(3)(B)). When there are no assets compelling the filing of a proof of claim and no claim existing for nondischargeability under §523(a)(2)(4) or (a)(2)(6), then such unlisted or unscheduled debts nonetheless are discharged. *Beezley v California Land Title Co. (In re Beezley)* (9th Cir 1993) 994 F2d 1433; *White v Nielsen (In re Nielsen)* (9th Cir 2004) 383 F3d 922.
- Domestic support obligations (see 11 USC §101(14A)) owed either for spousal or child support, including such amounts owed to a governmental unit (11 USC §523(a)(5)).
- Certain fines, penalties, and forfeitures payable to governmental units (11 USC §523(a)(7)), including state court criminal restitution (see *Kelly v Robinson* (1986) 479 US 36, 93 L Ed 2d 216, 107 S Ct 353), certain sanctions against disciplined attorneys (see, *e.g., State Bar v Taggart (In re Taggart)* (9th Cir 2001) 249 F3d 987), and payments due under federal criminal restitution orders (11 USC §523(a)(13)).
- Student loans, in the absence of "undue hardship." 11 USC §523(a)(8).
- Liability for wrongful death or personal injury caused by the debtor's operation while under the influence of alcohol or drugs of a motor vehicle, vessel, or aircraft. 11 USC §523(a)(9).
- Claims that were or could have been listed or scheduled by the debtor in a prior case concerning the debtor in which the debtor waived discharge or was denied a discharge under 11 USC §727(a)(2)-(7). 11 USC §523(a)(10).
- Certain claims against the debtor arising from any act of fraud or defalcation while acting in a fiduciary capacity committed with respect to any depository institution or insured credit union (11 USC §523(a)(11)), and certain claims for failure to maintain the capital of an insured depository institution (11 USC §523(a)(12)).
- Obligations to a spouse, former spouse, or child of the debtor incurred in connection with a marital dissolution or separation, other than a domestic support obligation (11 USC §523(a)(15)). A previous balancing test, pitting the debtor's ability to pay against the detriment to the spouse, was eliminated by BAPCPA. Note that these debts, as well as those under 11 USC §523(a)(6), remain vulnerable to what remains of the "superdischarge" in Chapter 13 cases. See 11 USC §1328(a)(2).
- Claims for condominium, cooperative housing, or homeowners' association fees or assessments that become due and payable postpetition with respect to the debtor's interest in a unit, share, or lot, for as long as the debtor or trustee has a legal, equitable, or possessory ownership interest in the unit, share, or lot. 11 USC §523(a)(16).
- Amounts owed to a pension, profit-sharing, stock bonus, or other retirement plan established under specified sections of the Internal Revenue Code. 11 USC §523(a)(18).
- Liability for violation of federal or state securities laws or regulations, or common law fraud, deceit, or manipulation in connection with the purchase or sale of a security, resulting from a federal or state court or administrative agency judgment, order, consent decree, or a settlement agreement. 11 USC §523(a)(19).

Although these debts are automatically excepted from discharge, a complaint may be filed by the debtor or by any creditor at any time to determine the dischargeability of such debts (Fed R Bankr P 4007(b)), although the "any time" language does not foreclose a defense of laches. *Beaty v Selinger (In re Beaty)* (9th Cir 2002) 306 F3d 914. In so doing, a debtor would be attempting to prove that the debt in question fell outside the definition of a particular type of nondischargeable debt.

Under Fed R Bankr P 4007(b), a closed case may be reopened at any time, without payment of a fee, to file a

nondischargeability complaint, other than under 11 USC §523(c)(1). In fact, reopening the case is not even a requirement for proceeding under 11 USC §523(c)(1). *Staffer v Predovich (In re Staffer)* (9th Cir 2002) 306 F3d 967. Note that although the bankruptcy court has exclusive jurisdiction over nondischargeability actions brought under §523(a)(2), (a)(4), (a)(6), and (a)(15), state courts have concurrent jurisdiction over other dischargeability issues. 28 USC §1334(b). Most Chapter 7 practitioners, however, would prefer to litigate dischargeability issues before a bankruptcy judge, rather than a state court judge who may lack a comprehensive understanding of the Bankruptcy Code or an appreciation of the concept of a "fresh start."

A prebankruptcy waiver of the dischargeability of a debt is void as against public policy (*Hayhoe v Cole (In re Cole)* (BAP 9th Cir 1998) 226 BR 647), and a bankruptcy court may not adjudicate the subsequent dischargeability of a debt it imposed as a sanction on a nondebtor in the case before it. *Hansbrough v Birdsell (In re Hercules Enters.)* (9th Cir 2004) 387 F3d 1024.

Interest on nondischargeable debts continues to accrue during bankruptcy and survives discharge. See *Foster v Bradbury (In re Foster)* (9th Cir 2003) 319 F3d 495 (child support); *Great Lakes Higher Educ. Corp. v Pardee (In re Pardee)* (9th Cir 1999) 193 F3d 1083 (student loan); *Ward v State Bd. of Equalization (In re Artisan Woodworkers)* (9th Cir 2000) 204 F3d 888 (tax).

Some exceptions to discharge do not apply in Chapter 13 cases. See 11 USC §1328(a).

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§5.60 b. Denial and Revocation of Discharge

The debtor's conduct before and during a Chapter 7 case may result in a denial of the entire discharge or revocation of the discharge. See generally §§5.61-5.62.

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§5.61 (1) Denial of Discharge

Bankruptcy Code §727(a) lists twelve grounds for denial of a discharge. The first one, 11 USC §727(a)(1), results from the debtor's legal status, in that a debtor that is not a natural person is not eligible to receive a discharge in Chapter 7. The next six are acts or omissions of the debtor that are offensive to the integrity of the bankruptcy system, and include the following: transfer, removal, destruction, mutilation, or concealment of any of the debtor's property with the intent to hinder, delay, or defraud a creditor or the trustee (11 USC §727(a)(2)) as well as concealment, destruction, falsification, mutilation, or failure to keep or preserve any books, documents, or records relating to the debtor's financial condition or business transactions, unless such failure was justified under the circumstances of the case (11 USC §727(a)(3)).

NOTE: Under 11 USC §727(a)(2)-(7), the focus is on the debtor's conduct. Whether or not creditors were injured by the conduct is irrelevant. *Bernard v Sheaffer (In re Bernard)* (9th Cir 1996) 96 F3d 1279; *First Beverly Bank v Adeeb (In re Adeeb)* (9th Cir 1986) 787 F2d 1339.

The eighth and ninth grounds for denial of discharge relate to the timing of any prior bankruptcy discharge, and the tenth covers a waiver by the debtor. The debtor will be ineligible to receive a discharge if the debtor received a discharge in a Chapter 7 or Chapter 11 case filed within 8 years before the filing of the present case. 11 USC §727(a)(8). The debtor will be ineligible for a discharge if the debtor received a discharge in a Chapter 12 or Chapter 13 case filed within 6 years before the filing of the present case, unless payments under the Chapter 12 or 13 plan totaled at least 100 percent of the allowed unsecured claims, or at least 70 percent of such claims and the plan was proposed in good faith and constituted the debtor's best effort. 11 USC §727(a)(9). The debtor will not be eligible for a discharge if the court approves a written waiver of discharge executed by the debtor after the bankruptcy case was filed. 11 USC §727(a)(10).

BAPCPA added two further grounds for denial of discharge: The debtor's failure to complete a personal financial management course as described in 11 USC §111(a)(2) after filing the petition will result in denial of discharge. 11 USC §727(a)(11). There are exceptions applicable if the debtor is mentally incapacitated, physically disabled, or on active military duty in a combat zone (as set forth in 11 USC §109(h)(4)) or the debtor resides in a district for which the U.S. Trustee has determined there are no adequate instructional courses available. 11 USC §727(a)(11). The final ground, in 11 USC §727(a)(12), is tied to 11 USC §522(q)(1), which applies a homestead cap of $136,875 to debtors who have been convicted of certain felonies that demonstrate an abuse of the Bankruptcy Code, and debtors who owe debts arising from violation of the securities laws or from crimes or torts that caused serious bodily injury or death to another person in the preceding 5 years. Section 727(a)(12) allows the court to delay discharge while proceedings concerning §522(q)(1) are pending.

In Chapter 7 cases, the deadline for filing a complaint to object to the debtor's discharge is the same as the deadline for a complaint to determine the nondischargeability of a debt, *i.e.*, 60 days after the date first set for the §341(a) meeting of creditors. Fed R Bankr P 4004(a). This deadline may be extended if a motion to do so is filed within the 60-day period. See Fed R Bankr P 4004(b). The 60 days is not jurisdictional but may be waived by failure to assert untimeliness as a defense. *Kontrick v Ryan* (2004) 540 US 443, 157 L Ed 2d 867, 124 S Ct 906.

NOTE: Some of the grounds stated in §727(a) do not apply if the offending act or omission occurred more than 1 year before the date of filing of the bankruptcy petition. See 11 USC §727(a)(7).

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§5.62 (2) Revocation of Discharge

A discharge may be revoked under 11 USC §727(d) on request of the trustee, a creditor, or the U.S. Trustee in limited circumstances (11 USC §727(d)(1)-(3)):

- Fraud not known to the requesting party before discharge. 11 USC §727(d)(1).
- The debtor's acquisition of, or entitlement to, property that would be property of the estate, and knowingly and fraudulently failing to report, surrender, or deliver such property to the trustee. 11 USC §727(d)(2). A good example is property inherited by the debtor within 180 days after the petition is filed. See 11 USC §541(a)(5).
- Refusal to obey court orders, or certain refusals to testify, as set forth in 11 USC §727(a)(6). 11 USC §727(d)(3).
- Failure to explain satisfactorily a material misstatement in, or the debtor's failure to make available requested records for, an audit ordered by the U.S. Trustee (see 28 USC §586(f)). 11 USC §727(d)(4).

The complaint to revoke discharge must be brought within 1 year after the discharge is granted, or for actions under 11 USC §727(d)(2)-(3), within 1 year after the date the case is closed, if later than 1 year after discharge. 11 USC §727(e).

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§5.63 3. Discharge Limitations

A debtor is not eligible to receive another discharge in a Chapter 7 bankruptcy proceeding during the 8-year period after the date of filing of the initial bankruptcy petition. See 11 USC §727(a)(8). Individual debtors must complete a financial management course before receiving a discharge in a Chapter 7 case. 11 USC §727(a)(11). Loans owed to pension, profit-sharing, stock bonus, or similar plans may no longer be discharged if they are loans permitted under ERISA §408(b)(1) (29 USC §1108) or IRC §72(p), or certain types of loans from thrift savings plans. See 11 USC §523(a)(18).

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§5.64 C. Conversion

Conversion of a Chapter 7 case to another chapter of the Bankruptcy Code may occur voluntarily or involuntarily. The debtor may voluntarily convert or consent to conversion of the case to one under Chapter 11, 12, or 13, if otherwise eligible for those chapters, as long as the case was not previously converted to Chapter 7 from any of those chapters. 11 USC §706(a), (c)-(d). Notwithstanding this, the bankruptcy court has authority under 11 USC §105 to deny a debtor's motion to convert his or her Chapter 7 case to Chapter 13 based on a finding of bad faith. *Marrama v Citizens Bank (In re Marrama)* (2007) 549 US 365, 166 L Ed 2d 956, 127 S Ct 1105. A debtor's Chapter 7 case may also be involuntarily converted with approval, on motion of a party in interest, but only to Chapter 11. 11 USC §706(b). For further discussion of conversion of bankruptcy cases from one relief chapter to another, see §§4.72-4.78.

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6

Executory Contracts

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§6.1 I. INTRODUCTION

At the time the bankruptcy case is filed, the debtor may be a party to contracts with continuing performance obligations on both sides. For individual debtors, such contracts may include real property leases, installment land sale contracts, motor vehicle leases, installment payment contracts for household goods, insurance contracts, club memberships, and various kinds of service contracts. For business debtors, such contracts may include real property and equipment leases, motor vehicle leases, franchise or licensing agreements, manufacturing and other outsourcing agreements, warehousing and distributing agreements, sales contracts, commission agreements, and many kinds of service contracts. From the debtor's standpoint, continuance of the contract during and after bankruptcy may be either beneficial or detrimental to the estate or the debtor. The Bankruptcy Code therefore gives the trustee, the debtor in possession, and, in some situations, an individual debtor, the right to assume or reject executory contracts and unexpired leases. See 11 USC §365. This chapter primarily focuses on executory contracts relating to unexpired leases and some of the potentially related executory contracts relating to personal property. For additional discussion of residential and commercial leases in bankruptcy, see chap 7.

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II. DEFINITION OF EXECUTORY CONTRACT

§6.2 A. "Executory Contract" Defined

The Bankruptcy Code does not define "executory contract." Most courts, including those in the Ninth Circuit, apply the "Countryman" definition:

> A contract under which the obligations of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing performance of the other.

Countryman, *Executory Contracts in Bankruptcy*, 57 Minn L Rev 439, 446 (1973). See *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702, 705 n7. Although the issues of contract construction and breach are governed by state law, the issue of whether a contract is executory is one of federal law. *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492.

Unexpired leases are a subset of executory contracts. An unexpired lease may concern either real property or personal property. Leases of real property "include any rental agreement to use real property." 11 USC §365(m). Bankruptcy Code §365 applies equally to all executory contracts and unexpired leases, except as expressly provided in the statute. Certain subsections of §365 apply exclusively to unexpired leases of real property (see 11 USC §365(b)(1), (b)(3), (d)(3)-(4), (h)(1)), while other subsections apply exclusively to unexpired leases of personal property (see 11 USC §365(d)(5), (p)). For additional discussion of residential and commercial leases in bankruptcy, see chap 7.

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B. Contracts Not Within Definition

§6.3 1. Financing Agreements

Some contracts that appear to be executory contracts or unexpired leases may in fact be secured or unsecured financing agreements. The most common examples are installment sales or rent-to-own contracts, as well as finance leases. See *Pacific Express, Inc. v Teknekron Infoswitch Corp. (In re Pacific Express, Inc.)* (9th Cir 1986) 780 F2d 1482 (equipment lease characterized as installment sale, not executory, because seller's performance substantially complete on delivery of equipment); *In re Crummie* (Bankr ND Cal 1996) 194 BR 230 (retail automobile installment sales contract not executory). Ground leases, due to their lengthy terms and the extent of the estate conveyed, may be suspected to be disguised financing agreements. See, *e.g., Liona Corp. v PCH Assocs. (In re PCH Assocs.)* (2d Cir 1986) 804 F2d 193, 200 (in sale-leaseback transaction, ground lease was not true lease, because no true landlord-tenant relationship existed). The analysis may be affected by applicable state statutes. For example, Com C §1203 provides criteria to determine whether a transaction in the form of a lease creates a lease or a security interest.

Some courts considering sale-leaseback transactions involving the issuance of municipal bonds and the execution of real property leases, as well as other lease agreements, have analyzed the transaction in accordance with federal law as embodied in 11 USC §§502(b)(6) and 365, together with the legislative history of §502(b)(6). These courts have looked to the "economic realities" of the situation to determine the character of the agreement. See, *e.g., City of San Francisco Mkt. Corp. v Walsh (In re Moreggia & Sons, Inc.)* (9th Cir 1988) 852 F2d 1179; *City of Olathe v KAR Dev. Assocs.* (*In re KAR Dev. Assocs.)* (D Kan 1995) 180 BR 629 (only damages from rejection of true lease are subject to cap under §502(b)(6); true lease determination is to be made with reference to economic realities test). In contrast, the Seventh Circuit opined that courts should apply state law to determine how to characterize a purported lease, unless it appears that state law is designed to defeat federal policy by ignoring the economic substance of the transaction and elevating document form over substance. See *United Airlines, Inc. v HSBC Bank USA, N.A.* (7th Cir 2005) 416 F3d 609, 617 (applying California law to conclude that airport "lease" was financing transaction). In several related appeals, the court found it appropriate to apply state law in order to recharacterize leases of airport facilities as financings, materially reducing the airline tenant's liabilities.

Even if the arrangement is deemed a lease under state law, the court may examine the economic substance of the transaction to determine whether a true lease exists for the purposes of the Bankruptcy Code. See, *e.g., City of San Francisco Mkt. Corp.*, 852 F2d at 1184 (agreement was not true lease when lessee had significant possessory interest and minimal obligations to lessor).

The factors that a court might consider to determine whether a true lease exists include:

- Whether the amount of rent charged is related to the market rental value of the property (*Liona Corp.*, 804 F2d at 201);
- Whether the tenant has the right to acquire the property at the end of the term for little or no additional value (*United Airlines, Inc.,* 416 F3d at 616); and
- Whether the parties have the rights and obligations traditionally assigned to landlords and tenants (*City of San Francisco Mkt. Corp. v Walsh (In re Moreggia & Sons, Inc.), supra*; *In re Independence Village, Inc.* (Bankr ED Mich 1985) 52 BR 715, 718).

The distinction between financing arrangements and executory contracts is important. The rights of a lender to receive payments and enforce a lien on collateral are markedly different from those of a lessor who owns and may repossess property on default under a lease. Most important, a trustee cannot permanently alter a lessor's payment rights and at the same time retain possession of the leased goods or premises. See, *e.g.,* 11 USC §365(d)(3) (requiring postpetition performance of all real property lease obligations pending assumption or rejection); 11 USC §365(b)(1) (conditioning assumption of lease on cure of defaults and adequate assurance of future performance); 11 USC §1124 (defining impairment of claims to include failure to pay amounts to cure or compensate for damages caused by defaults, as required by 11 USC §365(b)). See §6.22 (concerning requirement that trustee assume or reject entire lease). By

contrast, a trustee may retain possession of a secured lender's collateral yet modify the lender's repayment rights. See, *e.g.,* 11 USC §§1123(b)(5), 1322(b)(2) (reorganization plans may modify the rights of all holders of secured claims, except those secured only by a lien on the debtor's principal residence). Moreover, a trustee may set aside a lien that is not properly perfected or is otherwise unenforceable. See 11 USC §544; see also §2.33. A secured lender thus may become unsecured, while the trustee retains the putative collateral free and clear of any claim or lien in favor of the lender.

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§6.4 2. Option Agreements

In the Ninth Circuit, the "Countryman" test (see §6.2) applies to real property purchase option agreements. *Unsecured Creditors' Comm. v Southmark Corp.* (*In re Robert L. Helms Constr. & Dev. Co.*) (9th Cir 1998) 139 F3d 702, 705. Under this approach, an option is likely to be executory if the optionee, before the bankruptcy petition was filed, had announced its intent to exercise, but had not fully exercised, its rights under the option agreement. In this situation, both the optionor and the optionee would have obligations to perform in each other's favor. If, however, as of the petition date, the optionee has not announced its intent to exercise the option, the optionor has no performance obligations under the agreement, and the option agreement is not executory. In the latter situation, the option is an asset of the optionee and is the basis of a claim against the optionor, but nothing more. 139 F3d at 706.

If the option creates an enforceable property right under state law, it may be enforceable as such in the debtor-optionor's bankruptcy case. See *In re Bergt* (Bankr D Alaska 1999) 241 BR 17 (right of first refusal is similar to option and is not necessarily terminated by rejection). See also *In re Koneta* (Bankr D Ariz 2006) 357 BR 540 (real property purchase option recorded in real property records, and therefore enforceable under Arizona law, would be enforceable against optionor as debtor in bankruptcy).

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III. ASSUMPTION OR REJECTION OF EXECUTORY CONTRACT

§6.5 A. Who Assumes or Rejects

In Chapter 7 cases, the trustee has the power to assume or reject executory contracts and unexpired leases of the debtor. *Dean v Telegadis (In re Dean)* (Bankr WD Pa 2004) 317 BR 482 (only trustee in Chapter 7 case has assumption powers). In Chapter 11 cases, only the debtor in possession, or the Chapter 11 trustee, if one has been appointed, has the power to assume or reject executory contracts and unexpired leases. In Chapter 13 cases, either the Chapter 13 trustee or the debtor may exercise the power to assume or reject. 11 USC §1322(b)(7). As a result, some executory contracts that are not assumable by a Chapter 7 trustee or Chapter 11 debtor in possession may be assumed in a Chapter 13 case. See §6.30.

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§6.6 B. Assumption or Rejection Permitted

Under 11 USC §365(a), the trustee, debtor, or debtor in possession, "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor." On assumption, the contract or lease becomes property of the estate, to be performed in full in accordance with all of its terms. *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492. See also *Durkin v Benedor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276, 1280; see also §6.43. On rejection, the estate is relieved of its performance obligations under the contract or lease. Rejection, however, constitutes a material breach and gives the other party to the contract a prepetition claim for damages. See 11 USC §365(g); see also §§6.44-6.46.

The trustee's power to assume is limited by 11 USC §365(b), concerning assumption after defaults have occurred, and 11 USC §365(c), concerning contracts that cannot be assumed. After assuming the contract, the trustee, subject to certain conditions, may assign it to a third party. 11 USC §365(f). In this way, even if the estate is not in a position to enjoy the benefits of the contract or lease, it can profit from selling it, or at least avoid incurring rejection damages.

For additional discussion of assumption and rejection of residential leases, see §§7.35-7.44. On assumption and rejection of commercial leases, see §§7.45-7.59.

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§6.7 C. Inapplicability to Contracts and Leases Terminated Prepetition

The ability to assume or reject under 11 USC §365 applies only to contracts or leases that both (1) have not been terminated under applicable nonbankruptcy law before commencement of the debtor's bankruptcy case, and (2) have not expired by their own terms after the petition date. See *In re National Steel Corp.* (Bankr ND Ill 2004) 316 BR 287. Whether a lease or contract terminated prepetition is a question of state law. *Vanderpark Props. v Buchbinder* (*In re Windmill Farms, Inc.*) (9th Cir 1988) 841 F2d 1467, 1469; *In re Beck* (Bankr D Haw 1980) 5 BR 169, 171 (debtor could not assume beauty salon license that licensor terminated prepetition under nonbankruptcy law). Whether a contract is executory, however, is a question of federal law. *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492, 1494.

NOTE: Many California real property leases permit a lessor, on the lessee's breach of a lease and abandonment of premises, to either (1) terminate the lessee's right of possession, or (2) elect to have the lease continue in effect and to enforce all rights and remedies under the lease, including the recovery of rent as it comes due. Compare CC §1951.2 (what lessor may recover from lessee on termination of lease) with CC §1951.4 (lessor's rights and remedies on continuation of lease). If a lessor exercises its rights to continue the lease under CC §1951.4 at the commencement of the lessee's bankruptcy case, the lease likely will be "unexpired" for purposes of 11 USC §365 and subject to assumption in the bankruptcy case. For further discussion of landlords' rights in bankruptcy cases, see chap 7.

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D. Timing of Assumption or Rejection

§6.8 1. Chapter 7

In Chapter 7 cases, the trustee is deemed to have rejected all executory contracts and unexpired leases of residential real property that are not, within 60 days after the entry of the order for relief, the subject of a motion for assumption, rejection, or extension of the deadline for assumption or rejection. 11 USC §365(d)(1).

NOTE: The date of entry of the order for relief is the petition date in voluntary cases and, in involuntary cases, the date an involuntary petition is approved and the order for relief is entered. See §1.8. For convenience, the date of the order for relief is referred to in this chapter as the "petition date."

If a trustee is prohibited from assuming or assigning an executory contract or unexpired lease under §365(c), the lease may be terminated under 11 USC §365(e)(2). That subsection permits enforcement of contract clauses providing for termination on an event of bankruptcy if applicable law prohibits assumption by the trustee. See §§6.30-6.38 for discussion of prohibitions on assumption of certain executory contracts.

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2. Chapters 11 and 13

§6.9 a. Nonresidential Real Property Leases

In all cases under the Bankruptcy Code, leases of nonresidential real property are deemed rejected unless a motion to assume, reject, or extend the initial deadline is filed (and, in some circuits other than the Ninth, the order on the motion is entered) within the earlier of (1) 120 days after the petition date, or (2) the date a plan confirmation order is entered. 11 USC §365(d)(4). The trustee may request a 90-day extension for cause from the bankruptcy court. However, the order granting such extension must be entered before the initial 120-day period elapses. *In re Tubular Technols., LLC* (Bankr D SC 2006) 348 BR 699. To obtain an extension beyond the additional 90-day period, the trustee must obtain the consent of the landlord. 11 USC §365(d)(4)(B)(ii). Former 11 USC §365(d)(4) provided a shorter period (60 days) within which to file a motion to assume, reject, or extend the deadline to make the decision. However, the court, on a modest showing of cause, typically would extend the deadline through plan confirmation to permit the debtor sufficient time to formulate its reorganization plan and the plan's treatment of leases. The requirement to show cause is expected to be more exacting than it was prior to the enactment of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23). A debtor-tenant has a maximum of 7 months to make its assumption decision, but only if it is able, during the first 120 days, to show cause for granting the statutorily permitted 90-day extension. See §6.12.

PRACTICE TIP: Amended §365(d)(4) materially alters the dynamics of a Chapter 11 case in which nonresidential real property leases are an important asset of the debtor's estate. For example, in large retail cases, the debtor will need to engage in significant prebankruptcy planning to evaluate the performance of each location and whether each lease is above or below market, and to time the bankruptcy filing so that the debtor can obtain optimal results from the holiday shopping season. Tightened restrictions on extensions of the assumption deadline also increase the leverage of commercial landlords in dealing with troubled lessees. It may be possible for the debtor to pay the lessor a fee in exchange for consent to an extension of the deadline. Such payment may be outside of the debtor's ordinary course of business, however, and may require court approval under 11 USC §363(b).

For additional discussion of assumption and rejection of residential leases, see §§7.35-7.44. On assumption and rejection of commercial leases, see §§7.45-7.59.

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§6.10 b. Other Executory Contracts and Leases

Bankruptcy Code §365(d)(2) permits the trustee, debtor, or debtor in possession in a Chapter 11 or 13 case to assume or reject executory contracts or unexpired leases (other than leases of nonresidential real property; see §6.9) at any time before plan confirmation. Historically, courts allowed some executory contracts and unexpired leases (other than nonresidential real property leases) that were not addressed by motion during the case or in the Chapter 11 or 13 plan to "ride through" the bankruptcy case unaffected. See §6.11 for further discussion of the concept of "ride-through."

In cases under Chapter 11 and Chapter 13, a court has the discretion, on motion of the nondebtor contracting party, to shorten the period for assumption or rejection and require the trustee to make its decision by a date certain. 11 USC §365(d)(2); *In re Resource Technol. Corp.* (Bankr ND Ill 2000) 254 BR 215, 227 (court exercised discretion to require prompt assumption or rejection because plan proposal relied on assumption and creditors were entitled to know whether plan could proceed or alternative action would be required in debtor's case).

A court considering a motion to shorten the assumption/rejection period should analyze four factors in order to determine what constitutes a "reasonable time":

(1) The extent of likely noncompensable damage the nondebtor party will suffer;

(2) The importance of the contract to the debtor's operations;

(3) The amount of time the debtor reasonably needs to appraise its financial situation and the potential contribution of its assets to a plan; and

(4) The pendency of the debtor's plan exclusivity period.

See *Zions Credit Corp. v Rebel Rents, Inc. (In re Rebel Rents, Inc.)* (Bankr CD Cal 2003) 291 BR 520, 530.

When equity permits, a court may deny a motion to compel the debtor to assume or reject, and thus may allow the contract to ride through the case. *In re Hernandez* (Bankr D Ariz 2002) 287 BR 795, 803 (after considering four equitable factors, court denied motion to compel rejection and permitted debtors to amend plan to delete references to subject contract, thereby causing ride-through).

PRACTICE TIP: In addition to moving for an order to expedite the trustee's decision, a real property lessor may seek relief from the automatic stay, under 11 USC §362(d), in order to exercise its state law remedies. See §§4.15-4.26, 10.17-10.52.

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§6.11 3. Ride-Through

In cases under Chapter 11 or 13, if an executory contract or lease (other than one concerning personal property) is not addressed in the confirmed plan, or is one that 11 USC §365(c) prohibits the trustee from assuming (see §6.30), then the contract or lease may be deemed to have continued in force, unaffected by the bankruptcy case. This concept of "ride-through" arises most often in Chapter 11 cases. See, *e.g., Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.*) (5th Cir 2006) 440 F3d 238, 254 n19 (recognizing that executory contract, and nondebtor party's claims thereunder, may "ride through" bankruptcy); *In re Parkwood Realty Corp.* (Bankr WD Wash 1993) 157 BR 687, 690 (shareholders' agreement not rejected by plan boilerplate remained binding on debtor after plan confirmation); *Diamond Z Trailer, Inc. v JZ L.L.C. (In re JZ L.L.C.)* (BAP 9th Cir 2007) 371 BR 412 (debtor's failure to schedule executory contract does not bar application of "ride-through" doctrine). In Chapter 7 cases, ride-through may apply to nonassumable contracts, such as individual debtors' employment contracts.

Ride-through is distinct from assumption in that the subject contract does not benefit from Bankruptcy Code protections such as the voiding of ipso facto provisions and prohibitions against assignment, or the grant of a reasonable period of time in which to cure defaults regardless of the contract's default provisions. *In re Hernandez* (Bankr D Ariz 2002) 287 BR 795, 800 (carefully analyzing and adopting ride-through doctrine in Chapter 11 case).

PRACTICE TIP: In cases in which the debtor is an individual, any personal property lease not assumed in a confirmed plan (or, presumably, under an order entered earlier in the case) will be deemed rejected as of the conclusion of the confirmation hearing, and applicable stays under 11 USC §§362 and 1301 will terminate automatically with respect to the leased property. 11 USC §365(p)(3). The narrow scope of this provision arguably validates the concept of ride-through with respect to other executory contracts.

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E. Motion to Assume, Reject, or Extend Election Period

§6.12 1. When to File Motion

BAPCPA has sharply curtailed a trustee's ability to obtain an extension of time to assume or reject a lease of nonresidential real property. The initial deadline to file a motion to assume, reject, or extend the deadline is the earlier of the date 120 days after the petition date or the date the plan confirmation order is entered. 11 USC §365(d)(4)(A). See §6.9. Absent landlord consent, the court may grant only one 90-day extension of the deadline to assume or reject. As a consequence, a debtor may be forced to assume the lease prematurely in the course of its reorganization, and may ultimately default. This result is somewhat mitigated by BAPCPA provisions that limit the amount of a landlord's administrative claim under a nonresidential real property lease that was assumed and then later rejected postpetition to the amount of rent due for the 2-year period following the later of the rejection date and the date of the actual turnover of the premises. See 11 USC §503(b)(7) for precise claim calculation provisions. The remainder of the landlord's rent claim is unsecured, subject to the cap in 11 USC §502(b)(6). See chaps 7, 10.

In a case filed before October 17, 2005, to prevent automatic rejection of a contract or lease, the motion to assume, reject, or extend the election period had to be *filed* within the 60-day period. However, the order granting the motion could be entered after expiration of the 60-day period and would relate back to the date the motion was filed. Further, multiple extensions of the deadline could be granted as long as each extension motion was filed before the end of the election period. See, *e.g., Willamette Waterfront, Ltd. v Victoria Station, Inc. (In re Victoria Station, Inc.*) (9th Cir 1989) 875 F2d 1380, 1384.

BAPCPA changed the rules concerning motions for extensions by requiring the order granting the motion to be entered within the 120-day period. The rule permitting orders granting a motion to assume a contract to be effective even after the 120-day (or 210-day, as applicable) deadline, so long as the motion was filed before the deadline, appears to still be in effect in Chapter 11 and 13 cases in the Ninth Circuit. See, *e.g., In re R. Ring Enters.* (2009) 2009 Bankr Lexis 685 (restaurant lease). In Chapter 7 cases, however, it appears that extension orders relating to all executory contracts and leases (except of nonresidential real property) must be entered within 60 days after the petition date. It is likely that applicable orders regarding assumption also will be required within that time. Similarly, with respect to nonresidential real property leases in a case under any chapter of the Bankruptcy Code, 11 USC §365(d)(4)(B) now requires *entry* of the extension order before the lapse of the 120-day period. *In re Tubular Technols., LLC* (Bankr D SC 2006) 348 BR 699. This does not apply to assumption orders; see *In re R. Ring Enters., supra*. Outside the Ninth Circuit, many courts have required all orders granting either assumption or extension to be actually *entered* before the election period lapses. See, *e.g., DeBartolo Props. Mgmt., Inc. v Devan* (D Md 1996) 194 BR 46, 51.

To obtain an extension of the deadline in a case filed before October 17, 2005, the movant must show "cause." See generally *Willamette Waterfront, Ltd. v Victoria Station, Inc. (In re Victoria Station, Inc.)* (BAP 9th Cir 1988) 88 BR 231, 236, aff'd (9th Cir 1989) 875 F2d 1380 (enumerating factors relevant to whether cause exists to extend election period, including importance of lease as estate asset, complexity of case, number of leases, and ongoing payments to landlord). Other considerations include whether a plan has been filed or is in the process of being negotiated and whether the trustee is continuing to perform its postpetition obligations under the lease or contract.

Bankruptcy Code §365(d)(4) affords substantial leverage to commercial landlords, and it remains to be seen whether courts will approve motions to extend the deadline if the debtor has paid a fee to purchase the landlord's consent. It also remains to be seen whether courts will permit debtors to reject leases of nonresidential real property prospectively, *e.g.,* obtain an order in September providing for rejection to be effective on January 31 of the following year, so that a debtor can remain in place and conduct its retail business through the post-holiday sales before closing the location.

Motions concerning assumption, rejection, or modification of the election period should be made under Fed R Bankr P 6006 and 9014.

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§6.13 2. Forfeiture May Result From Failure to Act Timely

It is imperative that a debtor act promptly to accurately identify all unexpired leases of nonresidential real property and all other executory contracts and unexpired leases on Schedule G, as required by Fed R Bankr P 1007, so that the trustee can take appropriate action for each such lease or contract.

It is also imperative that the trustee or debtor in possession act promptly to preserve its rights under 11 USC §365(d)(1) or (d)(4) regarding such leases and contracts. *Carrico v Tompkins* (*In re Tompkins*) (BAP 9th Cir 1989) 95 BR 722, 724. Failure to make a timely motion to assume or to extend the time period for assumption will result in rejection, which constitutes a breach and may result in the forfeiture of rights under the affected lease or contract. When a real property lease is deemed rejected by operation of §365(d)(4), the landlord has the absolute right to compel turnover of the premises. *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885. Under 11 USC §365(d)(4), this right is enforced automatically, because the trustee is required to "immediately surrender" to the lessor the nonresidential real property that was the subject of the deemed-rejected lease. Moreover, the court does not have the power to revive a contract after it is deemed rejected. *Carrico v Tompkins* (*In re Tompkins), supra*.

A trustee or debtor in possession may try to avoid forfeiture by contending that the subject lease is not a "true lease," but a financing or other arrangement. There is a body of case law that examines the "economic realities" of arrangements that appear to be leases of nonresidential real property to determine whether the parties actually intended to or did create a true lessor-lessee relationship. See *City of San Francisco Mkt. Corp. v Walsh* (*In re Moreggia & Sons, Inc.*) (9th Cir 1988) 852 F2d 1179 (agreement was not true lease when "lessee" had significant possessory interest and minimal obligations to lessor). A similar analysis is appropriate for leases of residential real property.

PRACTICE TIP: Debtors should work closely with their bankruptcy trustees to prevent the forfeiture by the trustee's inaction of contracts and leases that debtors believe to be of value. Parties whose interests may be adversely affected by forfeiture, such as a debtor's sublessee or a lender secured by a leasehold mortgage, should be alert to bankruptcy case filings and take steps to protect their interests in the case. The most prudent way to protect such interests is to enter into subrogation and attornment agreements with the lessor, or comparable agreements in the context of other executory contracts, *before* bankruptcy.

Failure to promptly reject leases and contracts that have no value to the estate also can be costly. Amounts coming due under such agreements may be afforded administrative priority and constitute a drain on the estate. See 11 USC §§365(d)(3), 503(b)(1).

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§6.14 3. Court Approval

Court approval is required for every assumption of an executory contract or unexpired lease by a trustee or debtor in possession. Court approval also is required for all rejections, except those that occur automatically by operation of the Bankruptcy Code. See 11 USC §365(d)(1), (d)(4). Approval may be obtained in the form of an order granting a motion or approving a stipulation regarding assumption or rejection. *Elliott v Four Seasons Props.* (*In re Frontier Props.)* (9th Cir 1992) 979 F2d 1358. The order providing for assumption or rejection also may be incorporated into an order confirming a Chapter 11 or Chapter 13 plan. See 11 USC §§1123(b)(2), 1322(b)(7). If the order is included in the plan confirmation order, the nondebtor contracting party must be served with the plan and a specific notice stating the intent to assume or reject and setting forth the amount and proposed terms of any cure of defaults or compensation for damages caused by default. *Century Indem. Co. v NGC Settlement Trust (In re National Gypsum Co.)* (5th Cir 2000) 208 F3d 498. See also *Dataprose, Inc. v Amerivision Communications, Inc*. *(In re Amerivision Communications, Inc*.) (BAP 10th Cir 2006) 349 BR 718 (boilerplate provisions in plan, coupled with assumption schedule, provided sufficient notice to nondebtor party of rejection of lease).

Although rejection historically has been effective only after entry of an order or after expiration of the applicable statutory period (as extended by any court order), courts increasingly permit rejection to be effective retroactive to the date of the rejection motion if the trustee's intentions to reject are clear, even without a formal surrender of the leased premises. See *Pacific Shores Dev., LLC v At Home Corp. (In re At Home Corp.)* (9th Cir 2004) 392 F3d 1064; *Stonebriar Mall Ltd. Partnership v CCI Wireless, LLC (In re CCI Wireless, LLC)* (D Colo 2003) 297 BR 133, 138 (retroactive lease rejection permissible because plain language of §365 silent as to effective date of rejection; effectiveness not conditioned on prior entry of rejection order).

PRACTICE TIP: A debtor may be able to reduce administrative expenses by unequivocally manifesting its intent to reject as early in the case as possible, as this will increase the probability of obtaining a retroactive rejection order. In addition, precedent allowing retroactive rejection may be used to allow debtors to comply with the new statutory deadlines yet remain in possession of premises they intend to reject by rejecting prospectively, *i.e.,* effective as of a date after expiration of the applicable statutory assumption/rejection period.

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§6.15 4. Business Judgment Rule

The "business judgment" rule applies to every decision to assume or reject a contract. To satisfy the rule, the trustee or debtor in possession must demonstrate that its chosen course of action reflects its reasonable business judgment and thus promotes the interests of the bankruptcy estate. *Agarwal v Pomona Valley Med. Group, Inc.* (*In re Pomona Valley Med. Group, Inc*.) (9th Cir 2007) 476 F3d 665, 670; *Durkin v Benedor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276. A court may not substitute its own business judgment, or that of other parties in interest, for that of the trustee or debtor in possession. *Orion Pictures Corp. v Showtime Networks, Inc. (In re Orion Pictures Corp.)* (2d Cir 1993) 4 F3d 1095, 1098.

"Good faith" may be viewed as a corollary of the business judgment rule. Several courts have declined to grant a motion to reject a contract if the debtor did not appear to have financial problems, but was instead trying to minimize the cost of breach or avoid the obligation of specific performance. See *Dressler v Seeley Co. (In re Silberkraus)* (Bankr CD Cal 2000) 253 BR 890, 906, aff'd (9th Cir 2003) 336 F3d 864 (creditor's motion to convert case to Chapter 7 was granted; debtor's Chapter 11 case was filed in bad faith to avoid entry of judgment for specific performance of executory real property sales agreement); *In re Southern Cal. Sound Sys.* (Bankr SD Cal 1987) 69 BR 893 (debtor had filed its petition in bad faith, solely to get out of a bad contract; motion to reject exclusive licensing contract denied). Compare *In re Liberate Technols.* (Bankr ND Cal 2004) 314 BR 206, 218 (bad faith for solvent debtors to file Chapter 11 solely to take advantage of 11 USC §502(b)(6) cap on landlord damages at a time when debtors were not facing any level of financial distress), with *In re Chameleon Sys., Inc.* (Bankr ND Cal 2004) 306 BR 666, 669 (not bad faith for debtor to file Chapter 11 for sole purpose of rejecting lease and enjoying benefit of §502(b)(6) cap on landlord damages).

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F. Conditions to Assumption

§6.16 1. Before Default

If there are no defaults under an executory contract or unexpired lease, the trustee or debtor in possession normally will be permitted to assume the agreement simply by satisfying the "business judgment" rule.

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§6.17 2. After Default

If defaults have occurred under an executory contract or unexpired lease—other than a breach of a covenant relating to the debtor's financial condition, the commencement of a bankruptcy case, or the satisfaction of any penalty provision relating to the debtor's failure to perform nonmonetary obligations under the contract or lease (see 11 USC §365(b)(2); see also §6.19)—11 USC §365(b)(1) requires the trustee to clear three additional hurdles before the court will authorize assumption. Court approval will be denied unless the trustee satisfies all of the following requirements:

- Cures, or provides adequate assurance that the trustee will promptly cure, such default (11 USC §365(b)(1)(A)) (except in the circumstances discussed below);
- Compensates, or provides adequate assurance that the trustee will promptly compensate, the nondebtor contracting party for any actual pecuniary loss to that party resulting from such default (11 USC §365(b)(1)(B)); and
- Provides adequate assurance of future performance under the contract or lease (11 USC §365(b)(1)(C)).

Litigation often arises over the existence of a default and the adequacy of proposed cure payments and compensation for pecuniary loss, as well as whether the trustee has adequately demonstrated its ability to perform in the future.

Post-BAPCPA, the debtor is no longer required to cure nonpenalty, nonmonetary defaults under unexpired real property leases, except to the extent that the defaults can be cured by providing nonmonetary performance after the trustee's assumption. 11 USC §365(b)(1)(A). If the nonmonetary default arises from a failure to operate in accordance with the lease terms, then the default must be cured by operating in accordance with the lease after assumption and the pecuniary losses resulting from nonoperation must be compensated in accordance with 11 USC §365(b)(1)(B). The debtor is required, however, to cure nonmonetary defaults before assuming other executory contracts, and likely will be unable to assume any lease or contract under which the default in question is not curable, *e.g.,* when a debtor has breached a franchise contract by closing its business for too many consecutive days. In situations where a real property lease and an operating agreement are tightly intertwined, a debtor who has incurably defaulted under its operating agreement may be precluded from assuming the related lease.

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§6.18 3. Cure

"Cure" requires payment of all delinquent amounts due under the contract or lease to be assumed. The cure payment is calculated at the nondefault rate (see 11 USC §365(b)(2)(D); *Worthington v General Motors Corp. (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029), and may include postpetition attorney fees of the nondebtor party (*In re Crown Books* (Bankr D Del 2001) 269 BR 12), but only to the extent that attorney fees are recoverable under the assumed contract or lease, or under applicable nonbankruptcy law. *In re Rowland* (ED Pa 2003) 292 BR 815, 819. Although the statutory language requires "prompt" payment, courts may allow cure payments to be made over a period of time, depending on the facts and circumstances of each case. Compare *In re New Valley Shopping Ctr., LP* (Bankr D Kan 2001) 260 BR 10, 26 (permitting 2-year stretch-out of cure payments), with *In re Uniq Shoes Corp.* (Bankr SD Fla 2004) 316 BR 748, 752 (finding proposed 4-year payment period not "prompt").

As a corollary to the requirement that payment defaults be cured as a condition to assumption, prepetition payments made during the applicable preference period on account of an assumed lease or executory contract are not avoidable under 11 USC §547(b). *Alvarado v Walsh (In re LCO Enters.)* (9th Cir 1993) 12 F3d 938, 943.

Creditors who are not vigilant may be estopped from seeking damages if they fail to appear in the bankruptcy case and oppose a motion that seeks (1) an order permitting assumption and (2) findings that there are no existing defaults that must be cured, and no damage payments that are due as a condition to assumption, or that a nominal proffered cure amount is appropriate. If an order is entered finding that no cure is due, the nondebtor party may be found to have waived its right to a cure. See *Manus v NRG Energy, Inc. (In re O'Brien Envt'l Energy)* (3d Cir 1999) 188 F3d 116. A trustee hoping to obtain the benefit of such a waiver should give explicit notice of the relief sought. See *Folger Adam Sec., Inc. v DeMatteis/MacGregor, J.V.* (3d Cir 2000) 209 F3d 252 (no waiver of defenses when asset sale notice not explicit that waiver could result). Compare *In re Rascon* (ND Cal 2005) 321 BR 48 (when notice and plan provided creditor due process, plan confirmation order effectively reduced allowed amount of secured claim to value of collateral) with *County of Ventura Tax Collector v Brawders (In re Brawders)* (BAP 9th Cir 2005) 325 BR 405, aff'd (9th Cir 2007) 503 F3d 856 (plan confirmation order not binding to reduce allowed amount of tax lien when due process notice requirements not satisfied).

WARNING: *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 545 F3d 1113 purported to overrule *County of Ventura Tax Collector v Brawders (In re Brawders), supra*. *Espinosa* was subsequently amended, rehearing en banc denied in *Espinosa v United Student Aid Funds, Inc.* (9th Cir 2008) 553 F3d 1193. The U.S. Supreme Court granted certiorari in *United Student Aid Funds v Espinosa* (2009) 174 L Ed 2d 289, 129 S Ct 2791.

PRACTICE TIP: Debtors have become very aggressive in attempting to minimize their obligation to cure defaults by filing motions to assert that no or minimal defaults exist, and leaving it to the lessor to recognize the issues raised, object to the motion, and allege and prove the amounts of the cure claim.

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§6.19 a. Not Necessary to Cure Certain Defaults

To facilitate the assumption of desirable contracts and leases, 11 USC §365(b)(2) permits a trustee to assume a contract or lease without first curing defaults relating to (1) the commencement of the bankruptcy case; (2) the appointment of a receiver, trustee, or custodian for the debtor; or (3) the insolvency or financial condition of the debtor. These so-called ipso facto provisions generally are not enforceable in bankruptcy. See 11 USC §365(e)(1); see also §6.53. Additionally, 11 USC §365(b)(2)(D) allows the trustee to cure without paying penalty rates or penalty provisions relating to the debtor's or trustee's failure to satisfy nonmonetary obligations.

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§6.20 b. Noncurable Defaults May Prevent Assumption

Before enactment of BAPCPA, 11 USC §365(b)(2)(D) was held not to excuse performance of material nonmonetary obligations, notwithstanding that the failure to perform may not be curable and may preclude assumption of the affected agreement. For example, automobile dealership agreements customarily provide that the dealer's failure to conduct ordinary business operations (*i.e.,* "going dark") for a number of consecutive days (*e.g.,* 7) entitles the manufacturer to terminate the agreement. State statutes, such as Veh C §3060(a)(2), contain similar provisions. *General Motors Corp. v Worthington (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029 held that 11 USC §365(b)(2)(D) does not relieve the debtor or trustee from complying with such provisions. At least one bankruptcy court in the Ninth Circuit criticized *Claremont* as inconsistent with prior Ninth Circuit rulings that plans under Chapter 11 or 13 can cure all defaults. *Bank of America v Garcia (In re Garcia)* (Bankr D Ariz 2002) 276 BR 627, 636 (analyzing prior case law to effect that "cure" has consistent meaning throughout Bankruptcy Code, and that 11 USC §§1123(a) and 1322(b) permit a plan to provide for cure of any default), citing *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc. (In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338. More recently, the First Circuit rejected the *Claremont* approach, reasoning that requiring the debtor to cure *any* nonmonetary default would undermine the basic goal of promoting the rehabilitation of the debtor in order to maximize the value of the estate for the benefit of the debtor and creditors. *Eagle Ins. Co. v Bankvest Capital Corp. (In re Bankvest Capital Corp.)* (1st Cir 2004) 360 F3d 291, 300. A New York bankruptcy court, in *In re New Breed Realty Enters.* (Bankr ED NY 2002) 278 BR 314, 321, adopted a compromise approach, agreeing with the *Claremont* analysis of §365(b)(2)(D), but holding that the court had discretion to deny enforcement of the provisions concerning nonmonetary performance when the creditor failed to show that it had suffered substantial economic detriment, and enforcement would preclude the bankruptcy estate from realizing the intrinsic value of its assets.

BAPCPA amended §365(b)(1)(A) to afford some relief from the *Claremont* approach, but only with respect to nonmonetary defaults under real property leases. See *In re Hathaway* (WD Wash 2009) 401 BR 477, 484 ("legislatively overruled *Claremont Acquisition* in enacting the current version" of §365(b)(1)(A)). The amended statute excuses the cure of "a default arising from any failure to perform nonmonetary obligations under an unexpired lease of real property, if it is impossible for the trustee to cure such default by performing nonmonetary acts at and after the time of assumption." 11 USC §365(b)(1)(A). The amended section further provides that nonmonetary defaults relating to "a failure to operate in accordance with a nonresidential real property lease" (*e.g.,* "going dark") must be cured by "performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with [11 USC §365(b)(1)(B)]." 11 USC §365(b)(1)(A).

Amended §365(b)(1)(A) offers some relief to a trustee in its capacity as a tenant but does not appear to enable the trustee to assume non-real-estate-related leases or contracts under which noncurable nonmonetary defaults have occurred, such as a dealership agreement that the debtor violated by "going dark" for too many consecutive days. Indeed, the restriction of the new provisions to real property leases might be construed as an indication of congressional intent to adopt *Claremont* and prohibit a trustee from assuming an executory contract or unexpired lease of personal property under which incurable nonmonetary defaults have occurred.

For further analysis of amended §365(b)(1)(A) and (b)(2)(D) in relation to the *Claremont* and *Bank Vest* cases, see Brown & Ahern, 2005 Bankruptcy Reform Legislation With Analysis 2d, 99-102 (2d ed 2006).

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§6.21 4. Adequate Assurance of Future Performance

"Adequate assurance of future performance" (see 11 USC §365(b)(1)(C)) generally requires a trustee to provide enough information for a court to find that assumption would not alter the material economic expectations of the nondebtor party to the contract. See *Bruder v Peaches Records & Tapes, Inc. (In re Peaches Records & Tapes, Inc.)* (BAP 9th Cir 1985) 51 BR 583, 589 (assumption and assignment permissible when they "do not interfere, in any significant way, with the primary economic expectations of a lessor or with existing property uses"). See also *In re Martin Paint Stores* (Bankr SD NY 1996) 199 BR 258, 261, aff'd (SD NY 1997) 207 BR 57 (11 USC §365(b)(3) is intended to protect landlord's economic expectations). In addition, if a debtor-tenant has defaulted under a shopping center lease, a trustee must meet the minimum standards specified by 11 USC §365(b)(3) for "adequate assurance of future performance" under a shopping center lease. These standards include assurances of (a) continued performance of payment obligations, including no substantial decline in percentage rents generated by the tenant; and (b) compliance with all lease covenants and restrictions, including those on radius, location, use, exclusivity, and tenant mix. On shopping center leases, see §7.53.

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G. Limitations on Assumption or Rejection

§6.22 1. Entire Lease or Contract

The trustee must assume or reject an executory contract or unexpired lease in its entirety, with all its burdens, and cannot assume the beneficial elements of the contract while rejecting its burdensome elements. *In re David Orgell, Inc.* (Bankr CD Cal 1990) 117 BR 574, 575. The effect of this rule may vary depending on the court's determination as to what constitutes a single executory contract or unexpired lease. Much of the litigation under 11 USC §365 has focused on the question of what constitutes "the contract." Courts have ruled that a single document may contain a number of severable agreements. See §6.23. Courts have also found that in certain circumstances multiple documents may constitute a single contract. See §6.24.

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§6.23 a. Severability

Contract rights are determined by state law. See *Butner v U.S.* (1979) 440 US 48, 59 L Ed 2d 136, 99 S Ct 914. In general, the following factors are relevant to any severability analysis under state law: (1) whether the nature and purpose of the agreements within the one document are distinct, (2) whether there is separate and distinct consideration for each agreement, and (3) whether the obligations of each party to the instrument are interdependent or interrelated. *Byrd v Gardinier (In re Gardinier, Inc.)* (11th Cir 1987) 831 F2d 974, 976. See also *Hudson v Wylie* (9th Cir 1957) 242 F2d 435, 446. In the Ninth Circuit, the severability analysis focuses on "the intent and actions of the contracting parties," which are "determined from the language employed by the parties, viewed in the light of the circumstances surrounding them at the time they contracted." *Otto Preminger Films, Ltd. v Qintex Entertainment, Inc. (In re Qintex Entertainment, Inc.)* (9th Cir 1991) 950 F2d 1492, 1496. As a practical matter, a contract should be severable only when a party's failure to perform one promise would not defeat the purpose of, or excuse the other party's performance under, the entire agreement.

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§6.24 b. Integration

When several documents are found to constitute a single agreement, the trustee is required to assume or reject the entire group without "cherry-picking" among the constituent documents. Courts analyze the integration of multiple documents much as they do the severability of provisions of a single document, by focusing on the parties' intent, as evidenced by the language and substance of the agreement. *Moore v Pollock (In re Pollock)* (BAP 9th Cir 1992) 139 BR 938, 940. Multiple agreements contained in multiple documents may be construed as a single contract even if not expressly integrated. *Dimond v U.S. (In re Steen)* (9th Cir 1975) 509 F2d 1398, 1402 (court integrated two documents after considering timing, parties, size of transaction, and interrelationship of agreements). See CC §1642. See also *Pieco, Inc. v Atlantic Computer Sys. (In re Atlantic Computer Sys.)* (SD NY 1994) 173 BR 844, 850 (collecting extensive list of cases regarding integration of multiple documents into one contract). See also *In re Oregon Arena Corp.* (D Or, Feb. 28, 2006, No. 304-31605-e1p11) 2006 US Dist Lexis 10042 (contemporaneously executed agreements that included extensive cross-references and encompassed same subject matter construed as one integrated agreement to be assumed or rejected in its entirety).

To facilitate reorganization, a court may refuse to approve integration of several related contracts. For example, when a debtor had purchased a business and, in connection with the purchase, had leased three business locations from the seller, the court permitted the debtor to assume or reject each lease independently of the others. *In re Plitt Amusement Co.* (Bankr CD Cal 1999) 233 BR 837, 847. See also *Jewell v Beeler* (*In re Stanton*) (BAP 9th Cir 2000) 248 BR 823, aff'd (9th Cir 2002) 303 F3d 939 (disapproving aggregation of deed of trust with contemporaneously executed factoring agreement and guaranty).

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2. Severability of Apparently Executory Contracts

§6.25 a. Nonexecutory Obligations

Some courts have held that an apparently executory contract was in fact not executory for purposes of 11 USC §365, but rather was an amalgam of executory and nonexecutory obligations, and that the latter obligations would not be affected by rejection of the executory elements of the contract. *Stewart Title Guar. Co. v Old Republic Nat'l Title Ins. Co.* (5th Cir 1996) 83 F3d 735, 741 ("only the executory portions of the document are subject to rejection… the executed portions of the contract remain intact, and property rights acquired under the contract prior to filing become property of the estate [despite] rejection of the unperformed obligations of the contract"). This approach effectively results in severance of the contract and enables the trustee to enjoy the benefit of the nonexecutory portion of the contract, while separately assuming or rejecting its executory portions.

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§6.26 b. Obligations Required by Public Policy

In a few cases, courts have found that certain obligations could not be rejected as a matter of public policy. For example, the debtor-landlord in *Saravia v 1736 18th St. N.W., Ltd. Partnership* (DC Cir 1988) 844 F2d 823, 824, rejected its tenants' leases, and accordingly was released from performing the landlord's obligations under those leases. Nonetheless, the court held that the landlord was required by the public housing laws, which promote public health, safety, and welfare, to continue to maintain the property and to provide basic utility and other services to its residential tenants. 844 F2d at 826.

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§6.27 c. Obligations Arising Under State Law

One provision of the Judicial Code, 28 USC §959(b), may offer nondebtor contract parties additional support for enforcement of certain agreements, including those relating to compliance with zoning or environmental laws. Section 959(b) provides, in pertinent part, that

> a trustee,… including a debtor in possession, shall manage and operate the property in his possession [in such capacity] according to the requirements of the valid laws of the State in which such property is situated, in the same manner that the owner or possessor thereof would be bound to do if in possession thereof.

See *Baker & Drake, Inc. v Public Serv. Comm'n of Nev. (In re Baker & Drake, Inc.)* (9th Cir 1994) 35 F3d 1348 (bankruptcy code did not preempt valid state regulation of taxicabs).

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§6.28 d. Homeowners' Association Fees

Applicable state laws vary, but the usual result of bankruptcy court analysis is that condominium or homeowners' association fees relate to the maintenance and upkeep of common areas, which necessarily confer a benefit on the owner, and that, as long as the owner continues to hold title, the owner (as well as the unit) is liable for the association fee. *In re Lenz* (Bankr D Colo 1988) 90 BR 458, aff'd (D Colo 1990) 110 BR 523. In 1994, 11 USC §523(a)(16) was added to the Bankruptcy Code to prohibit the discharge of postpetition obligations incurred while the debtor occupies or receives rent for the use of its premises.

As amended by BAPCPA, §523(a)(16) expands the scope of the discharge exception to encompass all postpetition fees or assessments relating to the debtor's ownership interest in a condominium unit, cooperative corporation share, or lot in a homeowners' association "for as long as the debtor or the trustee has a legal, equitable, or possessory ownership interest" in the applicable unit, corporation, or lot. The amended section also clarifies that it does not affect the dischargeability of such fees or assessments to the extent they arise before the petition date in a pending or subsequent bankruptcy case.

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§6.29 e. Real Property Covenants Likely to Be Executory Contracts in California

The fact that an executory contract creates rights affecting real property does not necessarily insulate those rights against rejection, as illustrated by *Steffan v McMillan (In re Coordinated Fin. Planning Corp.)* (BAP 9th Cir 1986) 65 BR 711. The Chapter 7 debtor in *Steffan v McMillan* was a joint owner of real property in California. The recorded memorandum of ownership established the mutual rights of first refusal between the debtor and its co-owner in the event of any sale. 65 BR at 712. The court found that the right of first refusal was a covenant that ran with the land under CC §1468. Nonetheless, the court held that the covenant was contractual in nature, not merely an attribute of the real property, and was an executory contract as a matter of federal law. The trustee therefore was permitted to reject the right of first refusal and sell the property to a third party. The jilted co-owner was granted a lien against the property to secure repayment of amounts it paid for the right of first refusal. 65 BR at 713; see 11 USC §365(j). Compare *Steffan v McMillan (In re Coordinated Fin. Planning Corp.), supra,* with *In re Bergt* (Bankr D Alaska 1999) 241 BR 17 (right of first refusal was not an executory contract subject to rejection).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/6 Executory Contracts/§6.30 3. Prohibitions on Assumption of Certain Contracts

§6.30 3. Prohibitions on Assumption of Certain Contracts

Bankruptcy Code §365(c) identifies three categories of contracts that either cannot be assumed or can be assumed only with the prior consent of the nondebtor party. 11 USC §365(c)(1)-(3). The prohibition in 11 USC §365(c)(1) applies to many common types of contracts. See §§6.31-6.38.

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§6.31 a. Applicable Law Prohibits Assumption or Assignment Without Nondebtor's Consent

Bankruptcy Code §365(c)(1) prohibits the trustee or debtor in possession from assuming or assigning a contract when (1) applicable state or federal nonbankruptcy law excuses the nondebtor party "from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession" regardless of whether the contract actually contains explicit restrictive language, and (2) the nondebtor party does not consent. A contract provision restricting assignment does not alone impair a trustee's right to assume or reject. *Everex Sys. v Cadtrak Corp. (In re CFLC, Inc.)* (9th Cir 1996) 89 F3d 673.

Section 365(c)(1) is widely accepted as giving effect to state laws prohibiting the assignment of "personal" contracts, *i.e.,* when the personal attributes of the individual contract party are material. See, *e.g., Rieser v Dayton Country Club Co. (In re Magness)* (6th Cir 1992) 972 F2d 689, 695 (debtor's golf membership in country club was personal contract, which trustee could not assume and assign). In the Ninth Circuit, §365(c)(1) has also been found to encompass the California Vehicle Code. See §6.32.

Some courts permit a debtor in possession to assume a contract as long as it has no actual intent to assign the contract to a third party (which would not be permitted absent consent). See *Institut Pasteur v Cambridge Biotech Corp.* (1st Cir 1997) 104 F3d 489. See also *In re Footstar, Inc.* (Bankr SD NY 2005) 323 BR 566, 573 (permitting Chapter 11 debtor in possession to assume contract, notwithstanding §365(c)(1) prohibitions). In the Ninth Circuit, however, if a contract is governed by a law described in 11 USC §365(c)(1)(A), neither a trustee nor a debtor in possession can assume the contract without the nondebtor's consent, regardless of the actual intent of the debtor or debtor in possession to perform, rather than assign, the contract. *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747 (debtor in possession could not assume patent license over objection of patentor because identity of licensee is material to licensor and federal patent law prohibits assignment of license without patentor's consent). The U.S. Supreme Court has recognized that the Ninth Circuit's application of 11 USC §365(c) differs from other circuits, but has declined to resolve the issue. See *NCP Mktg. Group v BF Star Prods.* (2009) ___ US ___, 173 L Ed 2d 1028, 129 S Ct 1577. See also discussion of assumption of construction liens in §9.15.

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§6.32 (1) Automobile Dealership Contracts

California and many other states provide statutory protection to both automobile manufacturers and dealers in connection with many aspects of their relationships. Vehicle Code §11713.3(e) sets forth a typical provision that balances the needs of dealers to be able to sell their franchises with the needs of manufacturers to retain control over who is representing their products to the public:

> There shall be no transfer or assignment of the dealer's franchise without the consent of the manufacturer or distributor, which consent shall not be unreasonably withheld.

Bankruptcy courts generally uphold this provision as within the scope of 11 USC §365(c)(1), and the focus of litigation is whether the manufacturer is reasonable in withholding its consent to the proposed assignee. See *Ford Motor Co. v Claremont Acquisition Corp. (In re Claremont Acquisition Corp.)* (CD Cal 1995) 186 BR 977, 984, aff'd *General Motors Corp. v Worthington (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029; *In re Van Ness Auto Plaza, Inc.* (Bankr ND Cal 1990) 120 BR 545, 547. In any event, if defaults have occurred, the trustee will have to satisfy the cure, compensation, and adequate assurance of future performance requirements of 11 USC §365(b)(1). The trustee may not be able to assume the contract at all if noncurable defaults have occurred. See §6.20.

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§6.33 (2) Other Franchise Agreements

There is little authority on the assignment of franchise agreements, such as those covering retail or restaurant operations, but it seems that they should be subject to assumption by a trustee in a California bankruptcy case. Even trustees of petroleum franchisees (*i.e.,* gas station operators) should be able to assume (and later assign) their franchise agreements. Under Bus & P C §21148, a petroleum franchisor must consent to a transfer of the franchise unless the franchisor demonstrates certain facts, as specified in the statute, to support its nonconsent. In any event, the statute gives the franchisor a right of first refusal to purchase the franchise from the franchisee on the same terms as those of the proposed assignment. But see *In re Adelphia Communications Corp*. (Bankr SD NY 2007) 359 BR 65 (municipal ordinances restricting transfer of cable franchise agreements were enacted to protect public and were sufficient to bar assignment of debtor's franchise agreement).

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§6.34 (3) Partnership and LLC Agreements

The laws of most states, including California, permit partners and LLC members to encumber or assign the economic attributes of their partnership or LLC membership interests. See *Northrop Grumman Tech. Servs., Inc. v The Shaw Group, Inc. (In re ItGroup, Inc.)* (D Del 2003) 302 BR 483. See also Corp C §§15672, 16502, 17301. Those laws generally do not permit partners or LLC members to assign their entire partner or membership interests without consent of the other partners or members. See Corp C §§15674(a), 16503, 17301. Therefore, if the partner's or member's identity is important (which is usually true for a general partner or managing member), the bankruptcy trustee of such partner or member probably will not be permitted to become a full partner or LLC member without consent of the other partners or members. See *Broyhill v DeLuca* (*In re DeLuca*) (Bankr ED Va 1996) 194 BR 65 (LLC operating agreement was nonassumable personal services contract of managing member; debtors in possession could not assume management interest and related duties and responsibilities, but did succeed to right to share in profits, losses, and distributions allocable to their membership interest). But see *In re Daugherty Constr.* (Bankr D Neb 1995) 188 BR 607, 611 (LLC Articles of Organization and Operating Agreement constitute executory contracts that debtor may attempt to assume under 11 USC §365, notwithstanding provisions that purport to terminate debtor's interest on commencement of bankruptcy case).

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§6.35 (4) Government Contracts

Many contracts with the federal government are governed by the Nonassignment Act (41 USC §15). This Act prohibits the transfer of a government contract from the original contractor to another party and further provides that "any such transfer shall cause the annulment of the contract or order transferred." Bankruptcy Code §365(c)(1) prohibits a trustee from assuming such contracts without the government's consent. *In re West Electronics, Inc.* (3d Cir 1988) 852 F2d 79, 82 (Nonassignment Act precluded assumption over government's objection; bankruptcy court should have granted government's motion for relief from stay to permit termination of contract); *U.S. v TechDyn Sys. Corp. (In re TechDyn Sys. Corp.)* (Bankr ED Va 1999) 235 BR 857, 863 (relief from stay granted if government opposed debtor's assumption of contracts that were subject to 41 USC §15).

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§6.36 b. Relief From Stay for Nonassumable Contracts

Nondebtor parties often seek relief from the automatic stay to terminate contracts, such as patent or copyright licenses, that cannot be assumed in bankruptcy over the nondebtor's objection. Some courts, however, have been reluctant to grant motions for relief from stay on this basis, because the debtor's circumstances can change during the case and the nondebtor party may decide to give its consent after all.

PRACTICE TIP: If applicable law prevents assignment, a trustee or debtor in possession may be able to retain its contract rights by arguing that the subject contract is not executory and therefore is an estate asset.

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§6.37 c. No Assumption of Financing Agreements

Bankruptcy Code §365(c)(2) prohibits the assumption of any contract "to make a loan, or extend other debt financing or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor." 11 USC §365(c)(2). The prohibition in §365(c)(2) applies whether or not the contract itself contains any prohibitions, as long as the contract concerns the making of a loan or financial accommodation. In the Ninth Circuit, the prohibition against assumption of a financial accommodation contract is absolute, regardless of the consent of the nondebtor party. *Transamerica Commercial Fin. Corp. v Citibank, N.A.* (*In re Sun Runner Marine, Inc.*) (9th Cir 1991) 945 F2d 1089, 1093. If a trustee or debtor in possession wishes to obtain financing during a bankruptcy case, Bankruptcy Code §364 establishes the standards for doing so.

Section 365(c)(2) protects lenders from having to make postpetition loan advances on the same terms that were applicable before the debtor's bankruptcy filing. This section encompasses contracts that provide for an extension of credit as a material element and therefore are unassumable. See *In re Whiteprize, LLC* (Bankr D Ariz 2002) 275 BR 868, 873 (debtor could not assume land sale contracts that provided for sellers to provide long-term carryback financing). Section 365(c)(2) is construed narrowly, however, and does not apply to a contract when the extension of credit is incidental to the primary purpose of the agreement. *In re United Airlines, Inc*. (7th Cir 2004) 368 F3d 720, 725 (merchant's credit card-processing agreement was assumable executory contract, not "financial accommodation," as primary purpose was provision of service to debtor); *In re Neuhoff Farms, Inc.* (Bankr ED NC 2000) 258 BR 343; *In re Emerald Forest Constr.* (Bankr D Mont 1998) 226 BR 659. See also *United Sur. & Indem. Co. v Maxon Eng'g Servs., Inc.* (*In re Maxon Eng'g Servs., Inc.)* (Bankr D PR 2005) 324 BR 429 (payment and performance bonds were not executory contracts and were not unassumable financial accommodations; debtor paid all premiums prepetition, and its only continuing obligation was performance of underlying construction contracts, nonperformance of which would trigger, not excuse, surety's performance obligations).

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§6.38 d. No Assumption of Terminated Commercial Real Estate Leases; Other Terminated Contracts

Although 11 USC §365(c)(3) is redundant of the rule that §365 applies only to *executory* contracts and *unexpired* leases (see §6.1), the shopping center lobby caused §365(c)(3) to be added in order to preclude the assumption of any lease of nonresidential real property that terminated under applicable nonbankruptcy law before the petition date. 11 USC §365(c)(3). See discussion in §7.53. It should not be inferred from the exclusion of personal property and residential leases in §365(c)(3) that such leases or any other contracts can be assumed after a prepetition termination. Although landlords usually should obtain relief from the automatic stay before evicting tenants whose residential leases terminated before bankruptcy, courts have held that the stay does not apply to prevent eviction if the landlord actually obtained an unlawful detainer judgment before the bankruptcy petition was filed. *Marquand v Smith* (*In re Smith*) (Bankr CD Cal 1989) 105 BR 50; *Lee v Baca* (1999) 73 CA4th 1116, 86 CR2d 913. This rule is consistent with 11 USC §362(c)(1), which provides that the automatic stay does not apply to acts against property that has ceased to be property of the estate. See §4.7.

As a precaution, however, landlords holding prebankruptcy unlawful detainer judgments customarily seek, and bankruptcy courts commonly grant, expedited relief from stay. Similar relief has been sought by and granted to landlords who filed unlawful detainer complaints but did not obtain judgments before the tenant filed its bankruptcy petition. This practice has been incorporated into 11 USC §362(b) by BAPCPA, which excepts from the stay any action for eviction or unlawful detainer or similar proceeding by a lessor that obtained a prebankruptcy judgment of possession against the debtor-tenant of residential real property. 11 USC §362(b)(22), (*l*)(4). Title 11 USC §362(*l*) provides such a tenant the opportunity to obtain the protection of the stay by (1) filing with the petition and serving on the lessor a statement that, under applicable nonbankruptcy law, the tenant could remain in possession by curing the entire monetary default; (2) depositing with the bankruptcy clerk an amount equal to the sum of all rent that will come due in the first 30 days of the case; and (3) filing and serving a further certification that the entire monetary default has in fact been cured. 11 USC §362(*l*)(1)-(2). The lessor may object to the foregoing certifications and obtain a hearing within 10 days. 11 USC §362(*l*)(3). If the objection is sustained, the stay immediately will cease to apply. To enable the court and the parties to determine the applicability of 11 USC §362(b)(22), debtors will be required to indicate on their petitions the existence of any adverse judgment of possession concerning the residential real property where the tenant resides, the name and address of the lessor who obtained the judgment, whether postjudgment monetary cure is available, and whether 30 days' rent has been posted.

Further, if a residential landlord has commenced a prepetition eviction action based on endangerment of, or illegal use of controlled substances on, the premises, or if the landlord files with the court and serves on the debtor a certification that the debtor has been involved in such activities within the preceding 30 days, the stay will cease to apply to the premises and any related eviction action 15 days after service of the certification. 11 USC §362(b)(23), (m). The debtor can preserve the stay by filing and serving, within the 15-day period, an objection to the lessor's certification and by providing satisfactory evidence, at or before a hearing to be held within 10 days after the filing of the objection, that the alleged prohibited situation did not exist or has been remedied. 11 USC §362(m)(2).

For further discussion of landlord rights in tenant bankruptcies, see chap 7.

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IV. PERFORMANCE PENDING ASSUMPTION OR REJECTION

§6.39 A. Performance by Nondebtor Party

Nondebtor parties to executory contracts and unexpired leases normally are required to continue to provide goods and services and otherwise perform under those agreements after the commencement of the bankruptcy case as if no case had been filed. See, *e.g., In re Coast Trading Co.* (Bankr D Or 1982) 26 BR 737, 741 (nondebtor party cannot repudiate executory contract; remedies are limited to seeking order shortening time for debtor to assume or reject contract, or seeking relief from automatic stay to terminate contract). This is so even if the contract includes a clause making bankruptcy or insolvency an event of default. 11 USC §365(e). See §6.53. A nondebtor party that desires to terminate such a lease or contract, even one that cannot be assumed in the bankruptcy case (see §§6.30-6.38), must first obtain relief from the stay. *Computer Communications, Inc. v Codex Corp.* (*In re Computer Communications, Inc.*) (9th Cir 1987) 824 F2d 725. A nondebtor party also may seek relief from stay in order to be excused from performance or to obtain clarification of the debtor's postpetition payment obligations or other related relief. See *In re Lucre, Inc.* (Bankr WD Mich 2006) 339 BR 648 (granting relief from stay for nondebtor party and holding that debtor could not compel nondebtor party to continue performance under contract).

To the extent that the debtor requires the nondebtor party to perform its obligations under the contract during the debtor's bankruptcy case but before the debtor has assumed the contract, the amounts payable to the nondebtor usually will be found to be actual and necessary costs and expenses of preserving the estate, and will be treated as an administrative priority claim. 11 USC §503(b)(1). See §3.10. The estate, however, is required to pay only the reasonable value of goods and services received postpetition, which may be less than what is specified in the contract. *In re Bryant Universal Roofing, Inc.* (Bankr D Ariz 1998) 218 BR 948, 956 (contract is "persuasive but not binding guide to a determination of the appropriate amount" of nondebtor's administrative claim for services provided postpetition).

Bankruptcy Code §365(b)(4) provides special relief for lessors. If there has been a default under an unexpired lease, the trustee cannot require the lessor to provide goods or supplies incidental to the lease unless the trustee compensates the lessor for such goods and services in accordance with the lease terms. 11 USC §365(b)(4). Moreover, by operation of 11 USC §365(d)(3) and (d)(5) (and former 11 USC §365(d)(10)), lessors of *nonresidential* real property are entitled to payment of all amounts due under the lease from the petition date pending assumption or rejection, regardless of the effect on the estate. See §6.41.

The nondebtor party should obtain a bankruptcy court order authorizing the trustee to incur and pay postpetition obligations under the contract. This step is particularly important for an obligation that is not simple trade debt, because such an obligation may be viewed as not "in the ordinary course" of the debtor's business, and therefore as an obligation requiring prior court approval under 11 USC §364. To determine whether a transaction is "ordinary course," courts examine two factors: (1) whether it is common for entities in the same business as the debtor, and (2) whether it subjects the debtor's creditors to economic risks different from those they reasonably expected when they extended credit to the debtor. *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700. Obtaining a court order also is important if any secured creditor asserts a security interest in the debtor's cash flow (see 11 USC §363(a)). If there is no court order and the secured creditor has not consented to the use of its cash collateral to pay the nondebtor party's claim, the claim may not be paid, because the trustee may not have any other source of funds.

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§6.40 B. Performance by Debtor

Bankruptcy Code §365 contains specific requirements concerning the performance of a trustee or debtor in possession under unexpired nonresidential real and personal property leases pending assumption or rejection (see 11 USC §365(d)(3) and (d)(5)) but does not impose performance requirements with respect to other executory contracts. If a debtor ceases to perform its obligations under an executory contract or a residential lease during a bankruptcy case, the nondebtor party's principal recourse is to seek an order compelling assumption or rejection by a date certain under 11 USC §365(d)(2), granting relief from the automatic stay under 11 USC §362(d) (see §§4.15-4.26), or granting adequate protection under 11 USC §363(e) (see chaps 7, 10).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/6 Executory Contracts/ C. Additional Performance Requirements: Commercial Leases/§6.41 1. Leases of Nonresidential Real Property

C. Additional Performance Requirements: Commercial Leases

§6.41 1. Leases of Nonresidential Real Property

Pending assumption or rejection, the trustee or debtor in possession must perform all of the debtor's obligations as lessee under a lease of nonresidential real property, except any obligation to cure defaults triggered by so-called ipso facto clauses or to satisfy any penalty rates or penalty provisions relating to defaults arising from the failure of the debtor to perform nonmonetary obligations (see 11 USC §365(b)(2), (e)(1)), to the extent that such obligations arise after the petition date. 11 USC §365(d)(3). These obligations include payment of *all* amounts due under the lease, including rent, interest, late fees, common area charges, percentage rents, real estate taxes, and any items termed "additional" or "further" rent, regardless of the fair and reasonable value of the trustee's use of the leased property. The filing of a rejection motion, however, may terminate the accrual of postpetition obligations as of the date the rejection motion is filed. See *Pacific Shores Dev., LLC v At Home Corp. (In re At Home Corp.)* (9th Cir 2004) 392 F3d 1064.

NOTE: Bankruptcy Code §365(d)(3) does not apply to postpetition performance of a debtor's obligations as *lessor*; it applies only to its obligations as lessee. *Einstein/Noah Bagel Corp. v Smith (In re BCE W., LP)* (9th Cir 2003) 319 F3d 1166.

Courts usually prorate leasehold obligations that are payable postpetition but accrue in part prepetition. *El Paso Props. Corp. v Gonzales (In re Furr's Supermarkets, Inc.)* (BAP 10th Cir 2002) 283 BR 60 (analyzing competing approaches of Seventh and Third Circuits and adopting Seventh Circuit's proration approach); *In re Handy Andy Home Improvement Ctrs., Inc.* (7th Cir 1998) 144 F3d 1125 (articulating and adopting proration approach, in which only obligations *accruing* postpetition are within 11 USC §365(d)(3)); *In re National Refractories & Minerals Corp.* (Bankr ND Cal 2003) 297 BR 614, 620 (postpetition, prerejection physical or environmental damage to leased premises would result in administrative claim). But see *Centerpoint Props. v Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)* (3d Cir 2001) 268 F3d 205 (rejecting proration approach and adopting performance date approach; holding that entire amount of taxes payable to landlord postpetition under lease terms had administrative priority, regardless of when tax liability of debtor to landlord (or of landlord to taxing authority) accrued). Similarly, obligations for rent under 11 USC §365(d)(3) normally are prorated based on the actual number of days of occupancy. *In re Travel 2000, Inc.* (Bankr WD Mich 2001) 264 BR 444. The Sixth Circuit, however, has held a trustee liable under §365(d)(3) for payment of an entire month's rent in a case in which the rent was due on the first day of the month and the trustee rejected the lease on the second day. *Koenig Sporting Goods, Inc. v Morse Road Co.* (*In re Koenig Sporting Goods, Inc.*) (6th Cir 2000) 203 F3d 986, 989; *HA-LO Indus. v CenterPoint Props. Trust* (7th Cir 2003) 342 F3d 794, 799 (adopting *Koenig* approach and distinguishing rent obligations, which accrued entirely postpetition, from *Handy Andy* tax obligations, which accrued both pre- and postpetition but were billed only postpetition).

An Illinois bankruptcy court ruled that §365(d)(3) did not apply to postpetition rent that accrued between payment dates specified in the lease, when the debtor filed its petition several days after the payment due date, but that rent accruing between the petition date and the next scheduled payment date (known as "stub rent") was entitled to administrative priority under §503(b)(1). *In re UAL Corp.* (Bankr ND Ill 2003) 291 BR 121, 127. A debtor cannot challenge the lease rate for payments under §365(d)(3), but may argue that stub rent claims that are accorded general administrative status are subject to challenge to the extent that the lease rate exceeds current market rates. *Orland Holdings, LLC v Rhodes, Inc. (In re Rhodes, Inc.)* (Bankr ND Ga, Nov. 17, 2005, No. 04-78434) 2005 Bankr Lexis 2688.

A trustee or debtor in possession may obtain a court order permitting it to delay performance under a lease of nonresidential real property for up to 60 days after the petition date, but no longer. 11 USC §365(d)(3).

California bankruptcy courts generally view the landlord's right under 11 USC §365(d)(3) as a right to receive immediate payment of postpetition rent unless the debtor is unable to pay all administrative claims. *In re Tandem Group, Inc.* (Bankr CD Cal 1986) 61 BR 738, 741. The majority view is that §365(d)(3) does not confer superpriority status on the landlord's claim. *In re LPM Corp.* (Bankr SD Cal 2000) 253 BR 914, 919, aff'd (9th Cir 2002) 300 F3d

1134. At least one bankruptcy court outside California has adopted the view that *some* claims under §365(d)(3) may be entitled to superpriority status. *In re Pudgie's Dev.* (Bankr SD NY 1998) 223 BR 421, 427, aff'd (SD NY 1999) 239 BR 688. In any event, claims that arise under §365(d)(3) in a Chapter 11 case will be subordinate to administrative expenses that accrue after the case is converted to Chapter 7. *Kir Temecula v LPM Corp. (In re LPM Corp.)* (9th Cir 2002) 300 F3d 1134, 1137. See 11 USC §726(b).

PRACTICE TIP: If a trustee or debtor in possession under a commercial lease is not making the required postpetition payments, the landlord has several options: (a) move to compel payment of rent; (b) move to compel surrender of the premises; and (c) move to convert the case to a Chapter 7 case. *In re LPM Corp.* (Bankr SD Cal 2000) 253 BR 914, 918, aff'd (9th Cir 2002) 300 F3d 1134.

For further discussion of landlord rights in tenant bankruptcy cases, see chap 7.

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§6.42 2. No Waiver of Lessor's Rights

Acceptance by a lessor of the trustee's performance under 11 USC §365(d)(3) does not constitute a waiver of the lessor's rights under 11 USC §365(b), (f). 11 USC §365(d)(3); *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885, 888.

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V. EFFECT OF ASSUMPTION OR REJECTION

§6.43 A. General Effect of Assumption

On assumption, an executory contract or unexpired lease becomes a postpetition asset and a liability of the bankruptcy estate, and the trustee (or its assignee) is required to perform all of its payment and other obligations as if no bankruptcy case were pending. All of the debtor's obligations under the assumed agreement become obligations of the bankruptcy estate with administrative priority under 11 USC §503(b)(1). See §3.10. After assuming an executory contract or unexpired lease, a trustee may assign it to a third person, subject to the limitations of 11 USC §365(f). See §§6.54-6.58.

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B. General Effect of Rejection

§6.44 1. Damage Claim; Mitigation

Rejection results in a breach of the subject agreement and gives rise to a damage claim payable in the bankruptcy case. See 11 USC §365(g). On rejection, a nondebtor party usually will have a general unsecured claim for damages resulting from rejection and also may have a secured claim in an amount up to the amount of any security deposit received from the debtor as well as rights of offset or recoupment with respect to amounts owed by the nondebtor to the debtor. The nondebtor party also may have an administrative priority claim for goods provided or services rendered to or on behalf of the trustee, under the contract, during the bankruptcy case up to the rejection date. See 11 USC §503(b).

Section 365(g) provides rules for calculating when the breach of a rejected contract is deemed to occur. Generally, rejection of a contract that has not been assumed is deemed to be a prepetition breach, giving rise to a prepetition claim. See *Bank of Montreal v American HomePatient, Inc. (In re American HomePatient, Inc.)* (6th Cir 2005) 414 F3d 614, 620 (rejection of contract gave rise to breach deemed to occur immediately before petition date, notwithstanding state law to contrary). If a contract was assumed during the bankruptcy case, however, the subsequent rejection is a postpetition breach, and gives rise to an administrative claim for all amounts payable under the assumed contract. *Nostas Assocs. v Costich (In re Klein Sleep Prods.)* (2d Cir 1996) 78 F3d 18 (superseded in part by 11 USC §503(b)(7)). See also *Elliott v Four Seasons Props. (In re Frontier Props.)* (9th Cir 1992) 979 F2d 1358, 1367.

BAPCPA amended 11 USC §503(b)(7) to limit the administrative claim for damages under an assumed but later rejected lease of nonresidential real property to the amount payable under the lease, exclusive of penalties, for the 2-year period following the later of the rejection date and the date the premises actually are delivered to the landlord. The balance of the unpaid rent is treated as a general unsecured claim subject to the cap imposed by 11 USC §502(b)(6).

Rejection of a contract does not automatically result in allowance of a claim for damages in favor of the nondebtor party. If the court finds that the rejected contract was not enforceable under applicable nonbankruptcy law prior to rejection, the nondebtor will not have any allowable claim for rejection damages. *Durkin v Benedor Corp. (In re G.I. Indus.)* (9th Cir 2000) 204 F3d 1276, 1280. Similarly, rejection does not abrogate any obligation of the nondebtor party under applicable nonbankruptcy law to mitigate damages. In cases in which 11 USC §503(b)(7) applies, however, the administrative claim for 2 years' rent will not be subject to "reduction or setoff for any reason whatsoever except for sums actually received or to be received from any entity other than the debtor." 11 USC §503(b)(7).

As written, these provisions do not appear to require the lessor to seek to mitigate its damages or contemplate that its administrative rejection claim would be reduced for failure to mitigate. However, because contract rights generally are a question of state law, courts generally will import any mitigation requirements imposed on lessors under applicable nonbankruptcy law and that are often applied to limit landlords' prepetition claims. Note that application of such mitigation requirements to an administrative rejection claim appears to be inconsistent with the statute and should not be permitted. The statute does provide, however, that if the lessor enters into a new lease of the premises, the amounts paid or payable under the new lease will be taken into account in setting the lessor's allowed administrative claim. If the replacement lessee also becomes a debtor in a bankruptcy case and rejects the lease (or, possibly, otherwise defaults), such that the mitigation effort fails or is reduced in value, then the lessor's damage claim against the original lessee's estate may be increased pro tanto. *Giant Eagle, Inc. v Phar-Mor, Inc*. (6th Cir 2008) 528 F3d 455.

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§6.45 2. Limitations on Rejection Damages

Damage claims may be limited in some respects. For example, any administrative claim arising from the nondebtor's postpetition performance under an executory contract, other than a commercial lease of real or personal property, is limited to an amount equal to the fair value conferred on the bankruptcy estate. See 11 USC §503(b). But see discussion in §6.41 regarding stub rent. In addition, 11 USC §502, concerning the allowance of claims or interests, limits the claims of certain creditors.

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§6.46 3. Landlords' Claims

Bankruptcy Code §502(b)(6) limits the claim of a real property lessor for damages arising from rejection of its lease (in addition to any damages existing on the petition date, before rejection, plus any administrative claim) to an amount equal to the "rent reserved by such lease" for the greater of (1) 1 year, or (2) 15 percent of the rent for the remaining term of the lease, not to exceed 3 years. 11 USC §502(b)(6). For further discussion, see §§7.42, 7.45, 7.55, 7.59, 8.13.

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§6.47 C. Termination

Rejection of an executory contract or unexpired lease constitutes a breach, but does not terminate or rescind the contract or lease. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc.)* (9th Cir 2006) 439 F3d 558, 563 ("[w]hile rejection of a lease prevents the debtor from obtaining future benefits of the lease (such as ongoing possession of leased premises), it does not rescind the lease or defeat any pending claims or defenses that the debtor had in regard to that lease"). See also *In re Aslan* (Bankr CD Cal 1986) 65 BR 826, 829, aff'd (9th Cir 1990) 909 F2d 367. In any event, in the Ninth Circuit, rejection terminates all of the debtor's performance obligations, and the nondebtor's only remedy is a claim for damages. *Kaonohi Ohana, Ltd. v Sutherland (In re Kaonohi Ohana, Ltd.*) (9th Cir 1989) 873 F2d 1302, 1306 (dismissal of specific performance complaint against debtor was correct because specific performance is not available as remedy for rejection of executory contract). See also *TPG of Scottsdale, LLC v Scott Desert Shadows, LLC* (*In re Scott Desert Shadows, LLC*) (Bankr D Ariz, Apr. 14, 2006, No. 05-14892-PHX-CGC) 2006 Bankr Lexis 1220 (claim for reformation cannot lie when underlying contract has been rejected); *Dunkley v Rega Props. (In re Rega Props.)* (9th Cir 1990) 894 F2d 1136, 1140. But see *Abboud v Ground Round, Inc. (In re Ground Round, Inc.)* (BAP 1st Cir 2005) 335 BR 253, 261 (rejection of lease did not terminate landlord's specific performance right to require debtor to retransfer liquor license to landlord).

Current Ninth Circuit law appears to preclude specific performance, including enforcement of negative covenants, as a remedy for a trustee's rejection of an executory contract or unexpired lease, regardless of whether the contract or state law provides the right to injunctive relief. It should be noted, however, that the Bankruptcy Code provides modified specific performance rights to certain real property lessees or purchasers, and intellectual property licensees, under rejected agreements. See 11 USC §365(h)-(i), (n).

Some bankruptcy court decisions have distinguished between rejection and termination:

> [R]ejection of an executory contract or lease under Section 365 does not result in the termination or extinguishment of the covenants, rights or remedies created by the executory contract or lease, or, of any property interests appurtenant to the executory contract or lease.

CASC Corp. v Milner II (*In re Locke)* (Bankr CD Cal 1995) 180 BR 245, 263 (mortgagee's interest in debtor-tenant's leasehold survived debtor's rejection of lease). See also *Eastover Bank for Sav. v Sowashee Venture (In re Austin Dev. Co.)* (5th Cir 1994) 19 F3d 1077, 1082 (rejection is just "power to breach," and does not result in repudiation or termination of contract); *McLaughlin v Walnut Props., Inc.* (2004) 119 CA4th 293, 14 CR3d 369 (same). See also *Selby's Market, Inc. v PCT* (*In re Fleming Cos., Inc*.) (D Del, Mar. 16, 2007, No. 05-749-SLR) 2007 US Dist Lexis 18739 (arbitration clause survives rejection of executory contract). Under this analysis, most claims resulting from rejection are quantified in monetary terms and paid as prepetition claims, but specific performance would be available as a remedy in appropriate circumstances. However, at this juncture, a party claiming a possessory interest in leased premises through a debtor has no greater rights than the debtor, unless that party is in contractual privity with the nondebtor party to the lease and is likely to lose its possessory rights on the trustee's rejection of the lease. See *Syufy Enters., L.P. v City of Oakland* (2002) 104 CA4th 869, 128 CR2d 808 (subtenant's possessory interest was terminated when debtor-tenant's possessory interest was terminated by deemed rejection of commercial lease in bankruptcy case).

PRACTICE TIP: A lender or subtenant who wants to enter into a leasehold mortgage or a sublease with a potential debtor-tenant should, at the time of contracting with the tenant, enter into a nondisturbance and attornment or other appropriate agreement with the tenant's landlord, in order to establish direct privity of contract around the tenant, thus creating rights between the nontenant parties that will survive the tenant's bankruptcy case.

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§6.48 D. Abandonment

Some courts outside of the Ninth Circuit have ruled that rejection results in abandonment, not termination, of a rejected contract. See, *e.g.*, *B.N. Realty Assocs. v Lichtenstein* (SD NY 1999) 238 BR 249. But see *Thompson-Mendez v St. Charles Olde Court Partnership, LLC (In re Thompson-Mendez*) (Bankr D MD 2005) 321 BR 814 (deemed rejection of residential lease did not result in abandonment or termination, nor did it make contract disappear; absent formal abandonment under 11 USC §554 or filing of motion for relief from stay, landlord's ejectment action violated automatic stay).

The Ninth Circuit has not expressly adopted this abandonment theory. Instead, although there is some disagreement over whether rejection terminates a lease or contract or merely results in a breach, bankruptcy courts in the Ninth Circuit have found that rejection of a real property lease terminates a debtor's possessory rights: The debtor cannot remain in possession of the premises after termination of the lease. *CASC Corp. v Milner II* (*In re Locke*) (Bankr CD Cal 1995) 180 BR 245.

PRACTICE TIP: A Chapter 7 debtor wishing to preserve its rights under an executory contract or unexpired lease without assuming liability for prepetition defaults (which are dischargeable unless assumed) should attempt to have the trustee file a notice of intent to abandon the subject lease under 11 USC §554 before expiration of the deadline under 11 USC §365(d)(1) or (d)(4). See §§2.83-2.84.

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VI. POSTREJECTION PROTECTION FOR NONDEBTOR PARTIES

§6.49 A. Real Property Lessees

A debtor-lessor's rejection of an unexpired real property lease can be catastrophic for the nondebtor-lessee. To minimize the lessee's damages, 11 USC §365(h)(1) prevents the automatic eviction of lessees on rejection and provides them with an option. A lessee can accept the rejection as terminating the lease, move out, and assert a claim for damages in the bankruptcy case. 11 USC §365(h)(1)(A)(i). Alternatively, the lessee can retain all of its rights under the lease (including possessory rights and rights relating to rental payments) for the duration of the lease, including all extension periods. 11 USC §365(h)(1)(A)(ii). A lessee that elects the second option can reduce its rent payments under the lease by offsetting amounts equal to all damages caused by the debtor's nonperformance after rejection. Such a lessee can also assert a claim for damages arising from the debtor's nonperformance before the rejection date but cannot seek an affirmative recovery for damages arising from and after the rejection date. 11 USC §365(h)(1)(B). Despite this apparent protection, a lessee that elects to remain in possession after rejection may lose its possessory rights if the trustee sells the property free and clear of interests, in accordance with 11 USC §363(f). *Precision Indus., Inc. v Qualitech Steel SBQ, LLC (In re Qualitech Steel)* (7th Cir 2003) 327 F3d 537. Other courts have held that a trustee's sale of the property pursuant to 11 USC §363(f) does not terminate a tenant's leasehold interest. *In re Haskell L.P.* (Bankr D Mass 2005) 321 BR 1; *In re Churchill Props. III, L.P.* (Bankr ND Ill 1996) 197 BR 283. See also *South Motor Co. v Carter-Pritchett-Hodges, Inc. (In re MMH Auto, Group, LLC)* (Bankr SD Fla 2008) 385 BR 347 (reviewing cases on each side of issue).

PRACTICE TIP: *Precision Indus., Inc. v Qualitech Steel SBQ, LLC (In re Qualitech Steel), supra,* may be unusual in that the tenant ignored a notice of sale and failed to appear and demand adequate protection of its interests. A tenant that elects to remain in possession after rejection of its lease should monitor the case and oppose any sale motion that does not adequately protect such tenant's interests. All tenants should seek subordination of their landlord's mortgagee during initial negotiation of the lease. See 11 USC §363(e)-(f).

See also discussion in §§7.42, 7.45, 7.55, 7.59, 8.13.

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§6.50 B. Timeshare Interest Purchasers

A nondebtor-purchaser of a timeshare interest may either accept rejection as terminating the timeshare plan or elect to retain its interests under the plan. In the latter situation, the nondebtor-purchaser may offset damages caused by the trustee's nonperformance after rejection against payments due to the trustee under the timeshare plan. The nondebtor-purchaser may also assert a claim for prerejection damages, but cannot seek affirmative recovery from the bankruptcy estate of postrejection damages. 11 USC §365(h)(2).

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§6.51 C. Purchasers in Possession

A nondebtor party to an executory contract to purchase real property or a timeshare interest who is *in possession* of the subject property may either accept rejection as terminating the contract, or elect to continue to perform under the contract and compel limited specific performance by the trustee. 11 USC §365(i). See *In re Maier* (Bankr WD NY 1991) 127 BR 325, 327. In the latter event, the purchaser can offset damages caused by the trustee's nonperformance after rejection against the purchaser's payment obligations, but cannot assert a claim for postrejection damages against the bankruptcy estate. 11 USC §365(i)(2)(A). If the purchaser elects to perform, the trustee is required to deliver title in accordance with, but not otherwise to perform under, the purchase agreement. 11 USC §365(i)(2)(B).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/6 Executory Contracts/§6.52 D. Purchasers' Liens

§6.52 D. Purchasers' Liens

A purchaser who is not in possession of the subject property is not entitled to elect to perform and compel delivery of title. However, any such purchaser, and any purchaser in possession who elects to remove itself from the property and accept rejection as terminating the contract, has a lien on the debtor's interest in the subject property in an amount equal to the amount of the purchase price paid by the purchaser. 11 USC §365(j).

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§6.53 VII. THE ANTI-IPSO FACTO PROVISION

Many contracts include clauses that are intended to terminate or modify the rights of a party in the event of the party's bankruptcy, insolvency, prebankruptcy receivership, or similar event. Bankruptcy Code §365(e)(1) prevents the enforcement of these ipso facto clauses in most cases. See 11 USC §365(e)(1). The purpose of the anti-ipso facto provision of §365(e)(1) is to enable the estate to realize the full value of the debtor's contract rights for the benefit of the debtor's creditors. *Spieker Props., LP v MFM The SPFC Liquidating Trust (In re Southern Pac. Funding Corp.)* (9th Cir 2001) 268 F3d 712.

Bankruptcy Code §365(e)(2) provides that ipso facto clauses are enforceable in contracts that cannot be assumed. Section 365(e)(2) parallels and preserves the limitations on assumption found in 11 USC §365(c). *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747, 753 n6. These contracts include ones that cannot be assumed or assigned as a matter of applicable nonbankruptcy law without consent of the nondebtor party, regardless of whether the contract prohibits assumption or assignment. 11 USC §365(c)(1). See §§6.31-6.35. These also include financial accommodation contracts. 11 USC §365(c)(2). See §6.37.

On these types of contracts, the court should grant relief from the automatic stay to permit the nondebtor party to terminate the contract. *In re West Electronics, Inc.* (3d Cir 1988) 852 F2d 79, 82 (Anti-Assignment Act precluded assumption over government's objection; bankruptcy court should have granted government's motion for relief from stay to permit termination of contract). But see *Bonneville Power Admin. v Mirant Corp. (In re Mirant Corp.)* (5th Cir 2006) 440 F3d 238, 248 (no relief from stay to enforce Anti-Assignment Act ipso facto clause against debtor in possession when no prohibited "transfer" of contract to third parties occurred). Some courts have declined to grant such relief early in the case, in the belief that the nondebtor party may change its mind during the case, as long as the interests of that party are adequately protected in the interim. See also §6.35.

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§6.54 VIII. ASSIGNMENT UNDER 11 USC §365(f)

The Bankruptcy Code recognizes assumption and assignment of executory contracts and unexpired leases as important means of promoting reorganization and maximizing the value of the debtor's estate. Section 365(f)(1) facilitates assumption and assignment by permitting the trustee to assign most contracts that the trustee can assume. 11 USC §365(f)(1). Section 365(f)(1) abrogates contractual anti-assignment language and permits assumption and assignment without consent of the nondebtor party. However, §365(f)(1) does not override 11 USC §365(c)(1). Thus, at least in the Ninth Circuit, if applicable nonbankruptcy law provides that a contract cannot be assigned without the nondebtor's consent, both assumption and assignment are conditioned on that consent.

Section 365(f)(1) also nullifies contract terms that, although not expressly prohibiting assignment, impose undue burdens on or create economic hurdles to assignment. For example, *South Coast Plaza v Standor Jewelers W., Inc. (In re Standor Jewelers W., Inc.)* (BAP 9th Cir 1991) 129 BR 200 held that a lease provision that conditioned the tenant's assignment of the lease on payment to the landlord of 75 percent of the amount by which the lease value had appreciated (effectively capturing the bulk of any premium that might be paid to the tenant by its assignee), although arguably valid under California law, was rendered invalid and unenforceable in the tenant's bankruptcy case by operation of §365(f)(1). Similarly, under §365(f)(1), the court may disregard cross-default provisions that restrict a trustee's ability to cure defaults and assume and assign the main contract. *In re Sambo's Restaurants, Inc.* (Bankr CD Cal 1982) 24 BR 755. Further, the court may disregard a "change of ownership" provision that serves to deny a trustee's assignee the full economic benefit of ownership of properties that it bought from the bankruptcy estate. *Crow Winthrop Dev. LP v Jamboree LLC (In re Crow Winthrop Operating Partnership)* (9th Cir 2001) 241 F3d 1121.

An anti-assignment clause that has been rendered inoperative in bankruptcy by §365(f)(1) may be reactivated after the contract is assumed by a third party. For example, in *In re David Orgell, Inc.* (Bankr CD Cal 1990) 117 BR 574, 576, the court refused to enforce a lease covenant providing for an increase in rent to the current market rate on the trustee's assignment of the lease, but it ruled that the trustee's assignee would take the lease subject to the escalation clause and that the escalation would take effect on the assignee's subsequent assignment of the lease.

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§6.55 A. Conditions to Assignment

There are two principal conditions to assignment of an executory contract or unexpired lease under 11 USC §365(f)(2): First, the trustee must assume the contract or lease under 11 USC §365(a) or (b). 11 USC §365(f)(2)(A). If a cure payment is necessary, 11 USC §365(b)(1) requires the trustee to make it, although the trustee and the assignee should decide in advance of assignment who will bear the cost of the payment.

Second, the nondebtor party must be given adequate assurance of performance by the assignee. 11 USC §365(f)(2)(B). This rule generally requires the assignee to provide financial and operating information showing that it is likely to be able to perform and protect the nondebtor's financial expectations under the assigned contract. See *Bruder v Peaches Records & Tapes, Inc. (In re Peaches Records & Tapes, Inc.)* (BAP 9th Cir 1985) 51 BR 583, 589 (assumption and assignment permissible if they "do not interfere, in any significant way, with the primary economic expectations of a lessor or with existing property uses"). See also *In re Martin Paint Stores* (Bankr SD NY 1996) 199 BR 258, 261, aff'd (SD NY 1997) 207 BR 57 (11 USC §365(b)(3) is intended to protect landlord's economic expectations). If an unexpired lease of real property is being assigned, the lessor may require the assignee to deliver a security deposit in the amount the landlord would require if the assignee were the initial tenant under a new lease. 11 USC §365(*l*).

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§6.56 B. Additional Conditions for Shopping Center Leases

Bankruptcy Code §365(f)(1) expressly states that the general power to assign leases set forth in §365 is subject to restrictions on assignment of shopping center leases contained in 11 USC §365(b)(3). Thus, in addition to satisfying the two conditions described in §6.55, an assignee of a debtor-lessee's shopping center lease must provide adequate assurance that (1) its financial condition and operating performance will be similar to those of the debtor and any guarantors at the commencement of the lease, (2) it will generate the same level of percentage rents as the debtor, (3) it will comply with special shopping center-related covenants in the lease, and (4) it will not disrupt the tenant mix or balance of the shopping center. 11 USC §365(b)(3). The multi-factor test set forth in *In re Joshua Slocum*, *Ltd.* (3d Cir 1990) 922 F2d 1081, 1087, is regularly used by courts in determining whether premises are a "shopping center" under §365(b)(3) and evaluates whether the following are present:

> (a) A combination of leases; (b) All leases held by a single landlord; (c) All tenants engaged in the commercial retail distribution of goods; (d) The presence of a common parking area; (e) The purposeful development of the premises as a shopping center; (f) The existence of a master lease; (g) The existence of fixed hours during which all stores are open; (h) The existence of joint advertising; (j) Contractual interdependence of the tenants as evidenced by restrictive use provisions in their leases; (k) The existence of percentage rent provisions in the leases; (l) The right of the tenants to terminate their leases if the anchor tenant terminates its lease; (m) Joint participation by tenants in trash removal and other maintenance; (n) The existence of a tenant mix; and (o) The contiguity of the stores.

A shopping center may be found to exist when only some of these factors are present. The court noted, quoting Collier, that "the most important characteristic will be a combination of leases held by a single landlord, leased to commercial retail distributors of goods, with the presence of a common parking area." 922 F2d at 1087, citing 3 Collier on Bankruptcy ¶365.05[5].

The restrictions in §365(b)(3)(C) mandating compliance with special shopping center-related covenants in any lease, financing agreement, or master agreement relating to shopping centers have been interpreted to encompass any conditions, covenants, and restrictions (CC&Rs) applicable to a common interest development. See *In re Three A's Holdings, LLC* (Bankr D Del 2007) 364 BR 550 (applying California law to prohibit assignment pursuant to §365(b)(C)(3) to a pharmacy when pharmacy's use of premises was not explicitly authorized under CC&Rs of local business improvement district). Further, the court in *Three A's* held that standing to enforce §365(b)(C)(3) was not restricted to the lessor, and that the owners' association could enforce the use restrictions. See also discussion in §7.53.

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§6.57 C. Assignment Procedures; Designation Rights

An assignment may be accomplished by a motion for approval of the assumption and assignment under 11 USC §365(f), preferably combined with a motion for approval of a sale under 11 USC §363. These motions are governed by Fed R Bankr P 9014 and Fed R Bankr P 6006 and 6004, respectively. The advantage of framing the motion under both sections is that 11 USC §363(m) provides the assignee with protections not available under §365. The assignment cannot be done by a sale motion alone, however. Until the contract has been assumed, it is not property of the estate capable of being sold by the trustee.

PRACTICE TIP: A new twist has developed in this area that should be noted. Many cases now refer to the power of a debtor-tenant to assume or reject a lease as "designation rights" and permit debtors to sell those rights to third parties. Landlords must watch sale motions carefully, as designation rights are often defined as including automatic 90-day extensions of the deadline to assume or reject, and courts often permit this extension except as to landlords that appear in the case and timely object to that provision in the terms of sale.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/6 Executory Contracts/§6.58 D. Trustee's Liability After Assignment

§6.58 D. Trustee's Liability After Assignment

The trustee is not liable for any breach that occurs under a lease or contract after it has been assigned to a third party. 11 USC §365(k). Although assignees often remain as secondary obligors under agreements assigned outside of bankruptcy, an assignment made under a bankruptcy court order acts as a release of any obligation for future payment or performance that might otherwise survive the assignment as a matter of applicable nonbankruptcy law.

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7

Residential and Commercial Leases

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I. INTRODUCTION

§7.1 A. Scope of Chapter

This chapter addresses basic principles of bankruptcy law that apply when a tenant files bankruptcy, including:

- The effect and scope of the automatic stay that becomes effective on a tenant's filing of a bankruptcy petition (see §§7.4-7.18);
- Alternatives for relief from or termination of the stay (see §§7.19-7.34);
- The purpose and the process of assuming or rejecting an unexpired residential lease (see §§7.35-7.44);
- Special issues and rules concerning assumption and assignment or rejection of commercial leases, including landlord claims for rejection damages (see §§7.45-7.59); and
- Ethical considerations and remedies for the filing of bankruptcy petitions in bad faith (see §7.60).

Bankruptcy filings by landlords have been the subject of few reported decisions, and have therefore received relatively scant attention in commentaries and even in certain sections of the Bankruptcy Code. This chapter discusses the existing law as it pertains to landlord bankruptcies and considers actions that may be helpful to nondebtor-tenants. See §§7.61-7.67.

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§7.2 B. Bankruptcy Notices and Forms

Because a bankruptcy filing instantly stays a state court proceeding against the debtor or property of the estate, counsel must notify the state court that this has occurred as soon as counsel becomes aware of the filing. See §§7.4-7.5 and description of mandatory form in §§7.68-7.69.

Similarly, because counsel representing parties affected by the bankruptcy need to know about developments in the bankruptcy case that may affect their client's interests or require a response, counsel should promptly file a request for special notice in the bankruptcy court as soon as they learn of the bankruptcy filing. See §4.8. See also Practice Tip in §7.27 and form in §7.69. Requesting notice is a critical first step to being able to represent a landlord or creditor effectively after a tenant files a petition in bankruptcy.

Additional forms for use in bankruptcy proceedings are also described or provided in this chapter, including:

- Landlord forms for requesting or compelling payment (see §§7.70-7.72);
- Central District forms for stay relief motions (see §7.73);
- Forms for debtor's certification of cure of monetary default underlying eviction judgment and landlord's objections to it (see §7.16); and
- Forms for proceedings arising from new exceptions to the automatic stay concerning prepetition judgment for possession or residential eviction based on endangerment of property or illegal use of a controlled substance (see §7.18).

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§7.3 C. When Tenant Files Bankruptcy

In today's economy, counsel practicing in the landlord-tenant area are likely to encounter obstacles associated with a tenant bankruptcy. In the 1980s, bankruptcy courts were clogged with residential tenants filing petitions in bankruptcy simply to delay inevitable evictions. See *Marquand v Smith (In re Smith)* (Bankr CD Cal 1989) 105 BR 50, 51. Immediately after the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) went into effect, however, bankruptcy filings declined substantially nationwide, presumably based on the more stringent requirements for consumer filings. Nonetheless, with the recent collapse of the housing market and freeze in commercial credit availability, consumer bankruptcies have hit record high levels and retail bankruptcies are sharply up nationwide.

Landlord counsel often respond to tenant bankruptcies by either engaging bankruptcy counsel to assist them or developing their own set of countermeasures to protect their rights or keep an eviction moving after a tenant files (see §§7.19-7.34). Whether they appear as attorney of record in bankruptcy court or not, all counsel involved in landlord-tenant relationships should familiarize themselves and their clients with the basic consequences of a bankruptcy filing, primarily the automatic stay (see §§7.4-7.13). While a bankruptcy filing will ordinarily stop an eviction or collection action in its tracks, BAPCPA provisions have attempted to address the problem identified in *Marquand v Smith (In re Smith), supra* (see §§7.16, 7.18). Still, because the stay is effectively a federal court injunction, and a violation of the stay carries serious consequences (see §7.6), counsel must carefully follow the procedures for invoking exceptions to the stay, or for seeking relief from the stay.

Tenant bankruptcies can have significant effects on commercial landlords and raise special issues under the Bankruptcy Code. While landlords generally cannot avoid these issues by drafting special rights or options triggered by bankruptcy in their leases (so-called ipso facto clauses, see §6.53), the bankruptcy statutes provide important protections for the interests of commercial landlords. The Bankruptcy Code provides special limits on the right of a bankrupt nonresidential tenant to assume or assign its lease (see §§7.45-7.59), and the Code requires that any such assumption or assignment adhere to all terms of the lease—debtor-tenants may not pick and choose which terms to accept or ignore. See 11 USC §365(b)(1), (b)(3)(C); *Stewart Title Guar. Co. v Old Republic Nat'l Title Ins. Co.* (5th Cir 1996) 83 F3d 735. Moreover, provisions added to the Bankruptcy Code by BAPCPA have confirmed a landlord's right to obtain compensation for damages caused by nonmonetary defaults and to object to an assignment to a nonconforming use. See 11 USC §§365(b)(1)(A), (b)(3), (f), discussed in §§7.48, 7.53).

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II. AUTOMATIC STAY AFFECTS LEASE RIGHTS

§7.4 A. Stay Arises on Filing of Bankruptcy Petition

When a debtor files a bankruptcy petition, the Bankruptcy Code provides an automatic stay (11 USC §362(a)) that immediately prevents a third party, such as a landlord or any other creditor, from taking action or continuing to take any action against the debtor or property of the bankruptcy estate. The scope of the stay is very broad. On specific acts stayed by §362(a), see §4.1. On exceptions to the stay, see §4.10.

Because the stay is a federal injunction against the prohibited actions, violation of the stay is punishable by contempt or other sanctions. See §7.6. Courts frequently cite the legislative history of 11 USC §362(a). See, *e.g., Kertesz v Ostrovsky* (2004) 115 CA4th 369, 373, 8 CR3d 907, quoting *Delpit v Commissioner* (9th Cir 1994) 18 F3d 768, 771, and legislative history from 1978. The stay applies even if the bankruptcy petition is ultra vires or a sham. *Wekell v U.S.* (9th Cir 1994) 14 F3d 32, 33.

Unless an exception to the stay applies under 11 USC §362(b), or relief from the stay is granted by the bankruptcy court, the stay of an act against property of the estate continues until the property is no longer property of the estate. 11 USC §362(a), (c)(1). Property of the estate is broadly defined. 11 USC §541. The stay of any other prohibited act, such as actions or proceedings against the debtor, continues until the earliest of:

- The time the bankruptcy case is closed;
- The time the bankruptcy case is dismissed; or
- The time a discharge is granted or denied.

11 USC §362(c)(2). A mere ruling granting a motion to dismiss, or even a writing setting forth the court's findings or determinations in considering such a motion, is not effective as a dismissal of a bankruptcy case. A separate, unambiguous order is required before the dismissal will be effective. *Garland v Estate of Maloney (In re Garland)* (BAP 9th Cir 2003) 295 BR 347. See also §7.34.

In addition, confirmation of a plan of reorganization may have the effect of lifting the stay as to acts that would result in exercise of control over property of the estate, because confirmation of the plan usually terminates the existence of the bankruptcy estate. See *Hillis Motors, Inc. v Hawaii Auto. Dealers' Ass'n* (9th Cir 1993) 997 F2d 581. Whether plan confirmation would have this effect in any particular case depends on the terms of the plan in that case.

NOTE: BAPCPA limits the availability of the stay to individual or joint debtors who are repeat bankruptcy filers whose previous bankruptcy cases were recently dismissed. See, *e.g., Nelson v George Wong Pension Trust (In re Nelson)* (BAP 9th Cir 2008) 391 BR 437 (no automatic stay took effect when Chapter 13 debtors had two prior cases dismissed within 1 year). Landlord counsel faced with repeat filer situations should carefully review the statutes on this issue to determine if they apply. 11 USC §362(c)(3)-(4). The debtor may file a motion asking the court to extend or impose the stay if the repeat filing was made in good faith. See ND Cal Local Bankr R 4001-2.

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§7.5 1. Notice of Stay of State Court Proceedings

Because the automatic stay immediately stays existing state court litigation against the debtor, the state court should be promptly informed of the bankruptcy filing. Thus, Cal Rules of Ct 3.650(a) requires the party that caused a stay of the state court proceeding to immediately file in that proceeding a notice of the stay, and attach a copy of the order or other document evidencing the automatic stay. See §7.68. The usual practice is to attach a copy of the file-stamped bankruptcy petition or the notice to creditors (also referred to as the notice of commencement of bankruptcy action or case), sent out by the clerk of the bankruptcy court (see Practice Tip in §7.42), to the notice of stay. If the party that caused the stay has not appeared in the state court action, or fails to promptly notify the state court, even if that party has appeared, the other party should promptly notify the state court of the bankruptcy filing and resulting stay of the action.

When a stay is vacated or no longer in effect, the party who filed the original notice of the stay is required to immediately serve and file a notice to that effect. Cal Rules of Ct 3.650(d). See §7.74. If a levying officer is requested to execute a writ of possession after the stay has been vacated, the landlord would usually provide such officer with a copy of the notice.

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§7.6 2. Violation of Stay Carries Serious Consequences

A willful violation of the automatic stay exposes the offending party to serious consequences. See discussion in §§4.11-4.13.

PRACTICE TIP: Because a willful violation of the automatic stay presents a risk of severe penalties, the better practice in a questionable case is to file a motion for relief from (or modification or termination of) the stay. See §§7.20-7.31. Alternatively, counsel may consider negotiating a stipulation for relief from the stay, which is generally quicker than a motion, even with a notice period and the time it takes for the bankruptcy court to review and approve the stipulation. See §7.32. It also may be possible to obtain an order for possession or surrender of the premises directly from the bankruptcy court. See §7.33. In some cases, a motion to dismiss the bankruptcy may be available. See §7.34.

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§7.7 3. Automatic Stay May Not Be Waived in Advance

Because the automatic stay is a binding federal injunction of the prohibited action, only the bankruptcy court can provide relief from the stay. Therefore, the stay cannot be waived, modified, or changed in advance through artful drafting. See discussion of prebankruptcy waivers in §4.16. Hence, landlords should not rely on any contractual terms that purport to alter the parties' rights when a bankruptcy is filed. So-called ipso facto clauses in many leases, which provide that the lease terminates automatically when the tenant files for bankruptcy (*Nelson v Angel* (1954) 124 CA2d 861, 269 P2d 626), becomes insolvent (*People v California Safe Deposit & Trust Co.* (1919) 41 CA 727, 183 P 289), or makes an assignment for the benefit of creditors (*Boness v Richardson Mineral Springs* (1956) 141 CA2d 251, 296 P2d 581), are not enforceable against debtors or trustees in bankruptcy (11 USC §365(e)) and do not justify a landlord's "self-help" eviction (see §6.53; California Landlord-Tenant Practice §§8.137-8.153 (2d ed Cal CEB 1997)). Moreover, even a bankruptcy court does not have authority to nullify future automatic stays by issuing an "in rem" order to insulate property from the effect of a bankruptcy filing. *Johnson v TRE Holdings (In re Johnson)* (BAP 9th Cir 2006) 346 BR 190. On the other hand, during a pending bankruptcy, a debtor-tenant may stipulate to an order for relief from stay, but only with permission from the bankruptcy court after notice to interested parties. See Fed R Bankr P 4001. See also §§4.18, 7.32, 10.39-10.42.

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B. Scope of Stay Is Broad

1. Activity Subject to Stay

§7.8 a. All Litigation, Administrative Procedures, and Informal Actions Against Debtor

Generally, 11 USC §362(a) provides a broad automatic stay of any act to collect a debt from the debtor or retrieve property from the debtor or the estate in bankruptcy. On specific acts stayed by §362(a), see §4.1. On exceptions to the stay, see §4.10.

BAPCPA added additional exceptions to the stay for residential tenants, if a judgment for possession was entered before the bankruptcy or the landlord is seeking possession based on endangerment of the property or the illegal use of controlled substances on it. 11 USC §362(b)(22)-(23). Those exceptions are governed by specific procedures that must be carefully followed to be applicable or invoked. See §§7.16, 7.18. For exceptions related to common lease issues, see §§7.14-7.18.

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§7.9 b. Acts of Landlord; Application of State Law

When a tenant files a petition in bankruptcy, the automatic stay prevents the landlord from enforcing the lease by, *e.g.,* serving a 3-day notice to cure a default or quit, filing an unlawful detainer complaint, proceeding in a pending action against the tenant, or proceeding with an eviction by a writ of execution. See 11 USC §362(a). In somewhat overlapping provisions, 11 USC §362(a)(1) forbids the prosecution of an action to collect a prepetition debt, while 11 USC §362(a)(6) precludes an action to collect, assess, or recover against the debtor "claims" existing or arising prepetition. Because the definition of a "claim" is read more broadly than "debt," even an action for possession of property, as well as collection of rent, will fall within the scope of the stay. 11 USC §§101(5), (12), 362(a)(6); *Lanford v Northwest Bell Tel. Co. (In re Lanford)* (Bankr D Minn 1981) 10 BR 129, 131. In addition, 11 USC §362(a)(3) bars actions for possession of property of the estate.

Under bankruptcy law before BAPCPA, if a bankruptcy petition was filed after a judgment for possession had been entered, execution of the writ would violate the automatic stay of 11 USC §362(a) if such action affected "property of the estate" of the debtor. Title 11 USC §541(a)(1) defines "property of the estate," as used in 11 USC §362(a), to include "all legal or equitable interests of the debtor in property as of the commencement of the [bankruptcy] case." If the tenant were deemed to have no legal or equitable interests after entry of judgment, however, then the stay would not prevent execution of the writ. Thus, whether a tenant's mere possessory interest in such circumstances is a property right protected by the stay has been a controversial issue in recent years.

BAPCPA partially resolved the controversy by creating an exception to the stay if a judgment for possession of residential premises was entered before the petition was filed. 11 USC §362(b)(22). See §7.16.

PRACTICE TIP: Since these provisions do not apply to commercial tenancies, landlords with judgments for possession of commercial premises would still be stayed from enforcement, but now they have additional arguments for relief, based on the added exceptions for residential tenancies.

In general, state law is used to determine the debtor's rights in property at the time bankruptcy is commenced, subject to any qualifying or contrary Bankruptcy Code provisions. See, *e.g., Raleigh v Illinois Dep't of Revenue (In re Stoecker)* (2000) 530 US 15, 147 L Ed 2d 13, 120 S Ct 1951; *Vanderpark Props. v Buchbinder (In re Windmill Farms, Inc.)* (9th Cir 1988) 841 F2d 1467, 1469. On the application of state law to determine whether the debtor has an interest in the property for the purpose of a motion for relief from stay, see §7.21.

In 1989, a bankruptcy court held that entry of a judgment for possession causes the tenant to lose whatever interest the tenant previously had in an apartment. *Marquand v Smith (In re Smith)* (Bankr CD Cal 1989) 105 BR 50. Further, CCP §715.050, enacted in 1994, ostensibly permits enforcement of a writ of possession issued after a judgment in an unlawful detainer action despite the tenant's filing bankruptcy, but the enforceability of this section is doubtful. In 1996, a federal district court ruled that §715.050 conflicted with the Bankruptcy Code and declared it invalid under US Const art VI, cl 2 (the supremacy clause). *Di Giorgio v Lee* (*In re Di Giorgio)* (Bankr CD Cal 1996) 200 BR 664, judgment vacated as moot, remanded with instructions to dismiss (9th Cir 1998) 134 F3d 971 (see §§7.11, 7.16). While a California appellate court in 1999 agreed with *Smith* and held that §715.050 was constitutional, a later California bankruptcy court opinion agreed with *Di Giorgio* that §715.050 is unconstitutional and preempted by bankruptcy law. Compare *Lee v Baca* (1999) 73 CA4th 1116, 1119, 86 CR2d 913, with *Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867. In *Westside Apartments,* the court stated that creditors who seek to rely on *Smith, Baca,* or CCP §715.050 to avoid obtaining relief from the automatic stay risk liability for violating the automatic stay. 271 BR at 876.

Because BAPCPA added procedures that provide an exception to the stay if a judgment for possession of residential property has been entered (see 11 USC §362(b)(22); see also §7.16), the problem addressed in *Westside Apartments* is now of diminished significance in the residential context. The policy issues and arguments concerning postbankruptcy enforcement of a judgment for possession of commercial property, however, remain in play. For further discussion, see §§7.14, 7.16-7.19.

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§7.10 c. Acts of State Court

The acts of state courts, such as rendering judgments or orders against the debtor, are generally prohibited in the same manner after the filing of a bankruptcy petition as are acts of creditors under 11 USC §362(a). See §§4.1, 7.8-7.9. State court actions, including entry of judgment, taken in violation of the automatic stay are void. *Wright v Turner (In re Turner)* (BAP 9th Cir 1997) 204 BR 988, 992. See also *Sindler v Brennan* (2003) 105 CA4th 1350, 129 CR2d 888 (state court's dismissal of action while stay in effect is void).

The law is unsettled on whether a state court judgment entered after a trial on the merits violates the automatic stay, when the bankruptcy petition is filed after the completion of trial but before judgment is entered. Compare *Rexnord Holdings, Inc. v Bidermann* (2d Cir 1994) 21 F3d 522, 527 (entry of judgment postbankruptcy, following verdict or statement of decision on merits made before bankruptcy, is ministerial act not subject to stay), with *Bonilla v Trebol Motors Corp.* (1st Cir 1998) 150 F3d 77 (if state court has not announced judgment or submitted decision to clerk before bankruptcy, ministerial act exception to stay does not apply). No published Ninth Circuit case has squarely addressed this issue. The automatic stay may be annulled retroactively to give effect to an act that would otherwise be voidable as a violation of the stay. See authorities and discussion in *Wright,* 204 BR at 991.

On the sheriff's right to proceed with an eviction when the tenant files a bankruptcy petition after the state court issues the writ of possession, see §§7.16-7.19.

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2. Property Protected by Stay

§7.11 a. Lease Rights

The protection of the automatic stay inures to the benefit only of the debtor, the property of the debtor, or the property of the bankruptcy estate. *Advanced Ribbons v Interstate Distrib., Inc. (In re Advanced Ribbons & Office Prods.*) (BAP 9th Cir 1991) 125 BR 259, 263. The sweeping definition of property of the estate, "all legal and equitable interests of the debtor in property as of the commencement of the case" (11 USC §541(a)(1)), includes lease rights when the lease remains unexpired or unterminated. *Marquand v Smith (In re Smith)* (Bankr CD Cal 1989) 105 BR 50, 54. Further, until the state legislature expressly eliminates any equitable interest in possession after lease termination, the automatic stay also protects bare possessory interests in a terminated lease, even if a judgment for unlawful detainer has been entered, although BAPCPA made it easier for landlords to enforce such judgments in the residential context. See 11 USC §362(b)(22); *Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867. See also §§7.16-7.19. During a bankruptcy, any lease rights that have become property of the estate must be either accepted or rejected by the trustee or debtor in possession. See §§7.35-7.59.

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§7.12 b. Security Deposits

The automatic stay prohibits "the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor." 11 USC §362(a)(7). By considering a security deposit as having created a "debt" owed to the debtor, some view this statute as prohibiting the landlord's application of a tenant's security deposit without relief from stay. A bankruptcy decision from Delaware, however, disputes this view, holding that a security deposit is not a "debt" owing from the landlord to the debtor-tenant unless the term had expired and there were no defaults. *In re APF Co.* (Bankr Del 2001) 270 BR 363. The court therefore held that the landlord did not need to seek relief from stay to preserve its right to apply the deposit in partial satisfaction of the amount of rent owed to it.

Because a security deposit provides a landlord with a secured claim in the amount of the deposit for unpaid rent due at the filing of the petition, or for any damages resulting from the rejection of the lease, it may be claimed as such when a proof of claim is filed. See, *e.g., In re Far W. Corp.* (Bankr ED Cal 1990) 120 BR 551. When a proof of claim is filed, the security deposit must be applied to the *capped amount* of damages allowable under 11 USC §502(b)(6). *In re Connectix Corp.* (Bankr ND Cal 2007) 372 BR 488, based on a rule from *Oldden v Tonto Realty Corp.* (2d Cir 1944) 143 F2d 916. This rule applies even if the security deposit is in the form of a letter of credit rather than cash. *In re Connectix Corp., supra*; *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295. Indeed, rejection of a lease does not bar an action to recover on the balance of a security deposit, even if held as a letter of credit. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc.)* (9th Cir 2006) 439 F3d 558. See discussion of security deposits and other lease credit enhancements in chap 8.

If the debtor was current on the rent before the bankruptcy was filed, the trustee may offset any security deposit against postpetition rental obligations. *In re Standard Furniture Co.* (Bankr SD Cal 1980) 3 BR 527, 531. For a discussion of postpetition rental obligations in residential tenancies, see §§7.37-7.42; in commercial tenancies, see §§7.47-7.49. If the deposit is greater than the capped amount of damages the landlord may claim (see §7.59) and the amount of postpetition administrative rent due, it may be subject to disgorgement back to the bankruptcy estate. *In re Pyxsys Corp.* (Bankr D Mass 2003) 288 BR 309, 319, citing *Oldden* and legislative history of 11 USC §502(b)(6).

WARNING: If the debtor was current under a commercial lease before the lease terminated, the landlord may have to return *the entire deposit,* and cannot use it to offset the landlord's damages for lost future rent, unless CC §1950.7 is waived. See *250 L.L.C. v Photopoint Corp. (USA)* (2005) 131 CA4th 703, 32 CR3d 296. In order to reduce the prospect of disgorgement, landlords should add express waivers of CC §1950.7 to their commercial lease forms.

Because security deposits must be applied to a landlord's *capped* amount of damages, and are subject to disgorgement if held in an amount in excess of a landlord's allowable general and administrative claims, landlords holding very large deposits may not be as "secured" as they think they are against the consequences of a tenant bankruptcy. However, the rule requiring application of a letter of credit to a capped claim may not apply if no proof of claim is filed. *EOP-Colonnade of Dallas Ltd. Partnership v Faulkner (In re Stonebridge Technols., Inc.)* (5th Cir 2005) 430 F3d 260. In *Stonebridge,* the Fifth Circuit held that the cap on rejection damages allowed under §502(b)(6) "does not limit the beneficiary's entitlement to the proceeds of a letter of credit unless and until the lessor makes a claim against the estate." 430 F3d at 270. This holding appears analytically correct based on the words of the statute, but it has not yet been addressed in the Ninth Circuit, where the *Oldden* rule is firmly established. See *In re AB Liquidating Corp.* (9th Cir 2005) 416 F3d 961, 964 (*Oldden* rule bars drawing on letter of credit in excess of damages allowed under §502(b)(6)), and *In re Connectix Corp., supra.*

PRACTICE TIP: After a bankruptcy has been filed, landlords with large security deposits in the form of letters of credit in excess of the allowed amount of a claim under 11 USC §502(b)(6) should consider *not* filing a claim against the estate, in effect waiving recovery from the bankruptcy estate in order to claim the full amount available under a letter of credit. This tactic allowed the landlord in *Stonebridge* to apply the full amount of its letter of credit to its damages. On the other hand, it is uncertain whether courts in the Ninth Circuit will follow *Stonebridge,* and the debtor may attempt to impose the damages limitation of §502(b)(6) by filing a proof of claim on behalf of the

landlord under Fed R Bankr P 3004. The extent of the landlord's actual damages, the size of the letter of credit, and the potential amount of security lost under the *Oldden* rule may determine whether this tactic is prudent under the circumstances.

For more on the damages cap of 11 USC §502(b)(6), see §7.59. For additional discussion of letters of credit as security deposits, see chap 8. See also Wang & Bradbury, *Commercial Lease Termination Damages—Calculation and Application of the Bankruptcy Cap,* 26 Cal Real Prop J 33 (Spring 2008).

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§7.13 3. Person Shielded by Stay

The automatic stay protects only the debtor, not codefendants in the same lawsuit. 11 USC §362(a); *Almy v Terrace Land Dev., Ltd.* (ND Cal 1983) 32 BR 390. Therefore, in most cases a landlord can proceed against nondebtor codefendants (*i.e.,* nonfiling tenants) in an unlawful detainer action, although as a practical matter, execution of the judgment for possession should wait until the writ can be enforced against all occupants. Also, a landlord may pursue a separate action for damages against a co-obligor on the lease who is not in possession of the premises, such as a guarantor or nonfiling cosigner of the lease. See *Veeco Inv. Co. v Mercantile Nat'l Bank (In re Veeco Inv. Co.)* (Bankr ED Mo 1993) 157 BR 452, 454; *Anniston Fed. Sav. & Loan Ass'n v E.K.P., Inc. (In re E.K.P., Inc.)* (Bankr ND Ala 1984) 42 BR 19, 20.

WARNING: Chapter 13 cases impose a codebtor stay for the benefit of nonfiling parties who may be jointly liable with the debtor for "consumer debts," *i.e.,* debts incurred primarily for personal or household purposes. 11 USC §§101(8), 1301. The broad definition of consumer debt can be a two-edged sword, however, since BAPCPA contains provisions making it easier for bankruptcies involving primarily consumer debt to be dismissed. See 11 USC §707(b); *In re Maya* (Bankr SD Cal 2007) 374 BR 750; *In re Davis* (Bankr ND Ohio 2007) 378 BR 539.

In any event, counsel should be alert to the possibility of successive filings in cases in which there are multiple occupants.

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C. Exceptions to Automatic Stay

§7.14 1. Expired Commercial Leases

With respect to nonresidential real property leases, the Bankruptcy Code allows recovery of possession after expiration of the term, without seeking relief from stay. While the automatic stay prohibits acts to recover possession of "property of the estate" (11 USC §362(a)(3)), a debtor-lessee's interest in a nonresidential lease that expired before the bankruptcy or during the pendency of the bankruptcy case is excluded from the definition of property of the bankruptcy estate. 11 USC §541(b)(2). Acts against such property are, therefore, not subject to the automatic stay. 11 USC §362(b)(10), (c)(1). Note, however, that this exception applies only to leases where the stated term has expired. If a lease has been terminated before the expiration of the stated term, *e.g.,* because of a tenant default, the landlord must seek relief from the stay or a surrender order from the bankruptcy court, unless one of the exceptions to the stay provided in BAPCPA applies. See §§7.16-7.33.

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§7.15 2. Declaratory Relief and Dischargeability Actions Not Subject to Stay

The automatic stay does not prohibit a creditor or any other interested party from filing an adversary proceeding in the bankruptcy court to seek a decree or declaratory judgment of what is or is not property of the estate. *Civic Ctr. Square, Inc. v Ford (In re Roxford Foods, Inc.)* (9th Cir 1993) 12 F3d 875.

Adversary proceedings against a debtor in bankruptcy to determine the dischargeability of debts are not prohibited by the automatic stay. See 11 USC §523(c)(1); Fed R Bankr P 4007. See also §§4.38-4.68 on bankruptcy court litigation. For an example of a landlord's unsuccessful attempt to have a debt for back rent and damages declared nondischargeable, see *Kuan v Lund (In re Lund)* (BAP 9th Cir 1996) 202 BR 127.

The trustee, a creditor, or the U.S. Trustee may object to a debtor's Chapter 7 discharge (11 USC §727(c)(1)) on the grounds set forth in 11 USC §727(a), or may request revocation of a discharge (11 USC §727(d)-(e)) on the grounds set forth in 11 USC §727(d). Because BAPCPA expanded the grounds for denying a discharge, the relevant bankruptcy rules were revised accordingly. See Fed R Bankr P 4004, 4007. A state court judgment against a debtor on a fraudulent misrepresentation claim can preclude the debtor from contesting the issue in a subsequent proceeding to declare the debt to be nondischargeable. *Diamond v Kolcum (In re Diamond)* (9th Cir 2002) 285 F3d 822. See also *Muegler v Bening* (9th Cir 2005) 413 F3d 980 (affirming the preclusive effect of a state court fraud judgment on nondischargeability action in bankruptcy court).

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§7.16 3. Possessory Rights After Termination of Lease or Entry of Judgment

A 2002 bankruptcy court opinion confirms that because of the broad definition of property interests under 11 USC §541, the automatic stay protects a tenant's bare possessory interest in a terminated lease. *Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867. See §7.9. BAPCPA clarified the application of the automatic stay to a residential lease in which a judgment for possession had been entered before the bankruptcy was filed. Congress created an exception to the stay to allow a *residential* landlord to enforce a judgment for possession obtained before the tenant filed a petition for bankruptcy. 11 USC §362(b)(22). Generally, if the landlord has obtained a judgment for possession before the bankruptcy and it is based on a *nonmonetary* default, the automatic stay will not apply to enforcement of the judgment. See 11 USC §362(b)(22), (*l*). The exception in §362(b)(22) is subject, however, to the provisions of 11 USC §362(*l*) concerning judgments based on monetary defaults, such as nonpayment of rent. Under §362(*l*), if the judgment is based on a default in paying rent, in jurisdictions like California where the state law may allow the tenant to remain in possession if the default is cured after judgment is entered (see CCP §1179), the tenant may be able to keep the stay in effect to block eviction.

Residential tenants filing bankruptcy must disclose in their petitions if a judgment for possession of their residence has been entered. 11 USC §362(*l*)(5). If the judgment is based on a monetary default, the exception to the stay applies automatically to allow the eviction to proceed unless the tenant files with the petition and serves upon the landlord a certification that:

- There are circumstances under which he or she would be permitted to cure, under nonbankruptcy law applicable in that jurisdiction, the entire monetary default that gave rise to the judgment for possession, after that judgment for possession was entered (11 USC §362(*l*)(1)(A)); *and*
- He or she (or an adult dependant of the tenant) has deposited with the clerk of the court any rent that would become due in the 30 days following the filing of the petition (11 USC §362(*l*)(1)(B)).

Both conditions must be satisfied. Filing the certification allows the tenant to retain the protection of the stay for 30 days after the petition is filed, with specified exceptions. 11 USC §362(*l*)(1). Check local bankruptcy court website for local forms. For further information, see Directory. If the certification is filed, the clerk will arrange for the rent deposited to be promptly transmitted to the landlord. 11 USC §362(*l*)(5)(D).

After filing the certification, the tenant may extend the automatic stay beyond 30 days by filing and serving an additional certification, within 30 days after the bankruptcy petition was filed, that the tenant "has cured, under nonbankruptcy law applicable in the jurisdiction, the entire monetary default that gave rise to the judgment." 11 USC §362(*l*)(2). Check local bankruptcy court website for local forms. For further information, see Directory. In that case, the automatic stay will apply to the landlord's action for possession *unless* the landlord successfully objects to the tenant's certifications. 11 USC §362(*l*)(2)-(3).

WARNING: Whether bankruptcy courts will interpret "cure" as simply requiring payment of the money owed, or as including some additional equitable showing, is unknown. Under applicable nonbankruptcy law, a court has discretion to grant or deny relief from forfeiture; tendering the full amount of rent due is simply a condition required for the court to consider such an application. See CCP §1179.

If no certification is filed, the clerk immediately serves upon the parties a certified copy of the docket indicating the absence of a filed certification and the applicability of 11 USC §362(b)(22) as an exception to the stay. 11 USC §362(*l*)(4)(B). If the exception applies, the landlord can proceed to enforce the judgment for possession without further court order. See 11 USC §362(*l*)(4).

If the tenant files the certifications to keep the stay in effect, the landlord can try to invoke the exception to the stay by objecting to the veracity of the tenant's certifications. 11 USC §362(*l*)(3). Check local bankruptcy court website for local forms. For further information, see Directory. The court must then hold a hearing on the objection within 10 days to determine whether the certification is true. 11 USC §362(*l*)(3)(A). If the court sustains the landlord's objection,

§362(b)(22) applies immediately and relief from the stay is not required to enable the landlord to complete the eviction process. 11 USC §362(*l)*(3)(B). If the court finds that the certifications are true, the eviction will be stayed and the exception to the stay provided by §362(b)(22) will not go into effect. See 11 USC §362(*l*)(2).

In enacting these elaborate provisions, Congress did not address how bankruptcy courts should apply these provisions in the context of applicable nonbankruptcy law. For instance, while California law does allow relief from forfeiture to be granted after judgment is entered, such relief is *discretionary.* See CCP §1179. Until case law is developed on these issues under BAPCPA, it remains unclear whether a bankruptcy court that conducts the hearing on the landlord's objection to the tenant's certifications may exercise its discretion and sustain the landlord's objections, even if the certifications are true. See also §§7.9, 7.19.

WARNING: Although the problem of tenants filing bankruptcy to stall and delay evictions occurs in the commercial context, as well as with residential leases, the BAPCPA exception for terminated leases applies only to *residential* leases. See 11 USC §362(b)(22). Yet there is arguably less need for the stay to apply in the commercial context, because housing is a more basic need than retaining possession of commercial space. Until the law changes on this issue, however, commercial landlords must still seek relief from the bankruptcy court before attempting to enforce any writ of possession concerning a terminated commercial lease. On consequences of violating the stay, see §7.6.

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§7.17 4. Actions Against Chapter 13 Debtors on Postpetition Obligations After Plan Confirmation

If the obligation of a debtor-tenant in Chapter 13 arose postpetition, three reported trial cases within the Ninth Circuit suggest that the automatic stay would not apply to efforts to collect that debt after confirmation of the debtor's Chapter 13 plan: *In re Petruccelli* (Bankr SD Cal 1990) 113 BR 5, 6, *In re Mason* (D Ore 1985) 51 BR 548, and *In re Rhodes* (Bankr D Idaho 1995) 1995 WL 128486. This exception is based on the language of 11 USC §1327(b). Because the stay does not protect debtors from postpetition obligations, and because plan confirmation "revests" estate property in the debtor, the *Petruccelli, Mason,* and *Rhodes* courts held that the automatic stay did not apply to efforts to collect a postpetition obligation against a Chapter 13 debtor under a confirmed plan. This conclusion is not without controversy. See, *e.g., Security Bank of Marshalltown v Neiman* (8th Cir 1993) 1 F3d 687; *In re Aneiro* (Bankr SD Cal 1987) 72 BR 424, 429.

A 2001 Internal Revenue Service General Litigation Bulletin analyzed the diverging authorities on this issue, noting that "many courts have agreed that after confirmation of the Chapter 13 plan, all property revests in the debtor except property that is specifically retained as property of the estate in the plan or order confirming the plan." IRS GLB 200127046, at p 13, citing *Petruccelli* and several other cases within and outside the Ninth Circuit. It described the view expressed in *Aneiro,* requiring creditors to obtain relief from stay to pursue a postpetition debt postconfirmation, as a "minority" view. Note, however, that assets that vest in the debtor upon confirmation may revest in the bankruptcy estate upon conversion to Chapter 7. See *Captain Blythers, Inc. v Thompson (In re Captain Blythers, Inc.)* (BAP 9th Cir 2004) 311 BR 530, aff'd (9th Cir 2006) 182 Fed App 708.

PRACTICE TIP: The split of authority on this issue presents a dilemma for practitioners. On the one hand, because the penalties for violating the stay are harsh, it is generally advisable to seek relief from stay if there is any possible doubt. On the other hand, seeking relief from stay invariably burdens a creditor with significant additional expense and delay. In situations like this, where a majority of courts within one's circuit have held that the stay does not apply, the risk of being sanctioned for violating the stay may be small enough that a client could rationally decide to authorize an attempt to proceed without moving for relief. Such a decision should only be made after counsel has carefully explained the risks and benefits of each alternative course of action to the client.

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§7.18 5. Eviction Action Against Residential Tenant for Endangerment of Property or Illegal Use of Controlled Substance

Another exception to the stay was added by BAPCPA for residential evictions based on endangerment of the property or the illegal use of controlled substances on it. See 11 USC §362(b)(23). This exception is subject to 11 USC §362(m), however, so that unlike a true "exception" to the stay, this exception will apply only if it is affirmatively invoked by the landlord. See 11 USC §362(b)(23). It provides landlords with a procedure to nullify the stay after the tenant files bankruptcy, to allow an eviction based on the tenant's endangering the property or using controlled substances on it to proceed. The stay applies for at least 15 days after the tenant files for bankruptcy, but if a landlord files the proper certification, and if the certification withstands any challenges the tenant may raise as to its truth or legal sufficiency, then the stay will be nullified. 11 USC §362(b)(23), (m).

Procedurally, the landlord must file and serve on the tenant a certification that (11 USC §362(b)(23)):

- A pending eviction action seeks possession of residential property based on endangerment of the property or the illegal use of controlled substances on it; *or*
- The tenant, during the 30-day period before the date of the filing of the certification, has endangered the property or illegally used or allowed to be used a controlled substance on the property.

Check local bankruptcy court website for local forms. For further information, see Directory.

The stay on the landlord's eviction action will then expire 15 days after the certification is filed, *unless* the tenant files and serves on the landlord an objection to the truth or legal sufficiency of the landlord's certification. 11 USC §362(m)(1)-(2). Check local bankruptcy court website for local forms. For further information, see Directory.

If the tenant fails to object to the truth or legal sufficiency of the landlord's certification within 15 days, the §362(b)(23) exception applies immediately, and relief from stay is not required for the landlord to proceed with the process to recover possession. 11 USC §362(m)(3)(A). The clerk of the court will then immediately serve on the parties a certified copy of the docket indicating lack of objection. 11 USC §362(m)(3)(B). If the tenant files and serves on the landlord an objection to the landlord's certification, the court must hold a hearing within 10 days to determine if the situation giving rise to the landlord's certification existed or has been remedied. 11 USC §362(m)(2)(B).

If the tenant can demonstrate to the satisfaction of the court that the situation giving rise to the landlord's certification did not exist or has been remedied, the stay remains in effect until otherwise terminated. 11 USC §362(m)(2)(C). Conversely, if the tenant cannot convince the bankruptcy court that the situation giving rise to landlord's certification did not exist or has been remedied, the court will decree that 11 USC §362(b)(23) applies and relief from stay will not be required for the landlord to continue with the eviction. 11 USC §362(m)(2)(D)(i). The clerk of the court will immediately serve on the parties a certified copy of the court's order upholding the landlord's certification. 11 USC §362(m)(2)(D)(ii).

Under this scheme, the bankruptcy court is required to decide ultimate facts concerning the viability of the eviction action on just 10 days' notice, even though state courts decide these kinds of facts with the full panoply of due process procedures. It is unknown whether or to what extent bankruptcy courts will allow pre-hearing discovery on an expedited basis, an opportunity for pre-trial motions, or live testimony at such exception hearings.

PRACTICE TIP: Landlord counsel concerned that the 10-day hearing may not provide adequate due process on the issues should consider seeking *relief from the stay* as an alternative remedy, in case the court is not convinced by the landlord's certifications that the §362(b)(23) exception to the stay should apply. See §§7.20-7.31.

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III. AVOIDING EFFECT OF AUTOMATIC STAY

§7.19 A. When Order for Relief From Stay Is Required

Unless a clear exception to the stay applies (see §§4.19-4.23), there is debate among practitioners concerning whether a formal motion for permission from the bankruptcy court to proceed with an eviction is required. If the law is uncertain, there is tension between taking the conservative approach (always seeking relief from stay before taking any action of any sort against debtors in bankruptcy) and accepting the risk of reliance on a legal authority that indicates that the stay may not apply. See, *e.g., Di Giorgio v Lee (In re Di Giorgio)* (Bankr CD Cal 1996) 200 BR 664, 672, judgment vacated as moot, remanded with instructions to dismiss (9th Cir 1998) 134 F3d 971, and *Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867, 876, cited in §7.9.

This uncertainty was resolved as to residential tenancies with the exceptions to the stay added by BAPCPA (see §§7.16, 7.18). Moreover, the tenant's equitable rights under state law, recognized in *Di Giorgio* as supporting the stay, are expressly recognized and given a place in the statutory scheme. The exceptions provide a means for residential landlords to avoid the expense and delay of moving for relief from the stay, although questions remain concerning how these provisions will be applied. But BAPCPA contains no additional exceptions to the stay for commercial leases. See §§7.16, 7.18.

The consequences of violating the automatic stay are serious. See §§4.11-4.13. Therefore, in almost all instances where the law is uncertain, the safe course is to seek either permission to enforce the writ or a surrender order from the bankruptcy court. As a practical matter, a landlord may not have any choice but to seek relief from stay because a California sheriff may be unwilling to proceed with an eviction after bankruptcy without an order for relief. See, *e.g.,* California State Sheriffs' Association, Civil Procedural Manual, indicating practices adopted statewide on the circumstances under which sheriffs will perform evictions without a release of the stay. For online access to the manual, see Directory.

PRACTICE TIP: If time is crucial and if necessary to prevent irreparable injury, relief may be sought on an emergency or ex parte basis under 11 USC §362(f). If either of the BAPCPA exceptions to the stay might apply, landlords should file the appropriate documentation in the bankruptcy court to be sure they can proceed without obtaining relief from the stay. See 11 USC §362(b)(22)-(23), discussed in §§7.16, 7.18. If no statutory exception applies, and only in the limited context of collecting a postpetition obligation against a Chapter 13 debtor after confirmation of a plan, a practitioner could make a reasonable decision not to seek relief from stay and be able to convince a levying officer (or the local county counsel with whom the sheriff consults) that such relief is not required. See authorities cited in §7.17.

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B. Motion for Relief From Stay

§7.20 1. Grounds for Relief From Stay

The landlord may request relief from the automatic stay on specific grounds. 11 USC §362(d). For example, the motion may allege that the debtor has no equity or interest in the property and that the property is not necessary for reorganization (11 USC §362(d)(2)), or that nonpayment of rent or other reason for termination of the stay constitutes "cause" (11 USC §362(d)(1)). In addition, the same facts that support dismissal of a bankruptcy may also support a motion for relief from stay. *Farber v 405 N. Bedford Dr. Corp.* (*In re 405 N. Bedford Dr. Corp.)* (9th Cir 1985) 778 F2d 1374, 1378. See §7.34.

In the context of a commercial lease, a district court held that the filing of a complaint for unlawful detainer terminates the lease for purposes of preventing it from being an executory contract, which can be assumed in bankruptcy. *In re Escondido W. Travelodge* (SD Cal 1985) 52 BR 376. In *Escondido,* the court noted that cause exists to lift the automatic stay if the lease cannot be assumed, and that termination under California landlord-tenant law occurs when a landlord, after complying with the appropriate notice requirements, files an unlawful detainer in state court. Although the court recognized that mere filing is not a formal adjudication of the validity of the termination, it reasoned that relief from stay was nonetheless appropriate, to allow the validity of the termination to be litigated in the state court forum under state law. 52 BR at 382.

NOTE: Exceptions to the stay for residential tenancies may obviate the need to move for relief from stay. See 11 USC §362(b)(22)-(23), discussed in §§7.16, 7.18, to determine if any motion is necessary. Always review the current version of the Bankruptcy Code to ascertain whether the tenant's interest remains protected by automatic stay.

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§7.21 a. Property Interests Defined by State Law

When considering a motion for relief from the stay, bankruptcy courts look to state law to determine whether the debtor has an interest in the leased property. The prevailing view in the Ninth Circuit is that a lease is terminated for nonpayment of rent at least by the time that the landlord files an unlawful detainer action after proper notice is given. *Vanderpark Props. v Buchbinder (In re Windmill Farms, Inc.)* (9th Cir 1988) 841 F2d 1467, 1470. In California, bankruptcy courts have held that once a lease is terminated, the leasehold interest no longer exists, and therefore the reason for the stay no longer exists as to that interest. Thus, the termination of a lease constitutes "cause" within the meaning of 11 USC §362(d) to terminate the stay. *Vanderpark Props. v Buchbinder (In re Windmill Farms, Inc.), supra*; *In re Eureka S. R.R., Inc.* (Bankr ND Cal 1987) 72 BR 813, 817; *In re Escondido W. Travelodge* (SD Cal 1985) 52 BR 376; *Kearny Mesa Crossroads v Acorn Invs. (In re Acorn Invs.)* (Bankr SD Cal 1981) 8 BR 506, 509.

Although a debtor's possessory interest may be asserted as property of the estate subject to protection under the stay (see, *e.g., Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867, discussed in §§7.9, 7.11, 7.16), this consideration arguably should carry little weight. After all, the basic function of the bankruptcy courts is to facilitate reorganization or the orderly liquidation of the debtor's assets and the payment of creditors. A residential leasehold holds no value to the trustee or the creditors, at least in a Chapter 7 bankruptcy, because the leasehold cannot be liquidated and typically has no value as an asset. Hence, there is little justification for protecting it from at least nonmonetary relief. *In re Torrez* (Bankr ED Cal 1991) 132 BR 924, 941; *California Sec. Mgmt. Corp. v Kennedy (In re Kennedy)* (Bankr CD Cal 1984) 39 BR 995, 997. This reasoning is likely underlying the BAPCPA exception to the stay for residential tenancies that have been terminated before the bankruptcy. See 11 USC §362(b)(22), discussed in §7.16. Further, while a residential lease in a rent-controlled jurisdiction may have value for allowing occupancy at below market rates, such a leasehold interest may not be property that the trustee could assume and assign, if the rent control law excuses the landlord from accepting performance of the lease from anyone other than the debtor. See, *e.g.,* 11 USC §365(c); *B.N. Realty Assocs. v Lichtenstein* (SD NY 1999) 238 BR 249, 254. Specific analysis of the landlord's right to relief from stay under such circumstances would be required. *B.N. Realty Assocs. v Lichtenstein, supra.*

PRACTICE TIP: A debtor in a Chapter 13 bankruptcy may argue, however, that maintaining an equitable possessory interest in his or her residence is necessary or essential to successful reorganization, especially if the debtor would have to pay significantly more rent in a new residence. An increase in rent and moving expenses would deplete the available resources of the debtor to pay creditors under the reorganization plan. See §7.35.

A commercial leasehold that has been terminated before the bankruptcy holds no value to the estate, because there is no longer an interest that can be assumed and assigned. *In re Escondido W. Travelodge* (SD Cal 1985) 52 BR 376. When there is nothing to assume or assign, a landlord may seek an order from the bankruptcy court directing the debtor to surrender possession, without even litigating an unlawful detainer action. 11 USC §365(d)(4); *Anderson v Elm Inn, Inc. (In re Elm Inn, Inc.)* (9th Cir 1991) 942 F2d 630, 633. See §7.33.

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§7.22 b. State Judgment Given Collateral Estoppel Effect

If the BAPCPA exceptions to the stay (see §§7.16, 7.18) do not apply, landlords can argue that the state court proceedings should provide the basis for relief from the stay. For instance, if the tenant has filed bankruptcy after a judgment for possession of commercial property has been entered, the new exceptions to the stay for judgments in residential eviction actions would not apply. But on the landlord's motion for relief, the bankruptcy court could rule that the judgment for possession is preclusive under collateral estoppel principles. *Brown v Felsen* (1979) 442 US 127, 139 n10, 60 L Ed 2d 767, 776 n10, 99 S Ct 2205 (noting that state court judgments cannot bind the bankruptcy court on issues of exclusively federal law but that "questions actually and necessarily decided" may be collaterally estopped); *McArthur v Bugna (In re Bugna)* (Bankr CD Cal 1992) 137 BR 785, aff'd (9th Cir 1994) 33 F3d 1054. See also *Huse v Huse-Sporsen (In re Birting Fisheries, Inc.)* (BAP 9th Cir 2003) 300 BR 489 (bankruptcy court had exclusive jurisdiction to determine whether foreign judgment conflicted with bankruptcy law or orders). Thus, an unlawful detainer judgment can be given preclusive effect on the bankruptcy court absent fraud or similar circumstances. *Beaver St. Assocs. v Lady Liberty Tavern Corp. (In re Lady Liberty Tavern Corp.)* (Bankr SD NY 1988) 94 BR 812, 814.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/7 Residential and Commercial Leases/ §7.23 c. Eviction Following Foreclosure

§7.23 c. Eviction Following Foreclosure

Special considerations may apply to evictions under CCP §1161a, which involve recovery of possession of residential property from the occupants or former owners by a purchaser after a foreclosure sale. See generally California Landlord-Tenant Practice §§8.68A-8.68E (2d ed Cal CEB 1997). The first example involves a bankruptcy filing before foreclosure; the second involves a bankruptcy filing after foreclosure.

EXAMPLE 1: A borrower defaults on a loan secured by real property, then files bankruptcy. The secured lender obtains relief from the automatic stay to conduct the foreclosure sale. The purchaser (who may or may not be the lender) then wants to proceed with an eviction of the occupants or former owners. In such case, there should be no question that there is no longer a stay against proceeding with and completing an eviction. In fact, once the foreclosure sale has taken place and the trustee's deed on sale has been recorded, the property is no longer property of the estate. The bankruptcy court has given the lender permission to complete the foreclosure process and title becomes vested in a party other than the debtor.

In addition, if the purchaser is not the original lender, it is arguable that the stay cannot apply because the cause of action under CCP §1161a did not arise until after the bankruptcy petition was filed. In other words, it follows from the nature of the action that an eviction suit, brought by a stranger to the creditor-debtor relationship after a trustee's sale, is not a prepetition claim against the debtor.

Unlawful detainer proceedings are summary in nature and are limited to issues concerning the right to possession. See Landlord-Tenant §§9.5-9.9. The plaintiff's burden on a cause of action under CCP §1161a is limited to demonstrating that it acquired the property at a regularly conducted sale and thereafter perfected title. *Vella v Hudgins* (1977) 20 C3d 251, 255, 142 CR 414; *Cruce v Stein* (1956) 146 CA2d 688, 692, 304 P2d 118. Generally, neither a landlord nor a tenant may raise other issues. See Landlord-Tenant §§9.8, 10.53-10.55.

There is a narrow exception, however, that allows raising lack of title defensively if the plaintiff alleges acquisition of title by foreclosure under CCP §1161a. In *Vella v Hudgins, supra,* the supreme court stressed that availability of such a challenge to title is "a narrow and sharply focused examination of title" limited to the formalities of the trustee's sale. 20 C3d at 255. An attack on title acquired at a foreclosure sale, other than to show a purchaser's noncompliance with the statutes governing such sales, does not constitute a valid defense to recovery of possession. *MCA, Inc. v Universal Diversified Enters. Corp.* (1972) 27 CA3d 170, 177, 103 CR 522; *Old Nat'l Fin. Servs., Inc. v Seibert* (1987) 194 CA3d 460, 239 CR 728.

Similarly, a defense to eviction based on lack of compliance with statutory formalities should not prevent the landlord from obtaining relief from stay to proceed with an eviction after the foreclosure. This is because the order that terminated the stay to allow the foreclosure in the first place is often an adjudication that the debtor has no protectable interest in the property, allowing the landlord to argue that the stay literally does not apply to the subsequent eviction proceeding. Further, at least one court has declared that the bankruptcy court has no jurisdiction over a debtor in possession after foreclosure, requiring the landlord to proceed in state court to obtain possession. See *California Sec. Mgmt. Corp. v Kennedy (In re Kennedy)* (Bankr CD Cal 1984) 39 BR 995.

PRACTICE TIP: To prevent confusion, in any proposed order granting relief from stay to proceed with a foreclosure, counsel should include language that allows the creditor or lender and its successors to obtain possession from the debtor after the sale according to procedures under state law, in addition to allowing the foreclosure sale itself. See, *e.g.,* form in Moving for Relief From an Automatic Stay in Bankruptcy, App S (Cal CEB Action Guide September 2006). See also Practice Tip in §7.28.

Although the better practice in pleading for an order for relief from stay on behalf of a lender is to include the right to both conduct the sale *and* recover possession of the property, this does not always happen. The lender's counsel and eviction counsel may be different. If the purchaser is also the foreclosing lender, the debtor may argue that the action for possession constitutes yet another (albeit separate) aspect of enforcing a prepetition claim and that the order did

not provide for that action. If the order is ambiguous or uncertain, it may mean that proceedings in state court must come to a halt, or it may yield a claim for violation of the stay.

In that event, counsel should seek an amended order providing for additional relief, nunc pro tunc, if necessary, to validate any notices or complaints already served. Although even unknowing violations of the automatic stay are void, bankruptcy courts have discretion to *annul* the stay retroactively so as to validate past actions that would otherwise be void. See *Jewett v Shabahangi (In re Jewett)* (BAP 9th Cir 1992) 146 BR 250, 252, and *Davis v Courington (In re Davis)* (BAP 9th Cir 1995) 177 BR 907, 911. The bankruptcy court will balance the equities on a case-by-case basis to determine whether retroactive annulment is justified. *National Envt'l Waste Corp. v City of Riverside (In re National Envt'l Waste Corp.)* (9th Cir 1997) 129 F3d 1052.

The lender may also seek relief from stay on the separate issue of possession, if necessary.

EXAMPLE 2: A borrower defaults on a loan secured by real property. The secured lender conducts the foreclosure sale. Then the borrower files bankruptcy. When a foreclosure sale is completed before the petition is filed, proof of the debtor's lack of interest in the property is usually straightforward and made by offering the trustee's deed into evidence. The debtor cannot undo a completed *valid* sale by filing a bankruptcy petition. However, debtors claiming an irregularity in the sale may argue that the right to bring an action to cancel the sale is a chose in action, which is personal, if not real, property of the estate. *Crevier v Welfare & Pension Fund for Local 701 (In re Crevier)* (9th Cir 1987) 820 F2d 1553.

Potentially, debtors in this position could seek an injunction under the bankruptcy court's general injunctive powers found in 11 USC §105 as a substitute for the stay under 11 USC §362. *Grundy Nat'l Bank v Looney (In re Looney)* (4th Cir 1987) 823 F2d 788, 792; *Explorer Drilling Co. v Martin Exploration Co. (In re Martin Exploration Co.)* (5th Cir 1984) 731 F2d 1210, 1214. But see *Official Creditors Comm. v Metzger (In re Dominelli)* (9th Cir 1986) 788 F2d 584, 586 (noting limitations on bankruptcy court's broad equitable powers). Such injunctive relief may be pursued alternatively or in addition to defending the eviction based on an irregularity in the sale.

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§7.24 2. Procedure for Motion for Relief From Stay

Relief from the automatic stay is obtained primarily by a motion to modify or terminate the stay under 11 USC §362(d). See grounds in §§4.19-4.23, 7.20-7.23 and forms described in §7.73. If time is critical, the landlord's motion can be made ex parte or be accompanied by a request for an order shortening notice time on the hearing. See, *e.g.,* 11 USC §362(f); Fed R Bankr P 4001(a)(2). Bankruptcy courts routinely grant such requests because unlawful detainer actions are summary proceedings entitled to preference in state court. Likewise, bankruptcy courts routinely grant relief from the automatic stay when the landlord seeks only possession of residential rental property and no unexpired long-term lease is involved.

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§7.25 a. Format and Supporting Documents

The motion should be supported by admissible evidence of the factual basis for the relief sought in declarations by the creditor or landlord, or an employee or representative of the creditor or landlord. If the motion itself contains the necessary foundational facts, it may be verified. The motion should state:

- The landlord's interest in the property;
- The debtor's continued possession;
- The existence, nature, and status of any existing or former lease;
- Any defaults, such as nonpayment of rent; and
- Any steps taken to terminate the tenancy.

If an unlawful detainer action was filed before the tenant's filing of the bankruptcy petition, the motion should include copies of any termination notices, complaints, answers, or other procedural matters and request that judicial notice be taken of them. Note that under BAPCPA, a motion for relief from stay would not be needed to proceed with a residential eviction if judgment was entered before the bankruptcy, subject to provisions allowing the debtor to cure the default. See 11 USC §362(b)(22), (*l*), discussed in §7.16.

The motion should argue with reference to authorities that the debtor has no interest or equity in the property or that the defaults, and any subsequent actions to terminate based on them, constitute cause for relief from stay, or both. Finally, the prayer for relief should either (1) request an order terminating the stay and granting the moving party possession of the property or (2) request retroactive annulment of the stay if, for example, counsel wishes to avoid invalidation of notices or other actions already taken in ignorance of the stay. *National Envt'l Waste Corp. v City of Riverside (In re National Envt'l Waste Corp.)* (9th Cir 1997) 129 F3d 1052; *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569, 572; *Jewett v Shabahangi (In re Jewett)* (BAP 9th Cir 1992) 146 BR 250, 252.

WARNING: Because Fed R Bankr P 4001(a)(3) stays the order granting relief from stay for 14 days after entry of the order unless the bankruptcy court orders otherwise, counsel should request in the moving papers that the stay period be shortened or that the order become effective immediately on being entered.

Counsel should always consult local rules on any relief from stay motion, and ascertain whether the court requires submission of a proposed order with the motion. Particular requirements for the format and contents of moving papers are also set forth in local district court rules and in the policies of individual court departments; counsel should check these before preparing and filing the motion. In the bankruptcy courts of the southern district of California, for example, specific motion forms for cases involving unlawful detainer matters are required. SD Cal Local Bankr R 4001-2; Form CSD 1163 (Motion for Relief From Automatic Stay (Unlawful Detainer)). In the central district, for example, preprinted forms for motions for stay relief and orders granting or denying relief from the automatic stay in unlawful detainer matters are mandatory. See §7.73.

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§7.26 b. Filing Motion for Relief From Stay

A motion to modify or terminate the automatic stay is the initiation of a contested matter in a bankruptcy case, but it will not always be filed before it is served. All districts require some form of cover (or information) sheet for the motion. Forms may be obtained from the respective clerks' offices or from local court's website. See Directory for information.

NOTE: Bankruptcy courts are moving toward requiring electronic filing and may not permit paper filing; counsel should consult local rules and the court's website for current filing requirements and how to apply for an exemption from them. See Warning at §7.69.

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§7.27 c. Serving Motion for Relief From Stay

Local rules usually require service of the motion, by first-class mail or personal service, on or before the same day as it is filed. Proof of service should be filed promptly, because the failure to show proper notice can be cause for denial. Some rules require the proof of service to identify the capacity (*e.g.,* debtor, creditor, debtor attorney) in which the person was served. See §4.24.

PRACTICE TIP: In all cases, counsel should check local rules (available online; see Directory) to see if notice should be given to any party who has filed a request for special notice with the court under Fed R Bankr P 2002.

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§7.28 d. Scheduling and Attending the Hearing

When there is a pending execution of a writ of possession following an unlawful detainer action (see California Landlord-Tenant Practice §§13.64-13.67 (2d ed Cal CEB 1997)), and assuming the writ pertains to commercial property, counsel may want to set a hearing date for the landlord's motion for relief from the stay as close as possible to the next available date for the sheriff to complete the eviction and lockout. The earlier the hearing, the less time will be available, *e.g.,* for delaying tactics such as successive bankruptcy filings on behalf of another occupant. Because BAPCPA provides an exception to the stay for residential leases that were terminated before the bankruptcy, those provisions would control the landlord's rights in that context, and relief from stay would not be necessary if the exception applies. See 11 USC §362(b)(22), (*l*), discussed in §7.16.

Under 11 USC §362(g), the moving party has the burden of showing at the hearing lack of equity in the property. The burden on all other issues is on the party resisting the motion.

PRACTICE TIP: Because time is crucial in an eviction, counsel should bring a proposed order and copies of it to the hearing for immediate signature and entry on granting of the motion. The order should provide that it be effective in the pending bankruptcy despite conversion of the case to another chapter. It should also include relief to seek and enforce remedies incidental to recovery of possession, such as disposition of abandoned personal property. See also Warning in §7.25.

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3. Defenses to Motion

§7.29 a. Bankruptcy Discharge of Delinquent Rent in Public Housing

There is a split of authority concerning whether 11 USC §525(a) precludes evicting a public housing tenant for nonpayment of rent. Section 525(a) prohibits bankruptcy-based discrimination by governmental units against debtors and may provide a defense to a stay relief motion based solely on nonpayment of rent. For further discussion, see California Eviction Defense Manual §18.20B (2d ed Cal CEB 1993).

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§7.30 b. Other Defenses

In addition to defenses based on lack of proper procedures in the motion for relief from stay (see §§7.24-7.28), a debtor may be able to raise substantive issues. For example, in an eviction following a foreclosure sale, the debtor may claim that there were mistakes made during the foreclosure process that invalidate the sale. See §7.23. Also, if no judgment was entered in the state court eviction proceeding, the debtor may try to litigate the eviction in the bankruptcy court and raise state court defenses, such as warranty of habitability, retaliatory eviction, discrimination, or others. See California Landlord-Tenant Practice §§10.53-10.69 (2d ed Cal CEB 1997). In that event, the bankruptcy court will usually grant relief and abstain from adjudicating the defenses because the forum for such defenses is more properly the state court in which the eviction is pending. See, *e.g., California Sec. Mgmt. Corp. v Kennedy (In re Kennedy)* (Bankr CD Cal 1984) 39 BR 995 (bankruptcy court lacked jurisdiction to hear complaint for possession after foreclosure). The bankruptcy judge may, however, limit any recovery by the landlord to possession only, and require the landlord to come back to the bankruptcy court for any orders or to file a claim to allow the landlord to collect money damages from the debtor. See §7.70.

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§7.31 4. Relief Granted on Conditions

The court may grant relief from stay to proceed with the eviction, or it may wish to stay the order on condition that the debtor meets specific obligations, *e.g.,* payment of postpetition rent to the landlord when due or according to a specified schedule. If the debtor's interests have terminated or the leased property is not property of the bankruptcy estate, landlords have a strong argument against imposing any conditions on relief from stay in order to proceed swiftly with an eviction, and relief from stay may not even be necessary under BAPCPA. See §§7.4, 7.11-7.18. Indeed, if a judge has ruled that there is no estate or debtor interest to be protected, the judge arguably has no jurisdiction to address issues related to the debtor's bare possessory interest. See, *e.g., California Sec. Mgmt. Corp. v Kennedy (In re Kennedy)* (Bankr CD Cal 1984) 39 BR 995. But see discussion of the BAPCPA exception to automatic stay in §7.16.

On the other hand, if a state court action is in its early stages, and the landlord's objective is to collect the rent or get possession as soon as possible, a landlord might wish to have the bankruptcy court impose these types of conditions on the debtor and specifically order that the debtor must relinquish possession directly if the conditions are not met; this could save the landlord the time and expense of litigating a state court eviction action from beginning to end. Bankruptcy courts may issue surrender orders when a debtor's rights to possession have terminated, and they have broad authority to issue orders necessary to carry out the provisions of the Bankruptcy Code. See, *e.g., Anderson v Elm Inn, Inc. (In re Elm Inn, Inc.)* (9th Cir 1991) 942 F2d 630, 633. See also 11 USC §105. In any event, Fed R Bankr P 4001(a)(3) provides that an order granting relief from stay is stayed for 14 days after entry of the order unless the bankruptcy court orders otherwise.

One common condition to relief from stay is that the landlord may only seek possession of the property in state court, but may not attempt to collect any rent due. Typically, a landlord would be required to pursue any monetary claim by filing a proof of claim against the estate (or a request for payment of administrative expense, with respect to postpetition amounts that are due), and would not be allowed to collect any judgment from the debtor or estate without a separate order from the bankruptcy court granting relief from the stay for that purpose. See §7.70 for description of claim form and §7.71 for request for payment of administrative expense. Note that if limited relief is granted for the purpose of continuing existing state court claims, a material amendment to the pleadings that changes the nature of the relief sought could violate the automatic stay and render void any findings made in the state court. *In re Wardrobe* (9th Cir 2009) 559 F3d 932.

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§7.32 C. Stipulation for Relief From Stay

Before or after the filing of a motion to modify, terminate, or obtain relief from the automatic stay, nothing prevents landlord's counsel from attempting to obtain from the debtor or debtor's attorney a stipulation for an order for relief from (or modification of) the stay. The permission of the trustee should be obtained when it appears that the possessory interest in the subject property belongs to the bankruptcy estate, and not the debtor. See §§7.11, 7.14, 7.16-7.19. Generally, if the parties cooperate, a stipulation is quicker, less costly, and usually more reliable than a motion, even if additional terms are imposed by the debtor. A stipulation for an order granting relief from the bankruptcy stay to allow an eviction to proceed will frequently be accepted by a debtor-tenant if the landlord is willing to grant a temporary stay of execution of the state court writ of possession to allow the tenant additional time to move out voluntarily.

WARNING: The stipulation should only grant relief to allow entry and execution of judgment for possession of the premises. Any attempt to exact a monetary judgment for prepetition debts against the tenant, as a condition of allowing more time for the tenant to move, will inevitably meet with objections from creditors and the trustee, and result in the court not approving the stipulation.

Theoretically, the stipulation could be conditioned on certain payments from the debtor, but the basis for the amount must clearly be represented as a postpetition obligation and must be reasonable, and may be characterized as ensuring the landlord adequate protection under 11 USC §362(d). (See, *e.g.,* 11 USC §365(b)(1)(B), which provides a method for adequate protection on a lease assumption in bankruptcy.) Any overreaching in this respect will result in the court rejecting the stipulation.

If a stipulation can be reached among the parties, simplified procedures and special forms exist to give notice and obtain approval by the court in the form of an order. Fed R Bankr P 4001(d). See also local bankruptcy rules and forms. For online access to these rules and forms, see Directory. Parties to the stipulation will nearly always include the creditor and the debtor, and the trustee if the stipulation allows the creditor to take action against property of the estate. The stipulation will be more easily approved by the court if it contains the recitation of facts listed in §4.18.

Whether the order should be prepared as a document separate from the stipulation is largely a matter of local practice. Also, the application process for court approval of a stipulation varies, including the form of the application and to whom (and the number of days for which) notice must be given. Local rules and individual court department practices should be consulted even though most courts in all districts generally follow Fed R Bankr P 4001(d). An ex parte application for an order shortening time for notice to interested parties of the stipulation may be routinely granted in some courts. For a detailed outline of additional matters to be considered when preparing and negotiating a stipulation for an order granting relief from stay, and sample forms for a stipulation and a motion for approval and notice to interested parties, see Moving for Relief From an Automatic Stay in Bankruptcy, Steps 12-14, Apps G, L (Cal CEB Action Guide September 2006).

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§7.33 D. Application for Surrender of Premises

A landlord may attempt to recover possession by obtaining relief directly from the bankruptcy court by applying for an order requiring the debtor to surrender or vacate the property after the debtor fails to assume a lease of commercial property (see §7.57) or rejects it. See 11 USC §365(d)(4); *Anderson v Elm Inn, Inc. (In re Elm Inn, Inc.)* (9th Cir 1991) 942 F2d 630, 633. This process may also be used in a case involving a commercial lease that has terminated by its own terms or by operation of law. See §7.14. In the residential context, when a judgment for possession was entered before the bankruptcy, relief from stay is generally no longer necessary under BAPCPA. See 11 USC §362(b)(22), (*l*). This exception could save landlords significant expense and delay, although the practical application of its new procedures remains uncertain. See §7.16.

PRACTICE TIP: In a bankruptcy case involving a commercial lease, the issues of whether the lease was assumed in a timely manner, whether the lease was validly terminated, or whether possession should be turned over to the landlord may be contested in a lease assumption motion filed by the trustee or debtor. A landlord may oppose such a motion by submitting an application for surrender of the premises.

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§7.34 E. Motion to Dismiss Bankruptcy

Motions to dismiss are available in all chapters of bankruptcy actions (see, *e.g.,* 11 USC §§105(a), 349, 707, 1112, 1307). Historically, they have been used less frequently to terminate the automatic stay than motions for relief under 11 USC §362(d). See §§7.19-7.31. The primary disadvantage of moving to dismiss had been that such motions were rarely granted. Indeed, until BAPCPA, there was a statutory presumption in favor of allowing bankruptcy relief requested by the debtor. See *Voelkel v Naylor (In re Voelkel)* (BAP 9th Cir 2005) 322 BR 138 (bankruptcy court's dismissal order reversed for not reciting facts rebutting statutory presumption of 11 USC §707(b) and articulating clear abuse found). In BAPCPA, however, the presumption has been deleted from §707(b), and the circumstances in which bankruptcy cases may be dismissed have been expanded, encouraging bankruptcy courts to dismiss more cases, more often. For general discussion of dismissal, see §§4.79-4.91.

It is improper for a solvent tenant to use the bankruptcy process to obtain the §502(b)(6) cap on its landlord's damages for breach of a commercial lease. Bankruptcy courts have dismissed such cases, confirming that using the bankruptcy process in this way does not meet the requirement of "good faith." See *NMSBPCSLDHB, LP v Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)* (3d Cir 2004) 384 F3d 108; *In re Liberate Technols.* (Bankr ND Cal 2004) 314 BR 206, 214; *BEPCO, L.P. v 15375 Mem. Corp. (In re 15375 Mem. Corp.)* (D Del 2009) 400 BR 420 (reversing bankruptcy court's denial of dismissal). In the event of such a dismissal, the landlord may, in a separate state court proceeding, recover the attorney fees it incurred in obtaining dismissal of the bankruptcy matter. See, *e.g., Chinese Yellow Pages Co. v Chinese Overseas Mktg. Serv. Corp.* (2008) 170 CA4th 868, 88 CR3d 250; *Circle Star Assocs. v Liberate Technols.* (2007) 147 CA4th 1203, 55 CR3d 232.

In the context of an unlawful detainer for nonpayment of rent, a motion to dismiss a tenant bankruptcy may be successful, particularly if there is evidence that the landlord is the only creditor (or one of a few) and that the bankruptcy was filed in bad faith. See, *e.g., Meadowbrook Invs. Group v Thirtieth Place, Inc. (In re Thirtieth Place, Inc.)* (BAP 9th Cir 1983) 30 BR 503, 505; *In re Fast Food Props., Ltd. No. 1* (Bankr CD Cal 1980) 5 BR 539, 540. But see *Smyrnos v Padilla (In re Padilla)* (BAP 9th Cir 1997) 213 BR 349; *In re Johns-Manville Corp.* (Bankr SD NY 1984) 36 BR 727, 737.

A dismissal revests property of the bankruptcy estate in the person or entity in which it was vested before the filing of the petition (11 USC §349(b)(3)). An advantage to this procedure over a motion for relief under 11 USC §362(d) is that counsel may be able to obtain in the dismissal order a bar to the refiling of another bankruptcy by the same debtor for 180 days. See 11 USC §109(g)(1). In addition, a judgment of dismissal is effective when entered. See Fed R Bankr P 9021. On the effect of dismissal on the adjudication of creditors' claims made before dismissal, see *Nathanson v Hecker* (2002) 99 CA4th 1158, 121 CR2d 773, discussed in §7.42.

PRACTICE TIP: Some practitioners argue that a motion to dismiss may be employed even after an unsuccessful motion for relief from stay because the statutory grounds are different for each procedure. Also, if a landlord is aware of facts supporting grounds for dismissal, they may be raised in a motion for relief from stay, because the same facts that support a dismissal may also support a motion for relief from stay. *Farber v 405 N. Bedford Dr. Corp.* (*In re 405 N. Bedford Dr. Corp.)* (9th Cir 1985) 778 F2d 1374, 1378. See §7.20.

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IV. RESIDENTIAL LEASE ASSUMPTION OR REJECTION

§7.35 A. Purpose

Lease assumption or rejection by formal process was instituted to inject a degree of certainty into the landlord-tenant relationship after a bankruptcy filing. It allows the court, the landlord, and other creditors to ascertain whether the debtor or trustee will perform the obligations of the lease, and it provides a landlord assurances that defaults in rent will be cured if the lease is assumed. It also allows for the rejection of burdensome obligations while permitting retention of those which have some value to the estate. *Dellway Villa Apartments v Goodloe (In re Goodloe)* (Bankr MD Tenn 1986) 61 BR 1016, 1018.

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§7.36 B. 60-Day Limit for Assumption or Rejection

The trustee in bankruptcy must accept or reject a lease of residential property within 60 days after the order for relief in a Chapter 7 proceeding (liquidation). 11 USC §365(d)(1). In a proceeding under Chapter 9 (adjustment of municipality debts), Chapter 11 (reorganization of debts of an individual not qualified for Chapter 13), or Chapter 13 (adjustment of debts of an individual with regular income), the trustee may accept or reject a lease of residential property at any time before a plan is confirmed. 11 USC §365(d)(2).

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C. Effect of Lease Assumption

§7.37 1. Rights of Assuming Trustee or Debtor

A trustee who assumes the lease within the required time may assign the lease despite lease restrictions on transfers. 11 USC §365(f)(3); *Cukierman v Mechanics Bank (In re J. F. Hink & Son)* (9th Cir 1987) 815 F2d 1314; *In re David Orgell, Inc.* (Bankr CD Cal 1990) 117 BR 574. While transfer restrictions will be disregarded to allow the debtor to assign the lease under bankruptcy law, a debtor who assumes a lease must assume the entire lease, taking all the burdens with the benefits and with all other covenants and rights unchanged as to both parties. See *Stewart Title Guar. Co. v Old Republic Nat'l Title Ins. Co.* (5th Cir 1996) 83 F3d 735, 741.

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2. Obligations of Assuming Trustee or Debtor

§7.38 a. Curing Existing Defaults

An assuming trustee (or debtor) must cure all existing defaults under the lease or give prompt assurance that the defaults will be cured. 11 USC §365(b)(1)(A). The assurance also must cover the future performance of the lease. 11 USC §365(b)(1)(C). As a condition of assumption, the trustee must pay all delinquent rent and pay or give adequate assurance of payment of actual consequential out-of-pocket losses. 11 USC §365(b)(1)(B).

The Bankruptcy Code does not distinguish between "former," "existing," or "current" landlords, so a landlord may claim a right to cure payment on assignment of the lease even after the property is sold, provided the right is preserved in the sale agreement. *ECPG (Peoria) Assocs. Ltd. Partnership v Building Block Child Care Ctrs. (In re Building Block Child Care Ctrs.)* (BAP 9th Cir 1999) 234 BR 762. In *ECPG,* the tenant had filed its bankruptcy petition before the sale and assignment, and the landlord expressly retained its interest in the past due payments when it assigned the lease to the new owner. If the tenant is in default under the lease when the petition is filed, the trustee may not require the landlord to continue paying for utilities or other services incidental to the lease before the trustee assumes the lease, unless the landlord is compensated for any such services supplied before the assumption. 11 USC §365(b)(4).

Under California law, a landlord who intentionally interrupts or terminates a tenant's utility service with the intent of terminating the tenant's occupancy is subject to statutory penalties. CC §789.3. Although the statute does not create a presumption that a landlord who interrupts services does so with the intent to evict, a landlord runs a risk of such a claim if utility services happen to be interrupted without notice after a tenant bankruptcy. Thus, a landlord who stops paying utilities should provide advance notice to both the tenant and the trustee in bankruptcy that payment will cease (as permitted by 11 USC §365(b)(4)) on a specified date, and that the landlord expects the trustee to assume the payments if the trustee intends to retain the services. Proceeding in this manner permits the trustee to assume the payments without interrupting utility service to the tenant, and it minimizes the risk of a claim against the landlord. CC §789.3(a).

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§7.39 b. Prepetition Rent Workouts

Occasionally, before the filing of the petition, the debtor and the landlord may informally resolve rent delinquencies by mutual agreement in the form of a payment schedule or even a promissory note that extends the time for payment of past-due rental obligations. Such arrangements present the question of whether the debtor can separate this obligation as a mere monetary claim and avoid curing the default in order to remain in possession. The problem has been addressed, with mixed results, in the context of commercial leases.

In *In re Offices & Servs. of White Plains Plaza* (Bankr SD NY 1986) 56 BR 607, for example, the court held that when back-rent obligations had been reduced to a promissory note payable over an extended period of time, defaults under the note had to be cured as part of the assumption of the lease. The Ninth Circuit confirmed that payments under promissory notes defined as "further rent" under a lease are considered administrative rent claims under 11 USC §365(d)(3). *Cukierman v Uecker (In re Cukierman)* (9th Cir 2001) 265 F3d 846. But see *Moore v Pollock (In re Pollock)* (BAP 9th Cir 1992) 139 BR 938, 940 (court reached opposite result on similar facts); *Upstairs Gallery v Macklowe W. Dev. Co. (In re Upstairs Gallery)* (BAP 9th Cir 1994) 167 BR 915.

In *Pollock,* the court considered an attempt by Chapter 11 debtors to assume a sublease of commercial property. The sublease had been executed by the debtors in connection with a purchase agreement, note, and security agreement, all entered into contemporaneously with the objecting sublessor for the purchase of a campground. Before the order for relief, the debtors defaulted on the note. While the sublessor argued that the note and sublease were integral and indivisible parts of the purchase transaction, the trial court and the bankruptcy appellate panel both concluded that the obligations were divisible, such that one could be assumed without performing the other, based on three principal factors: (1) ruling for the sublessor would result in forfeiture, "which courts of equity abhor"; (2) the sublessor had received the agreed consideration—a secured note; and (3) the sublease had already been pledged to the sublessor under the security agreement, putting it in secured status. 139 BR at 941.

In *Upstairs Gallery,* the court held that lease termination payments made to a landlord may be recoverable as a preference under 11 USC §547. The issue was whether compromise of rent obligations that extended into the future gave rise to payments on account of an antecedent debt, or provided "new value" by releasing the future rent obligation. The court looked at the substantive effect of the agreement over its form and held that because the lease obligation was incurred when the lease was formed, the later compromise of the obligation did generate a payment on account of an antecedent debt. 167 BR at 918. See also *Richardson v Philadelphia Hous. Auth. (In re Richardson)* (Bankr ED Pa 1988) 94 BR 56, 62 (prepetition payment agreement for delinquent rent was preferential transfer under §547(b) requiring landlord to remit to bankruptcy estate).

Note that BAPCPA modified §547 to provide that a transfer would not be a preference to the extent that it was in payment of a debt incurred by the debtor in the ordinary course of business with the transferee, and if it was made in the ordinary course of business *or* according to ordinary business terms (previously, a showing of both was required for the defense). See 11 USC §547(c)(2); see also §2.47. Additionally, §547 excludes transfers of less than $5000 from preference exposure in cases in which the debtor's debts "are not primarily consumer debts." See 11 USC §547(c)(9). Nonetheless, landlords should be aware of preference issues when substituting or modifying rent obligations for potentially insolvent tenants.

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D. Effect of Rejection

§7.40 1. Rejection Implies Voluntary Termination

The Ninth Circuit has yet to squarely address the effect of rejection on a residential lease. The Ninth Circuit has repeatedly held, however, that rejection of a nonresidential lease terminates the lease and the right of possession. See *Anderson v Elm Inn, Inc. (In re Elm Inn, Inc.)* (9th Cir 1991) 942 F2d 630; *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885, based on 11 USC §365(d)(4), which expressly applies to nonresidential leases. These cases have held that when a nonresidential lease was rejected, the landlord was entitled to an immediate order directing the surrender of possession, avoiding the need for relief from stay.

Although 11 USC §365(d)(4) on its face applies only to nonresidential leases, the reasoning of these cases could also apply to rejection of residential leases. As a practical matter, rejection of the leasehold interest is logically inconsistent with continued possession by the tenant. Rejection indicates a voluntary decision to discontinue the relationship represented by the lease. Thus, although a tenant's equitable possessory interest may be protected by the stay after an *involuntary* termination (*Westside Apartments, LLC v Butler (In re Butler)* (Bankr CD Cal 2002) 271 BR 867), the 2005 exceptions to the stay for terminated residential leases reflect Congressional intent to reduce the protection of such interests. See, *e.g.,* 11 USC §362(b)(22), (*l*), discussed in §7.16. Moreover, a lease rejection indicates a *voluntary* termination of the lease and thus an arguable relinquishment of any equitable interest the tenant might otherwise have had. See *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885; *Anderson,* 942 F2d at 633, cited in §7.57. See also discussion of *Westside Apartments, Marquand v Smith (In re Smith)* (Bankr CD Cal 1989) 105 BR 50, 55, and *Lee v Baca* (1999) 73 CA4th 1116, 86 CR2d 913, in §§7.9, 7.16-7.19.

Outside the Ninth Circuit, it has been said that the effect of rejection of a *residential* lease "is one of the great mysteries of bankruptcy law." *In re Henderson* (Bankr SD NY 2000) 245 BR 449, 453. Although rejection of a lease is treated as a breach that occurred before the bankruptcy was filed (see 11 USC §365(g)(1)), the Second Circuit has held that this does *not* mean that the lease has terminated (see *Medical Malpractice Ins. Ass'n v Hirsch (In re Levigne)* (2d Cir 1997) 114 F3d 379, 386). Under this authority, courts addressing the effect of rejection on rent-controlled leases have suggested that, although a rejection of a residential lease may terminate the *estate's interest* in the lease, it leaves a right of possession to revert to the debtor. See, *e.g., In re Henderson, supra*; *B.N. Realty Assocs. v Lichtenstein* (SD NY 1999) 238 BR 249, 254. Therefore, especially in the context of a residential rent-controlled lease, a landlord would be required to seek relief from stay to regain the right of possession after rejection.

PRACTICE TIP: If a tenant remains in possession after rejection of the lease, a landlord could request a surrender order (see §7.33) under the reasoning of *Marquand, Baca, Anderson,* and *George* and the court's broad equitable powers under 11 USC §105. Although this method is certainly the quickest for regaining possession, the landlord should always seek relief from stay in the alternative (see §7.19), because it is unclear whether a court would apply the principles of 11 USC §365(d)(4) in a residential context.

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§7.41 2. Postpetition Rent Must Be Paid

Even if a lease is rejected, the landlord is entitled to compensation for rent or rental value of the premises from the date of the petition through the date of rejection, which should also be the date by which possession is relinquished. 11 USC §503(b); *Thompson v IFG Leasing Co. (In re Thompson)* (9th Cir 1986) 788 F2d 560. The compensation is set at the reasonable rental value, which may be, but is not always, the same as the lease rate. *Brown v Danning (In re Frederick Meats, Inc.)* (9th Cir 1973) 483 F2d 951; *Merchants Fund, Inc. v Bartl (In re Merchants Storage Co.)* (Bankr ED Va 1981) 15 BR 448. On setoffs for security deposits held by the landlord, see §7.12.

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§7.42 3. Landlord Claim Issues

Rent that accrues from and after the order for relief (which is usually the date the bankruptcy petition is filed) but before the effective date of a lease rejection is granted administrative priority under 11 USC §503(b)(1). *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401; *Thompson v IFG Leasing Co. (In re Thompson)* (9th Cir 1986) 788 F2d 560. This means that the claim will ordinarily be paid ahead of other claims against the estate. See §§7.47-7.49. In cases commenced by involuntary petitions or resulting from a conversion from one chapter to another, the order for relief would occur after the date of the original petition. See 11 USC §§303(h), 348(b). Nonetheless, claims arising in the ordinary course of business after the filing date but before the order for relief are still accorded administrative priority status. See 11 USC §502(f) on claims for the "gap" period between an involuntary petition and the order for relief; §502(f) claims are granted administrative priority under §507(a)(2).

In general, landlords claiming postpetition rent should not use the standard proof-of-claim form required for other kinds of claims (see, *e.g.,* §7.70); rather, a request for payment of administrative expenses under §503(b)(1) should be made. If the debtor does not pay the amount claimed or if a dispute is anticipated, the request should be set for hearing and made in the form of a motion for allowance and payment of administrative expenses. See forms in §§7.71-7.72 and Practice Tip in §7.49. If a lease is terminated prepetition and the debtor does not move to assume the lease or obtain relief from forfeiture, damages for rental value accruing in unlawful detainer are not allowed as an administrative claim. *In re Boll Weevil, Inc.* (Bankr SD Cal 1996) 202 BR 762.

To seek recovery of amounts due for prepetition rent and damages resulting from rejection of the lease, a landlord should file a proof of claim as a general unsecured creditor. See §7.70. The amount of a landlord's claim for damages from lease rejection is capped according to a formula provided by statute. See 11 USC §502(b)(6); see also §7.59. If the debtor-tenant contests the claim, the bankruptcy court's determination of the allowable amount of the claim may be res judicata of the lease liability, prohibiting the tenant from contesting the liability in a subsequent state court proceeding after the bankruptcy has been dismissed. *Nathanson v Hecker* (2002) 99 CA4th 1158, 121 CR2d 773.

PRACTICE TIP: The notice of commencement of a case in Chapter 7 or 13 (essentially, a notice sent out by the bankruptcy clerk to the creditors listed in the debtor's schedules; see §7.5) contains the deadline for filing claims. That date is called the "claims bar date," and should be promptly calendared because claims filed after that date may be disallowed. In cases under Chapter 11, the claims bar date is generally set by the court on the debtor's motion. In all cases, any notice of a claims bar date should be calendared to be sure the claim is timely filed.

Note that special rules apply to the assumption or rejection of nonresidential leases. 11 USC §365(d)(3)-(4). See §§7.45-7.59.

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§7.43 E. Exceptions: Expired or Terminated Leases

If a lease has expired by its own terms or has terminated, in most cases, the debtor or trustee cannot assume the lease. See 11 USC §365(a). "Bankruptcy cannot breathe new life into a terminated lease." *In re Bacon* (Bankr ED Pa 1997) 212 BR 66, 70. In such cases, the landlord may proceed against the tenant to recover possession as if the lease were rejected. See §§7.14, 7.40, 7.45, 7.57.

EXAMPLE: Under a public housing lease, the trustee of the bankruptcy estate of a defaulting tenant could not assume the lease because the lease had terminated before the bankruptcy petition was filed. See *Robinson v Chicago Hous. Auth. (In re Robinson)* (Bankr ND Ill 1994) 169 BR 171, 174, aff'd (7th Cir 1995) 54 F3d 316.

Note that the court in *Robinson* construed the term "expired" in reference to 11 USC §365(a) to include a residential lease that was terminated under Illinois state law by a judgment of possession before the filing of the bankruptcy petition.

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§7.44 F. Government Housing Cases

Whether a debtor is obligated to assume the lease to retain rights to possession in public or government-subsidized housing after the filing of a bankruptcy petition is the subject of conflicting reported opinions. Some courts have held that such a debtor is protected by 11 USC §525(a) and may retain the tenancy despite the failure of the trustee to assume the lease. See *Stoltz v Brattleboro Hous. Auth. (In re Stoltz)* (2d Cir 2002) 315 F3d 80 (debtor-tenant may retain lease if unpaid prepetition rent is discharged, even though lease is deemed rejected due to trustee's failure to assume); *In re Day* (Bankr ED Pa 1997) 208 BR 358, 363; *In re Sudler* (Bankr ED Pa 1987) 71 BR 780, 786. Furthermore, such a debtor may confirm a Chapter 13 plan, if proposed in good faith, without assuming the lease, unless the Chapter 13 petition was filed within 6 years of a Chapter 7 discharge; in that case, all rent owing after the discharge must be paid in the Chapter 13 reorganization. *In re Day,* 208 BR at 374.

Another line of cases has declined to follow the *Sudler* rule altogether. See *In re Valentin* (Bankr ED Pa 2004) 309 BR 715 (disagreeing with *Stoltz* and granting relief from stay); *In re Bacon* (Bankr ED Pa 1997) 212 BR 66, 69 n4 (stating in dictum that Chapter 7 debtor has no right to assume lease; it is only trustee's right); *Housing Auth. v Collins (In re Collins)* (Bankr WD Pa 1996) 199 BR 561 and authorities cited. See also §7.29.

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V. COMMERCIAL LEASE ASSUMPTION OR REJECTION

§7.45 A. Overview

The policy underlying the Bankruptcy Code provisions for assumption or rejection of commercial leases recognizes that a debtor's commercial leasehold may have value that can be realized for the benefit of the estate and creditors by allowing the lease to be assumed and assigned. Leases for desirable properties or leases that might be considered to be below-market rents can be among a debtor's most valuable assets. Similarly, the Bankruptcy Code provides debtors a valuable right to reject leases that require above-market rent payments or that are otherwise burdensome to the estate. Because debtors do not always know whether a leasehold has value or not, the stakes in commercial assumption or rejection can be high. If the debtor rejects a lease prematurely, it may lose value that should be brought into the estate for the benefit of creditors. On the other hand, if a debtor assumes the lease, the obligations under it become postpetition administrative priority obligations of the estate. See, *e.g., Nostas Assocs. v Costich (In re Klein Sleep Prods.)* (2d Cir 1996) 78 F3d 18; *In re Bergt* (Bankr D Alaska 1999) 241 BR 17, 25. Premature assumption now presents less risk to debtors, because BAPCPA caps the landlord's administrative claim for rejection of an assumed lease at 2 years' rent. See 11 USC §503(b)(7), discussed in §7.55. See also discussion of rejection damages in §7.59.

For business planning, commercial landlords need to know whether their leases will be assumed. They also have a keen interest in ensuring that any prospective assignee will be committed to full performance of the lease obligations and not adversely affect the synergy of the landlord's commercial property. With the 1984 amendments to 11 USC §365 (see §1.4), the so-called "shopping center amendments," Congress sought to balance these competing interests—by imposing special rules on the timing of the decision to assume or reject, and new parameters on the debtor's rights to assume and assign commercial leases. Over time, however, the desire of bankruptcy courts to accommodate the needs of debtors and creditors resulted in a relaxation of the principles of the 1984 amendments. With BAPCPA, Congress made changes to reinforce the principles of the 1984 amendments. Those changes include (1) additional protections for landlords against the uncertainty of a prolonged period of time to assume or reject, (2) clarification of the effect of a nonmonetary default on the tenant's right to assume the lease, and (3) strengthening the protections against an assignment to a nonconforming use. See §§7.46, 7.48, 7.51, 7.53, 7.55, 7.59.

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B. Time Limits

§7.46 1. Decision or Extension Required in 120 Days

Once a commercial tenant's bankruptcy petition has been filed, the debtor-tenant under a nonresidential real property lease must assume or reject the lease by *the earlier of* 120 days after the date of the order for relief (which is typically the day the petition was filed) or the date of entry of an order confirming a plan of reorganization. See 11 USC §365(d)(4)(A). Before the 120-day period expires, the bankruptcy court may extend the period an additional 90 days on motion "for cause." 11 USC §365(d)(4)(B). If the court grants the additional 90-day extension, however, it may not grant any further extension without the *prior written consent* of the landlord in each instance. 11 USC §365(d)(4)(B)(ii). Thus, the uncertainty for commercial landlords concerning whether a lease will be assumed or rejected is limited to a maximum of 210 days, unless the landlord consents to a further extension. If the debtor-tenant fails to assume the lease within the 120 days, or 210 days if an extension is granted, the lease is *deemed rejected,* and the debtor must immediately surrender possession to the landlord. 11 USC §365(d)(4)(A).

This time period represents a significant and beneficial change in the law for landlords in commercial tenant bankruptcies. Under the former version of §365(d)(4) (which still applies to cases filed before October 17, 2005), a debtor-tenant had to make its decision within 60 days, or such additional time as the court "for cause" would fix. Although the wording of the statute suggested that any extension must be "fixed" by the court "within such 60-day period," the Ninth Circuit interpreted this as only requiring that the motion be made within the 60-day period, even if it was heard or decided after the expiration of the 60 days. See *Turgeon v Victoria Station, Inc. (In re Victoria Station, Inc.)* (9th Cir 1988) 840 F2d 682, 684; *Southwest Aircraft Servs., Inc. v City of Long Beach (In re Southwest Aircraft Servs., Inc.)* (9th Cir 1987) 831 F2d 848, 850. While the time could be shortened or extended by motion of the debtor, it was held that such motion must be filed (but not necessarily heard) within the 60-day period. *Southwest Aircraft Servs., Inc. v City of Long Beach, supra.*

Outside the Ninth Circuit, courts criticized the view that 11 USC §365(d)(4) only required that the motion be *made* within the initial period; they held that the statute unambiguously requires that any additional time be granted within the initial 60-day period. See, *e.g., In re DCT, Inc.* (Bankr ED Mich 2002) 283 BR 442, 444 (failure to have extension motion heard within 60 days resulted in lease being deemed rejected), citing *DeBartolo Props. Mgmt., Inc. v Devan* (D Md 1996) 194 BR 46, 51, and many others. Likewise, in a case decided under BAPCPA, a bankruptcy court held that any order extending the initial (120-day) deadline must be entered before the deadline expires, and the court has no discretion to extend the time after the date expires. *In re Tubular Technols. LLC* (Bankr D SC 2006) 362 BR 243; see also *In re Monahan Ford Corp.* (Bankr ED NY 2008) 390 BR 493 (attorney's failure to make timely motion for extension under §365(d)(4) was negligence as matter of law).

While BAPCPA lengthened the initial assumption period to 120 days, and placed a firm limit of 210 days without landlord consent, it is unclear whether or to what extent bankruptcy courts in the Ninth Circuit will follow these authorities. By only authorizing an additional 90-day extension "prior to the expiration of the 120-day period," BAPCPA suggests that the extension motion can only be granted before the 120 days expire. Yet the prior version of 11 USC §365(d)(4) also required the further extension to be granted within the original 60 days, and the Ninth Circuit interpreted this to mean that only the motion had to be made within that time, and the order granting it could come after the period had expired.

PRACTICE TIP: Landlord counsel faced with an extension motion set for hearing after the 120-day period has expired should argue that the motion cannot be granted, because BAPCPA only allows an extension to be granted prior to the expiration of the 120-day period. The argument would be that the Ninth Circuit's decision in *Turgeon* has been superseded, and the strict statutory construction applied in other jurisdictions should be applied in the Ninth Circuit. Similarly, because it is unclear whether *Turgeon* would still apply to extension motions under BAPCPA, counsel for debtor-tenants will be taking a risk in filing an extension motion too late to be heard before the 120-day period runs; an incorrect guess about whether a bankruptcy court will still follow the rule of *Turgeon* could

mean that a valuable lease is inadvertently deemed rejected.

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§7.47 2. Debtor Must Remain Current on Postpetition Rent; Proration or Payment Date Approach

In the 1984 amendments to the Bankruptcy Code, Congress expressly required debtors to remain current on postpetition rent arising under nonresidential real property leases pending assumption or rejection, and this obligation is unchanged under BAPCPA. 11 USC §365(d)(3). Prepetition rent arrearages need not be paid currently. If a lease is rejected, they are claimed as a general unsecured claim (see §7.70); if a lease is assumed, they must be cured (see §7.55). Section 365(d)(3) expressly requires performance of lease obligations arising under a nonresidential lease from the date of the order for relief until such lease is assumed or rejected. See *Feld v S & F Concession, Inc. (In re S & F Concession, Inc.)* (Bankr ED Pa 1985) 55 BR 689. In most cases, the date of the "order for relief" is the date that the bankruptcy petition is filed, and hence that is the date the obligations under §365(d)(3) commence. If the bankruptcy case was commenced by an involuntary petition, or if it has been converted from one chapter to another, however, the order for relief will be after the petition date. See 11 USC §303(h) (entry of order for relief in involuntary cases).

Previously, courts generally interpreted 11 USC §365(d)(3) to require the debtor to pay *prorated* daily rent for each day from and after the date the petition was filed until a lease was rejected, even if the first of the month (when rent is normally due) occurred before the petition was filed. See, *e.g., Feld v S & F Concession, Inc., supra*; *In re Galvan* (Bankr SD Cal 1986) 57 BR 732, 734; *Matter of Swanton Corp.* (Bankr SD NY 1986) 58 BR 474, 475; *Child World, Inc. v Campbell Mass. Trust (In re Child World, Inc.)* (SD NY 1993) 161 BR 571, 576; *In re Ernst Home Ctr.* (Bankr WD Wash 1997) 209 BR 955, 964. The highest-level court to adopt the proration rule is the Seventh Circuit. *In re Handy Andy Home Improvement Ctrs., Inc.* (7th Cir 1998) 144 F3d 1125. In *Handy Andy,* Judge Posner (Chief Judge of the 7th Circuit Court) explained that the proration rule is more sensible, tracks the purpose of the statute by giving postpetition creditors their rightful due, and allocates expenses equitably among the pre- and postpetition periods, rather than on the happenstance of billing dates and the strategic moves of the landlord and tenants. 144 F3d at 1128. Later cases from other jurisdictions agreed with *Handy Andy*'s approach and prorated expenses. *In re Furr's Supermarkets, Inc.* (BAP 10th Cir 2002) 283 BR 60, 67; *In re NETtel Corp.* (Bankr DC 2002) 289 BR 486, 490; *In re Phar-Mor, Inc.* (Bankr ND Ohio 2003) 290 BR 319, 323 (proration is "majority rule").

Decisions from Courts of Appeals for the Sixth, Third, and Fourth Circuits, however, rejected the proration rule, holding that whether an obligation is postpetition depends on the date the obligation is due. See *Koenig Sporting Goods, Inc. v Morse Road Co.* (*In re Koenig Sporting Goods, Inc.*) (6th Cir 2000) 203 F3d 986 (lease rejected on second of month; landlord awarded postpetition rent for whole month); *Centerpoint Props. v Montgomery Ward Holding Corp. (In re Montgomery Ward Holding Corp.)* (3d Cir 2001) 268 F3d 205 (requiring debtor to make tax payments that related to prepetition period because they came due postpetition); *In re Rose's Stores, Inc.* (4th Cir 1998) 155 F3d 560 (affirming district court decision that rent due after filing petition was postpetition obligation, even though it related to prepetition period); *In re Appletree Markets, Inc.* (Bankr SD Tex 1992) 139 BR 417, 420. Later decisions applying this "payment date" or "billing date" approach have relied on the wording of §365(d)(3), finding that an obligation "arises" when it is due and finding that it is inconsistent with the statute to prorate obligations that became due before or after the petition was filed, even if they relate to work done or services rendered during both periods. See, *e.g., Urban Retail Props. v Loews Cineplex Entertainment* (SD NY 2002) 2002 US Dist Lexis 6186, 2002 WL 535479 (landlord's capital improvement expense that came due postpetition required to be paid in full, although some work done prepetition); *In re CCI Wireless, LLC* (Bankr D Colo 2002) 279 BR 590; *In re UAL Corp.* (Bankr ND Ill 2003) 291 BR 121 (calls payment date approach "majority view"). But see *In re Pac-West Telecomm, Inc.* (Bankr Del 2007) 377 BR 119 (utility bill, usually sent by landlord to tenant on monthly basis, but because of malfunctioning meter was billed postpetition in one lump sum for 18-month prepetition period, was not required to be paid under §365(d)(3)).

The split of authority on this issue makes it difficult to predict which approach may ultimately be applied. Both sides claim to follow the "majority" approach, and the lower court decisions are not even consistent with cases decided by their own circuit Court of Appeals or within their own district. For example, the bankruptcy court in *In re UAL Corp.* applied the payment date approach notwithstanding that *Handy Andy,* a Court of Appeals opinion from the same circuit, applied proration; similarly, the bankruptcy court in *Phar-Mor* applied proration, notwithstanding that in *Koenig Sporting*

Goods, the Sixth Circuit applied the payment date approach. And while the Second Circuit has not yet decided the issue, a New York bankruptcy court recently held that landlords were entitled to prorated postpetition rent for the month in which the bankruptcy petition was filed, notwithstanding that the payment date approach was applied in *Urban Retail Props. v Loews Cineplex Entertainment, supra*. *In re Stone Barn Manhattan LLC* (Bankr SD NY 2008) 398 BR 359.

The Ninth Circuit itself has not squarely addressed the proration/billing date issue. Earlier opinions from bankruptcy courts within the Ninth Circuit applied proration. See, *e.g., In re Nat'l Refractories & Minerals Corp.* (Bankr ND Cal 2003) 297 BR 614, 619 (adopting proration and calling it "majority" approach); *Sticka v Lambert (In re Lambert)* (BAP 9th Cir 2002) 283 BR 16 (tax refund pertaining to year 2001 is properly prorated to number of days prepetition and postpetition). More recently, after extensive discussion of the split of authority on this issue, a bankruptcy court in Arizona held that the performance date determined whether an expense was required to be paid currently under 11 USC §365(d)(3). See *In re Designer Doors, Inc.* (Bankr D Ariz 2008) 389 BR 832. However, courts in the east seem to be trending back to proration, at least as to prorated postpetition rent for the month in which the bankruptcy was filed (called "stub rent"). See, *e.g., Goody's Family Clothing, Inc. v Mountaineer Prop. Co. II, LLC* (*In re Goody's Family Clothing, Inc.)* (D Del 2009) 401 BR 656 (while Third Circuit in *Montgomery Ward* applied payment date approach for amounts due under §365(d)(3), district court affirmed bankruptcy court's allowing stub rent as administrative expense under 11 USC §503(b)(3)); *In re Stone Barn Manhattan LLC, supra* (allowing stub rent claim under §365(d)(3), including lengthy analysis of the divergent views on the issue); *Duke Realty Ltd. Partnership v North Metro Mill Work Distrib., Inc. (In re Manis Lumber Co.)* (Bankr ND Ga 2009) 2009 Bankr Lexis 506 (following *Stone Barn*).

Failure to stay current on postpetition lease obligations is grounds for deeming the lease rejected or, at a minimum, for an order for relief from stay. *Buffkin v Goodson (In re Goodson)* (Bankr SD Fla 1981) 12 BR 883; *In re Future Growth Enters., Inc.* (Bankr ED Pa 1986) 61 BR 469. It can provide cause for denying an extension of time to assume or reject a commercial real property lease. *In re Perfectlite Co.* (Bankr ND Ohio 1990) 116 BR 84, 87, citing *Southwest Aircraft Servs., Inc. v City of Long Beach (In re Southwest Aircraft Servs., Inc.)* (9th Cir 1987) 831 F2d 848. Postpetition defaults may also be a factor in determining whether a lease option may be exercised by a debtor-tenant. Compare *Cannery Row Co. v Leisure Corp. (In re Leisure Corp.)* (BAP 9th Cir 1999) 234 BR 916 with *Coleman Oil Co. v Circle K Corp. (In re Circle K Corp.)* (9th Cir 1997) 127 F3d 904.

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§7.48 3. Performance of Nonmonetary Obligations

Under 11 USC §365(d)(3), the tenant must perform "all the obligations" of a lease, except those specified in 11 USC §365(b)(2), arising from and after the order for relief, until the lease is assumed or rejected. Since the phrase "all the obligations" is not limited to *monetary obligations,* courts have struggled to determine the impact of a nonmonetary default on rights to assume a lease. See, *e.g., Worthington v General Motors Corp. (In re Claremont Acquisition Corp.)* (9th Cir 1997) 113 F3d 1029 (debtor's default under covenant requiring continuous operations was "historical fact" that could not be cured and rendered contract unassumable); *Eagle Ins. Co. v Bankvest Capital Corp. (In re Bankvest Capital Corp.)* (1st Cir 2004) 360 F3d 291 (disagreeing with *Worthington*); *Bank of America v Garcia (In re Garcia*) (Bankr D Ariz 2002) 276 BR 627 (limiting *Worthington*). However, Congress added provisions that address this issue and resolve the controversy under BAPCPA.

Specifically, Congress modified 11 USC §365(b)(2)(D) to confirm that nonmonetary defaults need not be cured before assumption and will not preclude the debtor from assuming the lease; however, if the default is for failure to operate in accordance with a commercial lease, then the default must be cured at or after the time for assumption of the lease and the debtor must compensate the landlord for "pecuniary losses" resulting from the nonmonetary breach, as part of the cure obligation required to assume the lease. See 11 USC §365(b)(1)(A). Thus, a breach of a covenant to operate under a commercial lease will no longer result in losing the right to assume the lease, but a debtor must compensate the landlord for damages resulting from such a breach as part of the cure required to assume the lease.

PRACTICE TIP: The right to claim damages resulting from breach of an operating covenant still presents landlords with a dilemma of how to calculate such damages. Claims that cannot be quantified cannot be cured, and Congress provided no guidance on how landlords might calculate such claims. Landlords suffering from a bankrupt tenant whose store has gone dark in violation of an operating covenant should consider the impact of the dark store on foot traffic, percentage rent, and the image of the shopping center, and they may need expert testimony to quantify such damages for purposes of making a complete cure claim when the lease is being assumed.

Even though debtors must perform all obligations under the lease while deciding whether to assume or reject, many debtors desire to have store closing or "going-out-of-business" (GOB) sales during the pendency of the bankruptcy. While many commercial leases prohibit conducting such sales at leased premises, those provisions are generally unenforceable in bankruptcy because of the great need to provide debtors with an efficient means to liquidate inventory. On the other hand, this need does not give debtors carte blanche to conduct GOB sales in violation of lease provisions. Instead, debtors must specifically move for permission to conduct GOB sales according to a proposed set of guidelines; bankruptcy courts have recognized the need for reasonable modifications to proposed GOB sale guidelines to protect landlord interests. See, *e.g., In re Ames Dep't Stores, Inc.* (Bankr SD NY 1992) 136 BR 357, 359. Thus, while debtor motions to conduct GOB sales are routinely granted, timely landlord objections often result in modifications to proposed guidelines for GOB sales, including limitations on signage, duration, and advertising for the sale, and providing procedures for termination of the sale and handling of personal property that may be abandoned.

In addition, while courts have wrestled with the payment date or proration controversies concerning payment of rent under 11 USC §365(d)(3), similar controversies exist concerning non-rent obligations due under a lease. In addition to following the payment date approach for postpetition rent under §365(d)(3), the bankruptcy court in *In re Designer Doors, Inc.* (Bankr D Ariz 2008) 389 BR 832 (discussed in §7.48) held that the obligation to remove a mechanic's lien filed postpetition was not a §365(d)(3) obligation, because the obligation "arose" when the work was performed, and that occurred prepetition. In analyzing a similar lease obligation to keep the premises free of liens, a bankruptcy court in New York agreed with the analysis from *Designer Doors,* but reached the opposite result, because under New York law, a lien arises when it is filed, rather than when the work is completed. *In re BH S&B Holdings LLC* (Bankr SD NY 2009) 401 BR 96. See also *In re Plastech Engineered Prods., Inc.* (Bankr ED Mich 2009) 402 BR 217 (holding that *Koenig Sporting Goods, Inc. v Morse Road Co.* (*In re Koenig Sporting Goods, Inc.*) (6th Cir 2000) 203 F3d 986 (discussed in §7.47) does not require billing date approach for cost of repairs; administrative status depends on when

the costs accrued).

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§7.49 4. Priority Claim for Postpetition Rent

Under 11 USC §503(b)(1), administrative expenses are required to be "actual and necessary" to the estate, and they are allowed only in their "reasonable value." See, *e.g., Figone v Spear (In re GFS Creations, Inc.)* (Bankr ND Cal 1999) 240 BR 43, 45 (reasonable rental value used when no lease specified rent due); *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700. Under 11 USC §365(d)(3), however, debtors must remain current on postpetition obligations, "notwithstanding section 503(b)(1)." Hence, the Ninth Circuit has held that 11 USC §365(d)(3) gives landlords an administrative claim for the full amount of lease rent due for the postpetition, prerejection period, *regardless* of the actual value conferred by the lease on the estate. See *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401.

Further, because §365(d)(3) applies "notwithstanding section 503(b)(1)," there has been much discussion in reported cases concerning whether §365(d)(3)'s mandate for "immediate payment of postpetition lease obligations" provides nonresidential landlords a de facto superpriority, requiring payment regardless of the administrative solvency of the estate. The common view is that §365(d)(3) requires immediate performance of all lease obligations. *Towers,* 27 F3d at 404; *In re Telesphere Communications, Inc.* (Bankr ND Ill 1992), 148 BR 525, 530; *In re Leisure Time Sports, Inc.* (Bankr SD Cal 1995) 189 BR 511 (citing *In re Telesphere*). Under this interpretation, postpetition rent payments are immune from the usual tests applied to assertions of administrative priority and must be made regardless of the estate's solvency. See, *e.g., Omni Partners, Ltd. Partnership v Pudgie's Dev. of NY, Inc. (In re Pudgie's Dev. of NY, Inc.)* (Bankr SD NY 1999) 239 BR 688, 694; *In re Brennick* (Bankr D Mass 1995) 178 BR 305, 307 (rent payments are immune from disgorgement). See also *In re Pyxsys Corp.* (Bankr D Mass 2003) 288 BR 309, 316 (landlord entitled to immediate payment for rent, but it is subject to disgorgement in event of later administrative insolvency).

Previously, some cases in the Ninth Circuit held that 11 USC §365(d)(3) did not give landlords a superpriority right to immediate payment of postpetition rent, but only an administrative claim for it, payable like other administrative claims under 11 USC §503(b). See *Great W. Sav. Bank v Orvco, Inc. (In re Orvco, Inc.)* (BAP 9th Cir 1989) 95 BR 724; *In re Daisy/Cadnetix, Inc.* (Bankr ND Cal 1991) 126 BR 87 (citing *Orvco*). Later cases have expressed the view that *Orvco* was rejected by the Ninth Circuit in *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.), supra*. See, *e.g., In re Leisure Time Sports, supra*; *Cukierman v Uecker (In re Cukierman)* (9th Cir 2001) 265 F3d 846 (on final appeal, Ninth Circuit did not address *Orvco*). Other courts noted, however, that because *Towers* did not squarely overrule *Orvco* on the superpriority issue, a lessor is not entitled to immediate payment "unless it is shown that there are sufficient funds in the estate to pay the claim without jeopardizing full payment to all current and future administrative expense claimants." See, *e.g., In re MS Freight Distrib.* (Bankr WD Wash 1994) 172 BR 976, 979. The Ninth Circuit ultimately came to the same conclusion in *Kir Temecula v LPM Corp. (In re LPM Corp.)* (9th Cir 2002) 300 F3d 1134 (affirming bankruptcy court's refusal to grant relief from stay to allow landlord to collect postpetition rent payments when estate was administratively insolvent). See also *In re Palace Quality Servs. Indus., Inc.* (Bankr ED Mich 2002) 283 BR 868, 906 (rent payments due after conversion have administrative priority, but need not be paid immediately if estate's administrative solvency is uncertain).

Further, if a landlord's claim does not arise from postpetition, prerejection conduct, it will not have administrative priority. See, *e.g., K-4, Inc. v Midway Engineered Wood Prods., Inc. (In re Treesource Indus.)* (9th Cir 2004) 363 F3d 994 (because damages for breach of lease obligation to restore property arose upon rejection, they were not an administrative expense); *In re Nat'l Refractories & Minerals Corp.* (Bankr ND Cal 2003) 297 BR 614 (landlord's claim for postrejection rent applicable to the period necessary for the landlord to repair damage to the premises would not be recoverable as an administrative expense if debtor did not actually occupy the premises during that time); *In re Designer Doors, Inc.* (Bankr D Ariz 2008) 389 BR 832 (discussed in §§7.47-7.48) (obligation to remove postpetition mechanics' lien was not §365(d)(3) obligation, because the obligation "arose" prepetition). Note, however, the obligation to stay current on postpetition obligations under 11 USC §365(d)(3) applies only to debtor-*tenants*, not debtor-*landlords*. *Einstein/Noah Bagel Corp. v Smith (In re BCE W., LP)* (9th Cir 2003) 319 F3d 1166 (denied administrative claim by subtenants for debtor-sublandlord's breach of sublease).

PRACTICE TIP: If a debtor-tenant fails to keep postpetition rent current, a request for payment of administrative expenses and, if necessary, a motion to compel payment should be made. See forms in §§7.71-7.72. In addition, if permitted under applicable state law, a landlord may claim attorney fees incurred in making the motion, which may be recoverable to compensate the landlord for "actual pecuniary loss" resulting from the debtor's failure to pay the postpetition rent as required under 11 USC §365(d)(3). See §7.54.

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5. Extensions of Time and Grounds for Objection

§7.50 a. Extension for Cause

The standard governing a request for an extension of the initial 120-day period of time to assume or reject leases is vague, specifying only that "cause" be shown. See 11 USC §365(d)(4)(B). Before BAPCPA, when extensions could be granted repeatedly, the "cause" requirement was intended to protect commercial landlords "from delay and uncertainty by forcing a trustee or a debtor in possession to decide quickly whether to assume unexpired leases." *Sea Harvest Corp. v Riviera Land Co.* (9th Cir 1989) 868 F2d 1077, 1079. The seminal case on this issue of "cause" was *In re Wedtech Corp.* (Bankr SD NY 1987) 72 BR 464, 471. *Wedtech* held that debtors seeking an extension had the burden of persuasion to show why they needed more than the 60 days allowed by the former law, and landlords opposing a motion for an extension had to show how they would be prejudiced if the extension were granted (see §7.51).

The *Wedtech* decision cited a number of factors for courts to consider in determining whether cause existed to extend the deadline, such as whether the case was exceptionally complex and involved a large amount of leases, whether the leases were a primary asset of the estate or if they gave potential value and importance to a plan, and whether the debtor was current on the rent. As it played out, however, the risk of making a decision too soon, specifically the risk of assuming leases that may be burdensome or rejecting those that might be valuable to the estate, led bankruptcy courts to grant extensions virtually whenever debtors asked for them, rendering the standard of "cause" almost meaningless.

Congress specifically addressed this issue in BAPCPA. Although "cause" is still required to obtain a 90-day extension of the initial 120-day period, the meaning of "cause" is less important because bankruptcy courts no longer have discretion to grant repeated or open-ended extensions. Thus, under current law, even if cause is found to support a 90-day extension, no further extensions can be granted without the landlord's written consent. See 11 USC §365(d)(4)(B).

This change has had a dramatic impact on the course of retail bankruptcies after BAPCPA went into effect. Debtors in large retail cases are finding that the maximum 210 days is not enough time for them to decide which leases to assume or reject, and they are developing new approaches for trying to meet the statutory requirement of obtaining the landlord's written consent. In many cases, debtors are negotiating with landlords more directly, trying to persuade landlords that the extension benefits them by keeping the debtor in possession paying rent. Landlords with more valuable space may seek conditions on granting the written consent, such as requiring debtors to operate and pay rent for some portion of the extension, such as through the winter holiday season.

PRACTICE TIP: If the first extension has already been granted, landlord counsel should be alert for debtor attempts to obtain "written consent" from landlords who might not wish to provide such consent. In some cases, debtors are moving to approve "procedures" that would automatically extend the time based on a schedule debtors might file listing the landlord consents that they claim to have, thus avoiding any scrutiny of whether or to what extent written consent was actually obtained. In other cases, debtors may seek to bypass counsel of record, seeking a signature from property managers or leasing agents who may not be aware of landlords' rights in bankruptcy. To avoid any inadvertent granting of "consent," landlord counsel should insist that all communications go through counsel and carefully review any motion to establish procedures for further extensions, so that a timely objection can be filed.

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§7.51 b. Prejudice to Landlord; Stipulations to Extend

Under the former law, a common basis for asserting "prejudice" to a landlord in response to a debtor's showing of cause for an extension was if the extension sought would be unreasonably long or indefinite. Indeed, the courts recognized that the 1984 amendments were intended to limit the amount of time in which debtors may hold landlords in limbo. See, *e.g., Southwest Aircraft Servs., Inc. v City of Long Beach (In re Southwest Aircraft Servs., Inc.)* (9th Cir 1987) 831 F2d 848, 850. Hence, open-ended extensions were generally disfavored. *Chapman Inv. Assocs. v American Healthcare Mgmt., Inc. (In re American Healthcare Mgmt., Inc.)* (5th Cir 1990) 900 F2d 827, 830; *In re Musikahn Corp.* (Bankr ED NY 1986) 57 BR 938, 942 n5.

Because BAPCPA limits the period of uncertainty for commercial landlords to 210 days (unless they consent to a further extension), landlords need no longer worry about long or indefinite extensions, and they will have less need to litigate the issue of "cause" for an extension. See 11 USC §365(d)(4). Nonetheless, landlords who would be prejudiced by even one 90-day extension of the 120-day period should make a showing of such prejudice in response to the debtor's extension motion. For instance, failure to pay postpetition rent, as required under 11 USC §365(d)(3) until the lease is assumed or rejected, can be grounds for denying an extension. See, *e.g., In re Muir Training Technols., Inc.* (Bankr SD Cal 1990) 120 BR 154, 160.

Specific facts may also show sufficient prejudice to warrant denial of an extension as to a particular lease. For instance, a landlord with another prospective tenant ready to lease the premises would be prejudiced if the debtor's decision is delayed, the prospective tenant goes away, and the lease is later rejected, leaving the landlord with a costly vacancy it could have filled earlier.

Previously, when debtors could obtain multiple extensions of the time to assume or reject, stipulated compromises of the competing needs of the parties were common. For example, landlords objecting to long or open-ended extensions often stipulated to a finite extension if the debtor would agree to a "lock-in" through the winter holiday season. Under such a scenario, a debtor might obtain a stipulated extension through January 31, while agreeing that it cannot reject the lease, and it must remain open, operating, and paying the rent through December 31. Because the period for decision can no longer be extended beyond 210 days without the landlord's consent (see 11 USC §365(d)(4)(B), cited in §§7.46, 7.50), it remains to be seen how much litigation over extensions will occur in cases governed by BAPCPA. To the extent that any extension is sought beyond the holiday shopping season, however, landlords are likely to continue to press for "lock-in" commitments.

PRACTICE TIP: Debtors often agree to "lock-in" stipulations for the holiday season because they do their best business during the holidays, and they have no need of the right to reject the lease before the holidays have concluded, while landlords often seek stipulations to avoid the prospect of a rejected lease and a vacancy too late to relet the space for the key retail season.

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C. Assumption and Assignment Procedures

§7.52 1. Motion Required

Unlike rejection of a lease, which may occur automatically if a debtor allows the 120 days (see §7.46) to run without taking action, a debtor must affirmatively move to assume, or assume and assign, a lease. *Turgeon v Victoria Station, Inc. (In re Victoria Station, Inc.)* (9th Cir 1988) 840 F2d 682. The standard applied to a debtor's motion (provided it meets statutory requirements) is the "business judgment" test, which generally defers to the debtor's reasonable business judgment that assumption would be beneficial to the estate. *Orion Pictures Corp. v Showtime Networks, Inc. (In re Orion Pictures Corp.)* (2d Cir 1993) 4 F3d 1095. Under 11 USC §365(b), however, a debtor will not be allowed to assume a lease unless the debtor:

- Cures, or provides adequate assurances of a prompt cure of, any prepetition default (other than a nonmonetary default that cannot be cured by performance at or after assignment; however, a breach of a covenant to operate must be cured at or after assignment, and the landlord's damages from such a breach must be paid as part of the cure; see §7.48);
- Compensates the landlord for any actual pecuniary loss resulting from such a default; and
- Provides adequate assurances of future performance under the lease.

Similarly, a debtor may not assign a lease unless the debtor assumes the lease in accordance with the requirements of 11 USC §365(b) and provides adequate assurance of future performance by the assignee. 11 USC §365(f)(2). Thus, a debtor-tenant moving to assume or assign a lease must make an affirmative showing addressing these issues, and a landlord objecting to such a motion would challenge such a showing (see §7.53). Because of the need for retail tenants to move quickly on decisions once they are made, however, retail debtors often seek court approval of expedited procedures for assumption or rejection of leases, and bankruptcy courts routinely grant such motions. Once such procedures are in place, the time and opportunity for landlords to object to debtors' decisions about their leases are often considerably reduced.

PRACTICE TIP: Because of the current trend of approving expedited procedures, the need for vigilant monitoring and taking swift action to assert a landlord's rights is more acute than ever.

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§7.53 2. Shopping Center Rules

As with a residential lease (see §7.38), when a trustee (or debtor in possession) assumes a commercial lease, all defaults must be cured and adequate assurances of future performance must be given. 11 USC §365(b)(1). In addition, however, with respect to assumption of a lease in a shopping center under 11 USC §365(b)(3), adequate assurance of future performance is specifically defined to mean that:

- The source of rent and financial condition of the proposed assignee and its guarantors, if any, is similar to the financial condition and operating performance of the debtor-tenant and its guarantors when the tenant entered into the original lease;
- The percentage rent due under the lease, if any, will not substantially decline;
- Assumption or assignment is subject to all the terms of the lease, including radius, use, location, and exclusivity provisions, and will not breach any such provisions in any other retail lease, financing agreement, or master agreement relating to the overall shopping center; and
- Assumption or assignment will not disrupt the tenant mix or balance in the shopping center.

These special protections and hurdles to the sale and assignment of shopping center leases are intended to protect the rights of the landlord and the center's other tenants. *In re Joshua Slocum, Ltd*. (3d Cir 1990) 922 F2d 1081, 1086.

Because the requirements for assumption and assignment of shopping center leases are so specific, the grounds for landlords to object to assumption or assignment are obviously that the statutory requirements have not been met. Landlords may oppose a motion to assume the lease if the motion, *e.g.,* does not provide for a complete and prompt cure of defaults, does not provide adequate assurances that the assignee will be able to pay the rent, or (in the case of a shopping center lease) does not show that the assignee will abide by all terms of the lease. In order to preserve the time and opportunity to analyze a proposed showing of adequate assurances before an assignment, landlords should carefully scrutinize any motion to approve expedited procedures for assumption of leases. See §7.52.

Although 11 USC §365(b)(3) contains restrictions on the right to assign a shopping center lease, §365(f)(1) allows a court to approve an assignment despite language in a lease that would restrict or limit the tenant's right to assign. Formerly, it was unclear whether §365(f)(1) would allow a court to approve an assignment that violated §365(b)(3). Because bankruptcy courts are generally focused on realizing value from leases for the estate, some courts held that a use restriction that effectively prevented assignment could be viewed as an unlawful restriction on bankruptcy rights and disregarded under §365(f). See, *e.g., In re Rickel Home Ctrs.* (D Del 1998) 240 BR 826*,* appeal dismissed as moot (3d Cir 2000) 209 F3d 291. Other courts held that the specific provisions in §365(b)(3) trump the more general provision of §365(f), so an assignment in violation of a use restriction in a shopping center lease cannot be approved. *Trak Auto. Corp. v West Town Ctr. (In re Trak Auto Corp.)* (4th Cir 2004) 367 F3d 237 (reversing lower court decisions allowing the assignment). BAPCPA resolved this debate and strengthened a landlord's ability to object to an assignment of the lease for a nonconforming use. BAPCPA confirms that the restrictions on assignment in §365(b) prevail over the court's ability to disregard anti-assignment language in §365(f). The power to assign under §365(f) is now expressly limited by §365(b). See 11 USC §365(f)(1).

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§7.54 3. Recovering Attorney Fees to Enforce Lease

For years, counsel representing landlords in bankruptcy proceedings were burdened with an anomalous rule that attorney fees incurred in bankruptcy litigation seeking to "enforce the contract" may be recoverable (if recoverable under substantive state law), but fees incurred litigating issues unique to the bankruptcy context were not. See, *e.g., Collingwood Grains, Inc. v Coast Trading Co. (In re Coast Trading Co.)* (9th Cir 1984) 744 F2d 686; *Fobian v Western Farm Credit Bank (In re Fobian)* (9th Cir 1991) 951 F2d 1149. This rule was problematic, because the only way to enforce contractual rights against a party in bankruptcy was in a bankruptcy proceeding. Yet under *Fobian,* fees incurred litigating bankruptcy issues were not recoverable. In 2007, a unanimous U.S. Supreme Court struck down the *Fobian* rule, holding that a claim for attorney fees could not be disallowed solely because the fees were incurred litigating bankruptcy issues. *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199. The Court confirmed that a contract allowing recovery of attorney fees that is enforceable under substantive nonbankruptcy law is enforceable in a bankruptcy context unless the Bankruptcy Code expressly provides otherwise. The Court noted that under 11 USC §502(b), a claim is allowed except to the extent the claim implicates any of the nine exceptions in that statute, and since attorney fees are not included in such sections they could not be disallowed simply for arising in the bankruptcy context. The demise of the *Fobian* rule has had a material impact on litigants seeking fees in bankruptcy proceedings, as litigants have pressed for fees in a wide variety of contexts. In *Qmect, Inc. v Burlingame Capital Partners II, LP (In re Qmect, Inc.)* (Bankr ND Cal 2007) 368 BR 882, for instance, a bankruptcy court that had previously denied a motion for attorney fees to a successful defendant in an adversary proceeding, based on the *Fobian* rule, granted an amended motion to recover such fees based on the change in law represented by *Travelers.* In other cases, courts have denied fees anyway, finding the litigation was not the source of the state law right, or that the claim was not entitled to administrative status. See, *e.g., In re Decker* (Bankr D Mont 2008) 2008 Bankr Lexis 982 and *In re Security Aviation, Inc.* (Bankr D Alaska 2007) 374 BR 720.

In the landlord-tenant context, the source in federal law of a landlord's claim to attorney fees is 11 USC §365(b)(1), which requires compensation for "actual pecuniary loss" as part of a debtor-tenant's cure of defaults required for assumption of the lease. See, *e.g., Andrew v KMR Corp. (In re Bullock)* (BAP 9th Cir 1982) 17 BR 438. In *Andrew,* after a "considerable amount of legal maneuvering," the trustee was permitted to assume the lease. In connection with the assumption, the bankruptcy court awarded the landlord its fees and the bankruptcy appellate panel affirmed, stating that the purpose of 11 USC §365(b)(1)(B) is "to indemnify the other party to the contract or lease being assumed, against loss," and noted that the purpose of an attorney fee clause in a lease was the same. 17 BR at 439. Moreover, attorney fees and interest may be recoverable if necessary to enforce a landlord's right to receive postpetition amounts due under a lease and authorized by the lease. See *Urban Retail Props. v Loews Cineplex Entertainment* (SD NY 2002) 2002 US Dist Lexis 6186, 2002 WL 535479 (allowing fees and interest under §365(d)(3)); *In re Entertainment, Inc.* (Bankr ND Ill 1998) 223 BR 141, 151 (allowing fees and interest in connection with an assumed lease).

Some bankruptcy courts have relied on the reasoning in *Bullock* to award lessors their attorney fees as part of the obligations of 11 USC §365. See, *e.g., In re Pacific Sea Farms, Inc.* (Bankr D Haw 1991) 134 BR 11, 16; *In re 2495 Broadway Supermarket, Inc.* (Bankr SD NY 1989) 97 BR 765; *In re Westworld Community Healthcare, Inc.* (Bankr CD Cal 1989) 95 BR 730. In *Westworld,* the court devised a three-pronged test for approving attorney fees in connection with an assumed lease (95 BR at 734):

(1) Does the expense directly or indirectly relate to a default under the lease?

(2) If so, was the expense necessary to cure the default, adequately protect the landlord against future defaults, or indemnify the landlord against loss?

(3) If so, was the expense reasonable under the circumstances?

This test was cited and applied in *In re Pacific Sea Farms, Inc., supra*.

But the decision in *Westworld* was criticized by the bankruptcy appellate panel in *Lacey v Westside Print Works, Inc. (In re Westside Print Works, Inc.)* (BAP 9th Cir 1995) 180 BR 557 for indicating in dicta that fees might be allowed independently of a fees clause. Attorney fees may not be recoverable if the scope of the fees clause in the contract

would not cover the actions taken by the landlord for which the fees were claimed, if they were incurred for handling bankruptcy matters unrelated to the curing of defaults or for prepetition matters, or if the lease is ultimately rejected. See, *e.g., Abercrombie v Hayden Corp. (In re Abercrombie)* (9th Cir 1998) 139 F3d 755, 759; *Lacey v Westside Print Works, Inc. (In re Westside Print Works, Inc.), supra*; *In re Pacific Arts Publ'g, Inc.* (Bankr CD Cal 1996) 198 BR 319. Likewise, one court held that an attorney fees clause allowing recovery of fees to the prevailing party in a dispute arising from a breach of the lease is not broad enough to support recovery of fees on assumption of the lease in bankruptcy. *In re I-Mind Educ. Sys., Inc.* (Bankr ND Cal 2001) 269 BR 47. In addition, attorney fees resulting from a debtor's postpetition conduct are not recoverable as an administrative expense if they arise from litigation commenced prepetition on a prepetition contract. *Decker v Kadjevich (In re Kadjevich)* (9th Cir 2000) 220 F3d 1016. On the other hand, if the litigation is commenced by the trustee and fails, fundamental fairness may support an award of attorneys fees to the prevailing party, as an administrative expense. *In re Good Taste, Inc.* (Bankr D Alaska 2004) 317 BR 112.

In recent years, the Ninth Circuit has emphasized that the language of the attorney fees clause in the particular lease is a threshold issue in allowing administrative priority to attorney fees incurred in obtaining payment of administrative obligations. In *Cukierman v Uecker (In re Cukierman)* (9th Cir 2001) 265 F3d 846, the Ninth Circuit reversed the bankruptcy appellate panel's decision that attorney fees incurred in an administrative rent claim were entitled to administrative priority. The court noted that the fee clause in the contract—like many such clauses—applied to an action or proceeding in which there was a prevailing party, and the Ninth Circuit did not view the bankruptcy litigation as falling within that definition. In light of *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, it is unclear to what extent the Ninth Circuit's strict interpretation of the attorney fees clause in *Cukierman* will still apply to a claim for attorney fees as an administrative expense under 11 USC §365(b), since "bankruptcy litigation" itself is no longer a bar to recovery of contractual attorney fees.

PRACTICE TIP: Although the usual language awarding attorney fees to the prevailing party in an action or proceeding is appropriate in the context of nonbankruptcy litigation, practitioners may want to modify their attorney fees clauses with additional language to apply in the event of the tenant's bankruptcy, such as specifically providing that attorney fees are due "on demand" when they are incurred in connection with asserting or protecting the landlord's rights under the lease in a bankruptcy proceeding of the tenant. Moreover, because the *Fobian* rule against recovering fees in "bankruptcy litigation" is gone, counsel should not hesitate to press for recovery of attorney fees when a lease is assumed or, in appropriate contexts, for claims litigation, as well as in state court litigation after a bankruptcy case has been dismissed. See, *e.g., Chinese Yellow Pages Co. v Chinese Overseas Mktg. Serv. Corp.* (2008) 170 CA4th 868, 88 CR3d 250; *Circle Star Assocs. v Liberate Technols.* (2007) 147 CA4th 1203, 55 CR3d 232.

See §7.59 concerning the impact of the cap (on a landlord's claim for rejection damages) on the recoverability of attorney fees.

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§7.55 4. Effect of Assumption and Assignment

As part of the assumption process, landlords are entitled to a cure of all existing defaults. 11 USC §365(b)(1). This means that the debtor will typically submit proposed cure amounts in any motion to approve the assumption or assignment of a commercial lease.

WARNING: Landlord counsel should scrutinize such motions and confirm with clients the correct amount of the proposed cure payment, so that a landlord can timely object or submit the correct amount required to be paid as a cure in connection with the assumption.

After a lease has been assumed and assigned, the new assignee becomes the responsible tenant under the lease, and the debtor has no further liability under it. 11 USC §365(k). If the lease is assumed but not assigned, the obligations of the lease become administrative obligations of the estate, entitled to payment and priority under the Bankruptcy Code, even if a lease is later rejected when a reorganization fails. 11 USC §§503(b), 507; *Nostas Assocs. v Costich (In re Klein Sleep Prods.)* (2d Cir 1996) 78 F3d 18; *Elliott v Four Seasons Props. (In re Frontier Props.)* (9th Cir 1992) 979 F2d 1358, 1367. Note, however, that BAPCPA limits a landlord's administrative claim for rejection of a lease after it has been assumed. 11 USC §503(b)(7).

Under BAPCPA, the landlord's administrative claim for rejection of a previously assumed lease is capped at the sum of all monetary obligations due under the lease (except those arising from a failure to operate or a penalty rate or provision) for a period of 2 years from the *later of* rejection of the lease or the date of actual surrender of the premises. 11 USC §503(b)(7). No setoffs or reductions of this administrative claim amount are allowed except for amounts actually received or to be received from a third party. 11 USC §503(b)(7). While this amendment caps the administrative claim, the balance of the landlord's damages from the rejection would be a general unsecured claim, calculated in accordance with §502(b)(6). See 11 USC §503(b)(7); see also §7.59.

The administrative obligation of an assumed lease may be converted to a general unsecured claim if the debtor *refiles* a second Chapter 11 bankruptcy (sometimes referred to as a "Chapter 22"). See, *e.g., In re Jartran, Inc.* (7th Cir 1989) 886 F2d 859, 871; *In re Jamesway Corp.* (Bankr SD NY 1996) 202 BR 697, 702. If the reorganization plan has not been substantially consummated by a distribution to creditors, and the circumstances underlying the refiling were foreseeable, however, creditors may be able to get the second filing dismissed. *In re Delaware Valley Broadcasters Ltd. Partnership* (Bankr Del 1994) 166 BR 36; see also *In re Brown* (Bankr WD Va 2009) 399 BR 162 (dismissing Chapter 13 debtor's second filing, while first case pending, as filed in bad faith). Note also that BAPCPA includes substantial changes to the dismissal statutes in the Bankruptcy Code, expanding the availability of dismissal for repeat filings. See §§4.79-4.91, 7.34.

For discussion of bankruptcy limitations on landlord damage awards and application of tenant security deposits and other credit enhancements, see chap 8.

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D. Rejection of Lease

§7.56 1. Automatic Rejection or Noticed Motion

Unlike moving to assume a lease or for an extension of time to make the decision, a debtor may reject a lease by doing nothing at all. If a debtor does not make a motion to assume or extend the time within 120 days after the petition is filed, or within the additional 90 days that the court may allow, the lease is "deemed rejected." 11 USC §365(d)(4). If the court grants a 90-day extension, the court may only grant a subsequent exception if the landlord gives prior written consent. 11 USC §365(d)(4)(B)(ii). If the debtor wishes to reject the lease *sooner* than the expiration date for assumption, the debtor must make a noticed motion. Because postpetition (administrative) rent must be paid through the date that the order approving the rejection is entered, regardless of whether the estate derives any benefit from the premises before the rejection, debtors typically make motions to reject leases in order to shorten the time period during which they must pay postpetition rent. Debtors have much latitude to reject executory contracts (including leases), and courts will apply a liberal business judgment rule to the decision. See, *e.g., Agarwal v Pomona Valley Med. Group, Inc. (In re Pomona Valley Med. Group, Inc.)* (9th Cir 2007) 476 F3d 665, 670, citing many cases on this point.

Because landlords have an administrative claim for postpetition rent through the date of rejection, landlords and debtor-tenants have disagreed about whether a formal order approving the rejection is required before the debtor's administrative rent obligation ceases. If the lease has not been deemed rejected under 11 USC §365(d)(4), many courts have held that rejection is effective when the court enters an order approving the rejection. See, *e.g., Thinking Machs. Corp. v Mellon Fin. Servs. Corp. (In re Thinking Machs. Corp.)* (1st Cir 1995) 67 F3d 1021; *Maroon v Four Star Pizza (In re Four Star Pizza)* (Bankr WD Pa 1992) 135 BR 498, 501. See also *WB, Ltd. v Tobago Bay Trading Co. (In re Tobago Bay Trading Co.)* (Bankr ND Ga 1991) 142 BR 528, 532; *In re Worths Stores Corp.* (Bankr ED Mo 1991) 130 BR 531.

Some courts have held that court authorization is not required and that a rejection can be effective when a motion to reject is filed. See, *e.g., In re Joseph C. Spiess Co.* (Bankr ND Ill 1992) 145 BR 597 (discussing authorities allowing retroactive rejection). Moreover, a bankruptcy court has equitable authority to allow rejection of a commercial lease retroactive to the date of the motion when the debtor-tenant acts diligently and the landlord does nothing to secure rejection sooner. *Pacific Shores Dev., LLC v At Home Corp. (In re At Home Corp.)* (9th Cir 2004) 392 F3d 1064. In *Pacific Shores,* the tenant gave notice on the day of its petition of an intent to reject leases for premises it had never actually occupied, and sought an emergency hearing to allow rejection to be retroactive to the date of the motion. Although the landlord did not receive actual possession until the order was entered 11 days later, the Ninth Circuit affirmed the equitable authority of the bankruptcy court to allow the retroactive rejection on such facts. See also *Duke Realty Ltd. Partnership v North Metro Mill Work Distrib., Inc. (In re Manis Lumber Co.)* (Bankr ND Ga 2009) 2009 Bankr Lexis 506 (allowing equitable adjustment of effective date of rejection to 10 days after service of debtor's rejection motion). In recent years, debtors in larger cases have sought to avoid these issues by seeking bankruptcy court approval of streamlined procedures for assumption or rejection of leases. Through such procedures, debtors can avoid the time and expense of a formal motion to reject a lease, and can have the rejection effective automatically after giving a notice and expiration of a specified period (often 10 days) without a landlord objection.

PRACTICE TIP: The result in *Pacific Shores* was heavily dependent on the unique facts of that case. Usually, with a tenant in possession, administrative rent should continue to accrue, and rejection should not be effective until possession is actually surrendered. To preserve the right to administrative rent for the full postpetition period until the landlord can effectively relet the premises, landlords should ask that any rejection not be effective until the *later of* the date of entry of the order or the date that possession is actually surrendered. See §7.57. Landlords should also insist that any rejection procedures order include a minimum amount of notice of a rejection and an *outside date* for exercising the right.

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§7.57 2. Requires Relinquishment of Possession

If a nonresidential lease is rejected, it may no longer be assumed and assigned, and the premises must *immediately* be surrendered to the landlord. 11 USC §365(d)(4); *George v City of Morro Bay (In re George)* (9th Cir 1999) 177 F3d 885; *Anderson v Elm Inn, Inc. (In re Elm Inn, Inc.)* (9th Cir 1991) 942 F2d 630, 633. See §7.33. If the property is not voluntarily vacated, a landlord may apply ex parte for an order directing the tenant to surrender the property and permitting a sheriff or marshal to execute the order for possession. Moreover, if personal property remains on the premises after the debtor-tenant has vacated and rejected the lease, the landlord has an administrative priority claim for the reasonable value of storage of the property until it is removed. See *In re Pyxsys Corp.* (Bankr D Mass 2003) 288 BR 309, 316.

Note, however, that if possession is not surrendered after rejection, and no action is taken to compel surrender, the rejection itself may not terminate the lease. See *McLaughlin v Walnut Props., Inc.* (2004) 119 CA4th 293, 14 CR3d 369. In *McLaughlin,* a ground lease was deemed rejected for failure to timely assume it in bankruptcy, but the ground tenant never formally surrendered possession, and the bankruptcy case was later dismissed. Noting a recent federal trend to require surrender along with rejection to terminate lease obligations, the court of appeal held that the rejection of the ground lease was only a breach and did not terminate a lease. 119 CA4th at 300. The court reasoned that to conclude otherwise "would allow unscrupulous lessees to evade their contractual obligations by the simple expediency of filing for bankruptcy, then dismissing their petition after the lease had been rejected." 119 CA4th at 301.

PRACTICE TIP: Although the *McLaughlin* decision concluded that lease rejection did not equal lease termination, its main concern was to preserve the landlord's right to contractual damages against the debtor-tenant when the case was dismissed after rejection. For this purpose, its rejection/termination analysis may be unnecessarily confusing. In bankruptcy, the landlord's claim for damages after a lease rejection would be capped according to the formula in 11 USC §502(b)(6). See §7.59. But if the bankruptcy is dismissed, the landlord can claim the full damages allowed by state law under CC §1951.2. Thus, the practical effect of the *McLaughlin* analysis appears to be that the landlord's obligation to mitigate its rental damages does not accrue until after the rejection, when the debtor clearly relinquishes any interest in the property.

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§7.58 3. Effect on Rights Held by Nondebtor Parties

While rejection of a commercial lease requires the tenant to vacate and surrender possession, the impact on third parties is less obvious but can be very important. For instance, subtenants claiming a right of possession through a master tenant that has rejected a lease *lose their right of possession* if the master lease is rejected in bankruptcy. *Syufy Enters., L.P. v City of Oakland* (2002) 104 CA4th 869, 128 CR2d 808. Unlike a right of possession, however, a right of first refusal or third party option rights attached to a lease may survive a debtor's rejection of the lease. Because landlords sometimes include specific property rights (*e.g.,* to purchase equipment) that arise upon termination of the lease, they need to know whether a tenant can frustrate those rights by rejecting its other obligations under a lease. In the Ninth Circuit, a debtor is unlikely to be allowed to avoid an option by rejecting the underlying contract. *In re Helms Constr. & Dev. Co.* (9th Cir 1998) 139 F3d 702; *In re Bergt* (Bankr D Alaska 1999) 241 BR 17.

In *Helms,* the debtor sought to sell property free and clear of an option of the original seller to repurchase the property, claiming the option was an executory contract that it had rejected. 139 F3d at 703. Reciting the *Countryman* definition (see §6.2), the Ninth Circuit noted that an option is not executory unless further performance is required from both sides before the bankruptcy petition is filed. If an option has been paid for and requires no performance unless it is exercised, and has not been exercised when the petition is filed, it is not executory and thus cannot be rejected by the debtor. 139 F3d at 706. In *Bergt,* the bankruptcy court analyzed a right of first refusal, and went a step further than *Helms* in holding that even if the right were an executory contract, a debtor's rejection of it would not result in avoidance of any property interest held by a nondebtor party. 241 BR at 21. In *Bergt,* Judge Ross supported his conclusion with an exhaustive and scholarly analysis of the numerous divergent authorities on this question, which can provide great assistance to any court or counsel grappling with the issue in the future. A later decision from Delaware, however, rejected the *Bergt* decision and called it the "minority" view. See *In re Kellstrom Indus., Inc.* (Bankr D Del 2002) 286 BR 833 (creditor's right of first refusal to purchase debtor's property was executory contract that could be rejected).

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§7.59 4. Landlord's Claim for Rejection Damages

Rejection of a lease is deemed to be a breach of the lease occurring immediately *before* the petition was filed. 11 USC §365(g)(1). Consequently, a landlord's claim for damages resulting from the breach is treated as a general unsecured claim that is not entitled to administrative priority under 11 USC §507. The landlord can and should make a claim for damages resulting from this breach, by filing a proof of claim promptly after the rejection occurs and definitely before any claims bar date (see description of form in §7.70). Note that in Chapter 7 and 13 cases, the claims bar date is set by statute to be 90 days following the *first date* set for the meeting of creditors under 11 USC §341. See Fed R Bankr P 3002(c). In Chapter 11 cases, the claims bar date is set by the court, usually in response to the debtor's motion to set it on a particular date. Fed R Bankr P 3003(c)(3).

Under 11 USC §502(a), a proof of claim is deemed allowed unless a party in interest objects. Thus, filing a timely claim with sufficient documentation creates a presumption of the validity of the claim. Moreover, a bare objection to a claim, without substance, may be inadequate to overcome the presumption of a claim's validity, even if the claim lacks appropriate documentation. See *Campbell v Verizon Wireless S-CA (In re Campbell)* (BAP 9th Cir 2005) 336 BR 430. Moreover, recent amendments to the bankruptcy rules include new limitations on the debtors' ability to make "omnibus" objections to invalidate large numbers of claims without making a showing as to each one. See Fed R Bankr P 3007. These changes make it more likely that a proper proof of claim, timely filed, will survive and that the claimant will receive its share in any eventual distribution, absent a specific objection by the debtor. If the debtor rebuts the presumption of validity with a meritorious objection, however, the claimant has the burden of proving the amount of the claim. See *Litton Loan Servicing v Garvida (In re Garvida)* (BAP 9th Cir 2006) 347 BR 697.

The amount of a landlord's unsecured claim for damages resulting from the rejection of a lease is limited in bankruptcy. Although the claim may include the full amount of any unpaid prepetition rents (11 USC §502(b)(6)(B)), the amount of a claim for damages resulting from the rejection of the lease is limited to the greater of (a) 1 year's rent or (b) 15 percent of the rent reserved for the remainder of the term of the lease, not to exceed 3 years' rent. 11 USC §502(b)(6)(A).

NOTE: While the cap can substantially reduce a tenant's exposure under a long-term lease, obtaining such a limit on damages is not, by itself, a legitimate basis for filing bankruptcy. If a solvent tenant files bankruptcy simply to cap the lease damages, the landlord should move to dismiss the case for bad faith. See §§7.34, 7.60.

This cap on damages that a landlord may claim in bankruptcy applies not only to a debtor-tenant, but also to a debtor-guarantor of lease obligations. *Arden v Motel Partners (In re Arden)* (9th Cir 1999) 176 F3d 1226. In order for charges that may not be designated as "rent" to be included in a claim for rejection damages, they must be equivalent to rent under the lease. *Kuske v McSheridan (In re McSheridan)* (BAP 9th Cir 1995) 184 BR 91, 99, overruled on other grounds in *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978. *McSheridan* provides a three-part test for determining which charges are equivalent to rent and thus includable in the calculation of the claim, subject to the cap; they must be:

- Designated as "rent" or "additional rent" in the lease;
- Related to the value of the lease; and
- Fixed, regular, and periodic.

Kuske v McSheridan (In re McSheridan), supra. In a shopping center lease, recurring charges for common area maintenance, insurance, and taxes typically meet the definition of "rent" and may be included in the claim. Note that the cap will apply to all damages resulting from lease termination. Hence, if the lease is terminated under state law before the bankruptcy, the damages limitation of 1 year or 15 percent under 11 USC §502(b)(6)(A) will apply to all amounts accruing from that prepetition termination date. *In re Connectix Corp.* (Bankr ND Cal 2007) 372 BR 488. This is true even if future damages attributable to lost rent for the full lease term were awarded to the landlord in a judgment before the bankruptcy. *Mid-Wilshire Assocs. v Lomax (In re Lomax)* (BAP 9th Cir 1996) 194 BR 862. Attorney fees

recoverable under such an action, however, may be claimed in addition to the capped amount of rental damages allowed by 11 USC §502(b)(6). See *Wall St. Plaza, LLC v JSJF Corp. (In re JSJF Corp.)* (BAP 9th Cir 2006) 344 BR 94, aff'd and remanded (9th Cir 2008) sub nom *JSJF Corp. v Wall St. Plaza, LLC (In re JSJF Corp.)* 2008 US App Lexis 10320.

On its face, 11 USC §502(b)(6) applies to cap damages "resulting from the termination of a lease of real property." Courts have reached divergent conclusions, however, concerning whether all of a landlord's potential damages against a debtor-tenant were subject to this statute. Previously, dicta in *Kuske v McSheridan (In re McSheridan), supra,* stating that a debtor's rejection of a lease "results in the breach of each and every provision of the lease, including covenants," suggested that a landlord's claim was limited to whatever could be included in a claim under §502(b)(6). 184 BR at 102. Under this analysis, if a landlord had damages from a tenant breach that did not meet the definition of "rent reserved" under *McSheridan,* not only could such damages not be included in the calculation of the claim allowed by §502(b)(6), but also they arguably could not be claimed at all. See, *e.g., In re Gantos, Inc.* (Bankr WD Mich 1995) 181 BR 903, 907 (unused construction allowance cannot be claimed separately from §502(b)(6)); *In re Pacific Arts Publ'g, Inc.* (Bankr CD Cal 1996) 198 BR 319, 322 (sustaining objection based on §502(b)(6) to lessor's claim for attorney fees); *In re Edwards Theatres Circuit, Inc.* (Bankr CD Cal 2002) 281 BR 675 (disallowing landlord's damages claim for failure to construct theater, without reaching scope of §502(b)(6)); *New Valley Corp. v Corporate Prop. Assocs. (In re New Valley Corp.)* 2000 US Dist Lexis 12663 (holding that deferred maintenance claim is subject to §502(b)(6) and disallowing claim because it did not meet the definition of "rent reserved").

This view was rejected in 2006 in *Wall St. Plaza, LLC v JSJF Corp., supra,* which clarified *McSheridan* and criticized *Pacific Arts Publ'g* and *Edwards Theatres Circuit,* in confirming that a lessor may have an uncapped claim for something other than damages resulting from the termination of the lease. The court explained that "the 'landlord's cap' of §502(b)(6) may limit the amount of a lessor's claim, but is not a criterion for its allowance." *Wall St. Plaza, LLC,* 344 BR at 101. Accordingly, the bankruptcy court's disallowance of a landlord's claim for attorney fees (in litigating a prepetition breach-of-lease case) because it is not for "rent" (as defined by *McSheridan*) is an error of law. In 2007, the Ninth Circuit confirmed that claims for damages not directly arising from the rejection of the lease are not limited by the §502(b)(6) cap, expressly overruling *McSheridan* to the extent that it suggests otherwise. *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978 (tort claims for waste, nuisance, and trespass arising from massive pile of dirt left on premises after rejection not subject to damages cap of §502(b)(6)).

These decisions are consistent with an established line of cases holding that certain kinds of damage claims that do not result from termination of the lease may be claimed by landlords in addition to their capped claims under §502(b)(6). See *In re Atlantic Container Corp.* (Bankr ND Ill 1991) 133 BR 980 (claim for intentional damage to property and failure to maintain); *In re Farley* (Bankr ND Ill 1992) 146 BR 739 (equipment taken); *In re Bob's Sea Ray Boats, Inc.* (Bankr D ND 1992) 143 BR 229 (property damages); *In re Q-Masters, Inc.* (Bankr SD Fla 1991) 135 BR 157 (property damages and vandalism); *In re Best Prods. Co.* (Bankr ED Va 1998) 229 BR 673 (allowing claim for prepetition deferred maintenance in addition to §502(b)(6) claim). Moreover, claims based on non-rent breaches may also be entitled to administrative priority, depending on when they occurred. Compare, *e.g., K-4, Inc. v Midway Engineered Wood Prods., Inc. (In re Treesource Indus.)* (9th Cir 2004) 363 F3d 994 (debtor's obligation to restore premises to prelease condition was a prepetition claim, not entitled to administrative priority); *In re Nat'l Refractories & Minerals Corp.* (Bankr ND Cal 2003) 297 BR 614 (cleanup costs would be allowable and allocable as an administrative or prepetition claim, according to when events giving rise to them occurred). Still, if the court is convinced that the claimed damages resulted directly from the rejection breach, the damages will not be allowed in addition to the capped amount allowable under §502(b)(6). See *In re Brown* (Bankr ND Ohio 2008) 398 BR 215 (refitting costs resulting from lease rejection included in capped claim).

PRACTICE TIP: Landlords with claims for damages resulting from breaches other than rejection or termination of the lease should claim them *in addition to* amounts allowable under 11 USC §502(b)(6). Such claims might include damages for failure to maintain, failure to keep the premises free of liens, failure to construct the premises, or attorney fees in litigating a prepetition breach of lease case. For a discussion regarding the recovery of attorney fees incurred in a bankruptcy proceeding, see §7.54.

Landlords with rent escalators in their leases should be aware that there is a split of authority concerning whether 15

percent "of the rent reserved" means the rent for the first 15 percent of the term remaining (a *time* calculation), or 15 percent of the total rent and charges to the end of the term (a *money* calculation). The former view, which seems to have the edge in California, generally reduces a landlord's claim by not allowing the landlord to include the value of escalated rent; the latter view allows landlords to claim a capped amount of escalated rental damages through the end of the lease term. Compare *In re Connectix Corp.* (Bankr ND Cal 2007) 372 BR 488 (time), *In re Iron-Oak Supply Corp.* (Bankr ED Cal 1994) 169 BR 414, 420 (time), and *In re Allegheny Intern., Inc.* (Bankr WD Pa 1991) 136 BR 396 (time), with *In re Gantos, Inc.* (Bankr WD Mich 1995) 176 BR 793 (money), *In re Today's Woman of Florida, Inc.* (Bankr MD Fla 1996) 195 BR 506 (money), and *In re Bob's Sea Ray Boats, Inc.* (Bankr D ND 1992) 143 BR 229 (money).

PRACTICE TIP: Counsel preparing a claim should clearly explain the basis for the claim and attach all relevant supporting documents, including a narrative explanation of the facts underlying the claim, the calculation of the claim amount, spreadsheets itemizing the amounts included in the calculation, and a copy of the lease. By doing so, landlords can invoke the presumption that their claim is prima facie valid under Fed R Bankr P 3001(f) and reduce the chance of a later objection to the claim. It will also help landlord counsel understand and defend the claim if an objection is made later. (Sometimes years can elapse between the filing date of a claim and the time the bankruptcy estate is actually deciding which claims to allow or challenge.)

Security deposits may only be applied to the *capped amount* of damages allowable on a landlord claim under §502(b)(6). See *AMB Prop., L.P. v Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)* (9th Cir 2005) 416 F3d 961; *Oldden v Tonto Realty Corp.* (2d Cir 1944) 143 F2d 916. Landlords holding deposits in excess of this sum may be required to disgorge such funds to the bankruptcy estate. *In re Pyxsys Corp.* (Bankr D Mass 2003) 288 BR 309, 319. Accordingly, secured landlords should consider applying deposits promptly in the event of a tenant default. Note, however, that the *Oldden* rule may not apply if the landlord never files a proof of claim. See discussion of *In re Stonebridge Technols., Inc.* (5th Cir 2005) 430 F3d 260 in §7.12. See also chap 8 on treatment of lease credit enhancements in bankruptcy.

For further discussion, see Wang & Bradbury, *Commercial Lease Termination Damages—Calculation and Application of the Bankruptcy Cap,* 26 Cal Real Prop J 33 (Spring 2008).

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§7.60 VI. SANCTIONS AND ETHICAL CONSIDERATIONS

The good faith mandates and remedies found in Fed R Civ P 11 apply to bankruptcy proceedings. See Fed R Bankr P 9011. Both rules require a good faith, objective basis for signing and filing pleadings in court proceedings. When the court determines that a bankruptcy petition is filed not to reorganize, but simply to delay an existing proceeding and frustrate a creditor, the case may be properly dismissed for bad faith, with sanctions ordered against the debtor. See *Price v U.S. Trustee (In re Price)* (9th Cir 2004) 353 F3d 1135 (dismissal of Chapter 7 appropriate if debtor could have paid debts through Chapter 13); *Moneymaker v CoBen (In re Eisen)* (9th Cir 1994) 31 F3d 1447. For further discussion, including creditors' remedies for bad faith conduct of the debtor or debtor's counsel, see §§4.9, 4.72, 4.79-4.91.

When an otherwise solvent debtor files bankruptcy for the purpose of obtaining the limit on a landlord's claims for damages for breach of lease provided by 11 USC §502(b)(6), the case may be properly dismissed. See *NMSBPCSLDHB, LP v Integrated Telecom Express, Inc. (In re Integrated Telecom Express, Inc.)* (3d Cir 2004) 384 F3d 108; *In re Liberate Technols.* (Bankr ND Cal 2004) 314 BR 206, 214; and authorities cited in §7.34. If a tenant files a petition in bankruptcy solely to avoid eviction, the filing may constitute an abuse of the bankruptcy process, and may subject both the tenant and his or her attorney to sanctions. See *National Home Equity Corp. v Villareal (In re Villareal)* (Bankr CD Cal 1984) 46 BR 284 (filing for bankruptcy solely to avoid foreclosure when debtor has no unsecured debts subjects debtor and attorney to sanctions). Note that BAPCPA contains a special exception to the automatic stay if a judgment for possession of residential rental property has been entered before the bankruptcy. See 11 USC §362(b)(22), discussed in §7.16. The court may also sanction an attorney if it finds that a petition was unjustifiably filed to frustrate a pending eviction. *Norwest Mortgage, Inc. v Waters (In re Waters)* (Bankr ED Wis 1986) 60 BR 339, 343.

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§7.61 VII. LANDLORD BANKRUPTCIES

Until recently, bankruptcy filings by landlords were the subject of few reported decisions, received scant attention in commentaries, and were virtually disregarded in certain sections of the Bankruptcy Code (see §7.63). However, the Bankruptcy Code does recognize the significant differences between the interests and concerns of a nondebtor-tenant following the landlord's bankruptcy filing and the interests and concerns of a nondebtor-landlord following the tenant's bankruptcy filing. A nondebtor-tenant is likely to be primarily concerned with retaining possession and use of the leased premises and in receiving the benefits of any reciprocal easement agreement or other covenants in the lease. This is true in the ground lease context, in which the landlord often has few ongoing obligations under the lease, and in retail and office leasing, in which the landlord has many lease obligations (*e.g.,* general maintenance and security of common areas, construction of premises).

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§7.62 A. Generally

A nondebtor-tenant generally may retain possession of the leased premises, even if the debtor-landlord elects to reject the lease. 11 USC §365(h); see §7.64. Notwithstanding the provisions of §365(h), the holding in *Precision Indus., Inc. v Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)* (7th Cir 2003) 327 F3d 537 has given some tenants cause for concern. The case holds that under 11 USC §365(f), a landlord in bankruptcy may have the right to sell its interest in a property that it has ground leased to a third party, "free and clear" of the ground lease, without regard to 11 USC §365(h). The tenant may request the court to prohibit or condition such sale as necessary to provide "adequate protection" of the tenant's interest. 11 USC §363(e). However, the *Qualitech* court specifically states that "'[a]dequate protection' does not necessarily guarantee a lessee's continued possession of the property, but it does demand, in the alternative, that the lessee be compensated for the value of its leasehold, typically from the proceeds of the sale." 327 F3d at 548.

Courts in other circuits have declined to follow *Qualitech*. See, *e.g., In re Haskell L.P.* (Bankr D Mass 2005) 321 BR 1 (sale "free and clear" of lease, when debtor did not offer or provide adequate protection for tenant's interest, cannot be approved over tenant's objections). Although the issue of whether a landlord may sell the real property to a third party (unencumbered by a tenant's estate) remains unsettled in the Ninth Circuit, tenants that desire to retain possession of leased premises must monitor proceedings and oppose any proposed sale that does not adequately protect the tenant's interests. As noted by the *Qualitech* court, 11 USC §363 provides a mechanism to protect the interests of tenants, even if the sale is not prohibited by 11 USC §365(h).

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§7.63 B. Assumption and Rejection

Bankruptcy Code §365 does not specify a time period for assumption or rejection of an unexpired lease of nonresidential property under which the debtor is a commercial landlord. By the express terms of §365(d)(4), the statutory time limits for assumption or rejection of an unexpired lease for nonresidential real property are applicable only when the debtor is a tenant. See §7.46. Section 365(d)(2), which allows assumption or rejection at any time before the confirmation of a plan, broadly applies to "an executory contract or unexpired lease of residential real property or of personal property."

One way to address the failure of §365 to specify a time period for assumption or rejection of a debtor-landlord's commercial lease would be to apply the time limits set by §365(d)(2). See 3 Collier on Bankruptcy ¶365.04[5] (15th ed rev 1996) (better approach would be to apply the rule of §365(d)(2) in recognition of the apparent oversight by Congress). However, the Ninth Circuit held that the language of §365(d)(3) did not apply broadly to all executory contracts. Rather, the Ninth Circuit narrowly interpreted the language as "an unexpired lease of nonresidential real property" to apply only to cases in which the debtor is the tenant. *Einstein/Noah Bagel Corp. v Smith (In re BCE W., LP)* (9th Cir 2003) 319 F3d 1166. A court interpreting §365(d)(2) may consider itself bound to apply the same method of statutory construction employed in *Einstein/Noah Bagel,* and find that §365(d)(2) does not apply to nonresidential leases under which the debtor is the landlord.

If §365(d)(2) is deemed to apply when the debtor is a commercial landlord, the nondebtor-tenant can request that the court order the trustee or debtor in possession to make an earlier determination of whether to assume or reject the ground lease. 11 USC §365(d)(2). Otherwise, a motion can be made by a nondebtor-tenant pursuant to 11 USC §105(d)(2), which expressly authorizes the court to set the date by which the estate must assume or reject an unexpired lease. Generally, when no period is specified, courts, depending on the facts and circumstances of a particular case, have allowed the estate a reasonable time to decide whether to reject or assume executory contracts. See, *e.g., In re Whitcomb & Keller Mortgage Co.* (7th Cir 1983) 715 F2d 375. See *Zions Credit Corp. v Rebel Rents, Inc. (In re Rebel Rents, Inc.)* (Bankr CD Cal 2003) 291 BR 520, 530, for a discussion of factors that courts have considered to determine what constitutes a reasonable time to decide whether to reject or assume.

Although a lease would be deemed rejected under §365(d)(4) if the debtor is the tenant and no action is taken (see §7.56), no similar provision exists for deemed rejection when the landlord is the debtor. If the estate takes no action to assume or reject the lease, the lease may "ride through" or "pass though" the proceeding and be binding on the parties after discharge is granted. See §6.11.

NOTE: The classic statement of the "ride-through" or "pass-through" doctrine appears in *Consolidated Gas, Elec. Light, & Power Co. v United Rys. & Elec. Co.* (4th Cir 1936) 85 F2d 799, 805 (if executory contract is not in default when bankruptcy case commences, contract remains in force unless rejected and, if not rejected, "passes with other property to the reorganized" debtor).

In practice, however, tenants in a landlord bankruptcy may prefer the certainty provided by 11 USC §365(h), which allows a tenant to retain possession of the premises if the term of the lease has commenced, and to offset against the rent the value of any damage caused by the landlord's nonperformance following rejection of the lease. See §§7.64-7.67. As such, instead of allowing a "ride-through" in the context of an unexpired ground lease, a tenant may prefer to request the court to require the estate to make a decision on assumption or rejection. See, *e.g., In re Resource Technol. Corp.* (Bankr ND Ill 2000) 254 BR 215.

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§7.64 C. When Landlord Rejects Lease

The rejection of the lease generally relieves the debtor-landlord of its obligations under the lease, including the obligation to continue providing services to the tenant following rejection of the lease. See, *e.g., In re Lee Road Partners, Ltd.* (Bankr ED NY 1993) 155 BR 55, 60, aff'd (ED NY 1994) 169 BR 507. The tenant may choose to treat the lease as terminated. 11 USC §365(h)(1)(A). Additionally, the tenant may choose to remain in possession and offset any damages caused by the landlord's nonperformance after the date of rejection against rent reserved under the lease. 11 USC §365(h)(1)(B). The tenant may not assert a claim against the estate for the landlord's nonperformance after the date of rejection, which effectively limits the tenant's recovery for postrejection default damages to the offset against the amount of rent reserved under the lease as it becomes due. 11 USC §365(h)(1)(B). However, the tenant is not barred from asserting an unsecured claim against the estate for damages arising from the landlord's nonperformance before the date of rejection. See §7.48.

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§7.65 1. Tenant's Rights When Landlord Rejects Lease

Bankruptcy Code §365(h) provides specific rights and remedies for nondebtor-tenants if the landlord files for bankruptcy and rejects the lease. If the term of the lease has commenced, the tenant may elect to retain its rights under the lease that are in or appurtenant to the real property for the remainder of the lease term and for any renewal or extension term, including any rights relating to (11 USC §365(h)(1)(A)(ii)):

- The amount and timing of payment of rent and other amounts due under the lease;
- Use of the premises;
- Possession of the premises, which may include the benefits of reciprocal easements if these are property rights encompassed within the defined premises;
- Quiet enjoyment;
- Subletting and assignment; and
- Hypothecation.

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§7.66 2. Enforceability of Lease Provisions in Shopping Center Lease

If the lease premises are located in a shopping center, and the tenant elects to retain its rights under the terms of such lease, rejection of the lease by the trustee does not affect the enforceability of lease provisions pertaining to (11 USC §365(h)(1)(C)):

- Radius;
- Location;
- Use;
- Exclusivity; or
- Tenant mix or balance.

See §7.53 on special bankruptcy rules for shopping centers.

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§7.67 3. Tenant's Right to Treat Lease as Terminated

If the tenant does not desire to retain its rights under the lease following the landlord's rejection, the tenant may elect to treat the lease as terminated under 11 USC §365(h)(1)(A)(i). If the tenant elects to treat the lease as terminated, the tenant may assert a claim against the estate. See, *e.g., Milstead v Tele Media Broadcasting, Inc. (In re Milstead)* (Bankr ED Va 1996) 197 BR 33 (tenant not required to consider disparity between amount of potential claims in deciding whether or not to retain rights under leases).

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VIII. BANKRUPTCY FORMS

§7.68 A. Notice of Stay of Proceedings

The Judicial Council adopted the form Notice of Stay of Proceedings (Judicial Council Form CM-180) for mandatory use in a state court action to advise other parties and the court of the filing of a bankruptcy. The form is available on the Judicial Council's website. See Directory. Under Cal Rules of Ct 3.650(a), the party that caused the stay must file a notice of the stay and attach a copy of the petition or other document that gives notice of the stay of the state court proceeding. Under Cal Rules of Ct 3.650(c), the notice must state whether the action is stayed as to all parties or only certain parties. If the latter, those parties must be identified in the notice. Under Rule 3.650(d), when the stay is vacated or terminated, the party who files the notice must immediately file and serve a notice of termination or modification of the stay. See also §§7.2, 7.5, 7.74.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/7 Residential and Commercial Leases/ §7.69 B. Form: Request for Special Notice

§7.69 B. Form: Request for Special Notice

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
Attorney for Claimant, _ _[*name*]_ _

United States Bankruptcy Court
_ _ _ _ _ _ _ _ District of California

In re _ _[*name(s)*]_ _,	)	**Bk. No.** _ _ _ _ _ _
Debtor(s)	)	**Chapter** _ _
	)	
	)	**REQUEST FOR SPECIAL**
_____	)	**NOTICE**

TO THE CLERK OF THE UNITED STATES BANKRUPTCY COURT, THE DEBTOR AND ITS COUNSEL OF RECORD, THE TRUSTEE AND ITS COUNSEL OF RECORD, AND ALL OTHER INTERESTED PARTIES AND THEIR COUNSEL OF RECORD:

Pursuant to Bankruptcy Rule 2002, claimant _ _[*name*]_ _ hereby appears in this action and requests that notice of all actions, proceedings, dismissals, orders, and filings in this action be sent to the claimant in care of the following address:

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature of attorney*]__
_ _[*Name of attorney*]_ _
Attorney for Claimant,
_ _[*name*]_ _

Copies: Original (file in bankruptcy court with original proof of service); copies for service (one each for debtor, debtor's attorney, trustee of the bankruptcy estate, and U.S. Trustee); office copy; client copy.

Comment: Some bankruptcy court districts (*e.g.,* the Central District of California) have a court-prescribed form "request for special notice," available online. The Central District has limited the use of a paper-filed request. Always check if such a form exists and whether its use is mandatory. The Central District also has in its electronic filing system a Request for Courtesy Notification of Electronic Filing (NEF). See Directory for the court's website. In the Northern District, there is a window in the electronic filing system to make a request for notice; the manual explaining that procedure may be found on the court's website; see Directory.

Any interested person may paper file a request for special notice with the bankruptcy court under Fed R Bankr P 2002. See §§7.2, 7.27. Most bankruptcy courts require that notice of a motion for relief from the automatic stay (and other proceedings) be served on all persons who have filed a request for special notice. Counsel should carefully check local rules and forms. Always attach a proof of service indicating the names of persons served, including the debtor in pro per or debtor's counsel, the bankruptcy trustee, and the U.S. Trustee. The proof of service should identify the capacity and address of each person served.

WARNING: Most bankruptcy courts have moved away from paper filing. For example, since January 1, 2005, the Northern District of California has required all documents to be electronically filed, which requires special training, a login name, and a password. See Northern District of California Bankruptcy Court, Amended Operating Order,

August 15, 2005. In such courts, paper filings *will not be accepted,* unless the filer obtains an order allowing an exemption. The Northern District has a form application for exemption that lists the limited circumstances in which an exemption is available, including "Infrequent-Filer." See Northern District of California Bankruptcy Court, Revised Application for Exemption From Electronic Filing. Nonbankruptcy practitioners intending to file papers in the bankruptcy court should consult the local rules for filing requirements in the court in which the matter is pending. See Directory for court websites.

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C. Landlord's Claim Forms

§7.70 1. Proof of Claim

A creditor's claim form, Proof of Claim (Official Bankruptcy Form B10), is available on the website of local bankruptcy courts (see Directory) and in all bankruptcy court clerks' offices, and should be used for general, unsecured claims, *e.g.,* prepetition delinquent rent and damages resulting from lease rejection are each paid as general, unsecured claims. Note that unlike other bankruptcy court filings, proofs of claim are not always required to be served. Counsel should consult the bar date order setting the procedure for filing and service of claims, or the local rules if there is no bar date order. On the use of this form, see §§7.12, 7.30-7.31, 7.39, 7.42, 7.47, 7.59. On claim filing requirements, see Fed R Bankr P 3001-3022, local bankruptcy court rules, and regional U.S. Trustee Guidelines, since requirements may vary among regions, districts, and individual court departments. See also Warning at §7.69 regarding electronic filing requirements in some courts.

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§7.71 2. Form: Landlord's Request for Payment of Postpetition Administrative Rent; Sample Letter to Debtor's Counsel

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
Attorney for Landlord, _ _[*name*]_ _

United States Bankruptcy Court
_ _ _ _ _ _ _ _ District of California

In re _ _[*name(s)*]_ _, **Debtor(s)**	)	**Bk. No.** _ _ _ _ _ _
	)	**Chapter** _ _
	)	
	)	**LANDLORD'S REQUEST FOR**
	)	**PAYMENT OF POSTPETITION**
	)	**ADMINISTRATIVE RENT [11**
_____	)	**USC §§365(d)(3), 503(b)]**

PLEASE TAKE NOTICE that _ _[*name of landlord*]_ _ **(Claimant), as landlord of those certain nonresidential premises located at** _ _[*address*]_ _ **(Premises), hereby requests immediate payment of $**_ _[*amount*]_ _ **in postpetition rental charges payable as administrative expenses for the period of** _ _[*date of default on postpetition lease obligations*]_ _ **through** _ _[*date premises vacated*]_ _**, as described below.**

On or about _ _[*date*]_ _**, Claimant as the landlord, and debtor as the tenant, entered into a written lease for approximately** _ _[*number*]_ _ **square feet of commercial space in the Premises. The debtor filed its petition in bankruptcy on** _ _[*date*]_ _**, and remained in possession of the property after that date.**

Claimant sought debtor's cooperation in immediately rejecting the lease but debtor declined to do so. During the postpetition period, the debtor remained current on the rentals required under the lease for a period of time, but failed to pay any amounts due under the Lease after _ _[*date of default on postpetition lease obligations*]_ _**. Debtor's time to assume or reject the lease expired on** _ _[*date*]_ _**, on which date the lease was deemed rejected by operation of law under Bankruptcy Code §365(d)(4). On** _ _[*date premises vacated*]_ _**, the debtor relinquished the keys to the Premises and restored Claimant to lawful possession. A calculation and itemization of the amount of the claim, with supporting invoices, is attached hereto.**

WHEREFORE, Claimant hereby requests the debtor to make immediate payment of its postpetition administrative rent claim.

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Claimant, _ _[*name*]_ _

[*Attach itemization of rent claim*]

ITEMIZATION OF ADMINISTRATIVE RENT CLAIM

Rent (pro rata)	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
CAM	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
Taxes	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
Total Rent Claim	_ _[*applicable dates*]_ _	$_ _[*total amount*]_ _

[*Attach supporting invoices or equivalent documentation*]

SAMPLE LETTER TO DEBTOR'S COUNSEL

[*This may accompany or precede the above Request for Payment.*]

Re: _ _[*Caption and bankruptcy case number*]_ _

Dear _ _[*name of debtor's counsel*]_ _**:**

To follow up on my conversations with your office earlier this _ _[*week/month*]_ _**, enclosed please find the landlord's request that the debtor immediately remit the sum of $**_ _[*amount*]_ _ **due and owing for postpetition rent and charges for the period of** _ _[*date of default on postpetition lease obligations*]_ _ **through** _ _[*date premises vacated*]_ _**. The request includes an itemization of the total and supporting invoices.**

Although you have admitted that your client owes rent through _ _[*date lease deemed rejected by operation of law*]_ _**, you have denied responsibility for rent after that date. My client, however, did not obtain possession until** _ _[*date premises vacated*]_ _**.**

[*If appropriate, add*]

Your client changed the locks on the premises while it was in possession, and despite my best efforts to have the keys returned as soon as possible in order to restore my client to possession, the keys were not returned until _ _[*date premises vacated*]_ _**.**

[*Continue*]

Please check with your client about this, and I think you will conclude that your client, in fact, retained possession and control through _ _[*date premises vacated*]_ _**. As you know, we had been seeking possession since directly after the bankruptcy was filed—we certainly wanted it as soon as possible.**

In any event, unlike other types of administrative claims, postpetition rent is required to be paid timely, and no motion should be necessary. 11 United States Code §365(d)(3). Further, if we are forced to incur attorney fees to enforce our rights under the lease, we can collect those fees as an administrative claim as well. *In re Narragansett Clothing Co.* (Bankr D RI 1990) 119 BR 388. As I mentioned previously, however, I would like to handle this as economically as possible to avoid unnecessary expense to both sides.

Please let me know if the debtor will pay our postpetition rent claim without requiring us to file a motion and set it for hearing. If there is an informal way to resolve this issue, let me know what you suggest. I look forward to hearing from you soon.

Very truly yours,

_ _[*Name of landlord's counsel*]_ _

Copies: Original (file in bankruptcy court with original proof of service); copies for service (one each for debtor, debtor's attorney, trustee of the bankruptcy estate, U.S. Trustee, and other persons as required by rules); office copy; client copy.

Comment: This form should be used to request payment of administrative priority claims, such as postpetition rent. The formal request may be preceded by a letter request, a sample of which accompanies this form. On the use of this form, see §§7.42, 7.49, and Warning at §7.69 regarding electronic filing requirements in some courts.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/7 Residential and Commercial Leases/ §7.72 3. Form: Notice of Motion and Motion for Allowance and Payment of Administrative Rent Claim; Supporting Memorandum; Supporting Declarations

§7.72 3. Form: Notice of Motion and Motion for Allowance and Payment of Administrative Rent Claim; Supporting Memorandum; Supporting Declarations

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
Attorney for Movant, _ _[*name of landlord*]_ _

United States Bankruptcy Court
_ _ _ _ _ _ _ _ District of California

In re _ _[*name(s)*]_ _,	)	**Bk. No. _ _ _ _ _ _**
Debtor(s)	)	**Chapter _ _**
	)	
	)	**NOTICE OF MOTION AND**
	)	**MOTION FOR ALLOWANCE**
	)	**AND PAYMENT OF**
	)	**ADMINISTRATIVE RENT**
	)	**CLAIM; SUPPORTING**
	)	**MEMORANDUM;**
	)	**SUPPORTING**
	)	**DECLARATIONS [11 USC**
	)	**§§503, 365(d)(3)]**
	)	
	)	**Hearing: _ _[*date; time*]_ _**
	)	**Dep't: _ _[*number*]_ _**
	)	**Courtroom: _ _[*number*]_ _**
_____	)	**Hearing judge: _ _[*name*]_ _**

TO THE HONORABLE _ _[*name*]_ _, UNITED STATES BANKRUPTCY JUDGE, THE DEBTOR AND ITS COUNSEL OF RECORD, THE UNSECURED CREDITORS' COMMITTEE AND ITS COUNSEL OF RECORD, THE OFFICE OF THE UNITED STATES TRUSTEE, AND ALL OTHER PARTIES IN INTEREST:

PLEASE TAKE NOTICE that on _ _[*date and time*]_ _, or as soon thereafter as counsel may be heard, before the Honorable _ _[*name*]_ _, United States Bankruptcy Judge, in Courtroom _ _[*number*]_ _ of the United States Bankruptcy Court, located at _ _[*address*]_ _, _ _[*name of landlord*]_ _ (Movant) will and hereby does move for allowance and payment of an administrative expense in the amount of $_ _[*amount of rent claim*]_ _ and $_ _[*amount of attorney fees earned*]_ _, for a total of $_ _[*amount*]_ _. Movant brings this motion pursuant to 11 United States Code §§503(a), 503(b)(1), and 365(d)(3) to obtain compensation for the postpetition use by _ _[*name of debtor*]_ _ (Debtor) of the premises located at _ _[*address*]_ _ (the Premises) for the period of _ _[*date of default on postpetition lease obligations*]_ _ through _ _[*date premises vacated*]_ _, under a lease executed on _ _[*date*]_ _ (Lease) between the Debtor as tenant and the Movant as landlord.

This motion for allowance and payment of the administrative claim is based on this Notice of Motion and Motion, the accompanying memorandum and exhibits, all matters of record in this case, the attached Declaration(s) of _ _[*name(s)*]_ _, and any arguments or evidence adduced before or at the hearing. Any opposition to the Motion must be in writing, filed with the Clerk of the Bankruptcy Court and served on undersigned counsel at least _ _[*e.g., 11*]_ _days before the scheduled hearing date. Any failure to file and serve timely opposition shall result in a waiver of any objection to the relief sought in the Motion.

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Movant, _ _[*name*]_ _

MEMORANDUM

I. INTRODUCTION AND FACTS

This is a motion for allowance and payment of an administrative claim for both postpetition rent and the attorney fees incurred in collecting the rent claim. Movant is the owner of nonresidential real property located at _ _[*address*]_ _ (the Premises). On or about _ _[*date*]_ _, the Debtor entered into a written lease of the Premises (the Lease) for a term of _ _[*e.g., 5*]_ _ years. _ _[*Refer to supporting evidence, e.g., paragraph number of declaration of party or party witness.*]_ _ A true and correct copy of the Lease is attached to the declaration of _ _[*name*]_ _ as Exhibit "A" and is hereby incorporated by reference.

On _ _[*date*]_ _, the Debtor filed its petition commencing the present case under Chapter 11.

On or about _ _[*date*]_ _, the Debtor filed a motion for an order authorizing rejection of the Lease. The Motion stated that the Debtor intended to vacate the Premises on _ _[*date*]_ _. Debtor, in fact, did vacate the Premises on that date. _ _[*Refer to supporting evidence.*]_ _

From the date of the bankruptcy filing until _ _[*date*]_ _, the Debtor was in possession of and doing business at the Premises. Despite the provisions of 11 United States Code §365(d)(3), which required the Debtor, as a debtor in possession, to make timely payments of all amounts due under the Lease pending assumption or rejection, and despite written and oral requests that it do so, the Debtor failed to pay any rent or charges for the postpetition, prerejection period of _ _[*date of default on postpetition lease obligations*]_ _ through _ _[*date premises vacated*]_ _. _ _[*Refer to supporting evidence.*]_ _ These charges are based on the testimony in _ _[*refer to supporting evidence, e.g., paragraph 6, declaration of party witness*]_ _, and are calculated as follows:

Rent	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
CAM	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
Taxes	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
Total Rent Claim	_ _[*applicable dates*]_ _	$_ _[*total amount*]_ _

The Lease also provides that Movant is entitled to reimbursement of attorney fees incurred in collecting unpaid rent and related charges. Movant expects to incur $_ _[*amount*]_ _ in attorney fees in bringing this Motion. _ _[*Refer to supporting evidence.*]_ _ Thus, Movant has an administrative claim against the Debtor in the sum of $_ _[*insert sum of total rent claim and attorney fees*]_ _.

II. ARGUMENT

Section 365(b)(3) of the Bankruptcy Code provides that a debtor in possession shall timely perform all obligations "arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected, notwithstanding section 503(b)(1) of this title." These provisions have not been changed by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

In *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401, the Ninth Circuit concluded that the trustee's failure to pay rent under a nonresidential real estate lease for the period prior to the rejection of the lease created an allowed administrative claim, regardless of the actual value conferred by the lease on the estate. Thus, it is clear that Movant is entitled to an administrative claim for the full contractual rent due and unpaid for the postpetition, prerejection period of _ _[*date of default on postpetition lease obligations*]_ _ through _ _[*date premises vacated*]_ _, the date the Lease was rejected and possession was returned to Movant. It is also clear that Movant is entitled to immediate payment of the outstanding postpetition Rent.

In addition, insofar as the Debtor failed to comply with section 365(d)(3) by refusing to pay postpetition rent for the subject period, Movant is entitled to an administrative claim for attorney fees incurred in bringing this Motion and immediate payment thereof. *In re Pacific Sea Farms, Inc.* (Bankr D Haw 1991) 134 BR 11; *In re Narragansett Clothing Co.* (Bankr D RI 1990) 119 BR 388, 391; *In re Revco D.S., Inc.* (Bankr ND Ohio 1989) 109 BR 264, 272.

Movant is thus entitled to allowance and payment of an administrative claim in the amount of $_ _[*enter sum of total rent claim and attorney fees*]_ _, the amount due and unpaid under the terms of the Lease for the postpetition, prerejection period of _ _[*date of default on postpetition lease obligations*]_ _ through _ _[*date premises vacated*]_ _, including attorney fees incurred in bringing this Motion.

III. CONCLUSION

For all the foregoing reasons, Movant respectfully requests that its administrative claim for compensation for Debtor's postpetition use of the Premises be allowed in the amount of $_ _[*enter sum of total rent claim and attorney fees*]_ _ and that the Court order the Debtor to pay said administrative claim immediately.

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature*]__
_ _[*Typed name*]_ _
Attorney for Movant, _ _[*name*]_ _

DECLARATION OF _ _[*name of party witness*]_ _

I, _ _[*name of party witness*]_ _**, declare:**

1. I am a principal of _ _[*name of entity*]_ _**, which is the property manager for** _ _[*name of landlord*]_ _ **(Movant), the owner of nonresidential real property located at** _ _[*address*]_ _ **(the Premises). I am over the age of 18 years, and of competent mind. If called upon, I could and would testify competently thereto.**

2. On or about _ _[*date*]_ _**, the Debtor entered into a written lease of the Premises (the Lease) for a term of** _ _[*e.g., 5*]_ _ **years. A true and correct copy of the Lease is attached hereto as Exhibit "A" and incorporated herein by reference.**

3. The Debtor vacated the Premises on _ _[*date*]_ _**.**

4. From the date of the bankruptcy filing until _ _[*date premises vacated*]_ _**, the Debtor was in possession of and doing business at the Premises.**

5. The total rent and charges ordinarily due on a monthly basis under the Lease are $_ _[*total amount*]_ _**, which is comprised of $**_ _[*amount*]_ _ **for base rent, $**_ _[*amount*]_ _ **for property taxes, and $**_ _[*amount*]_ _ **for common area maintenance (CAM) charges (collectively, the Rent).**

6. The Debtor failed to pay rent, CAM charges, and taxes for the period of _ _[*date of default on postpetition lease obligations*]_ _ **through** _ _[*date premises vacated*]_ _**. Thus, the total amount of unpaid rent and charges owing and prorated for that period under the Lease, all of which became due after the date of the bankruptcy filing, consists of:**

Rent	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
CAM	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
Taxes	_ _[*applicable dates*]_ _	$_ _[*amount*]_ _
Total Rent Claim	_ _[*applicable dates*]_ _	$_ _[*total amount*]_ _

7. The Lease provides that Movant is entitled to attorney fees incurred in collecting unpaid rent and related charges.

8. On _ _[*date*]_ _**, I spoke with** _ _[*name*]_ _**, a representative of Debtor, who told me that the Debtor would not pay the above rent and charges without clearance from** _ _[*name*]_ _**, the Debtor's bankruptcy attorney.**

I declare under penalty of perjury under the laws of the United States that the foregoing is true and correct. Executed on _ _[*date*]_ _**, at** _ _[*city*]_ _**, California.**

Date: _ _ _ _ _ _ __[*Signature of declarant*]__
_ _[*Typed name*]_ _

DECLARATION OF _ _[*name of landlord's counsel*]_ _

I, _ _[*name of landlord's counsel*]_ _, declare:

1. I am licensed to practice law before this Court. I am _ _[*an associate/a member/an employee*]_ _ **of** _ _[*name of firm*]_ _**, counsel of record for** _ _[*name of landlord*]_ _**, Movant in the motion to which this Declaration is attached. I have personal knowledge of the facts set forth herein and, if sworn as a witness, could testify competently thereto.**

2. On _ _[*date*]_ _**,** _ _[*name*]_ _**, counsel for the Debtor, contacted me and** _ _[*e.g., asked that my client* _ _[*name of landlord*]_ _ *stipulate to the rejection of its lease for the subject premises*]_ _**. I told counsel for the Debtor that** _ _[*e.g., my client would stipulate if the Debtor paid any and all postpetition amounts owing through the date of the rejection*]_ _**.**

3. On _ _[*date*]_ _**, I sent a letter to** _ _[*name of debtor's counsel*]_ _**, by fax, outlining the postpetition amounts that were due under the lease. A true and correct copy of the letter is attached hereto as Exhibit B.**

4. On _ _[*date*]_ _**, I called** _ _[*name of debtor's counsel*]_ _ **to inquire about the rejection motion that I had received and the status of the postpetition rent payments that were still outstanding. I asked if the Debtor would pay the rent and charges through the date of rejection. Counsel told me** _ _[*e.g., that she would have to check with her client and that she would get back to me the following week*]_ _**.**

5. On _ _[*date*]_ _**, I again called** _ _[*name of debtor's counsel*]_ _**, who said that the Debtor would not pay rent currently because the lease was "being rejected," and that my client would have an administrative claim for that rent. When I protested that §365(d) of the Bankruptcy Code required the Debtor to pay postpetition lease obligations currently until the lease was rejected, counsel said** _ _[*e.g., we would have to make a motion if we wanted to get paid*]_ _**.**

6. I have spent _ _[*e.g., 7*]_ _ **hours researching and drafting the attached Motion for Allowance and Payment of Administrative Rent Claim. I estimate that I will spend an additional** _ _[*e.g., 2*]_ _ **hours traveling to and attending the hearing on said Motion. My usual hourly rate for services I provide on this type of motion is $**_ _[*amount*]_ _ **per hour. Accordingly, my client** _ _[*name of landlord*]_ _ **will incur fees of $**_ _[*total amount*]_ _ **with respect to this Motion.**

I declare under penalty of perjury under the laws of the United States that the foregoing is true and correct. Executed on _ _[*date*]_ _**, at** _ _[*city*]_ _**, California.**

Date: _ _ _ _ _ _ __[*Signature of declarant*]__
_ _[*Typed name*]_ _

Copies: Original (file in bankruptcy court with original proof of service); copies for service (one each for debtor, debtor's attorney, trustee of the bankruptcy estate, U.S. Trustee, and other persons as required by rules); office copy; client copy.

Comment: This is a motion for the payment of an administrative priority claim for postpetition rent that became due before rejection of the lease either by debtor's motion or by operation of law. Note that the landlord cannot claim prepetition rent as an administrative claim (see §7.70). On the use of this form, see §§7.41-7.42, 7.47-7.49. If the formal request and motion is preceded by a demand letter for payment of postpetition rent (see sample in §7.71), a copy of the letter attached to the declaration of counsel may give additional support to the request for attorney fees. See also Warning at §7.69 regarding electronic filing requirements in some courts.

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§7.73 D. Central District Bankruptcy Court Stay Relief Forms

The U.S. Bankruptcy Court, Central District of California, adopted as mandatory a number of stay relief motion and court order forms, which must be used unless the individual judge or court department makes these motion forms or any other preprinted form optional. The Central District has also adopted an optional, preprinted form for use in opposing a stay relief motion, unless an individual judge or court department makes this form mandatory. These forms and others are available online at the Central District Bankruptcy Court's website. See Directory. Attorneys are cautioned to investigate prescribed formats, notice periods, and other requirements, as these may vary among the court departments. See §7.25. All districts require some form of cover (or information) sheet for the motion; these may be obtained from the respective clerks' offices.

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§7.74 E. Notice of Termination or Modification of Stay

The California Judicial Council adopted the form Notice of Termination or Modification of Stay (Judicial Council Form CM-181) for mandatory use in a state court action to advise other parties and the court of a termination or modification of the automatic stay. The form is available on the Judicial Council's website; see Directory. Under Cal Rules of Ct 3.650(d), the party that filed the notice of stay must immediately serve and file a notice that the stay is vacated, terminated, modified, or no longer in effect. See also §7.68.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/8 Lease Credit Enhancements/Chapter Outline

8

Lease Credit Enhancements

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II. CREDIT ENHANCEMENT INSTRUMENTS §8.2
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§8.1 I. INTRODUCTION

This chapter addresses several issues that arise when a tenant files for bankruptcy, and focuses on the nature, scope, and enforceability of lease credit enhancement instruments. Because a tenant's bankruptcy can subject the landlord to significant financial hardship, many landlords question the prudence of entering into a lease with a credit-risky tenant, no matter how well the lease is secured by credit enhancement. This sentiment is particularly justified when a tenant enters into bankruptcy, which threatens to stifle the landlord's ability to realize the tenant's lease security.

Once a tenant files for bankruptcy protection, the goal of the bankruptcy administrator of the debtor's estate is fairly straightforward—to gather and liquidate all the assets of the debtor for disbursement to the debtor's creditors. The debtor or trustee will probably claim that any security held by a landlord under the terms of a lease is an asset of the bankruptcy estate.

This chapter reviews the impact of the Bankruptcy Code and California law on the rights of commercial landlords holding credit enhancements securing their leases. Tenants do not often structure their leases with an eye toward filing for bankruptcy at a later date; therefore, this chapter is somewhat landlord-oriented.

This chapter does not address the many procedural issues involved when a tenant files for bankruptcy protection. For thorough review of such procedural issues, see chap 7. For discussion of ramifications for tenants of a commercial landlord's bankruptcy, see §§7.61-7.67.

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§8.2 II. CREDIT ENHANCEMENT INSTRUMENTS

Historically, sophisticated landlords have sought to enter into leases only with "creditworthy" tenants—*i.e.,* those tenants with a significant operating history, substantial tangible assets, and a meaningful net worth. With creditworthy tenants, landlords have relied on the tenant's signature, or that of an affiliated guarantor, to satisfy the landlord's credit concerns. Tenants that do not possess "creditworthy" qualities are usually required to post financially secure, liquid credit instruments to secure their lease obligations. Landlords typically require that such credit instruments be capable of quick liquidation on a tenant's default.

There are several types of credit enhancement instruments, each with significantly different characteristics and varying degrees of acceptability in the landlord community. These instruments include letters of credit (see §§8.3-8.4), lease bonds (see §§8.5-8.6), certificates of deposit (see §8.7), and cash (see §8.8).

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A. Letters of Credit

§8.3 1. General Terms

The most widely used and accepted method of credit enhancement in a lease with a credit-risky tenant is an irrevocable letter of credit. A letter of credit is a written undertaking issued by a financial institution that is a promise to pay money to the landlord/beneficiary on written notice from the beneficiary that the money is due and owing under the lease. See UCC §5-102(a)(10); Com C §5102(a)(10). The tenant's agreement that the money is owed to the landlord is not required. The tenant pays the financial institution a fee to issue the letter of credit and typically collateralizes its obligation to repay and draw on the letter of credit with assets that have varying degrees of liquidity. Letters of credit are used in a variety of commercial situations. In the commercial lease context, landlords often seek to substitute a bank's financial integrity or reputation for that of a credit-risky tenant. Commercial leases are usually structured to allow the landlord to draw on the full amount or any portion of the letter of credit to compensate the landlord for any damages that it may suffer if the tenant defaults under the lease.

Once a letter of credit is issued, the issuer (the bank) becomes statutorily obligated to honor drafts drawn by the beneficiary that comply with the terms of the letter of credit. See UCC §5-108(a); Com C §5108(a). Indeed, under long-standing commercial law principles, the obligation of the issuer to the beneficiary (here, the landlord) under the letter of credit is completely independent and distinct from the applicant's (here, the tenant's) obligation under the underlying contract (here, the lease) to the beneficiary. See UCC §5-103(d); Com C §5103(d). This independence principle (see §8.27) has been recognized as the cornerstone of letter-of-credit law. See *Kellogg v Blue Quail Energy, Inc. (In re Compton Corp.)* (5th Cir 1987) 831 F2d 586, 590; see also *Demczyk v Mutual Life Ins. Co. (In re Graham Square, Inc.)* (6th Cir 1997) 126 F3d 823, 827, and *Musika v Arbutus Shopping Ctr. Ltd. Partnership (In re Farm Fresh Supermarkets, Inc.)* (Bankr D Md 2001) 257 BR 770, 772 (finding that letters of credit were not included in property of estate). Thus, the issuer must pay on a proper demand from the beneficiary even though the beneficiary may have breached the underlying contract with the applicant.

The characteristics of a letter of credit are best understood by studying the perspective of each of the parties to the lease transaction toward the instrument. As with all credit enhancements, the landlord seeks the instrument that is (1) most readily converted into cash and (2) unlikely to be substantially affected by the bankruptcy of the tenant. An appropriately drafted letter of credit has the greatest probability of meeting these requirements.

For drafting and negotiating considerations when choosing a letter of credit as a lease credit enhancement (including form agreements), see Office Leasing: Drafting and Negotiating the Lease §§47.3-47.19 (Cal CEB 1996). See Office Leasing, App H for a standard form of letter of credit containing the protections discussed in this chapter.

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§8.4 2. Important Letter of Credit Provisions

The letter of credit should be drawable simply on the landlord's certification that such money is due and owing under the lease without requiring any tenant input or certification. The landlord should be able to draw on all or any portion of the letter of credit to cure a default and then apply any remaining portion against the landlord's damages, including any future rent damages, stemming from the default. This is necessary so that the landlord does not have to make repeated draws on a perpetually delinquent tenant.

NOTE: The underlying lease and letter of credit must carefully define the circumstances under which a landlord may draw on a letter of credit to avoid issues stemming from the automatic stay. See §§4.1-4.13, 7.12.

From the landlord's perspective, the letter of credit, which typically has a 1-year term, should automatically renew unless at least 30 days' prior notice is given to the landlord, and it should have an ultimate renewable term that exceeds the expiration of the lease by at least 120 days. This allows the landlord to assess any holdover or restoration-of-premises obligations of the tenant. Moreover, if the tenant files for bankruptcy protection within 90 days after the lease terminates or expires, the landlord should have the right to draw on the letter of credit for the amount of any payments made within the preference period (the 90-day period immediately preceding the filing of the tenant's bankruptcy petition; see §§2.42, 8.17) to guard against the risk of a possible preference claim. The letter of credit should be transferable to lenders and subsequent landlords, and it should state the fee for such transferability or that no fee is payable; otherwise, the issuer will most likely impose a significant transfer fee at the time of a request for transfer. The letter of credit should have attached to it copies of the exact documents necessary to draw on the letter of credit so that there is no question whether a proper draw request has been made. From the tenant's perspective, the letter of credit should state that if the landlord elects to transfer the letter of credit, any fee for such transfer will be paid by the beneficiary under the letter of credit (*i.e.,* the landlord).

NOTE: Often, a letter of credit issued by an out-of-state or nondomestic bank may be "confirmed" by a local bank. This confirmation is reflected in an additional document from the confirming bank. This amounts to a promise by the confirming bank to honor the letter of credit if the issuer does not do so.

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B. Lease Bonds

§8.5 1. General Terms

A lease bond is a credit instrument that is a promise by a surety to pay the tenant's debt on demand by the landlord. However, a lease bond does not contain the same characteristics as a letter of credit. See §§8.3-8.4. A lease bond represents only a promise from the surety to pay, and is not susceptible to liquidation in the same manner and as expeditiously as a letter of credit. In fact, a lease bond is often enforced only after a lengthy legal battle, and any legal fees incurred by the landlord would only reduce the proceeds recovered under the bond. Accordingly, due to liquidity concerns, landlords almost always prefer letters of credit over lease bonds. Although the lease bond costs about the same as a letter of credit, the tenant may prefer the former because surety companies are often more aggressive underwriters than are traditional letter-of-credit banks. Thus, the surety companies' collateral requirements might be less onerous.

NOTE: A "lease bond" should be distinguished from a "bondable lease." In a bondable lease, a tenant is rated creditworthy, enabling the landlord's lender to rely on the tenant's lease payments as if the tenant had issued a bond. Bondable leases may also be used to attract office building financing funded through use of mortgage-backed securities underwritten by investment bankers. For further discussion of bondable leases, see Office Leasing: Drafting and Negotiating the Lease §§1.34-1.37B (Cal CEB 1996).

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§8.6 2. Important Lease Bond Provisions

Assuming the bonding company (the surety; see §8.5) is satisfactory, a landlord's key concern is that if a tenant—the principal under the bond—defaults, obstacles may stand in the way of the landlord actually collecting on the bond. Theoretically, because of the surety's reputation and rating, a lease bond should be easier to collect on than a simple corporate or individual guaranty. Unless the landlord enjoys certain protections under the express language of the lease or bond, however, the bond will be no better than a corporate guaranty—*i.e.*, requiring the landlord to sue, overcome any defenses by the principal or the obligor, obtain a judgment, execute on that judgment, and collect the amount of its claim. Accordingly, a well-drafted lease bond will reflect many of the same protections afforded by a letter of credit. See §§8.3-8.4 for discussion of letters of credit; see Office Leasing: Drafting and Negotiating the Lease §§47.22-47.24, App Q (Cal CEB 1996) for form lease bond provisions and form of lease guaranty bond typically used by landlords and tenants.

In response to a claim, the surety may attempt to raise defenses that would be held by the tenant. For example, the surety may respond that the tenant has advised it that the tenant is not in default and that the claim, therefore, is invalid. A well-crafted bond will make absolutely clear that the surety (1) cannot dispute the claim, once it is made in the appropriate form, based on defenses that may be asserted by the tenant, and (2) is obligated to immediately and unconditionally pay the entire bond amount to the landlord.

In addition, to avoid the landlord's having to make monthly claims if the tenant remains in default, the bond language should provide that on default, the landlord may demand the entire bond amount even if the actual arrearage under the lease at that time is less than the full bond amount. A typical lease provision covering bonds will provide that the landlord has the option to use these funds to cure any existing defaults, to compensate it for any other damages or costs incurred, or to hold such funds as security for future performance under the lease.

Finally, absent language to the contrary, unless the surety voluntarily pays a claim as demanded, the landlord must initiate a lawsuit against the surety to establish liability under the bond. Such a lawsuit would present serious timing and expense concerns for the landlord. Accordingly, a well-drafted bond includes express language reinforcing the surety's obligation to honor the demand unconditionally. The lease bond should further provide that if the surety does not honor the initial claim, and the landlord brings a legal action to enforce the initial claim (as opposed to a legal action by the surety to recover amounts paid to the landlord), the surety will be liable to the landlord for all attorney fees and costs incurred, whether or not the lawsuit ultimately results in a judgment.

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§8.7 C. Certificates of Deposit

Another type of collateral occasionally provided by tenants is a certificate of deposit issued by a financial institution in the landlord's name. It is unconditionally payable to the landlord on demand, funded by the tenant, and automatically renewed for the length of the lease term. The principal amount accrues to the benefit of the landlord and the interest is payable to the tenant. In a properly negotiated transaction, the principal amount of the certificate of deposit should include any penalties for early withdrawal so that such penalties will not reduce the principal below the desired security amount. See Office Leasing: Drafting and Negotiating the Lease, App R (Cal CEB 1996) for a surety's form of certificate of deposit.

NOTE: Because the certificate of deposit secures the lease, counsel should make sure that the landlord properly perfected its security interest in the certificate of deposit under Article 9 of the Uniform Commercial Code or Division 9 of the California Commercial Code. See California Real Estate Finance Practice: Strategies and Forms, chap 7 (Cal CEB 2000).

Certificates of deposit will likely be treated similarly to cash security deposits under California state law and in a tenant's bankruptcy case.

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§8.8 D. Cash

Traditionally, cash has been the most common type of collateral used as a security deposit. For larger security deposits, however, landlords are usually reluctant to accept cash due to the following three distinct problems:

- The security deposits become an asset of the debtor's bankruptcy estate (see §§2.3-2.13), and therefore are subject to the bankruptcy cap (see §§7.59, 8.14).
- Cash security deposits are subject to CC §1950.7, under which a cash security deposit likely can only be applied to accrued rent as of lease termination, not future rent damages as allowed under CC §1951.2. Thus, at minimum, if a cash security deposit is used, the lease should have an unequivocal waiver of §1950.7 and expressly state that the security deposit can be applied to the landlord's damage claim under §1951.2. A well-crafted lease will also include the right for the landlord to elect to keep the lease in place under §1951.4 (see §8.11).
- Because cash security deposits are assets of the debtor's bankruptcy estate, they will be subject to the automatic stay in bankruptcy. See §§4.1-4.14, 8.15.

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§8.9 III. DAMAGES UNDER CALIFORNIA LAW

In determining how bankruptcy will effect a particular credit enhancement, counsel should fully understand the restrictions that bankruptcy law and state law impose on the availability and amount of damages recoverable in the event of a tenant's default. In general, under state law, if the tenant defaults under the terms and conditions of the lease, the landlord has alternative remedies:

- To terminate the lease and sue for damages (see §8.10); or
- To continue the lease and collect the rent (§8.11).

For further discussion of a landlord's remedies on a tenant's default, see generally California Landlord-Tenant Practice, chaps 8, 13 (2d ed Cal CEB 1997).

The restrictions imposed on the landlord's damages by bankruptcy law are discussed in §§8.12-8.21.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/8 Lease Credit Enhancements/§8.10 A. Damages If Lease Is Terminated (CC §1951.2)

§8.10 A. Damages If Lease Is Terminated (CC §1951.2)

If the tenant defaults, the landlord may treat the default as a termination of the lease and sue for damages. Under CC §1951.2, the landlord is entitled to:

- All unpaid rent earned at the time of the lease termination, plus interest to the time of judgment;
- The amount by which the rent that would have been earned after termination until the time of judgment exceeds the amount of lost rent that the tenant proves could reasonably have been avoided, plus interest to the time of judgment;
- The amount by which the unpaid rent for the balance of the lease term after the time of judgment exceeds the amount of lost rent that the tenant proves could reasonably be avoided by the landlord (discounted at the discount rate of the Federal Reserve Bank of San Francisco at the time of the judgment, plus 1 percent); and
- Any other amount necessary to compensate the landlord for losses proximately caused by the tenant's breach of the lease.

Thus, simply stated, if a tenant breaches a lease and the landlord terminates the lease, the landlord would be entitled to past due rent, plus future rent that the landlord expected to receive under the lease, less any rent that the landlord received or could receive by reletting the property to a third party, plus the costs incurred to achieve such mitigation. Although the formula is simple, judicial application of the formula has been inconsistent and unpredictable; *e.g.,* see *Smith v Sprayberry Square Holdings, Inc. (In re Smith)* (Bankr SD Ga 2000) 249 BR 328, 337, and *In re Atlantic Container Corp.* (Bankr ND Ill 1991) 133 BR 980, 990. If the tenant breaches the lease at its inception, a state court would not likely award the landlord the full statutorily mandated amount, but would probably award a lesser sum. Furthermore, if the tenant is in bankruptcy, the landlord's damages would be the lesser of either the actual damages under state law or the amount of the cap imposed by 11 USC §502(b)(6). See §§7.59, 8.14.

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§8.11 B. Damages If Lease Is Continued (CC §1951.4)

As an alternative to terminating the lease (see §8.10), if expressly provided in the lease, the landlord may by notice continue the lease and recover the rent, periodically, in separate lawsuits as it becomes due. See CC §1951.4. This remedy, however, is not applicable to a tenant in bankruptcy because such a tenant must cure all defaults if it elects to assume the lease. See discussion in §8.12.

When a landlord holds a large security deposit or letter of credit and its lease does not waive CC §1950.7, the landlord may be required to elect this remedy to exhaust its lease security before terminating its lease. See, *e.g., 250 L.L.C. v Photopoint Corp. (USA)* (2005) 131 CA4th 703, 711, 32 CR3d 296 ("California lessor with abandoned premises has two mutually exclusive remedies: deem the lease terminated and seek damages pursuant to §1951.2, or, under §1951.4, continue to perform under the lease and seek rent as it becomes due"). See also discussion in §§8.23-8.30; Bernhardt, *Midcourse Corrections: Gone with the Wind*, 28 CEB Real Prop L Rep 131 (Sept. 2005).

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IV. BANKRUPTCY LIMITATIONS ON DAMAGE AWARDS

A. Lease Assumption or Rejection

§8.12 1. Tenant Must Assume or Reject Lease

Under the Bankruptcy Code, a tenant under a real property lease who files a petition in bankruptcy has the option to either assume or reject the unexpired portion of the lease. See 11 USC §365(a). To assume the unexpired lease, the debtor-tenant or trustee must cure all outstanding defaults and provide adequate assurance of future performance. See 11 USC §365(b)(1)(A). If the tenant decides to reject the lease, or if the lease is deemed rejected by operation of bankruptcy law (see §7.56), the landlord will be entitled to assert a claim for any lease rejection damages it suffers. See 11 USC §365(g). The landlord's lease rejection damages are initially calculated under state law without regard to any bankruptcy limitations. See *Kuske v McSheridan (In re McSheridan)* (BAP 9th Cir 1995) 184 BR 91, 96, overruled on other grounds in *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978. See discussion of landlord's lease cap in §§7.59, 8.14.

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§8.13 2. Effect of Assumption or Rejection on Rent Claims

The rejection of a lease, which ordinarily requires an order of the bankruptcy court, generally dates from the entry of the court's rejection order. Until the lease is rejected, the obligation to pay rent postbankruptcy (administrative rent) is afforded a very high priority and is ordinarily paid in cash, in full, and in a timely manner. *Towers v Chickering & Gregory (In re Pacific-Atlantic Trading Co.)* (9th Cir 1994) 27 F3d 401. When rejection becomes effective, this priority is lost concerning general lease damages (priority is usually retained for accrued but unpaid postpetition, prerejection obligations), the landlord becomes like an ordinary creditor, and rejection damages are capped by the Bankruptcy Code. See §§7.59, 8.14.

WARNING: The bankruptcy court, under its equitable powers (11 USC §§105, 365(d)(3)), can retroactively date the lease rejection from the date of the bankruptcy filing (*i.e.*, the retroactive date could predate the day on which the landlord retakes possession of the premises). In that event, the tenant avoids accruing "administrative rent" during the interim. See *Pacific Shores Dev., LLC v At Home Corp.* (*In re At Home Corp.*) (9th Cir 2004) 392 F3d 1064; see also Comment, 28 CEB Real Prop L Rep 45 (Mar. 2005).

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§8.14 B. Cap on Landlord's Damage Award

Once a landlord's lease rejection damages have been calculated under state law (see §§7.59. 8.12), the Bankruptcy Code artificially caps the landlord's rejection damages at an amount equal to the "rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease." 11 USC §502(b)(6)(A). See also *AMB Prop., L.P. v Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)* (9th Cir 2005) 416 F3d 961.

For discussion of landlord's protection from this bankruptcy cap, see §§7.59, 8.28.

There is some debate as to what constitutes rent for purposes of calculating the cap on the landlord's damages under 11 USC §502(b)(6)(A). For example, some courts conclude that the term "rent" includes only fixed and regular payments, thus excluding such charges as general maintenance or utilities. See, *e.g., In re Rose's Stores, Inc.* (Bankr ED NC 1995) 179 BR 789, 791 (in calculating claim amount, taxes and insurance are included but general maintenance and utility charges are excluded). At least one court in the Ninth Circuit (*Kuske v McSheridan (In re McSheridan)* (BAP 9th Cir 1995) 184 BR 91, 99, overruled on other grounds in *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978) has held that to constitute "rent reserved" (*i.e.,* the tenant's fixed and regular obligations relating to its use and occupation of the property) the charge must be:

- Designated as "rent" or "additional rent" in the lease or otherwise be identified in the lease as the tenant's obligation;
- Related to the value of the property or the lease; and
- Properly classifiable as rent because it is a fixed, regular, or periodic charge.

Presumably, under this definition, the term "rent reserved" in the context of a triple-net or base year lease would include minimum rent, parking charges, real estate taxes, insurance, and common area maintenance fees owed by the tenant. Unfortunately, however, because the courts have not yet resolved this issue, the exact cap that a bankruptcy court would ultimately apply is uncertain and depends on the jurisdiction in which a particular case is filed.

NOTE: All damages that constitute "rent reserved" under the lease and result from the tenant's termination of the lease are subject to the cap under 11 USC §502(b)(6)(A). In addition to unpaid rent, additional damages that are likely subject to the cap include any obligations of the tenant to restore or demolish the premises at the end of its lease term. However, damages the landlord may suffer that are unrelated to lease termination or that do not constitute "rent reserved" under the lease, such as those resulting from the debtor's neglect of the premises, may be outside the cap. See *JSJF Corp. v Wall St. Plaza, LLC (In re JSJF Corp.)* (9th Cir 2008) 277 Fed Appx 718. Compare *Saddleback Valley Community Church v El Toro Materials Co. (In re El Toro Materials Co.)* (9th Cir 2007) 504 F3d 978, in which a tenant unsuccessfully attempted to avoid paying for the extensive damages it caused to the landlord's property by claiming that the landlord's repair claim was subject to the rent cap. The Ninth Circuit held that the damages were a tort claim, did not arise from the rejection of the lease, and thus were not subject to capping. In such cases, the landlord's additional claim would be a secured claim to the extent that there is a sufficient security deposit and the terms of the lease and state law allow it. An unsecured claim would be paid pro rata along with the other unsecured general creditors.

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§8.15 C. Effect of Automatic Stay

On the filing of a bankruptcy petition, the Bankruptcy Code stays all actions against the debtor or efforts to recover the debtor's property. See 11 USC §362(a); see also §§4.1-4.14. The purpose of the stay is to give the debtor a breathing spell from the collection and enforcement efforts of its creditors. Because of its broad reach, the automatic stay enjoins most actions taken by a landlord to enforce its lease after a bankruptcy filing by a tenant. For example, the automatic stay prohibits a landlord from sending a notice of default to the tenant or demanding payment of prepetition rent following a bankruptcy filing. For extensive discussion of the automatic stay and residential and commercial leases, see chap 7.

The broad reach of the automatic stay creates potential difficulties for a landlord attempting to draw on a letter of credit following the tenant's bankruptcy filing. First, funds drawn in excess of the landlord's actual damages are property of the bankruptcy estate (see §8.27), and the automatic stay enjoins any effort to draw the funds on the letter of credit. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc*.) (9th Cir 2006) 439 F3d 558. Second, commercial real estate leases often restrict a landlord's ability to declare a default until notice of default has been delivered to the tenant and the tenant fails to cure the default within a specified cure period. If no notice of default was sent to the tenant before the tenant's bankruptcy filing, the automatic stay may enjoin the landlord from delivering any notice of default or declaring a default. See *In re Metrobility Optical Sys., Inc.* (Bankr D NH 2001) 268 BR 326, 330. Consequently, the landlord, who is unable to declare a default due to the automatic stay, may be unable to draw on a letter of credit.

PRACTICE TIP: If the language of the letter of credit requires the landlord to certify only that the amount drawn is due and owing under the lease, rather than requiring the landlord to serve a traditional written default notice and certify that the tenant is in default under the lease, the landlord may be able to avoid this situation. The situation is further helped if the lease also clearly provides that defaults occur automatically without notice to the tenant.

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§8.16 D. Ipso Facto Defaults

The Bankruptcy Code prohibits the enforcement of contractual provisions declaring defaults against a debtor as a result of the debtor's bankruptcy filing or insolvency. 11 USC §365(e). These contractual provisions are commonly referred to as "ipso facto" clauses. See §6.53. Bankruptcy courts are split over whether §365(e) invalidates ipso facto clauses altogether or simply makes them unenforceable against the debtor. Compare *In re Metrobility Optical Sys.*, *Inc.* (Bankr D NH 2001) 268 BR 326, 329, with *Zenith Labs. v Security Pac. Nat'l Trust Co. (In re Zenith Labs., Inc.)* (Bankr D NJ 1989) 104 BR 667. If §365(e) is determined to invalidate such clauses altogether, then a landlord will not have a right to draw against a letter of credit based on a tenant's bankruptcy filing even if such a right was bargained for and expressly granted in the letter-of-credit documents.

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§8.17 E. Preferential Transfers

Under the Bankruptcy Code, a party that receives a payment from the debtor on account of an antecedent debt may be forced to disgorge that payment (and return it to the debtor) as a preferential transfer. 11 USC §547; see §§2.37-2.55. The purpose of §547 is to prevent the debtor from favoring one creditor over other similarly situated creditors. With respect to noninsiders, this provision applies to any transfer occurring during the 90-day period immediately preceding a tenant's bankruptcy filing that favors the landlord over the tenant's other creditors. The debtor must also have been insolvent as of the date of the transfer (11 USC §547(b)(3)) and is nonconclusively presumed insolvent during the 90-day period leading up to a bankruptcy filing (11 USC §547(f)).

The preference statutes, however, raise several issues for landlords holding letters of credit to secure their leases. See §§8.18-8.20.

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§8.18 1. Status of Proceeds From Letter of Credit

If a landlord draws on a letter of credit during the preference period (see §8.17), some courts have found that the landlord has received a preferential transfer, subject to being voided by the bankruptcy trustee. See, *e.g., Twist Cap, Inc. v Southeast Bank (In re Twist Cap, Inc.)* (Bankr MD Fla 1979) 1 BR 284, 285.

This ruling has been heavily criticized as incorrect. Because the letter of credit is not property of the debtor's bankruptcy estate, by definition, there has been no transfer of the debtor's assets. Accordingly, no preferential transfer could have occurred. See *Kellogg v Blue Quail Energy, Inc. (In re Compton Corp.*) (5th Cir 1987) 831 F2d 586, 589 (criticizing *Twist Cap, Inc. v Southeast Bank (In re Twist Cap, Inc.), supra*).

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§8.19 2. Payments in Lieu of Letter-of-Credit Draw

At least one federal court has held that a landlord may be sued for receiving preferential transfers in the form of payments from the debtor even though the landlord was fully secured under the terms of a letter of credit for the amounts of the payments received. See *Committee of Creditors Holding Unsecured Claims v Koch Oil Co. (In re Powerine Oil Co.)* (9th Cir 1995) 59 F3d 969, 972. Because of this ruling, landlords may be required to return payments they have received during the preference period even though, if the debtor had defaulted in its payments, the landlord would have had the right to draw on a letter of credit for the full amount of such payments and avoid preference liability altogether.

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§8.20 3. Preferences Resulting From Increase in Collateral Securing Letter of Credit

An applicant for a letter of credit is typically required to secure its obligation to reimburse the issuer by granting the issuer a security interest in certain of the applicant's assets—typically cash or a certificate of deposit, in the case of credit-risky tenant. If an existing letter of credit was not originally 100-percent secured, and the tenant's creditworthiness has decreased since the letter of credit was first issued, the issuer of the letter of credit may require the tenant to increase the amount of collateral securing the letter of credit, or to provide security to the issuer to secure an existing unsecured letter of credit, before renewing the letter of credit. Under the preference laws, an issue arises when the debtor either increases the amount of collateral securing a letter of credit or provides security to the issuer to secure an existing unsecured letter of credit during the preference period (see §8.17). Courts will treat a grant of a security interest as a transfer of assets for purposes of the preference laws. If the grant of a security interest occurs during the preference period on account of the debtor's existing obligation to reimburse the issuer under a letter of credit or to further secure an existing letter of credit, then the debtor may avoid the transfer against the issuer. In addition, the trustee may also sue and potentially recover under 11 USC §547(b) from the beneficiary of the letter of credit on the grounds that the beneficiary was "the entity for whose benefit such transfer was made." 11 USC §550(a)(1). In other words, even though the beneficiary is holding a letter of credit that was issued outside the preference period, the beneficiary may still face preference exposure based on a transfer (*e.g.,* a grant of a security interest) made to the issuer during the preference period. Although the landlord will have substantial defenses, potential preference issues could void the benefits and protections that a letter of credit affords the landlord. See chap 4 for discussion of defenses to preferences actions.

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§8.21 F. Equitable Powers of Bankruptcy Courts

The Bankruptcy Code grants the bankruptcy court general equitable powers to issue any order that promotes the purpose of the Code. See 11 USC §105. Some courts have used §105 to enjoin draws against letters of credit on the theory that such draws would materially affect the debtor's bankruptcy estate. See, *e.g.*, *Twist Cap, Inc. v Southeast Bank (In re Twist Cap, Inc.)* (Bankr MD Fla 1979) 1 BR 284, 285, discussed in §8.18. Conversely, other courts have permitted draws, finding that the letter of credit is not an asset of the debtor's bankruptcy estate. See *Musika v Arbutus Shopping Ctr. Ltd. Partnership (In re Farm Fresh Supermarkets, Inc.)* (Bankr D Md 2001) 257 BR 770, 772.

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V. EFFECT OF BANKRUPTCY LAW ON CREDIT ENHANCEMENTS

§8.22 A. Cash

The impact of bankruptcy on a landlord's security is best understood by analyzing the bankruptcy issues relating to a landlord's acceptance of a cash security deposit. A cash security deposit in bankruptcy creates two primary issues for the landlord. First, if the landlord has not applied the security deposit (*i.e.,* used it to cure a tenant default) before the bankruptcy filing, then the deposit would automatically become an asset of the debtor's bankruptcy estate, and the automatic stay (see §8.15) would likely prohibit the landlord from attempting to offset the security deposit against its damages without first obtaining relief from the automatic stay, even if the lease is ultimately rejected by the tenant. See *In re Atlantic Container Corp.* (Bankr ND Ill 1991) 133 BR 980, 989. Assuming the cash security deposit does not exceed the landlord's cap (see 11 USC §502(b)(6); see also §§7.59, 8.14) or the landlord's state law damages, the landlord would likely have a secured claim equal to the amount of the security deposit and an unsecured claim for any deficiency. See *In re Atlantic Container Corp., supra*. However, even though the landlord's damage claim would likely be secured, the landlord may still be enjoined for extended periods, by virtue of the automatic stay, from seeking to offset its damage claim against its security deposit, which could create cash flow problems for the landlord.

Second, and more problematic, the landlord may be forced to disgorge the cash security deposit to the extent that it exceeds the §502(b)(6) cap. See *Solow v PPI Enters. (US) (In re PPI Enters. (US))* (3d Cir 2003) 324 F3d 197. Although §502(b)(6) does not address this point, its legislative history and case law make clear that the amount of a security deposit that exceeds the cap must be returned to the bankruptcy estate. See *AMB Prop., L.P. v Official Creditors for the Estate of AB Liquidating Corp.* (*In re AB Liquidating Corp.)* (9th Cir 2005) 416 F3d 961, 964.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/8 Lease Credit Enhancements/§8.23 B. Letter of Credit

§8.23 B. Letter of Credit

Under the independence principle (see §8.27), most bankruptcy courts have held that a letter of credit and its proceeds are not property of a debtor's bankruptcy estate. See, *e.g., Kellogg v Blue Quail Energy, Inc. (In re Compton Corp.)* (5th Cir 1987) 831 F2d 586, 589; see also *Musika v Arbutus Shopping Ctr. Ltd. Partnership (In re Farm Fresh Supermarkets, Inc.)* (Bankr D Md 2001) 257 BR 770, 772. These courts have reasoned that the funds paid under a letter of credit belong to the issuer and not the debtor, and thus cannot be property of the bankruptcy estate. However, a small minority of bankruptcy courts have held otherwise. See, *e.g., First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc*.) (9th Cir 2006) 439 F3d 558 (funds drawn from letter of credit in excess of landlord's actual damages are property of bankruptcy estate) and *Twist Cap, Inc. v Southeast Bank (In re Twist Cap, Inc.)* (Bankr MD Fla 1979) 1 BR 284 (granting bankruptcy court jurisdiction for complaint filed by debtor seeking order to restrain bank from honoring letters of credit, despite contention that letters of credit were not property of debtor, when letters of credit were secured by debtor's properties). By treating the letter of credit as property of the debtor's bankruptcy estate, some of these courts have held that the automatic stay (see §8.15) prevents the beneficiary from drawing against the letter of credit following a bankruptcy filing. A landlord litigating before a court adopting that position could be enjoined from drawing on a letter of credit and thus lose the benefit of the letter of credit altogether.

The cap on landlord damages imposed by 11 USC §502(b)(6) (see §8.14) raises the question whether the debtor or a third party (*i.e.,* the issuer of a letter of credit) may use the §502(b)(6) limitation to (1) limit such third party's obligation to the landlord or (2) require the landlord to disgorge any amount drawn against a letter of credit that exceeds the §502(b)(6) cap. In other words, does the limitation on the amount of damages that a landlord may claim against *the debtor's estate* also serve to limit the independent obligation that a third party obligor owes to a landlord? See *Kopolow v P.M. Holding Corp. (In re Modern Textile, Inc.)* (8th Cir 1990) 900 F2d 1184, 1191; *Bel-Ken Assocs. Ltd. Partnership v Clark* (D Md 1988) 83 BR 357.

Although a letter of credit is not a guaranty, it is in many ways analogous to a guaranty because both provide for third party security of a lease. With respect to guaranties, courts have consistently held that a guarantor, who is itself not a debtor, cannot use §502(b)(6) as a defense to full payment under a guaranty. In this respect, there is no reason to treat a letter of credit differently from a guaranty. A letter of credit, like a guaranty, is an independent contract between the landlord and the issuer (*i.e.,* a bank). See *Hall v Goforth (In re Goforth)* (5th Cir 1999) 179 F3d 390.

Because of the independence principle (see §8.27), the debtor does not have a property interest in the letter of credit. See *Musika v Arbutus Shopping Ctr. Ltd. Partnership (In re Farm Fresh Supermarkets, Inc.)* (Bankr D Md 2001) 257 BR 770, 772. The debtor does, however, have an interest in the funds drawn from the letter of credit as property of the bankruptcy estate. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc*.) (9th Cir 2006) 439 F3d 558, 564. Since the trustee in *Onecast Media* sought return only of the letter-of-credit funds in excess of the landlord's actual damages, the court did not address whether §502(b)(6) would otherwise limit the landlord's damages claim.

In other decisions, the Ninth Circuit Court of Appeals and the Ninth Circuit Bankruptcy Appellate Panel held that a draw on a letter of credit given as security for a lease should reduce the amount of the landlord's allowed claim under §502(b)(6). See *AMB Prop., L.P. v Official Creditors for the Estate of AB Liquidating Corp. (In re AB Liquidating Corp.)* (9th Cir 2005) 416 F3d 961 (reasoned that decisional law and legislative history of §502(b)(6) required that proceeds landlord received from security deposit, established under lease as "fully collateralized" letter of credit, be subtracted from amount landlord could recover on its capped claim; declined to distinguish between effect of secured versus unsecured letters of credit on bankruptcy estate); *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295. In *Redback Networks,* the court concluded that, because the purpose of §502(b)(6) is "to compensate the landlord for his loss while not permitting a claim so large (based on a long-term lease) as to prevent other general unsecured creditors from recovering a dividend from the estate" (306 BR at 306), the proper analysis was to look at the impact that the draw on the letter of credit had on the property of the estate. Because the tenant in *Redback Networks* secured the letter of credit with a cash security deposit provided to the issuer (*i.e.,* the bank), and because the bank applied the cash security as an offset against the amount it paid to the landlord

under the letter of credit, the effect on the estate was the same as if the landlord had received the cash security deposit.

The court in *Redback Networks* specifically distinguished the case from those in which the debtor (*i.e.,* the tenant) did not pledge property of the estate to secure the letter of credit, stating that such situations were more analogous to a third party guaranty. The majority opinion in *Redback Networks* did not address the situation in which the letter-of-credit draw amount exceeds the §502(b)(6) cap (because that was not part of the facts of the case). However, the concurring opinion (by Judge Klein), which does not have the authority of case precedent, stated that (306 BR at 310):

> the common assumption that letters of credit and other forms of guaranty or credit enhancements are devices by which the [§502(b)(6)] cap can be circumvented is incorrect. Although landlords unquestionably get more out of their credit enhancements, the estate is never liable for more than the amount of the statutory cap.

This is true because the issuer of the letter of credit is subrogated to the rights of the beneficiary (*i.e.,* the landlord) against the estate, and once the allowable claim against the estate is paid in full, then all other claims, including the bank's claim against the security deposit, are disallowed. Arguably, the landlord should be able to draw up to the full amount of the letter of credit while the bank's claim may be limited by the cap of §502(b)(6). In effect, the bank—and not the landlord—is assuming the risk of the tenant declaring bankruptcy.

Both *AB Liquidating* and *Redback Networks* address postpetition letter-of-credit draws. Arguably, if a landlord draws prepetition on a letter of credit and applies the letter of credit to its state law damages, the landlord will not be required to reduce its capped claim by the amount of its draw on the letter of credit. See *Young v Condor Sys., Inc. (In re Condor Sys., Inc.)* (BAP 9th Cir 2003) 296 BR 5 (prepetition severance payments not relevant to calculation of cap under §502(b)(7)). However, at least one court has rejected this argument, siding with the Third Circuit's decision in *Solow v PPI Enters. (US) (In re PPI Enters. (US))* (3d Cir 2003) 324 F3d 197 and finding no reason to extend the reasoning of *Condor Systems* to prepetition letter-of-credit draws. See *In re Connectix Corp.* (Bankr ND Cal 2007) 372 BR 488.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/8 Lease Credit Enhancements/§8.24 C. Chart: Analyzing Bankruptcy Impacts on Consideration and Security

§8.24 C. Chart: Analyzing Bankruptcy Impacts on Consideration and Security

Type of Consideration/ Security	Possible Impacts Based on Tenant Filing for Bankruptcy Within 90 Days of Workout		
	Fraudulent Conveyance?	Preference?	Subject to Bankruptcy Cap?
Use of cash security deposit (received at lease inception)	No	No	No
Cash payment (paid before filing)	No	Yes	No
Draw on letter of credit (issued at lease inception and drawn before filing)	No	No	No
Extinguishment of undisbursed tenant improvement allowance (applied before filing)	No	No	No
Stock (received before filing)	No	Yes	No
Promissory note	No	Yes, as to security and payments made within 90 days of bankruptcy	Yes, as to payments paid postfiling
Creation of new letter of credit (securing the note and issued before filing)	No	Yes	Yes, as to payments paid postfiling

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VI. STRATEGIES TO MAXIMIZE RECOVERIES OF CREDIT ENHANCEMENTS

§8.25 A. General Considerations

Sections 8.26-8.30 discuss several approaches used by knowledgeable landlords under the current Bankruptcy Code to maximize recovery of a credit enhancement.

Few, if any, courts have resolved the issue whether a landlord can disguise or take a noncash security deposit so as to successfully steer clear of the cap imposed by 11 USC §502(b)(6). (See Judge Klein's concurring opinion in *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295, 301.) The reason for this lack of precedent is simple: Historically, very few commercial tenants posted security in an amount that substantially exceeds the cap under §502(b)(6). The amount of credit enhancement in leases with "high-tech" and other high-profile tenants, however, typically exceeds the bankruptcy cap amount. In many such leases, the amount of security can equal up to 2 years of the base rent.

NOTE: The phenomenon of credit enhancement is much more widespread than tenancies involving high-tech companies ("high-tech" usually refers to dot-com, Internet-related service, biotech, and telecommunications companies). Other industries that frequently depend on tenancies backed by credit enhancement include new media, traditional media, high-growth companies with minimal operating history (*e.g.,* software companies), law firms, and accounting firms. Even large established firms are being required to post credit enhancement because, due to the conversion of such firms to nonrecourse entities such as LLPs and LLCs, the partners are no longer personally liable for their firms' lease obligations.

In any event, because of the lack of guiding precedent, the ultimate success of any strategy designed to avoid the harsh effects of §502(b)(6) is uncertain. The strategies that have the best chance of avoiding the cap are discussed in §§8.26-8.30.

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§8.26 B. Irrevocable Standby Letter of Credit

An irrevocable standby letter of credit guarantees payment to the beneficiary if the applicant should default in its obligations in the underlying transaction. See §8.3. In a lease, by requiring the tenant to post a letter of credit to guarantee its performance under the lease rather than give a cash security deposit, the landlord may be able to avoid the effects of bankruptcy law, including the cap on landlord damages (see §8.14). See *EOP-Colonnade of Dallas Ltd. Partnership v Faulkner (In re Stonebridge Technols., Inc.)* (5th Cir 2005) 430 F3d 260 and the discussion of Judge Klein's concurring opinion in *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp*.) (BAP 9th Cir 2004) 306 BR 295, 301, in §8.23.

WARNING: Neither *Stonebridge* nor Judge Klein's concurring opinion in *Redback Networks* is binding precedent in the Ninth Circuit. Given the uncertainties created by legislative and case authority, any amount of credit enhancement over and above the cap may be of no value to a landlord creditor.

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§8.27 1. The Independence Principle

A standby letter of credit creates an independent contract between the issuing bank and the beneficiary of the letter of credit. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc*.) (9th Cir 2006) 439 F3d 558, 564. After the beneficiary makes a demand on the issuing bank in compliance with the terms of the letter of credit, the debtor may not prevent the issuing bank from distributing the proceeds of the letter of credit, absent fraud in the underlying contract. See *Kellogg v Blue Quail Energy, Inc. (In re Compton Corp.)* (5th Cir 1987) 831 F2d 586, 589. Bankruptcy courts have recognized this "independence principle" in finding that the proceeds of a letter of credit are not property of the debtor's bankruptcy estate and that a bankruptcy court has no authority to enjoin the payment under a letter of credit. 831 F2d at 590; see also *Redback Networks, Inc. v Mayan Networks Corp. (In re Mayan Networks Corp.)* (BAP 9th Cir 2004) 306 BR 295 (distinguishing true third party obligors, letter-of-credit issuers who bear substantial risk because the debtor provides them no security, from those issuers who are fully protected by the debtor's pledge of property of the estate). This unique characteristic of a letter of credit creates an immediate advantage for a landlord. Because the letter of credit generally is not property of the tenant's bankruptcy estate, the automatic stay should not enjoin the landlord from immediately drawing on the letter of credit.

To the extent that the landlord draws from the letter of credit in excess of its actual damages, however, the bankruptcy court has jurisdiction to enforce return of those funds. *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc.)* (9th Cir 2006) 439 F3d 558.

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§8.28 2. Protection From Bankruptcy Cap

Even more important than the treatment of letter-of-credit proceeds as property of the beneficiary (see §8.27), the letter of credit can also provide the landlord with protection against the damage cap imposed by 11 USC §502(b)(6). See §8.14. Because the issuing bank's obligation under a letter of credit is independent from the landlord/tenant relationship, arguably, neither the bank nor the debtor can assert the cap to estop a landlord from collecting the full amount of its damages from the issuing bank. In *EOP-Colonnade of Dallas Ltd. Partnership v Faulkner (In re Stonebridge Technols., Inc.)* (5th Cir 2005) 430 F3d 260, the Fifth Circuit addressed this issue and held that the cap does not limit a draw if the landlord did not file a claim against the debtor's bankruptcy estate. Case law in analogous situations also appears to support this conclusion. For example, courts have found that a nondebtor guarantor cannot assert the cap to avoid its liability for the tenant's rejection of a lease. See, *e.g., Kopolow v P.M. Holding Corp. (In re Modern Textile, Inc.)* (8th Cir 1990) 900 F2d 1184 (trustee's rejection of debtor's sublease did not discharge third party guaranty of obligations under sublease); *Bel-Ken Assocs. Ltd. Partnership v Clark* (D Md 1988) 83 BR 357 (statutory limitation on landlord's claim did not limit liability of third party guarantors after bankruptcy trustee rejected lease).

Likewise, at least one court has found that the cap for lease damages under the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) (Pub L 101-73, 103 Stat 183), which is even more restrictive than §502(b)(6), does not restrict the landlord from pursuing a letter of credit for the full amount owed even though it exceeds the FIRREA cap. See *FDIC v U.S. Trust Co.* (D Mass 1992) 793 F Supp 368, 373. Finally, the California Supreme Court has concluded that the independence principle (see §8.27) did not enjoin a lender from demanding payment on a letter of credit even though the lender's claim against its borrower had been barred under California's anti-deficiency laws. See *Western Sec. Bank v Superior Court* (1997) 15 C4th 232, 62 CR2d 243; see also California Mortgages, Deeds of Trust, and Foreclosure Litigation §§9.115-9.117 (4th ed Cal CEB 2009). Thus, because FIRREA and the California anti-deficiency laws artificially restrict the pursuit of a claim similar to the cap under §502(b)(6), it could be argued that this precedent allows a landlord, drawing on a letter of credit, to recover the full amount of its damages from the issuing bank, free from the restrictions of §502(b)(6).

Nonetheless, this theory is not risk-free. For example, although the letter-of-credit independence principle may ensure the distribution of proceeds under a letter of credit, it makes no assurance of the landlord's rightful entitlement to payment. Thus, although the debtor may not be able to stop the landlord from seeking recourse against a letter of credit, the debtor may be able to sue the landlord to recover any payment in excess of the cap. See *First Ave. W. Bldg., LLC v James (In re Onecast Media, Inc*.) (9th Cir 2006) 439 F3d 558. Moreover, the issuing bank may assert that, under UCC §5-117 or Com C §5117, on payment of the letter of credit, the bank becomes subrogated to the rights of the tenant, including the right to seek recovery of any payment exceeding the bankruptcy cap under §502(b)(6). Finally, although letters of credit have many of the same characteristics as guaranties, they are not guaranties and guaranty case law may be held not to apply (see discussion in §8.23). Unfortunately, given the lack of clear precedent, the outcome cannot be assured.

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§8.29 C. Tenant's Payment for Tenant Improvements and Leasing Commissions

Although the cap under 11 USC §502(b)(6) limits the landlord's claim for rent due and owing under the terms of a lease (see §8.14), it does not restrict a secured creditor from recovering the full amount of advances it made to the debtor. This result is best achieved if the lease was structured to (1) require the tenant to pay for all tenant improvements and leasing commissions and (2) provide the tenant with a separate secured loan to fund this amount. That debt would be reflected in a promissory note from the tenant to the landlord. By structuring the transaction in the foregoing manner, the landlord could avoid capitalizing the tenant improvements and leasing commission costs in the rent stream, and thus avoid the cap for these costs. Further, such a loan structure may not be subject to bankruptcy and state law limitations on lease awards because it could be characterized as a secured creditor/debtor relationship, as opposed to a landlord/tenant relationship. If the landlord also required the tenant to obtain an irrevocable letter of credit to secure its performance under the terms of the loan, the landlord will have the additional benefit of the independence principle (see §8.27).

Nevertheless, a bankruptcy court could disregard this transaction. As used in 11 USC §502(b)(6)(A), the term "rent reserved" refers to the tenant's fixed and regular obligations relating to its use and occupation of the property. See §8.14. A bankruptcy court, under its equity power, could use §502(b)(6) to cap the loan for tenant improvements under the theory that the loan payments, in reality, constitute payments by the tenant for its use and occupation of the property. Unfortunately, no bankruptcy courts have resolved or decided this issue to date.

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§8.30 D. Payment of Advance Rent Through Irrevocable Letter of Credit

Many landlords have sought to secure lease obligations through the receipt of large amounts of prepaid rent from tenants. Arguably, landlords could avoid the bankruptcy cap of 11 USC §502(b)(6) (see §8.14) by collecting advance rent or other fees under the lease. In theory, advance rent would be collected and applied before the bankruptcy and termination of the lease and thus would not be included in the calculation of the cap. To date, this strategy has not been tested in the courts. Moreover, of all of the strategies discussed in §§8.26-8.30, this strategy may be the easiest to attack in court for a couple of reasons.

First, the court could simply construe advance rent as a security deposit. As noted in §8.22, to the extent that a cash security deposit exceeds the bankruptcy cap, the excess security deposit must be refunded to the debtor.

Second, acceptance of a large amount of advance rent could constitute a fraudulent conveyance (see §§2.56-2.67). Under fraudulent conveyance laws, a debtor can avoid any payment or transfer of property made while the debtor was insolvent, or which effectively rendered the debtor insolvent, that is not supported by reasonably equivalent consideration. Assuming that the tenant is insolvent or is rendered insolvent, the payment of advance rent could be construed as a fraudulent conveyance. Moreover, the tenant is arguably paying in advance for rent that it would not be obligated to pay if it rejects the lease in bankruptcy. Nevertheless, because the tenant is getting the right to occupy the property at a future date for no additional consideration, the tenant arguably receives a reasonably equivalent value.

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9

Mechanics' Liens

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I. INTRODUCTION

§9.1 A. Scope of Chapter

This chapter describes the effect the filing of a bankruptcy petition has on mechanics' liens and related statutory remedies available to parties involved in a construction project. This discussion covers only voluntary bankruptcies under the bankruptcy chapters most commonly encountered with respect to mechanics' liens: Chapter 7 (see §§9.24-9.30) and Chapter 11 (see §§9.8-9.23). Many of the concepts discussed, however, apply to cases filed under other chapters of the Bankruptcy Code as well.

This chapter also describes alternative actions a creditor may take to (1) preserve its mechanics' lien and stop notice rights (see §§9.36-9.41) and (2) collect from the bankruptcy estate all or part of the money the debtor in bankruptcy owes to the creditor (see 11 USC §101(10), (13)). See discussion of claims in §§9.16-9.17, 9.28-9.29 and relief from automatic stay in §§9.42-9.45.

Payments of money to creditors and other transfers of the debtor's property that are subject to avoidance by the trustee or the debtor in possession are also discussed; see §§9.46-9.69.

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§9.2 B. Automatic Stay of Collection Activities

The filing of a petition under any chapter of the Bankruptcy Code immediately triggers the automatic stay (essentially, a statutory injunction) of a wide variety of collection activities against the debtor and the bankruptcy estate. See 11 USC §362(a). In construction-related disputes, §362(a) prohibits a creditor from (1) demanding payment from the debtor; (2) filing suit in state court on the contract with the debtor; or, (3) if the debtor is the property owner or lessee, recording a mechanics' lien, filing or pursuing a state court action to foreclose a mechanics' lien, or executing a lien judgment. See §§9.31-9.33. The operation of the stay is discussed in detail in §§4.1-4.26.

The Bankruptcy Code expressly authorizes a small group of postpetition collection activities, most of which do not apply to construction cases. See 11 USC §362(b).

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§9.3 C. Property of Bankruptcy Estate

The debtor's bankruptcy estate comprises, among other things and with certain exceptions, "all legal or equitable interests of the debtor in property as of the commencement of the case" and "any interest in property that the estate acquires after the commencement of the case." 11 USC §541(a). Property of the estate includes, *e.g.,* the debtor's real property, vehicles, equipment, tools, building materials, office equipment, bank accounts, accounts receivable, and causes of action against third parties. See *Sierra Switchboard Co. v Westinghouse Elec. Corp.* (9th Cir 1986) 789 F2d 705, 707; Fed R Bankr P 1007(b)(1) (see chap 2).

A surety bond issued by a third party to guarantee a contractor's payment or performance of its contracts or subcontracts, however, is not property of the estate. See *Dunbar v Contractors' State License Bd. (In re Dunbar)* (BAP 9th Cir 1999) 235 BR 465, 475, aff'd (9th Cir 2001) 245 F3d 1058.

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§9.4 1. Carve-Outs From Property of the Estate

In general, under 11 USC §541, all of the debtor's property as of the commencement of the bankruptcy case becomes property of the estate, except for certain assets expressly excluded by the Bankruptcy Code. An individual debtor may claim certain property of the estate as exempt under 11 USC §522 (see §§2.14-2.23). However, if at the time the case is filed the debtor holds only legal title but not an equitable interest in property, that property becomes property of the estate only to the extent of the legal title. 11 USC §541(d). In the context of mechanics' liens, this issue is most likely to occur when there are (1) joint checks payable to the debtor and a creditor (see §9.5) and (2) payments which skip over the debtor and are paid directly to a creditor (see §9.6).

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§9.5 a. Funds Held in Trust: Joint Checks

Funds in a check payable jointly to the debtor and a supplier or subcontractor of the debtor may or may not be considered property of the estate. Compare *Keenan Pipe & Supply Co. v Shields* (9th Cir 1956) 241 F2d 486 with *Georgia Pac. Corp. v Sigma Serv. Corp.* (5th Cir 1983) 712 F2d 962, 972 (joint check is insufficient by itself to establish constructive trust in favor of subcontractor). Funds that are considered to be held in trust for a particular creditor under state law, however, may not be considered to be held in trust under bankruptcy law. Trust concepts are interpreted more narrowly under bankruptcy law because of the policy favoring a prorata distribution of assets evenly among creditors. See *Torres v Eastlick (In re North Am. Coin & Currency, Ltd.)* (9th Cir 1985) 767 F2d 1573, 1575, amended at 774 F2d 1390. But see *Siegel v Boston (In re Sale Guar. Corp.)* (BAP 9th Cir 1998) 220 BR 660, 668, aff'd (9th Cir 2000) 199 F3d 1375 (distinguishing resulting trusts from constructive trusts). See also §9.49.

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§9.6 b. Payments Skipping Over Debtor

If the general contractor has an independent obligation to pay the debtor-subcontractor's supplier, then a prepetition payment by the general contractor directly to the supplier is not considered a transfer of the debtor-subcontractor's property (see 11 USC §547(b)), and any postpetition payment is not considered a transfer of property of the debtor's bankruptcy estate (see 11 USC §549(a)). *Shaw Indus., Inc. v Gill (In re Flooring Concepts, Inc.)* (BAP 9th Cir 1984) 37 BR 957. See further discussion in §9.48.

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§9.7 2. Cash Collateral

Cash collateral is a fund in which both the debtor's bankruptcy estate and a third party hold an interest. 11 USC §363(a). It usually refers to money (or its equivalent) owned by the debtor's bankruptcy estate in which a creditor has a security interest, such as a bank account containing rent money paid to the debtor by its tenants on real property subject to a deed of trust containing a rents-and-profits clause. See, *e.g., Wattson Pac. Ventures v Valley Fed. Sav. & Loan (In re Safeguard Self-Storage Trust)* (9th Cir 1993) 2 F3d 967, 969; *In re GOCO Realty Fund I* (Bankr ND Cal 1993) 151 BR 241; see also §§10.64-10.66. It may also refer to money held by a debtor-owner who owes a payment to a creditor-contractor, after a subcontractor or supplier has served the debtor-owner with a stop notice. See CC §§3158-3176.5.

After filing a bankruptcy petition, the debtor may use cash collateral only if (a) the secured creditor or other party holding an interest in it consents or (b) the court authorizes the use after notice to the secured creditor or interested party and a hearing. 11 USC §363(c)(2); see Fed R Bankr P 4001(d)(1).

PRACTICE TIP: A creditor holding a security interest in cash collateral usually will stipulate to a budget that allows the expenditure of funds for specific line items. The creditor, whether a construction lender or permanent lender, will be inclined to cooperate if the project as a whole, and therefore its security interest, will become more valuable or retain its value by making the expenditures in the budget. The stipulated budget is then submitted to the court for approval.

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II. OVERVIEW OF CHAPTER 11 (REORGANIZATION)

§9.8 A. Continued Business Operation Under Court Supervision

A petition is generally filed under Chapter 11 (instead of Chapter 7) to preserve the debtor's ongoing business operations in an effort to maximize payments to creditors. When a business files a Chapter 11 bankruptcy petition, it may continue to operate under its existing management unless and until the court orders otherwise. 11 USC §1108. The debtor is known in its new capacity as the debtor in possession and has the duties and most of the rights of a Chapter 11 trustee. 11 USC §§1101(1), 1107. After the filing, the court and the U.S. Trustee generally oversee the debtor's operations, and the debtor must adhere to the reporting requirements of the Bankruptcy Code and the Office of the U.S. Trustee. See §1.68.

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§9.9 1. Filing Schedules and Statement of Affairs

Within 14 days after filing the petition (unless the court extends the time), the debtor must file the following with the court (see 11 USC §521; Fed R Bankr P 1007):

- Schedules setting forth, among other things, the debtor's assets and liabilities; the names of the parties with whom it has partially performed contracts (*i.e.,* executory contracts; see §§9.12-9.15); and the names and addresses of its creditors, specifying (1) which creditors are secured and which are unsecured, (2) the amount owed to each, and (3) whether the debt is disputed, contingent, or unliquidated; and
- A statement of financial affairs setting forth, among other things, the annual income of the business for the previous 3 years, the payments made by the debtor to creditors within 90 days before the filing of the petition, and the payments made by the debtor to insiders within 1 year before the filing.

PRACTICE TIP: A list of the names and addresses of creditors must be filed with the petition (see Fed R Bankr P 1007(a)(1)) if the full schedules are not filed at that time. Court clerks routinely reject petitions that contain neither schedules nor a list of creditors.

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§9.10 2. Filing Operating Reports

After filing a Chapter 11 petition, the debtor must file with the court, and serve on the U.S. Trustee (and others by local rule), a quarterly operating report setting forth, among other things, the receipts and disbursements of the business (see Fed R Bankr P 2015(a)(5)). A monthly report is required in a Chapter 11 "small business case," unless the court, for cause, sets another reporting interval (see Fed R Bankr P 2015(a)(6)). Most courts have local rules that require monthly filing of the operating report within 20 days after the ending date of the reported month (see §§1.36-1.38 on locating local rules on bankruptcy court websites).

PRACTICE TIP: Subcontractors or suppliers who are contemplating extending credit to the debtor postpetition may review the schedules and operating reports to help determine the likelihood of being paid. These documents should not be relied on as the sole basis for a credit decision. Many small contractors and subcontractors fall into bankruptcy because they lack skill in financial management. Operating reports are unaudited and may be inaccurate. In addition, despite criminal penalties, some debtors purposely file inaccurate reports to stay in business.

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§9.11 B. Deferring Payment for Prepetition Work

On filing the petition, the debtor must cease making payments to prepetition unsecured creditors. 11 USC §549. Prepetition unsecured debts may be paid only (1) with court approval when an executory contract is assumed (see §9.13), (2) with special court permission (*e.g.,* when employee wages or other services essential to the continued operation must be paid to preserve the value of the estate's assets), or (3) through a confirmed plan of reorganization (see §§9.18-9.21). See *Rosenberg Real Estate Equity Fund III v Air Beds, Inc. (In re Air Beds, Inc.)* (BAP 9th Cir 1988) 92 BR 419, 423.

In large Chapter 11 cases it is becoming routine for the debtor to seek permission from the court at the beginning of the case to pay undisputed wage, benefit, and tax claims, to the extent that these are considered priority unsecured claims. Such requests are usually granted through "first day orders." This is seen as a way of facilitating smooth ongoing business operations and streamlining case administration by reducing the number of small undisputed creditors to whom notice must be sent during the course of administration of the case. It is uncontroversial when it is clear from the size of the unencumbered assets that the debtor has the resources to pay all anticipated administrative expenses, or when a secured creditor consents to the use of its cash collateral for this purpose.

NOTE: Payment of claims of a select group of general unsecured creditors, sometimes referred to as "critical vendors," is allowed in a first day order in much more limited circumstances. See *In re Kmart Corp.* (7th Cir 2004) 359 F3d 866 (payments to critical vendors allowed only if debtor shows benefit to other creditors).

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§9.12 C. Executory Contracts

If a construction project is incomplete when the debtor files a bankruptcy petition, any related contract to which the debtor is a party (whether the debtor is an owner, a contractor, a subcontractor, or a supplier) will probably be considered an executory contract. 11 USC §365. An executory contract is one in which performance is due to some extent on both sides, *i.e.,* the obligations of both parties are so greatly unperformed that the failure of either party to complete performance would constitute a material breach and excuse the performance of the other. See *Commercial Union Ins. Co. v Texscan Corp. (In re Texscan Corp.)* (9th Cir 1992) 976 F2d 1269, 1272; *Unsecured Creditors' Comm. v Southmark Corp. (In re Robert L. Helms Constr. & Dev. Co.)* (9th Cir 1998) 139 F3d 702, 705. See also discussion of executory contracts and leases in chaps 6-7.

EXAMPLE: General contractor *A* leases a job trailer from *B* for 12 months, with rent payable at the beginning of each month. If *A* files bankruptcy in month 6, the contract is executory because at the time of the bankruptcy *B* owes a duty to provide the trailer for 6 more months and *A* owes a duty to make monthly payments for those months. If *A* files bankruptcy in month 13, however, the contract is not executory, even if part of the rent is still owed, because *B*'s duty to provide the trailer ceased at the end of month 12 before the bankruptcy filing (*i.e.,* the contract terminated by its own terms).

The debtor is allowed to choose, with the court's approval, whether to assume or reject an executory contract. 11 USC §365(a). See §§6.5-6.38, 7.35-7.59.

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§9.13 1. Assumption by Debtor

If fully performing the executory contract will result in a net economic gain to the estate, the trustee or debtor in possession will try to assume the contract. The debtor is entitled to exercise sound business judgment on whether to assume the contract. *Lubrizol Enter., Inc. v Richmond Metal Finishers, Inc.* (4th Cir 1985) 756 F2d 1043. By assuming, the debtor takes on both the benefits and the burdens of the contract, as if the bankruptcy case had not been filed. To assume an executory contract, the debtor must, among other things, (1) cure any past defaults or provide adequate assurance that it will cure the defaults promptly in the future, (2) compensate the other party to the contract for losses resulting from the debtor's breach, and (3) provide adequate assurance of future performance under the contract. 11 USC §365(b)(1). See §§6.5-6.48, 7.36-7.39, 7.45-7.55.

EXAMPLE: Debtor is a general contractor who has an agreement with a subcontractor to pay it a lump sum to perform a set of tasks on a project, *e.g.,* plastering and painting walls. A progress payment is due by the 20th of each month for work performed by the subcontractor during the previous month. The bankruptcy petition was filed on the 15th of the month, and, as a consequence, the progress payment was not made. At the time of the filing, the subcontractor had not yet painted the walls, and refuses to proceed since it has not been paid. If and when this critical task is performed, the project will be completed and the debtor-contractor will receive its final payment and retention, which will generate enough money to pay all the debtor's subcontractors and suppliers. Thus the debtor-contractor seeks the court's permission to assume the subcontract and make up the missing progress payment.

PRACTICE TIP: The assumption of an executory contract will negate the ability of the trustee or debtor in possession to avoid as a preference a late payment made by the debtor to the creditor under the contract before the filing of the petition. See *Alvarado v Walsh (In re LCO Enters.)* (9th Cir 1993) 12 F3d 938, 943. On preferences, see §§2.37-2.55, 9.47. See also *Kimmelman v Port Auth. of NY & NJ (In re Kiwi Int'l Air Lines)* (3d Cir 2003) 344 F3d 311, 322.

Conflicts over the assumption of executory contracts frequently center on the debtor's ability to perform in the future and on the assignment of the contract obligations after the debtor assumes the contract. Some debtors assume the contract because it is profitable to sell the rights to a third party buyer who will assume the obligations. In this situation, the assignee often provides the funds to cure past defaults, and its financial condition provides the assurance of future performance. See *Metropolitan Airports Comm'n v Northwest Airlines, Inc. (In re Midway Airlines)* (7th Cir 1993) 6 F3d 492. In most cases, these assignments are valid even if there is a prohibition of assignments in the contract itself. See 11 USC §365(f)(1); *City of Jamestown v James Cable Partners (In re James Cable Partners)* (11th Cir 1994) 27 F3d 534.

In the Ninth Circuit, however, a debtor in possession cannot assume an executory contract without the other contracting party's consent, if applicable (*i.e.,* nonbankruptcy) law excuses the other party from accepting performance from, or rendering performance to, an entity other than the debtor. See 11 USC §365(c); *Perlman v Catapult Entertainment, Inc. (In re Catapult Entertainment, Inc.)* (9th Cir 1999) 165 F3d 747, 754. Compare *In re ANC Rental Corp.* (D Del 2002) 277 BR 226, 236 (applicable nonbankruptcy law must specifically state that contracting party is excused from accepting performance from third party under circumstances in which it is clear from law that (1) identity of contracting party is crucial to contract or (2) public safety is at issue). See also discussion in §6.31.

The *Perlman* and *ANC Rental* cases show a cleft between the Ninth Circuit view and the Delaware view. In the Ninth Circuit, it is more difficult for a debtor in possession to continue to reap the benefits of an executory contract if a nonbankruptcy law such as patent law prohibits assignment, *even if the same individuals are actually performing the contract*. The U.S. Supreme Court has recognized the division in the courts regarding the application of 11 USC §365(c), but has declined to resolve the issue. See *NCP Mktg. Group v BF Star Prods.* (2009) ___ US ___, 173 L Ed 2d 1028, 129 S Ct 1577.

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§9.14 2. Rejection by Debtor

If fully performing the executory contract will result in a net economic loss to the estate, the trustee or debtor in possession will ask the court's permission to reject the contract. On rejection, the other party to the contract will have a claim against the debtor's estate for damages resulting from the default. 11 USC §365(g); *In re RLR Celestial Homes, Inc.* (Bankr SD NY 1989) 108 BR 36. See also discussion in §§6.44-6.48, 7.40-7.44, 7.56-7.59.

EXAMPLE: The debtor is a supplier who (before bankruptcy) entered into a contract to supply fabricated steel to a subcontractor. After the contract was signed, the price of raw steel rose sharply. The debtor began losing money on each piece fabricated and filed a Chapter 11 petition. The job was not finished at the time of the filing. After filing the petition, the debtor rejected the contract. The subcontractor retained a new steel fabricator at a higher price and filed a proof of claim in the debtor's bankruptcy case for the difference it paid to have the steel prepared by the new fabricator. The claim for the difference between the contract price and the new price will be paid through the Chapter 11 plan of reorganization as a general unsecured claim. See 11 USC §726(a)(2). See also 11 USC §§365(g)(1), 501(a), 502(g).

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§9.15 3. Compelling Assumption or Rejection

In Chapter 11, except for leases of nonresidential real property, the trustee or debtor in possession may accept or reject an executory contract any time before confirmation of the plan. 11 USC §365(d)(2). If the nondebtor party to the contract determines that it is in its best interest to force the trustee or debtor in possession to assume or reject the contract expeditiously, it may make its own motion to the court, asking the court to set a deadline for assumption or rejection. 11 USC §365(d)(2). If a debtor is a lessee under a nonresidential lease, the lease must be assumed, or the court must allow an extension of the time period, within the earlier of 120 days of the petition date or the date of plan confirmation, or the lease is deemed rejected. The debtor is permitted only one 90-day extension of the time period unless the lessor consents to further extensions. 11 USC §365(d)(4). See also discussion in §6.10.

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D. Creditors' Claims in Chapter 11 Cases

§9.16 1. Filing Claims

A creditor must file a proof of claim with the bankruptcy court within the time fixed by the court, unless its claim is listed on the debtor's schedules in the correct amount and is not listed as disputed, contingent, or unliquidated. Fed R Bankr P 3001, 3003. On Chapter 7 claims and mechanics' liens, see §§9.28-9.29. On claims generally, see chap 3. On filing claims, see §§3.19-3.34.

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§9.17 2. Liquidating Claims

If the trustee or debtor in possession disputes that it owes the amount set forth in the proof of claim, it may file an objection to the claim. Fed R Bankr P 3007. The claimant must then provide evidence to prove the validity and amount of the claim. See authorities and Practice Tip in §9.29. See also discussion in §§3.38-3.53.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/9 Mechanics' Liens/§9.18 E. Reorganization, Conversion, or Dismissal

§9.18 E. Reorganization, Conversion, or Dismissal

There are three ways for a business to exit a Chapter 11 case: reorganization (see §§9.19-9.21), conversion (see §9.22), or dismissal (see §9.23).

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§9.19 1. Reorganization of Debtor

The debtor may propose a plan of reorganization. If the debtor does not do so within 120 days after filing, a creditor may propose a plan instead; this seldom occurs except in very large cases. 11 USC §1121. The debtor must file (with the proposed plan) a disclosure statement describing the financial condition of the business and its future projections. 11 USC §1125. Creditors are given an opportunity to vote on the plan, and the court may confirm the plan if it meets certain minimum criteria. 11 USC §1129. See chap 5 for further discussion of Chapter 11 plans.

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§9.20 a. Treatment of Mechanics' Lien Holders

Unless the creditor agrees to other treatment, the plan must provide that a creditor who holds a properly perfected mechanics' lien on collateral that has sufficient value to cover the lien will (1) be paid in full on the effective date of the plan or (2) have the right to retain its lien and later receive payments with interest. See 11 USC §§506, 1129(b)(2)(A).

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§9.21 b. Treatment of Unsecured and Undersecured Creditors

A creditor who has failed to perfect properly its mechanics' lien will be treated as an unsecured creditor and will likely receive only a portion of the amount it is owed, or nothing. Creditors who hold properly preserved mechanics' liens on property that is worth less than the amount of their collective debt will receive payment equal to 100 percent of the value of the liens (*i.e.,* the value of the property, less senior encumbrances) and payment as unsecured creditors on the balance. See 11 USC §§506(a), 1129(b)(2)(B).

EXAMPLE: If a subcontractor has a $50,000 mechanics' lien on a $100,000 piece of property that is encumbered by a $90,000 senior trust deed and there are no other mechanics' lienholders, the value of the mechanics' lien is $10,000. Thus, the subcontractor will be treated as a holder of a $10,000 secured claim and a $40,000 general unsecured claim. Compare this example with Examples in §9.50.

NOTE: All mechanics' liens on the same work of improvement carry the same priority; regardless of when a particular claimant worked on the property, the priority of its lien relates back to the date work first commenced on the property. Thus, all properly filed mechanics' lien claims will be secured and unsecured in the same proportions.

When a plan is confirmed, subject to certain conditions and exceptions, the debtor's original obligations to creditors are discharged and replaced by the obligations set forth in the plan. 11 USC §1141.

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§9.22 2. Conversion to Chapter 7 Bankruptcy or Dismissal

Unless unusual circumstances are specifically cited by the court indicating that a requested dismissal or conversion is not in the best interests of the creditors and the estate, the court must dismiss or convert a Chapter 11 case to a Chapter 7 case if a party in interest establishes cause. See 11 USC §1112(b)(4). See also discussion in §4.74.

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§9.23 3. Effect of Dismissal of Bankruptcy Case

When a case is dismissed, the automatic stay terminates, the property of the bankruptcy estate revests in the debtor, and the mechanics' lien claimants may again proceed with their state-law-based remedies. See 11 USC §§349(b), 362(c)(2)(B). But see *Commercial Elec., Inc. v JGC Enters. (In re JGC Enters.)* (9th Cir 2002) 40 Fed Appx 561 (unpublished opinion) (dismissal of bankruptcy did not revive mechanics' lien rights adjudicated in adversary proceeding during bankruptcy case that was later dismissed, if bankruptcy court did not rely on bankruptcy law in reaching its conclusions). The time limits for proceeding are set forth in 11 USC §108(c). See *Sawyer Nurseries v Galardi* (1986) 181 CA3d 663, 226 CR 502. See also discussion of dismissal of a Chapter 11 case in §4.90.

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III. OVERVIEW OF CHAPTER 7 (LIQUIDATION)

§9.24 A. Cessation of Debtor's Work or Business

The purpose of Chapter 7 is to liquidate assets, distribute proceeds to creditors, and provide individual debtors with a fresh start by allowing them to discharge debts that cannot be paid from the assets of the bankruptcy estate. See 11 USC §§704, 725-727. On the filing of a Chapter 7 petition (or conversion from Chapter 11), a trustee is appointed or elected (11 USC §§701-702), and the operations of the debtor cease immediately unless the court orders otherwise (11 USC §721). See chap 5 for additional discussion of Chapter 7 cases.

PRACTICE TIP: A Chapter 7 trustee rarely operates a business and will do so only when (1) funds are clearly sufficient to pay operating expenses and (2) operation will preserve or increase the value of the assets before the trustee liquidates the business. Because a trustee will be unfamiliar with the business and typically will be inclined to close operations, a creditor who believes operations are necessary to preserve the value of the assets should educate the trustee.

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§9.25 B. Appointment of Trustee; Duties

When a Chapter 7 petition is filed, a trustee is promptly appointed by the U.S. Trustee to take control of the debtor's assets. 11 USC §701(a)(1). Under 11 USC §704, the trustee will collect debts (see §9.26), liquidate assets (see §§2.72-2.82), and recover preferential payments (see §§2.37-2.55) and fraudulent transfers (see §§2.56-2.67) in order to satisfy claims filed against the estate. However, the trustee may also elect to abandon (see §§2.83-2.84) any assets that are inconsequential or burdensome, including those that may impose negative tax consequences on the estate. See, *e.g., Johnston v Webster (In re Johnston)* (9th Cir 1995) 49 F3d 538, 539.

Abandonment is accomplished without a hearing if the trustee or debtor in possession serves notice on all creditors and receives no objection. Fed R Bankr P 6007(a). A court hearing is required if a creditor objects to the trustee's or debtor's notice or makes a motion for abandonment. 11 USC §554(a)-(b); Fed R Bankr P 6007(a)-(b). Any unliquidated property that is listed on the schedules, regardless of whether it has value to the estate, is abandoned by operation of law at the close of the bankruptcy case. 11 USC §554(c).

EXAMPLE: Shortly before filing bankruptcy, the debtor-owner ceased work on the project and all contractors, subcontractors, and suppliers filed mechanics' liens. The debtor does not dispute the validity of the liens. Because of a depressed economy and cost overruns, the project is worth less than the total mechanics' liens against it. The trustee will need to hire a 24-hour security guard service to protect the project from vandals. The trustee serves a notice of intent to abandon the property, informing interested parties of their opportunity to object. If no one objects, the court will order the abandonment without a hearing.

The automatic stay terminates on the entry of the abandonment order (see 11 USC §362(c)(1)), and mechanics' lien claimants may then proceed with foreclosure. See California Mechanics' Liens and Related Construction Remedies, chap 3 (3d ed Cal CEB 1998).

The lien claimants may benefit from the trustee's early abandonment of the property because the automatic stay will terminate and foreclosure of the liens may proceed. See 11 USC §362(c)(1). Unless there is a cost savings or other advantage to the trustee in promptly abandoning, however, the trustee is likely to allow abandonment to happen by operation of law at the close of the case. 11 USC §554(c).

PRACTICE TIP: A lien claimant may be able to speed up the abandonment process by first contacting the trustee to determine a willingness to abandon, and then preparing the stipulation and proposed order. Even if the trustee is unwilling, any interested party may file a motion for an order requiring the trustee to abandon any property that is burdensome or of inconsequential value and benefit to the estate. 11 USC §554(b).

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§9.26 1. Collecting Debts

The trustee will collect the debtor's accounts receivable and pursue claims that the debtor held at the time the bankruptcy petition was filed. 11 USC §704(a)(1). These might include not only mechanics' lien claims held by the debtor-contractor or debtor-subcontractor, but also delay and change order claims.

PRACTICE TIP: Collection of accounts receivable is more difficult and expensive after a bankruptcy petition has been filed and a trustee appointed. Account debtors may assert setoffs, defenses, and chargebacks that the trustee alone may be unable to verify. If the receivables are significant, a debtor-contractor or debtor-subcontractor can help to maximize the recovery by delaying the filing of the petition, or if that is not possible, by entering into an agreement with the trustee to assist with collection.

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§9.27 2. Avoiding Preferences and Unauthorized Postpetition Transfers

The trustee will seek to recover money paid out by the debtor if the payment was a preference (see §§2.37-2.55, 9.47-9.54), an unauthorized postpetition transfer (see §§2.68-2.70, 9.46), or a fraudulent transfer (see §§2.56-2.67).

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3. Proofs of Claim in Chapter 7 Cases

§9.28 a. Filing Claims

Even if the claim is properly listed on the schedules, within 90 days after the first date set for the meeting of creditors, an unsecured creditor must file a proof of claim with the bankruptcy court unless the court sends a notice stating that claims are not to be filed because there are no apparent assets. See Fed R Bankr P 3001-3002 (on claim filings in Chapter 7 and 13 cases). On claims generally, see chap 3. On filing claims, see §§3.19-3.34.

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§9.29 b. Liquidating Claims

A proof of claim is deemed allowed, unless a party in interest objects under 11 USC §502(a), and it constitutes prima facie evidence of the validity and amount of the claim under Fed R Bankr P 3001(f). *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890.

If the trustee disputes that the debtor owes the amount set forth in the proof of claim, the trustee may file an objection to the claim, and the court will hold an evidentiary hearing on the objection. 11 USC §704(a)(5); Fed R Bankr P 3007(a). The filing of an objection to a proof of claim creates a dispute that is a "contested matter" within the meaning of Fed R Bankr P 9014. 278 F3d at 894.

If the trustee produces sufficient evidence to negate one or more of the sworn facts in the proof of claim, the burden reverts to the claimant to prove the validity of the claim by a preponderance of the evidence. *Lundell v Anchor Constr. Specialists, Inc. (In re Lundell)* (9th Cir 2000) 223 F3d 1035, 1039. However, applicable nonbankruptcy law may place the burden of proof elsewhere. See, *e.g., Raleigh v Illinois Dep't of Revenue (In re Stoecker)* (2000) 530 US 15, 147 L Ed 2d 13, 120 S Ct 1951 (leaving burden of persuasion on debtor with respect to tax claims). A decision of the bankruptcy court on the objection may be reviewed on appeal to a federal district court acting in its bankruptcy appellate capacity under 28 USC §158.

PRACTICE TIP: Often, a trustee objects to a claim because supporting evidence was not attached to the proof of claim. Counsel may head off objections by (a) attaching to the original proof of claim a summary of how the claim was calculated with copies of all material documents (*e.g.,* contracts, letters, invoices) and/or (b) responding promptly to a trustee's request for more information. See Fed R Bankr P 3001.

For further discussion of claims, see chap 3.

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§9.30 4. Distributing Assets

After all the debtor's assets have been turned into cash and the claims liquidated, the trustee will file a final report and distribute the assets according to the priority scheme established in the Bankruptcy Code. 11 USC §§704(a)(9), 726. Secured creditors (such as mechanics' lienholders) are entitled to the value of their interest in the collateral. 11 USC §506. The proceeds from the unencumbered assets are distributed to pay the trustee's fees (considered an administrative expense) and priority claims (such as employee wage and benefit and taxing authority claims), and, thereafter, unsecured creditors' claims. See 11 USC §§507, 726.

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IV. EFFECT OF STAY ON ACTIONS BY CREDITORS

§9.31 A. Stay of Collections, Recordation, and Existing and Future Enforcement Actions

Filing a bankruptcy petition immediately stays, among other things, all actions against the debtor to collect debts that arose before the filing of the bankruptcy petition; to enforce prepetition judgments; or to "create, perfect, or enforce any lien" against "property of the estate" or "property of the debtor" to the extent that such lien secures a claim that arose before the commencement of the bankruptcy case. 11 USC §362(a). For additional discussion of the automatic stay, see §§4.1-4.26.

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§9.32 1. When Debtor Is a Contractor

If a general contractor or subcontractor files a bankruptcy petition, a subcontractor under the debtor or a material supplier cannot demand payment from the debtor or file suit or enforce a judgment against the debtor based on the contract (see CC §3152) for money owed on work performed or goods supplied to a project before the bankruptcy petition was filed. See 11 USC §362(a).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/9 Mechanics' Liens/§9.33 2. When Debtor Is an Owner

§9.33 2. When Debtor Is an Owner

If an owner files a bankruptcy petition, a general contractor or subcontractor cannot, with respect to an obligation for work performed or goods supplied to a project before the petition is filed:

- Demand payment from the owner (see 11 USC §362(a)(6));
- File or pursue an action to foreclose a mechanics' lien under CC §3144 (see 11 USC §362(a)(1), (a)(3)-(4); *Village Nurseries v Gould (In re Baldwin Builders)* (BAP 9th Cir 1999) 232 BR 406; *Hand v Hunters Run Ltd. Partnership (In re Hunters Run Ltd. Partnership)* (9th Cir 1989) 875 F2d 1425, 1428); or
- Execute a foreclosure judgment obtained prepetition (see 11 USC §362(a)(2)-(4)).

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B. Actions Not Stayed

§9.34 1. Actions Against Third Parties and Their Property

The automatic stay does not stay actions against third parties or their property. For example, if the debtor does not own an interest in the property against which the lien is recorded, the automatic stay will not apply. See *Northeast Glass, Inc. v Alpen, Inc.* (*In re Northeast Glass, Inc.)* (Bankr D Mass 1990) 112 BR 475; *Sanwa Bank Cal. v Caldwell (In re Caldwell)* (Bankr CD Cal 1990) 111 BR 836.

CAVEAT: This is a trap for the unwary. If the debtor lacks an interest in the property and the stay therefore does not apply, the supplier or subcontractor may lose its lien rights by filing a Notice of Perfection with the bankruptcy court (see §9.37) instead of recording a mechanics' lien with the county. If the nature of the title to the property is such that application of the stay is in question, the supplier should seek clarification on whether the stay applies and, if it does, seek relief from stay. See §§9.42-9.45.

The stay does not apply to an action against a surety to recover on a California contractor's license bond. *Dunbar v Contractors' State License Bd. (In re Dunbar)* (BAP 9th Cir 1999) 235 BR 465, 475, aff'd (9th Cir 2001) 245 F3d 1058. A bond that is issued to guarantee payment of a contractor's subcontractors or suppliers (*i.e.,* a payment bond) also is not considered property of the estate. *O'Malley Lumber Co. v Lockard (In re Lockard*) (9th Cir 1989) 884 F2d 1171, 1177. See also *U.S. v Dos Cabezas Corp.* (9th Cir 1993) 995 F2d 1486, 1492. The reasoning of these cases could be applied equally to performance bonds whether they are a condition of licensure or contractually required by the project owner.

Arguably, the stay could apply if an action against a bond could adversely affect the rights of the bond principal's bankruptcy estate (*e.g.,* the stay might apply when the supplier's or subcontractor's claim against the estate is unsecured and the surety's indemnification claim is secured; on the other hand, the stay would be more likely to apply if the bond claimant were unsecured and the bonding company held a secured right of reimbursement from the debtor for amounts paid out to bond claimants). However, a bond requirement that the bond principal indemnify the surety does not by itself trigger the stay. See 995 F2d at 1491; *O'Malley Lumber Co. v Lockard (In re Lockard)* (9th Cir 1989) 884 F2d 1171, 1178 n12; *All Seasons Resorts, Inc. v Millner (In re All Seasons Resorts, Inc.)* (Bankr CD Cal 1987) 79 BR 901.

Even if the stay does not apply, or if the court is considering or has already granted a motion for relief from stay, a debtor may apply for injunctive relief against any action that would divert significant energies of key principals of the debtor in possession from reorganization efforts. See 11 USC §105(a); *Oberg v Aetna Cas. & Sur. Co. (In re A.H. Robins Co.)* (4th Cir 1987) 828 F2d 1023, 1026; *Maxicare Health Plans, Inc. v Centinela Mammoth Hosp. (In re Family Health Servs.)* (Bankr CD Cal 1989) 105 BR 937, 943. If served with a motion for relief from stay, the debtor could file a countermotion for such an injunction and might need to seek a preliminary injunction or a temporary restraining order followed by a preliminary injunction in order to prevent a gap in protection.

In an unpublished opinion, a federal district court ordered a stay of an entire action even though only one of four defendants was a debtor in bankruptcy and the plaintiff had requested the stay. See *Beardsley v All Am. Heating, Inc.* (WD Wash, May 22, 2007, No. C05-1962 P) 2007 US Dist Lexis 37210. The court, citing Ninth Circuit authorities, noted that even if the automatic stay did not apply to the remaining defendants, a court has inherent authority to stay litigation pending a collateral proceeding rather than litigating on a piecemeal basis.

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§9.35 2. Relation Back of Stop Notices

At least one court has held that a supplier who is owed money by a debtor-subcontractor does not violate the automatic stay by serving a stop notice on a construction lender or property owner. See *In re KDR Bldg. Specialties, Inc.* (Bankr SD Cal 1987) 76 BR 778. In *KDR,* the court noted that under California law, stop notice claimants share pro rata in the distribution of funds from a construction lender without regard to the order in which the stop notices were filed. From this, the court concluded that stop notices are intended to relate back to the date services were first performed and, therefore, may be perfected under 11 USC §546(b). See §9.37.

NOTE: In determining that the stay was not violated, the *KDR* court chose to focus on the fact that the stop notice related back to an earlier time, and characterized the serving of the stop notice as a "perfection," which is permitted under 11 USC §546(b). The court might have reached the same result—that the stay was not violated—by noting that the stop notice was served on a nondebtor party (the property owner and construction lender) and reached a fund that was not property of the debtor-subcontractor's estate.

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§9.36 C. Protecting Lien Rights During Stay

During the time the automatic stay prevents foreclosing the lien (see §9.31), the claimant must take alternative steps under bankruptcy law or lose its lien rights. If generally applicable law (*e.g.,* mechanics' lien statute) requires that an action be commenced to perfect a security interest that relates back to an earlier time, or to maintain or continue the perfection of a property interest, and if the action was not commenced before the petition was filed, perfection of the lien rights must be maintained or continued by giving Notice of Continued Perfection of Lien (see §9.70) within the time fixed by law for commencement of the action. Also, if the claimant did not record its mechanics' lien before the petition was filed, the claimant should take steps to perfect the lien promptly. See §§9.37-9.41.

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1. Recordation of Mechanics' Lien

§9.37 a. Perfecting Lien After Petition Filed

The time allowed under California law for an original contractor to record a mechanics' lien against the improved property is (1) 90 days after completion of the work of improvement if no notice of completion or cessation has been recorded or (2) 60 days after recordation of a notice of completion or a notice of cessation. CC §3115. The time for claimants other than an original contractor (*e.g.,* subcontractors and suppliers) to record mechanics' liens is (1) 90 days after completion of the work of improvement if no notice of completion or cessation has been recorded or (2) 30 days after recordation of a notice of completion or a notice of cessation. CC §3116. See generally California Mechanics' Liens and Related Construction Remedies §§3.33-3.44 (3d ed Cal CEB 1998).

If a claimant has not recorded its lien claim under these rules before the filing of the bankruptcy petition by the property owner, perfection of its lien rights is problematic. At least one authority holds that recording a mechanics' lien after the filing of the petition violates the automatic stay. See 11 USC §362(a)(4); *In re Associated Real Estate Technicians, Inc.* (Bankr SD Ohio 1983) 32 BR 306. Other authorities, however, hold that the recordation of a mechanics' lien is excepted from the bar of the stay by 11 USC §362(b)(3). See *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 550; *In re Lionel Corp.* (2d Cir 1994) 29 F3d 88, 93. See also *Village Nurseries v Gould (In re Baldwin Builders)* (BAP 9th Cir 1999) 232 BR 406, 415.

The rationale for this latter line of reasoning appears to be that, under California law, a mechanics' lien dates from the time of commencement of the work (see CC §3134; *Greenblatt v Utley* (9th Cir 1956) 240 F2d 243, 246) and that perfection, if timely (under CC §3115 or §3116), relates back to the time the lien arose. See discussion of mechanics' lien priority in Mechanics' Liens §§2.63-2.68. Consequently, the filing of a bankruptcy petition does not operate as a stay, because (1) the recordation is, for purposes of 11 USC §362(b)(3), "an act to perfect… an interest in property to the extent that the trustee's rights are subject to such perfection under section 546(b)," and (2) 11 USC 546(b)(1)(A) provides that the rights and powers of the bankruptcy trustee to avoid the lien of the mechanics' lien "are subject to any generally applicable law that… permits perfection of an interest in property to be effective against an entity [the mechanics' lien claimant] that acquires rights in such property before the date of perfection." See *In re Garner* (Bankr ND Cal 1997) 208 BR 698, permitting postpetition recordation of a trustee's deed on sale within the 15 days permitted under CC §2924h(c) when the foreclosure sale occurred before the filing of the bankruptcy petition.

On the timing of recordation of the lien, see §9.38.

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§9.38 b. Avoiding Violation of Stay

The case that has provided the most thorough analysis on the issue stated that it is not perfectly clear, but concluded that the better view is that perfection by recordation after the filing of a bankruptcy petition does *not* violate the automatic stay. See *In re Garner* (Bankr ND Cal 1997) 208 BR 698, 701. See also *In re Lionel Corp.* (2d Cir 1994) 29 F3d 88, discussed in §9.37. The recordation will be void, however, if later deemed by the court to have been done in violation of the stay (see *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569, 571). A mechanics' lien claimant who has not recorded by the date the bankruptcy petition is filed, therefore, can obtain an added level of assurance that perfection will be valid by recording the mechanics' lien within 30 days after the filing of the petition. This will bring the action under the exception to the stay found in the last clause of 11 USC §362(b)(3), *i.e.,* that the filing of a bankruptcy petition does not operate as a stay of any act to perfect an interest in property "to the extent that such act is accomplished within the period provided under section 547(e)(2)(A) of the Bankruptcy Code." Another option would be to seek relief from the stay in time to record the lien. See §§9.42-9.45.

See also Warning in §9.41.

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§9.39 2. Notice in Lieu of Filing Suit

The time allowed under California law to commence an action to foreclose a mechanics' lien is 90 days from the recording date of the lien claim. CC §3144. The automatic stay clearly bars the commencement of such an action against the debtor's property; no exception applies. See *Ryan v Grayson Serv., Inc. (In re Rincon Island Ltd. Partnership)* (Bankr CD Cal 2000) 253 BR 880, 884.

If the action is not commenced before the bankruptcy petition is filed, then a Notice of Continued Perfection of Lien (see §9.70) should be given to prevent a lapse of the underlying security interest (see §9.37), even if the mechanics' lien was recorded before the filing of the petition or within the permitted period after the filing of the petition (see §§9.37-9.38). See 11 USC §§362(b)(3), 546(b); *Village Nurseries v Gould (In re Baldwin Builders)* (BAP 9th Cir 1999) 232 BR 406, 414 (did not decide whether notice must be filed in bankruptcy court, but emphasized creditor must take "affirmative actions" calculated to inform debtor of intention to enforce lien rights); *In re 201 Forest St., LLC* (Bankr Mass 2009) 404 BR 6 (mortgagee lost right to foreclose when it failed to record extension of mortgage, or acknowledgment or affidavit that mortgage was not satisfied (as required by state law) before expiration of 5-year period of validity). See also *Ryan v Grayson Serv., Inc. (In re Rincon Island Ltd. Partnership), supra* (perfection under §546(b) can be accomplished by oral notice, if such notice or conduct is affirmative act calculated to inform debtor or trustee of creditor's intent to enforce its lien rights). But see *Hand v Hunters Run Ltd. Partnership (In re Hunters Run Ltd. Partnership)* (9th Cir 1989) 875 F2d 1425, 1428 (suggesting that, under Washington State law, notice of continued perfection is not necessary because 11 USC §108(c) tolls time for filing action to foreclose mechanics' lien); *Grover v County of Marin (In re Paul Potts Builders, Inc.)* (9th Cir 1979) 608 F2d 1279, 1283 (decided before 1987 and 1994 amendments to 11 USC §546(b); when valid mechanics' lien is recorded before owner declares bankruptcy, it remains valid despite claimant's failure to file timely action under CC §3144).

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§9.40 a. Filing and Service Requirements

At least one court has held that oral notice of the creditor's intent to enforce its lien rights is sufficient. See *Ryan v Grayson Serv., Inc. (In re Rincon Island Ltd. Partnership)* (Bankr CD Cal 2000) 253 BR 880, 888. See also *Marine Midland Bank v Breeden (In re Bennett Funding Group., Inc.)* (ND NY 2000) 255 BR 616, 633 (creditor's filing of motion for relief from automatic stay constituted sufficient notice for purposes of 11 USC §546(b)). However, at least one other court has held that neither informal communications with the debtors asserting that the contractor's claim was secured nor the filing of a secured proof of claim was adequate for §546(b) purposes because neither informed the debtors or the court that the contractor intended to enforce the lien. See *In re Worldcom, Inc.* (Bankr SD NY 2007) 362 BR 96, 120.

To avoid evidentiary issues and to facilitate orderly participation in the bankruptcy case, a Notice of Continued Perfection of Lien (see §9.70) should be filed with the clerk of the court in which the bankruptcy petition was filed. A copy of the notice should be served on the debtor or debtor in possession and the trustee, if any, and their counsel, on the U.S. Trustee, and on any other party who has requested notice (see §4.8) or is entitled to it under state law (see §9.39; California Mechanics' Liens and Related Construction Remedies §§3.33-3.44 (3d ed Cal CEB 1998)). A proof of service should be filed with the court. Fed R Bankr P 7005.

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§9.41 b. Time Limits

The Notice of Continued Perfection of Lien (see §9.70) must be filed and served within the time remaining under the respective provisions of California law for filing the lawsuit to foreclose (CC §3144). See §9.39. See also *Schafer v Carolina Kitchen & Bath, Inc. (In re Orndorff Constr., Inc.)* (Bankr MD NC 2008) 394 BR 372. This statutory period may be altered if a debtor-owner has recorded a defective notice of completion. See California Mechanics' Liens and Related Construction Remedies §3.44 (3d ed Cal CEB 1998).

WARNING: Waiting until the last minute to file an action to foreclose the lien is risky. If the owner files a bankruptcy petition, any subsequently filed action will be void. See *Schwartz v U.S. (In re Schwartz)* (9th Cir 1992) 954 F2d 569, 571; *Village Nurseries v Gould (In re Baldwin Builders)* (BAP 9th Cir 1999) 232 BR 406, 415. If the bankruptcy petition is filed close to the end of the time period for recording or filing suit under state law, neither counsel nor the client may be aware that a bankruptcy petition has been filed until it is too late to give notice of perfection under 11 USC §546(b). Often, the delay between the time the bankruptcy petition is filed and the time creditors receive the mailed Notice of Commencement of Case is a week or more. See §4.8.

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§9.42 V. RELIEF FROM STAY

The bankruptcy court has the power to modify or terminate the automatic stay to allow a creditor to proceed with suit on a mechanics' lien claim despite the filing of a bankruptcy petition. 11 USC §362(d). The grounds for relief from stay include the following:

- Cause, including lack of adequate protection (11 USC §362(d)(1); see §9.44); and
- Lack of equity (11 USC §362(d)(2); see §9.45).

Not all lien creditors will need to request relief from stay and proceed to judgment in state court to be paid on a lien claim. When the amount of the lien claim is not disputed, the claim will be paid eventually through the Chapter 11 plan of reorganization or by the Chapter 7 trustee. As a result, the creditor may simply (1) take the necessary steps to perfect the lien (see §§9.37-9.38) and (2) file with the court a Notice of Continued Perfection of Lien (see §9.70) and a Proof of Claim (see §§3.19-3.28, 9.16, 9.28).

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§9.43 A. Nature and Extent of Relief

Relief from stay to pursue mechanics' lien rights may be afforded in varying degrees; the court may:

- Allow the claimant to proceed with suit only to determine the amount owed; or
- Allow complete foreclosure of the lien.

The form and the extent of relief from stay are directly related to the grounds asserted by the creditor and the facts of the case.

EXAMPLE 1: If serious legal or factual disputes exist, particularly ones that would be time-consuming for the bankruptcy court to resolve or that would require substantial interpretation of nonbankruptcy laws, the bankruptcy court may stay any pending adversary proceeding on the claim and grant relief from the stay to allow resolution of the claim in a nonbankruptcy forum. The judgment obtained in the alternate forum normally is not enforced but becomes the amount of the creditor's claim, which is then paid through a Chapter 11 plan of reorganization or through a Chapter 7 distribution by the trustee. See, *e.g., Gary Aircraft Corp. v U.S. (In re Gary Aircraft Corp.)* (5th Cir 1983) 698 F2d 775. If the bankruptcy court believes that the alternate forum action would be expensive for the debtor, the bankruptcy court may deny relief from stay.

EXAMPLE 2: Relief from stay to proceed with a suit in state court is often sought when the debtor is merely a nominal party to a lawsuit in which the creditor is willing to waive any recovery from the debtor and the bankruptcy estate and look only to a third party such as an insurance company. In this situation, relief from stay would usually be granted because the creditor is not actually proceeding against the property of either the debtor or the bankruptcy estate, the estate will incur no defense costs, and the insurer will be responsible for any judgment. See, *e.g., In re Holtkamp* (7th Cir 1982) 669 F2d 505, 508. (Note that relief from stay is generally not required to sue the debtor's surety, because the automatic stay probably does not apply to an action by a creditor against a bond surety. See *U.S. v Dos Cabezas Corp.* (9th Cir 1993) 995 F2d 1486, 1491. See also §§9.3, 9.34.)

PRACTICE TIP: Before filing a motion for relief from stay, creditor's counsel should ask the debtor and the trustee if they are willing to stipulate to relief from stay, then obtain an order modifying the stay from the bankruptcy court by stipulation. See Fed R Bankr P 4001(d). If proceeding against the debtor's insurance, the creditor will probably need to agree that neither the debtor nor the estate will be liable for any amounts in excess of the policy limits.

An order granting a motion for relief from stay entered pursuant to Fed R Bankr P 4001(a)(1) is stayed until the expiration of 14 days after the entry of the order, unless the court orders otherwise. Fed R Bankr P 4001(a)(3). For additional discussion of seeking relief from stay, see §§4.15-4.26.

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B. Grounds for Relief From Stay

§9.44 1. Cause

A mechanics' lien claimant may seek relief from the automatic stay "for cause, including the lack of adequate protection" of the claimant's property interest. 11 USC §362(d)(1). Adequate protection is meant to preserve the status quo of a creditor for a reasonable length of time. If a creditor is adequately protected, its rights are frozen but not changed. *In re Chevy Devco* (Bankr CD Cal 1987) 78 BR 585, 588. Lack of adequate protection may be caused by, among other things, the following factors:

- An actual or threatened erosion of the value of the property against which the claimant holds a lien (*e.g.,* if the debtor-owner is committing waste on the property, if the improvements on the property are not adequately insured, or if the property improvements are exposed to the elements or to vandalism); or
- An erosion of the secured position of the lienholder (*e.g.,* if the debtor-owner will not be able to pay the real property taxes due after the filing of the petition; see 11 USC §362(b)(18)).

For general discussion of relief from stay for cause, see §4.20.

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§9.45 2. Lack of Equity

Alternatively, a mechanics' lienholder may seek relief from the automatic stay on the grounds that the debtor-owner lacks equity in the property on which the lien is held. The debtor or trustee then has the opportunity not only to introduce evidence that there is, in fact, equity in the property, but also to defeat the motion by showing that, despite a lack of equity, the property is necessary for an effective reorganization. 11 USC §362(d)(2), (g); *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 375, 98 L Ed 2d 740, 108 S Ct 626. The debtor or trustee must further show that reorganization is possible within a reasonable time. 484 US at 376.

EXAMPLE: The debtor-owner purchased two adjacent parcels of property. It hired contractors to construct a hotel on one parcel and a parking structure on the other. City ordinances require that the hotel have a certain number of parking spaces. The parking structure was completed before the bankruptcy petition was filed, and the creditor-subcontractors all filed mechanics' liens. The hotel will not be completed for another 3 months. The parking structure will receive no income unless and until the hotel is completed, and therefore the structure currently appraises for an amount less than the total mechanics' liens against it. If the parking structure is lost to foreclosure of the liens, the city will deny the hotel an occupancy certificate, and it will be unable to open. Under these circumstances, even though there is lack of equity, the court is likely to deny the mechanics' lien claimants' motion for relief from stay on the grounds that the parking structure is necessary for the debtor's reorganization if the debtor can prove that it has a reasonable chance of completing the project.

For general discussion of relief from stay due to lack of equity, see §4.21.

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VI. AVOIDABLE TRANSFERS

§9.46 A. Unauthorized Postpetition Transfers

After filing a bankruptcy petition, a debtor is prohibited from transferring any assets of the bankruptcy estate except:

- In the ordinary course of business (*i.e.,* in payment of ordinary postpetition obligations) (see, *e.g.,* 11 USC §§363(c), 721, 1107(a), 1108, 1304);
- As otherwise allowed by the Bankruptcy Code (see 11 USC §549(a)(2)); or
- As permitted by court order (see, *e.g.,* 11 USC §§363(b), 549(a)(2)(B)).

If the debtor makes other transfers, the trustee can "avoid" those transfers and recover the assets by filing suit in the bankruptcy court. 11 USC §§549-550.

See §§2.32-2.70 on trustee avoiding powers.

PRACTICE TIP: Contractors, subcontractors, or suppliers sometimes demand that payment be made on a prepetition obligation as a condition of their supplying goods or services postpetition. Although an appropriate executory contract may not exist in every case, unless the debtor assumes an executory contract under 11 USC §365(a) (see chap 6, §§9.12-9.13), these terms are not allowed, and payments made on prepetition invoices may be avoided later. A contractor, subcontractor, or supplier who is disappointed at not receiving payment on a prepetition obligation may, however, require C.O.D. (or similar payment arrangements) or choose not to do business with a debtor in possession who does not assume the executory contract after filing the petition.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/9 Mechanics' Liens/§9.47 B. Preferences

§9.47 B. Preferences

A trustee or debtor in possession generally may avoid (*i.e.,* set aside and recover back into the bankruptcy estate) a prepetition payment to or for the benefit of a noninsider creditor under 11 USC §547(b) if all of the following are true:

- The debt was incurred before the payment was made;
- The debtor was insolvent at the time of the payment;
- The payment was made on or within 90 days of filing the bankruptcy petition; and
- The creditor received more than it would have received had the payment not been made, had the case been one under Chapter 7, and had the creditor received payment as permitted by the Bankruptcy Code.

The debtor is presumed to have been insolvent during the 90-day period immediately preceding the filing. 11 USC §547(f). For general discussion of preferences, see §§2.37-2.55.

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§9.48 1. Payments Skipping Over Debtor

Payments made by a third party (who owes money to the debtor) directly to a debtor's creditor are not part of the debtor's property if the third party has an independent obligation to pay the creditor. See *Shaw Indus., Inc. v Gill (In re Flooring Concepts, Inc.)* (BAP 9th Cir 1984) 37 BR 957, 961, in which the bankruptcy appellate panel held that a prepetition payment, made under an agreement among the general contractor, the debtor-subcontractor, and a supplier that the general contractor would pay the supplier directly in exchange for the supplier's forbearance from further pursuit of its lien remedies, did *not* constitute a transfer of property of the debtor, and therefore was not a preference. The panel also held that prepetition payments made by the general contractor directly to a trust fund for the debtor's employees and to the laborers of the debtor were not transfers of the debtor's property. 37 BR at 963. See also discussion in §2.27.

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§9.49 2. Effect of Joint Checks

In *Keenan Pipe & Supply Co. v Shields* (9th Cir 1956) 241 F2d 486, a supplier on a public works project expressly agreed to waive its stop notice rights under former CCP §1190.1 in exchange for a joint check arrangement. Shortly before the subcontractor filed bankruptcy and under the arrangement, the contractor-obligor wrote a check jointly payable to the debtor-subcontractor and the creditor-supplier. The Ninth Circuit found that the payment was not a preference because the purpose and intent of both the general contractor and the subcontractor was that all funds in the joint check be delivered to the supplier, and therefore the money never became property of the subcontractor's estate. See §9.5. See also *Napolitano v Vibra-Conn, Inc. (In re R.J. Patton Co.)* (Bankr D Conn 2006) 348 BR 618, 626 (debtor-subcontractor's endorsement of joint checks payable to itself and supplier was avoidable as a preference because supplier had already forfeited lien rights through failure to comply with applicable law).

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3. Receipt of More Than Similarly Situated Creditors

§9.50 a. Statutory Distribution Formulas

A preference is avoidable only if it allows the creditor to receive more than the creditor would have received if the case were liquidated under Chapter 7. See §§2.37-2.43, 9.47. When the assets of a bankruptcy estate are distributed, a secured creditor receives payment equal to (1) 100 percent of the value of the creditor's interest in the estate's interest in the collateral (11 USC §506(a)(1)) and, (2) if the value of the collateral is insufficient to pay the full amount owed, the same percentage distribution on the balance of its claim as unsecured creditors receive (11 USC §726(a)). The lien is valued as of the time of the bankruptcy filing. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540. An unsecured creditor who receives full prepetition payment from a debtor whose estate will distribute less than 100 percent to unsecured creditors has per se received more than it would have received under Chapter 7. *Elliott v Frontier Props. (In re Lewis F. Shurtleff, Inc.)* (9th Cir 1985) 778 F2d 1416.

EXAMPLE 1: A claimant owed $100,000 holds a mechanics' lien against property worth $120,000 solely owned by the debtor. The property is encumbered by a $80,000 senior lien. If, under Chapter 7, unsecured creditors would receive a 10-percent distribution on their claims, and assuming no competing mechanics' lien claims exist, the claimant would receive $46,000, *i.e.,* $40,000 by virtue of its lien rights and 10 percent of its remaining $60,000 unsecured claim.

Under 11 USC §506(a)(1), if the debtor's interest in the property in which the creditor holds a security interest is at least as great as the value of the secured claim, a prepetition payment on the secured debt is not a preference because the lienholder is entitled to full payment on its claim under Chapter 7, and the payment cannot be avoided as a preferential transfer.

EXAMPLE 2: Assume the same facts as in Example 1, except that the value of the senior lien is less than $20,000. Even if the debtor made a prepetition payment to the claimant for its full $100,000, there would be no preference to recover.

Conversely, if the value of the mechanics' lien is for any reason less than the payment received by the creditor in exchange for the release, the amount by which the payment exceeds the lien value may be recovered as a preference, if no defenses apply. See §§9.55-9.69.

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§9.51 b. Holder of Unperfected Lien May Be Secured Creditor

For purposes of determining whether the creditor has received more than it otherwise would have in a Chapter 7 case, a creditor is considered to be "secured" even if it has not taken steps to perfect its mechanics' lien if, at the time payment is received, the time period provided under state law for perfecting the mechanics' lien rights has not yet expired. In other words, even the holder of an inchoate lien is a secured creditor for preference purposes. *Golfview Dev. Ctr., Inc. v All-Tech Decorating Co. (In re Golfview Dev. Ctr., Inc.)* (ND Ill 2004) 309 BR 758, 768.

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§9.52 c. Discounted Payoffs

A prepetition payment to a secured creditor that is less than the value of the security interest is not a preference. For considerations on how to structure a settlement, see §9.61.

EXAMPLE: A contractor held a $100,000 mechanics' lien against property solely owned by the debtor worth $120,000 before the bankruptcy petition was filed. Because the property was encumbered by an $80,000 senior lien, the mechanics' lien was worth $40,000. If the contractor received a $40,000 prepetition payment, the contractor did not receive an amount greater than he or she would have received in Chapter 7.

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§9.53 d. Only Debtor's Interest in Property Applies

Only the *debtor's* interest in the property encumbered by the lien is considered. Thus, if the property *owner* files a bankruptcy petition, the value of the owner's interest in the property is the value of the property minus senior encumbrances. If a *tenant* of the property files a bankruptcy petition, the value of the debtor's equity in the leasehold interest is the basis for the calculation. The court in *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540 determined that the creditor's mechanics' lien rights were worth nothing as of the filing date of the petition because the leasehold was worthless on that date. 176 BR at 546. A mechanics' lien claimant may have had a right to recover in full from the property of the *owner-landlord,* but that right is not a basis for considering the claimant to be a secured creditor of the debtor-lessee when the leasehold has no value. See 176 BR at 546.

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§9.54 e. Time and Method of Measuring Value

To ascertain whether a creditor received more than he or she would have in a Chapter 7 liquidation, it is assumed that the assets of the estate would have been distributed on the commencement date of the bankruptcy case. Therefore, the lien value on the date the petition was *filed* is used to calculate whether the creditor was fully secured, undersecured, or unsecured. *Alvarado v Walsh (In re LCO Enters.)* (9th Cir 1993) 12 F3d 938, 941; *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 545. See §9.60. The trustee or debtor in possession has the burden of proving the lien value on the date of the petition. 11 USC §547(g).

The value of the debtor's interest in the property serving as security, however, takes into account the effect of administrative claims filed during the bankruptcy. See *Alvarado,* 12 F3d at 942; *Neuger v U.S. (In re Tenna Corp.)* (6th Cir 1986) 801 F2d 819, 823.

The court must decide whether the creditor would have had, as of the filing date of the petition, an enforceable lien right equal to or greater than the amount of the payment received. *Cocolat, Inc.,* 176 BR at 546.

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§9.55 4. Defenses

Even if a prima facie case for a preference is established, the trustee under 11 USC §547(c) may not avoid a transfer:

- To the extent that the transfer was both (1) intended by the debtor and the creditor to be a contemporaneous exchange for *new value* given to the debtor and (2) in fact a *substantially contemporaneous exchange* (see §§9.57-9.63);
- To the extent that the transfer was in payment of a debt incurred by the debtor in the *ordinary course of business,* and the payment was made in the ordinary course of business according to ordinary business terms (see §§9.64-9.67);
- To or for the benefit of a creditor, to the extent that after the transfer the *creditor gave new value* to or for the benefit of the debtor; and
- The new value given is not secured by an otherwise unavoidable security interest; and
- The debtor did not make an otherwise unavoidable transfer to or for the benefit of the creditor on account of the new value (see §9.68); or
- Resulting from the filing and recordation of a *statutory lien* that is not avoidable under 11 USC §545 (see §9.69).

See also general discussion of defenses to preference claims in §§2.45-2.55.

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§9.56 a. Burden of Proof on Transferee

The transferee bears the burden of proving the elements of a defense in an action to avoid a preference. 11 USC §547(g).

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§9.57 b. Substantially Contemporaneous Exchange for New Value

The Bankruptcy Code protects transfers in which the debtor receives a substantially contemporaneous exchange of new value because these transfers do not deplete the bankruptcy estate or affect the equality of distribution of the estate's assets. 11 USC §547(c)(1); *O'Rourke v Coral Constr., Inc. (In re E. R. Fegert, Inc.)* (BAP 9th Cir 1988) 88 BR 258, aff'd (9th Cir 1989) 887 F2d 955. In *Fegert,* the subcontractor-creditors dismissed their suits against the debtor-contractor and released their claims against the debtor's surety in exchange for payments from the debtor. The bankruptcy appellate panel held that the subcontractors' releases of their rights against the surety constituted substantially contemporaneous exchanges for new value because the releases precluded the imposition of an equitable lien by the surety against the contract proceeds due from the government to the debtor-contractor. The panel supported this holding with the reason that, had the surety actually paid the subcontractors, its rights against the contract proceeds would have been senior to the debtor's rights to those funds under the doctrine of subrogation and under the debtor's agreement as the bond principal to indemnify the surety. 88 BR at 260. See also *Committee of Creditors Holding Unsecured Claims v Koch Oil Co. (In re Powerine Oil Co.)* (9th Cir 1995) 59 F3d 969, 973, in which the court ruled that other assurances of repayment, such as the right to draw on letters of credit, are considered in calculating the creditor's recovery, but only to the extent that the third party who was the source of the assurance held a secured claim for indemnity against the debtor.

See additional discussion of contemporaneous exchanges in §2.46.

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§9.58 (1) Definition of New Value

New value includes money or money's worth in goods, services, or new credit, or release by a transferee of property previously transferred to such transferee, but new value does not include the substitution of one obligation for another. 11 USC §547(a)(2). It may include the release of a mechanics' lien. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 547. See §9.61. If the value of the mechanics' lien, however, is less than the payment received by the creditor in exchange for the release, the new value defense protects only a portion of the payment, and the amount by which the payment exceeds the lien value may be recovered as a preference if there is a smaller prorata distribution to unsecured creditors. See *Creditors' Comm. v Spada (In re Spada)* (3d Cir 1990) 903 F2d 971. See §9.52.

The new value defense will be unavailable if the creditor is given a substituted payment for a dishonored check—even if the dishonored check was given in exchange for a lien release—when the lien release was not conditioned on the receipt of payment. The subsequent payments to make good on the check, no matter how quickly made, would be satisfying an antecedent debt. *Endo Steel, Inc. v Janas (In re JWJ Contracting Co.)* (9th Cir 2004) 371 F3d 1079. See also *Janas v Marco Crane & Rigging Co. (In re JWJ Contracting Co.)* (BAP 9th Cir 2002) 287 BR 501, 510. In both *Endo Steel* and *Janas,* a subcontractor signed an unconditional release of payment bond rights in exchange for the contractor's payment by a check that bounced. Several days later, the contractor sent the subcontractor a cashier's check in response to a demand. When the trustee sought to recover the payment as a preference, the court concluded that a credit transaction had occurred and that new value was not given for the unconditional release. See additional discussion of new value in §2.49.

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(2) Release of Mechanics' Liens on Private Works

§9.59 (a) Debtor's Property Versus Third Party's Property

On a privately owned project, release of a mechanics' lien against the debtor's property serves as new value for a payment received. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 547. See also *Angeles Elec. Co. v Superior Court* (1994) 27 CA4th 426, 435, 32 CR2d 660. Release of a mechanics' lien against property not owned by the debtor generally does not create new value. *Johnson v Bulger Contracting Co. (In re Empire Pipe & Dev., Inc.)* (Bankr MD Fla 1993) 152 BR 339, 340. But see discussion of *Lang v Heieck Supply (In re Anderson Plumbing Co.)* (Bankr ED Cal 1986) 71 BR 19 in §9.62.

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§9.60 (b) Value Determined as of Payment Date

To establish a prima facie case (that a preference has been received), the value of the debtor's interest in property is determined as of the filing date of the bankruptcy petition (see §9.54). To ascertain whether the mechanics' lien claimant has a new value defense, the value must be calculated as of the date the alleged preferential payment was made. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 547; *Lubman v C.A. Guard Masonry Contractor (In re GEM Constr. Corp.)* (Bankr ED Va 2000) 262 BR 638, 651.

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§9.61 (c) Lien Release in Exchange for Payment; Recorded Versus Unperfected Rights

The release of a mechanics' lien already recorded on the debtor's property qualifies as new value for purposes of 11 USC §547(c)(1). *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 547. Whether the release of an existing and valid right to record a lien on the debtor's property can serve as new value is an open question in the Ninth Circuit. See *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.), supra*; *Milchem, Inc. v Fredman (In re Nucorp Energy, Inc.)* (9th Cir 1990) 902 F2d 729, 732 n3. Although other courts have declined to expand the definition of "new value" (see *Cimmaron Oil Co. v Cameron Consultants, Inc.* (ND Tex 1987) 71 BR 1005; see §9.62), a logical argument can be made that losing the right to record a mechanics' lien (that has not expired at the time the payment is made) against the debtor's property is a constructive exchange for new value, assuming there was equity in the property to which the lien would have attached and (to make the new value defense complete) assuming the amount the owner owes the debtor under the construction contract is great enough to pay all mechanics' liens in full. See dictum in *Lubman v C.A. Guard Masonry Contractor (In re GEM Constr. Corp.)* (Bankr ED Va 2000) 262 BR 638, 654. See also dictum in *Committee of Creditors Holding Unsecured Claims v Koch Oil Co. (In re Powerine Oil Co.)* (9th Cir 1995) 59 F3d 969, 973. But see dictum in *Anderson v Ganis Credit Corp. (In re Jan Weilert R.V., Inc.)* (Bankr CD Cal 2000) 245 BR 377, 385, aff'd (BAP 9th Cir 2001) 258 BR 1, rev'd on other grounds in 315 F3d 1192.

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§9.62 (3) Release of Claims on Public Works Bonds and Payment Bonds

On a public works project, a subcontractor who is not paid by a debtor-contractor has no right to record a mechanics' lien, but instead has a right to seek payment from the contractor's surety bond. See generally California Mechanics' Liens and Related Construction Remedies, chaps 4, 10 (3d ed Cal CEB 1998). A payment bond is sometimes posted on a private project. See generally Mechanics' Liens §§2.104-2.105, 8.36. In *Lang v Heieck Supply (In re Anderson Plumbing Co.)* (Bankr ED Cal 1986) 71 BR 19, 20, the court noted that the supplier's acceptance of a payment from the debtor-contractor effectively released the supplier's "right to the lien he had against the contractor's bond." The court held that this release on acceptance of the payment constituted a contemporaneous exchange of new value, giving rise to an affirmative defense to the preference action.

The *Anderson* case has been criticized on two grounds: *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 548, noted that the *Anderson* reasoning was that a surety who pays a subcontractor subrogates to the subcontractor's rights against the debtor-contractor, and that the debtor's payment to the subcontractor eliminates the surety's claim for indemnity against the debtor's estate. Although the creditor in *Cocolat* urged that the elimination of this kind of claim was new value, the court reasoned that, unlike the elimination of a *lien* against the estate, the elimination of an unsecured *claim* against the estate does not enlarge the estate.

The court in *Cimmaron Oil Co. v Cameron Consultants, Inc.* (ND Tex 1987) 71 BR 1005 also criticized *Anderson.* It found that payments made to a lien creditor during the preference period (which resulted in the creditor's taking no affirmative steps to perfect its statutory lien rights) did not constitute contemporaneous exchange for new value. The *Cimmaron* court noted that Congress could have allowed courts to expand the doctrine of new value by legislating that new value *includes* certain transactions; instead, Congress stated what new value *means*. See also *Simon v Engineered Protection Sys., Inc.* (*In re Hatfield Elec. Co.)* (Bankr ND Ohio 1988) 91 BR 782 (release of owner's general unsecured claim for indemnity against debtor-contractor is actual value, but not new value).

The court in *Cocolat* seems to hold the better view: The mere elimination of a subcontractor's right to recover against the debtor-contractor's surety bond (with the consequent elimination of the surety's right to an unsecured indemnity claim against the debtor) does *not* amount to a substantially contemporaneous exchange of new value given to the debtor. This will not be the end of the analysis in all cases, however. The court in *Cocolat* noted distinguishing facts in the case of *O'Rourke v Coral Constr., Inc. (In re E. R. Fegert, Inc.)* (BAP 9th Cir 1988) 88 BR 258, aff'd (9th Cir 1989) 887 F2d 955, one of which was that the public agency for which the contract was being performed held retention funds that were owing to the debtor under the prime contract. Had the subcontractor in *Fegert* asserted a claim against the surety, the surety would have had the right to an equitable lien against the retention funds. Under these facts, the subcontractor's release of its claim against the surety resulted in a release of a potential *secured* claim against the debtor's property. This release was properly viewed as new value. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 548 n4. See also *Janas v Reuter Equip. Co. (In re JWJ Contracting Co.)* (9th Cir 2003) 2003 US App Lexis 18413 (unpublished opinion); *Lubman v C.A. Guard Masonry Contractor (In re GEM Constr. Corp.)* (Bankr ED Va 2000) 262 BR 638, 652. For further discussion of this concept, see *Rieser v Landis & Gyr Powers, Inc. (In re Bownic Insulation Contractors, Inc.)* (Bankr SD Ohio 1991) 134 BR 261.

Despite *Fegert,* if the surety's potential equitable lien on contract proceeds is undersecured (*e.g.,* because of competing claims) and if the trustee can show that no portion of the transfer could possibly have resulted in a reduction of the surety's lien, then the new value exception does not apply and the transfer is avoidable as a preference, or that portion of the claim that is unsecured is avoidable. See *Janas v Marco Crane & Rigging Co. (In re JWJ Contracting Co.)* (BAP 9th Cir 2002) 287 BR 501, 514.

Regardless of whether the surety's indemnity claim is secured or unsecured, the execution of an unconditional lien release in exchange for a check that is subsequently dishonored for insufficient funds does not constitute new value that protects the payment of the debt through a cashier's check that replaces the dishonored check. See *Endo Steel, Inc. v Janas (In re JWJ Contracting Co.)* (9th Cir 2004) 371 F3d 1079, 1083.

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§9.63 (4) Provision of Future Goods or Services

The creditor need not return transfers received within 90 days of the filing date of the petition if it can prove that, after the payment was received and before the petition was filed, it supplied goods or services having a value equal to or greater than the value of the transfer. If the value of the goods or services subsequently provided is less than the value of the payment received, the creditor may nonetheless have a partial defense equal to the value of the future goods and services. See §9.68.

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§9.64 c. Ordinary Course of Business

A second defense to a preference action is that the payment received was made in the ordinary course of business. The creditor bears the burden of proving that the payment was for a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee (see §9.65) and that:

- The payment itself was made in the ordinary course of business or financial affairs of the debtor and the transferee (see §9.66); or
- The payment was made according to ordinary business terms (see §9.67).

See 11 USC §547(c)(2); *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118. See also general discussion of ordinary course of business exception in §2.47.

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§9.65 (1) Debt Incurred in Ordinary Course of Business

The ordinary course of business defense is intended to leave undisturbed *normal* financial relations. The general policy of the preference section is to discourage unusual action by either the debtor or creditor. *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118, 1125. The defense can be established either through a subjective (see §9.66) or an objective (see §9.67) test. In addition, if the debt was not incurred in the ordinary course of the debtor's business, the repayment of the debt will not qualify for the defense. See 11 USC §547(c)(2).

EXAMPLE: In the months before filing the bankruptcy petition, the debtor ran short of cash to operate its business. The debtor's principal made a short-term loan to the debtor to cover the shortfall. Within 90 days of filing the petition, the debtor repaid the loan to the principal. The repayment of the loan cannot qualify for the ordinary-course-of-business defense. *Pioneer Tech., Inc. v Eastwood (In re Pioneer Tech., Inc.)* (BAP 9th Cir 1988) 107 BR 698, 702.

When the payment agreement between the debtor and the creditor has been revised or restructured, the court may consider both the revised agreement and the original transaction in its analysis under 11 USC §547(c)(2). *Wood,* 482 F3d at 1127.

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§9.66 (2) Payment Made in Ordinary Course Between Parties

One way to establish the ordinary-course-of-business defense is to show that the transfer was in accordance with the prior course of business of the debtor and the transferee. This is a subjective standard, *i.e.,* whether the parties themselves considered the transaction ordinary. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 549. Factors considered by the courts include:

- The length of time the parties were engaged in the transactions at issue;
- Whether the amount or the form of tender differed from past practices;
- Whether the debtor or creditor engaged in any unusual collection or payment activity; and
- Whether the creditor took advantage of the debtor's deteriorating financial condition.

Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.) (9th Cir 2007) 482 F3d 1118, 1129. Even a first-time transaction between the debtor and creditor can qualify as having been made in the ordinary course of business or financial affairs of the debtor and the creditor if the transaction was "ordinary in relation to" that debtor's and that creditor's past practices "when dealing with other, similarly situated parties." 482 F3d at 1126.

Although failure to make payments within the time required by the contract creates a rebuttable presumption that the payment is nonordinary, late payments may be within the ordinary course of business if they are a few days late and follow the prior practice between the parties. *UIC, Inc. v Plaintiff Comm. of Creditors (In re Powerine Oil Co.)* (BAP 9th Cir 1991) 126 BR 790, 795. See also *Sulmeyer v Pacific Suzuki (In re Grand Chevrolet, Inc.)* (9th Cir 1994) 25 F3d 728, 732 (declined to adopt rule stating "late payments can never be ordinary").

PRACTICE TIP: Counsel should look carefully at the invoice terms. If they call for payment within 30 days and payment is made within that period or shortly thereafter, the subjective standard under 11 USC §547(c)(2)(A) may be met even if the work was performed many months earlier. A chart listing all previous invoices and payments, including the number of days between the invoice date and the payment date, should aid in showing whether the challenged payments deviate from the prior course of dealing.

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§9.67 (3) Ordinary Business Terms (Industry Practices)

As an alternative to showing that the transfer was in accordance with the prior course of business of the debtor and the transferee (see §9.66), the creditor may prove that the contested transfer was made under an objective standard based on practices common to businesses similarly situated to those of the debtor and the transferee. *Bell Flavors & Fragrances, Inc. v Andrew (In re Loretto Winery, Ltd.)* (BAP 9th Cir 1989) 107 BR 707. This is an objective standard, *i.e.,* whether the relevant industry would consider the payment to have been made under ordinary business terms. *Cocolat, Inc. v Fisher Dev., Inc. (In re Cocolat, Inc.)* (Bankr ND Cal 1995) 176 BR 540, 550.

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§9.68 d. New Value

A third possible defense to a preference action available to a creditor on a construction project is that the creditor delivered new value to the debtor after receiving the challenged payment and before the debtor filed the petition. The key elements of the exception are (1) the creditor must give unsecured new value; (2) the new value must be given after the preferential transfer; and (3) the new value may not have been paid for by "an otherwise unavoidable transfer." *In re Workboats Northwest, Inc.* (Bankr WD Wash 1996) 201 BR 563, 565. To be a complete defense, the new value given must be equal to or greater than the value of the transfer sought to be avoided. 11 USC §547(c)(4); *Successor Comm. of Creditors v Bergen Brunswig Drug Co. (In re Ladera Heights Community Hosp., Inc.)* (Bankr CD Cal 1993) 152 BR 964; *Mosier v Ever-Fresh Food Co. (In re IRFM, Inc.)* (Bankr CD Cal 1992), 144 BR 886, aff'd (9th Cir 1995) 52 F3d 228. See also general discussion of new value defense in §2.49.

EXAMPLE: Debtor purchased $10,000 worth of goods from a creditor on an open account 6 months before filing a bankruptcy petition. Thirty days before the filing date, the invoice had not been paid. At that point, the debtor requested that the creditor supply $8000 worth of additional goods. The creditor demanded payment on the previous invoice before shipping more goods, and the debtor paid the full $10,000. Thereafter, the creditor shipped $8000 in additional goods. The trustee or debtor in possession can avoid only $2000 of the $10,000 paid because the $8000 shipment gave the creditor a "new value" defense for the remaining portion of the preference.

PRACTICE TIP: Creating a chart showing when each payment and each shipment was made makes it easier to calculate a running balance of the amount of the outstanding uncured preference. See *Successor Comm. of Creditors v Bergen Brunswig Drug Co., supra*.

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§9.69 e. Statutory Lien

A fourth possible defense to a preference action is that the action sought to be avoided is "the fixing of a statutory lien" that is not avoidable under 11 USC §545. See 11 USC §547(c)(6). Properly perfected mechanics' liens fall into this category. See *Souers v Nevada Ready Mix (In re Souers)* (Bankr SD Iowa 1994) 163 BR 346 (mechanics' lien properly perfected under state law before filing of Chapter 7 case not avoidable by trustee under 11 USC §545(2)). See also discussion of statutory liens and the trustee's avoidance powers in §§2.35-2.36.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/9 Mechanics' Liens/§9.70 VII. FORM: NOTICE OF CONTINUED PERFECTION OF LIEN

§9.70 VII. FORM: NOTICE OF CONTINUED PERFECTION OF LIEN

_ _[*Name of attorney; State Bar number*]_ _
_ _[*Address*]_ _
_ _[*Telephone number*]_ _
Attorney for Creditor, _ _[*name*]_ _

United States Bankruptcy Court
_ _ _ _ _ _ _ District of California

In re _ _[*name(s)*]_ _**,**	**)**	**Case No.** _ _ _ _ _ _
Debtor(s)	**)**	**Chapter** _ _
	)	
	)	**NOTICE OF CONTINUED**
_____	**)**	**PERFECTION OF LIEN**

TO THE CLERK OF THE BANKRUPTCY COURT, THE DEBTOR(S), THE TRUSTEE, AND ALL OTHER INTERESTED PARTIES, AND THEIR ATTORNEYS OF RECORD:

You are hereby notified that _ _[*name of creditor*]_ _ **(Creditor) hereby perfects, under 11 United States Code §546(b), its mechanics' lien in the amount of $**_ _[*amount*]_ _ **for material furnished by Creditor on that real property commonly known as** _ _[*address*]_ _ **and legally described in the attached mechanics' lien, a true copy of which is attached hereto as Exhibit A. You are further notified that said Creditor intends to enforce the lien to the fullest extent allowed by bankruptcy law and California state law.**

Date: _ _ _ _ _ _ _ _[*Name of firm*]_ _

By: __[*Signature of attorney*]__
_ _[*Typed name*]_ _
Attorney for _ _[*name*]_ _

Copies: Original (file in bankruptcy court with original proof of service); copies for service (for debtor, debtor's attorney, trustee (if any), U.S. Trustee, and other appropriate parties); office copy; client copy. Check local rules for number of copies required to be filed with the original (see Directory for website of local bankruptcy courts).

Comment: Familiarity with local bankruptcy court and department rules is essential. Attorneys are cautioned to investigate prescribed formats for the filing of papers, as these vary among the districts and their departments.

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10

Real Property Secured Loans

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§10.1 I. INTRODUCTION

A lender with a properly perfected security interest in real property possesses two sets of rights: (1) an obligation of the debtor, usually represented by a promissory note, and (2) an interest in the debtor's real property to secure performance of such obligation, usually enforceable by causing the property to be sold and the sale proceeds to be applied toward satisfaction of the debt.

The commencement of a case under Title 11 of the United States Code (the Bankruptcy Code) will affect and may alter the lender's rights. The commencement of a case will usually stay any action to collect the debt or enforce the lender's lien rights, such as foreclosing on the real property. See §§4.1-4.14. During the case, the collateral may be sold free and clear of the secured lender's lien or used as collateral for further borrowing, provided that there is adequate protection of the secured lender's interests. See §§2.72-2.82. Finally, the rehabilitative chapters under the Bankruptcy Code (Chapters 11, 12, and 13) may be used to modify the terms of the underlying loan.

This chapter is primarily intended to provide the reader with an overview of the bankruptcy process as it applies to the interests of a lender secured by real property, with an emphasis on parties' legal rights as interpreted by decisions in the Ninth Circuit. The discussion is limited to the Bankruptcy Code's effect on private parties' rights under Chapters 7, 11, 12, and 13.

PRACTICE TIP: If debtor's counsel is about to prepare a bankruptcy petition, counsel must explain to the debtor that even though the filing will precipitate the automatic stay and delay foreclosure (see §§10.2-10.4), a creditor's motion for stay relief (see §10.17) is likely. Counsel must prepare to defend the motion from the inception of the bankruptcy (see §10.43).

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II. AUTOMATIC STAY

A. Overview of Automatic Stay

§10.2 1. Generally

The filing of a voluntary or involuntary bankruptcy petition generally results in the imposition of the automatic bankruptcy stay without need for a hearing or court order. 11 USC §362(a). The automatic stay enjoins most creditor efforts to immediately recover property or take other legal action. The stay blocks a broad range of judicial and nonjudicial actions against the debtor, the debtor's property, and property of the bankruptcy estate (see §§4.1-4.26, 10.4-10.13) including litigation, lien enforcement, and self-help remedies of creditors. The expansive nature of the stay is meant to provide a temporary "breathing spell" so that the trustee or debtor can conduct an orderly liquidation or reorganization for the benefit of all creditors.

Before the stay terminates against abandoned property of the estate or terminates by virtue of a closure or dismissal of the case (or before an automatic termination under 11 USC §362(c)(3)(A) (see §4.14)), a creditor may obtain a court order allowing relief from stay to proceed against specific property. See §§10.17-10.52.

For more on the operation of the automatic stay, see chap 4.

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§10.3 2. Restrictions on Serial Filings

To address the problem of serial filings, the Bankruptcy Code significantly limits applicability of the automatic stay if an individual debtor had one or more cases pending in the bankruptcy court in the prior year. These limits apply to both single and joint cases filed by married individuals and to voluntary and involuntary petitions, and address two scenarios. See 11 USC 362(c). See also §10.8, citing specific code sections that limit the application of the automatic stay in enforcement of real property liens and secured lending situations.

For further discussion of restrictions on serial filings, see §§4.3-4.6.

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B. Scope of Automatic Stay

§10.4 1. Acts to Create, Perfect, or Enforce Lien

The automatic stay expressly enjoins acts to create, perfect, or enforce (1) "any lien against property of the estate" and (2) "against property of the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case." 11 USC §362(a)(4)-(5). The term "lien" is expansively defined under 11 USC §101(36)-(37), (51), (53) to include security interests, statutory liens, judicial liens, and other charges against, or interests in, property to secure payment of a debt. The automatic stay also prohibits the "enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case." 11 USC §362(a)(2). The automatic stay clearly restrains not only an actual foreclosure sale but also:

- The publication, recordation, or service of a notice of trustee sale (nonjudicial foreclosure), except a notice of postponement (see §10.5);
- A notice of default and election to sell; and
- The commencement or continued prosecution of a judicial foreclosure action or an action to have a receiver appointed to collect rents, issues, and profits.

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a. Exceptions: Foreclosure Sales

§10.5 (1) Postponing Sale

A foreclosing party does not violate the automatic stay by giving notice that a sale, noticed prior to commencement of the bankruptcy case, has been postponed from time to time, whether before or after plan confirmation. *Mason-McDuffie Mortgage Corp. v Peters (In re Peters)* (9th Cir 1996) 101 F3d 618; *First Nat'l Bank v Roach (In re Roach)* (9th Cir 1981) 660 F2d 1316. See also *Nghiem v Ghazvini (In re Nghiem)* (BAP 9th Cir 2001) 264 BR 557, aff'd (9th Cir 2002) 53 Fed Appx 489 (unpublished opinion) (oral postponement of foreclosure sale under CC §2924g does not violate stay, provided that underlying bankruptcy case is dismissed before postponed sale date). It has also been held that publishing notice of a foreclosure sale on the same day as the bankruptcy filing does not violate the stay. *Tully v World Sav. & Loan Ass'n* (1997) 56 CA4th 654, 65 CR2d 545.

Because Fed R Bankr P 4001(a)(3) provides that an order granting stay relief to allow foreclosure does not become effective until 14 days after its entry, a postponed foreclosure sale cannot commence until after the 14-day period expires, unless the bankruptcy court reduces or eliminates that period. Note that the usual 7-day waiting period under California law does not apply to stay relief motions in bankruptcy. See CC §2924g(e). See also California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009).

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§10.6 (2) Recordation of Trustee's Deed to Effect Prepetition Sale

If the borrower files a bankruptcy petition after a nonjudicial foreclosure sale but before the trustee's deed is recorded, an exception to the automatic stay should exist for recordation of the deed within 15 calendar days of the sale. The bankruptcy appellate panel in *Bebensee-Wong v FNMA* (*In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820, applying 11 USC §§362(b)(3) and 546(b), held that such recordation is valid because it relates back to 8 a.m. on the day of the sale, or the next business day following the 15th day if the county recorder is closed on the 15th day, and the sale is treated as final on the sale date under CC §2924h(c). See also *In re Stork* (Bankr ND Cal 1997) 212 BR 970 (trustee's deed recorded 16 days after sale and postbankruptcy filing, but court annulled stay to confirm sale because 11 USC §549(c) protected good faith purchaser who recorded before debtor recorded notice of bankruptcy petition); *Blatnick v Sanders (In re Sanders)* (Bankr SD Cal 1996) 198 BR 326 (sale held on same day as, but few hours after, bankruptcy filing not validated by recordation under CC §2924h, but stay annulled because of debtor's bad faith); *Davisson v Engles* (*In re Engles)* (Bankr SD Cal 1996) 193 BR 23 (stay relief granted to purchaser at prepetition foreclosure sale to record trustee's deed because bare legal title remaining was of no value to estate; debtor had failed to record notice of petition, so argument that purchaser had not timely complied with CC §2924h(c) was hypothetical).

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§10.7 b. Other Exceptions

Arguably, a bankruptcy petition filed in contravention of an order barring the debtor from filing additional bankruptcy petitions for 180 days is without effect. The Ninth Circuit reached that conclusion in a case involving a postpetition foreclosure conducted after such a filing, but the published decision was withdrawn and is no longer citable. *Umali v Dhanani (In re Umali)* (9th Cir 2003) 345 F3d 818, withdrawn (9th Cir 2004) 382 F3d 1158.

The U.S. Supreme Court has held that a bank's "administrative hold" of the debtor's deposit account pending a hearing on the bank's stay relief motion does not violate the automatic stay. *Citizens Bank v Strumpf* (1995) 516 US 16, 133 L Ed 2d 258, 116 S Ct 286. For transactions subject to California mortgage law, such a "freeze" may nonetheless be subject to attack as a violation of the one-action rule of CCP §726. For further discussion of the one-action rule, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 4 (4th ed Cal CEB 2009).

Several miscellaneous exceptions to the automatic stay regarding governmental liens can impact real estate collateral. Most notable is the exception allowed for creation or perfection of a statutory lien for state ad valorem property taxes that come due postbankruptcy. 11 USC §362(b)(18). Thus, accrual of unpaid property taxes secured by a senior lien under state law can erode a private lender's security.

Other exceptions have less wide-ranging impact. See 11 USC §362(b)(8) (Secretary of Housing and Urban Development may commence action to foreclose on certain mortgages and deeds of trust); 11 USC §362(b)(4) (acts taken by governmental units in exercise of their police or regulatory power); *U.S. v Klein (In re Chapman)* (BAP 9th Cir 2001) 264 BR 565 (government not barred from seeking forfeiture of debtor's house used to grow and distribute marijuana because such action is exercise of its police power); *Javens v City of Hazel Park (In re Javens)* (6th Cir 1997) 107 F3d 359 (stay does not prevent demolishing debtor's real property for code violations involving public health and safety). But see *Maricopa County v PMI-DVW Real Estate Holdings* (*In re PMI-DVW Real Estate Holdings)* (Bankr D Ariz 1999) 240 BR 24 (no exception for condemnation action to acquire real estate for road because no showing of specific public health, safety, or welfare issues).

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§10.8 c. BAPCPA Exceptions

Two changes enacted under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) (Pub L 109-8, 119 Stat 23) codify evolving case law dealing with abusive repeat filings:

- **Prior order granting stay relief regarding real property.** The automatic stay does not apply "to any act to enforce any lien against or security interest in real property" for 2 years after entry of an order lifting the automatic stay regarding the property in any prior bankruptcy case under 11 USC §362(d)(4)—provided, however, that the debtor may move for relief from the prior order based on changed circumstances or other good cause. 11 USC §362(b)(20). The relief order extending the automatic stay must be recorded with the county recorder. 11 USC §362(d)(4). These changes track case law authorizing "in rem" stay relief. See §10.22.
- **Ineligible debtor.** The automatic stay does not apply "to any act to enforce any lien against or security interest in real property" if the debtor is ineligible under 11 USC §109(g) (barring eligibility for individuals and family farmers with bankruptcy cases dismissed within the prior 180 days by the court for willful misbehavior or voluntarily after a stay relief motion was filed; see §10.22) or if the present case is filed in violation of an order in a prior bankruptcy case that prohibits the debtor from filing another bankruptcy. 11 USC §362(b)(21). See §10.7. See also §§4.3-4.6, 10.3.

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2. Tolling of Redemption and Reinstatement Periods

§10.9 a. Redemption

The automatic stay protects a debtor's preforeclosure equity of redemption because that right continues until the foreclosure sale actually commences (see California Mortgages, Deeds of Trust, and Foreclosure Litigation §2.73 (4th ed Cal CEB 2009)); if the sale is stayed, the equity of redemption is tolled along with the actual sale (see *In re Capital Mortgage & Loan, Inc.* (Bankr ED Cal 1983) 35 BR 967, 971).

Whether the automatic stay tolls the running of the period for postsale statutory redemption (following a judicial foreclosure) is undecided. In that context, the lien has been extinguished by the judicial foreclosure. Because expiration of the redemption period extinguishes the debtor's right to buy the property back from the foreclosure sale purchaser, arguably there is no real act for the stay to prohibit. However, at the expiration of the redemption period, the foreclosure sale purchaser must take some action to obtain title, typically the exchange of the certificate obtained at the sale for a deed to the property. On judicial foreclosures generally, see Mortgage Deed of Trust Foreclosure, chap 3.

Deferral of the taking of title until after the redemption period expired formed the basis of a Ninth Circuit decision holding, under prior bankruptcy law, that the automatic stay tolled the redemption period. See *Hamblen v Federal Sav. & Loan Ins. Corp. (In re Thomas J. Grosso Inv.)* (9th Cir 1972) 457 F2d 168. See also *In re Capital Mortgage & Loan, Inc., supra* (bankruptcy filing tolls periods within which debtor must reinstate or redeem loan). More recent cases have held that the automatic stay does not toll the running of the postforeclosure redemption period. See, *e.g., Johnson v First Nat'l Bank* (8th Cir 1983) 719 F2d 270, 276 (considering Minnesota redemption law). Until the Ninth Circuit decides this question under current bankruptcy law, taking into consideration California redemption law, creditors should proceed with a judicial foreclosure cautiously.

NOTE: The postsale redemption period is extended for up to 60 days after the entry of the order for relief (*i.e.,* the commencement of the bankruptcy case) by 11 USC §108(b) when the redemption period has not expired prior to the filing of the petition. See *Johnson v First Nat'l Bank, supra*; *In re Santa Fe Dev. & Mortgage Corp.* (BAP 9th Cir 1981) 16 BR 165 (dealing with extension of time to exercise option to purchase).

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§10.10 b. Reinstatement

Under CC §2924c(e), the reinstatement period in nonjudicial foreclosure proceedings expires 5 business days before a sale and is automatically revived whenever the sale is continued for more than 5 business days. Thus, as is most common, when the bankruptcy petition is filed before the sale is noticed, the automatic stay will toll the running of the reinstatement period by prohibiting publication of a notice of sale that establishes a sale date. See §10.4. As for a sale that has already been noticed at the time the petition is filed, the automatic stay will prevent the sale from taking place as scheduled and will also result in a tolling of the reinstatement period if the sale is continued for more than 5 business days. On California law that triggers new notice of sale and revives reinstatement right after sale is postponed for more than a period of 1 year, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009).

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§10.11 3. Foreclosure by Senior Lienholder When Debtor's Only Interest Is Junior Lien

A bankruptcy filing by the holder of a junior lien should automatically stay the foreclosure action of a senior lienholder. The junior lien is property of the holder's bankruptcy estate under 11 USC §541, and foreclosure by a senior lienholder would terminate the junior lien in violation of the automatic stay. See *In re Capital Mortgage & Loan, Inc.* (Bankr ED Cal 1983) 35 BR 967. See also *Monumental Life Ins. Co. v Bibo, Inc.* (*In re Bibo, Inc.)* (BAP 9th Cir 1996) 200 BR 348, vacated (9th Cir 1998) 139 F3d 659 (appeal mooted by payoff of junior lien); *Fidelity Mortgage Investors v Camelia Builders, Inc.* (2d Cir 1976) 550 F2d 47 (Bankruptcy Act decision); *Florida Inst. of Technol. v Carpenter* (*In re Westec Corp.)* (5th Cir 1972) 460 F2d 1139 (Bankruptcy Act decision). Affording protection to a junior lien is also consistent with cases protecting the estate's interest as a lessee (*Roslyn Sav. Bank v Comcoach Corp.* (*In re Comcoach Corp.)* (2d Cir 1983) 698 F2d 571) and as one of several co-owners of the collateral (*Harsh Inv. Corp. v Bialac* (*In re Bialac)* (9th Cir 1983) 712 F2d 426).

On the effect of the automatic stay on reinstatement rights of junior creditors in bankruptcy, the authorities are split. Compare *California Thrift & Loan Ass'n v Downey Sav. & Loan Ass'n (In re Eagles)* (BAP 9th Cir 1984) 36 BR 97 (automatic stay protection to borrower-debtor's reinstatement rights under prior California law does not extend to junior lienholder-debtor's reinstatement rights) with *In re Capital Mortgage & Loan, Inc., supra* (bankruptcy filing tolls periods within which junior lienholder-debtor must reinstate or redeem loan).

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§10.12 4. Postforeclosure Eviction

The purchaser at a foreclosure sale may sometimes need to bring an unlawful detainer action to evict a borrower who refuses to vacate. If the purchaser obtains an unlawful detainer judgment and writ of possession before the bankruptcy filing, the automatic stay arguably should not prevent eviction, because the borrower has no remaining legal or equitable interest in the property and eviction will not impact the bankruptcy estate. CCP §715.050; *Marquand v Smith* (*In re Smith)* (Bankr CD Cal 1989) 105 BR 50; *Lee v Baca* (1999) 73 CA4th 1116, 86 CR2d 913. But see *Westside Apartments, LLC v Butler* (*In re Butler)* (Bankr CD Cal 2002) 271 BR 867 (holding that §715.050 is unconstitutional; landlord must file stay relief motion even if unlawful detainer judgment entered and writ of possession issued before tenant filed for bankruptcy).

WARNING: The *Butler* court cautioned that future creditors seeking to rely on *Smith, Baca,* or §715.050 "for purposes of making an end run around obtaining relief from the automatic stay run the risk of liability for violating the automatic stay." 271 BR at 876.

Statutory amendments enacted under BAPCPA may impact a court's analysis of this issue: The automatic stay no longer blocks eviction or unlawful detainer proceedings by a "lessor" against a debtor involving "residential property in which the debtor resides as a tenant under a lease or rental agreement" if the lessor has obtained a judgment for possession before the bankruptcy case is filed. 11 USC §362(b)(22). A holdover resident arguably falls within this exception as a form of holdover tenant. Note, however, that this exception does not apply until 30 days after the petition is filed and that the debtor has an opportunity to extend the automatic stay if the entire monetary default is cured within the 30 days. 11 USC §362(*l*).

PRACTICE TIP: Many judges post guidelines that permit shortened-notice motions for relief from stay against holdover tenants. See, *e.g.,* Judge Tchaikovsky's or Judge Morgan's guidelines for stay relief motions at the website for the Northern District of California Bankruptcy Court listed in Directory (click on the Judges tab, then the name of judge, and then the Procedures link).

On tenant bankruptcy generally and on the effect of BAPCPA on residential tenant evictions, see chap 7. On eviction after foreclosure, see §7.23; California Landlord-Tenant Practice §§8.68A-8.68E (2d ed Cal CEB 1997).

PRACTICE TIP: If a stay relief motion is needed to proceed with foreclosure, counsel should consider including in the motion a request for leave to pursue an eviction action following foreclosure, as necessary, and include appropriate language in the proposed order. See §7.73.

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§10.13 5. Acts to Recover Claim Against Debtor or Debtor's Property

The Bankruptcy Code allows the debtor to retain certain property, such as exempt property and property acquired after case commencement. 11 USC §§522, 541(b); see §1.9. Property may also revert back to the debtor if the trustee abandons an asset. 11 USC §554; see §§2.83-2.84. In addition to protecting property of the estate, the automatic stay prevents (1) acts to create, perfect, or enforce a lien securing a prepetition claim against property of the debtor; (2) acts to collect, assess, or recover a prepetition claim against the debtor individually; and (3) acts to set off any debt that arose prepetition. 11 USC §362(a)(5)-(7). Therefore, unless the stay terminates earlier (see §§4.14, 10.2), a secured lender will need to seek relief from the automatic stay even if the collateral has been abandoned to the debtor or is retained by the debtor as exempt property.

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C. Violation of Automatic Stay

§10.14 1. Acts Violating Stay Are Void

The Ninth Circuit has held that acts taken in violation of the automatic stay are void ab initio and without effect. *Far Out Prods., Inc. v Oskar* (9th Cir 2001) 247 F3d 986; *Schwartz v U.S.* (*In re Schwartz)* (9th Cir 1992) 954 F2d 569, 571. The automatic stay of 11 USC §362 does not apply, however, to sales of assets by the debtor. Such sales may be subject to avoidance under 11 USC §549 and therefore may be voidable but are not void ab initio. *Burkart v Coleman* (*In re Tippett)* (9th Cir 2008) 542 F3d 684 (trustee did not obtain avoidance under §549 because court applied defense in favor of bona fide purchaser). However, 11 USC §362 clearly applies to creditor actions (see *Burkart v Coleman* (*In re Tippett), supra*); thus a foreclosure sale that violates the stay will be void. *Phoenix Bond & Indem. Co. v Shamblin (In re Shamblin)* (9th Cir 1989) 890 F2d 123 (tax sale). Not surprisingly, a lender's claim for costs of a void foreclosure sale held in violation of the automatic stay have been disallowed. *Pro Fin., Inc. v Spriggs (In re Spriggs)* (BAP 10th Cir 1998) 219 BR 909, aff'd (10th Cir 1998) 166 F3d 348 (unpublished opinion).

Bankruptcy courts do, however, have discretion to annul the automatic stay retroactively to validate otherwise void past actions. 11 USC §362(d); *Schwartz v U.S.* (*In re Schwartz), supra*; *Aheong v Mellon Mortgage Co. (In re Aheong)* (BAP 9th Cir 2002) 276 BR 233 (court has jurisdiction to issue order annulling automatic stay after dismissal of Chapter 13 case). A bankruptcy court must balance the equities on a case-by-case basis to determine whether retroactive annulment is justified. *National Envt'l Waste Corp. v City of Riverside (In re National Envt'l Waste Corp.)* (9th Cir 1997) 129 F3d 1052 (annulment allowed when debtor did not challenge contract termination until after confirmation of plan that accepted validity of termination). In deciding whether to grant retroactive relief from the stay, courts may focus on (1) whether the creditor was aware of the bankruptcy petition, and (2) whether the debtor engaged in unreasonable or inequitable conduct or whether prejudice to the creditor would result. See, *e.g., Stinson v Bi-Rite Restaurant Supply, Inc. (In re Stinson)* (BAP 9th Cir 2003) 295 BR 109, 116, aff'd in part and rev'd in part on other grounds in *Stinson v Cook Perkiss & Lew (In re Stinson)* (9th Cir 2005) 128 Fed Appx 30.

For additional discussion of violation of automatic stay, see §§4.11-4.13.

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§10.15 2. Rights of Third Party Purchaser at Void Sale

Prior to BAPCPA, courts were divided on whether 11 USC §549(c) created an implied exception to the automatic stay that would protect a good faith third party purchaser at a foreclosure sale held in violation of the stay. See §10.78. Section 549 empowers a trustee to avoid an unauthorized postpetition transfer of estate property. However, an exception to this avoidance power exists for a good faith purchaser of real property that pays fair equivalent value and purchases without knowledge of the commencement of the bankruptcy case. 11 USC §549(c). The exception is not available if a copy of the bankruptcy petition has been recorded before the sale with the county recorder for the county in which the property is located. 11 USC §549(c).

The Ninth Circuit ruled that §549(c) did not create an exception protecting a bona fide purchaser at a foreclosure sale held in violation of the automatic stay. In *40235 Wash. St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, 1081, the court held that §549 governed avoidance actions by the trustee, not transfers that are already void under the automatic stay. A second Ninth Circuit case also held that bona fide purchaser status alone was not cause for retroactive annulment of the stay, but it stated that a buyer could obtain relief if the equities allowed for retroactive annulment of the automatic stay. See *Fjeldsted v Lien (In re Fjeldsted)* (BAP 9th Cir 2003) 293 BR 12, which suggested 12 nonexclusive factors that might be considered in determining whether such relief is warranted (293 BR at 25):

(1) Number of case filings;

(2) Whether a repeat filing case is intended to delay and hinder creditors;

(3) Extent of prejudice to the creditor and third parties if annulment is not granted, including harm to a bona fide purchaser;

(4) Overall good faith of the debtor;

(5) Whether the creditors knew of the automatic stay;

(6) Whether the debtor is complying with the Bankruptcy Code and Federal Rules of Bankruptcy Procedure;

(7) Ease of restoring the parties to the status quo ante;

(8) Costs of annulment to the debtor and creditor;

(9) How quickly the creditor moved for annulment or how quickly the debtor moved to set aside the sale;

(10) Whether, after learning of the bankruptcy, the creditor continued to take steps in violation of the stay or whether it moved expeditiously to obtain relief;

(11) Whether annulment will cause irreparable injury to the debtor; and

(12) Whether annulment will promote judicial economy or other efficiencies.

See Bernhardt & Stillman, *Balancing the Automatic Stay*, 26 CEB Real Prop L Rep 144 (July 2003).

BAPCPA resolved the divided case law by creating a statutory exception to the automatic stay for transfers that are not avoidable under 11 USC §§544 and 549. See 11 USC §362(b)(24). This change should protect good faith buyers purchasing at a void foreclosure sale. In that situation, however, the foreclosing lender's damage exposure may increase if the property cannot be returned to the debtor.

PRACTICE TIP: Counsel for a debtor facing foreclosure should promptly record a copy of the bankruptcy petition and deliver to the lender and its counsel a notice of the automatic stay. A Judicial Council form (Notice of Stay of Proceedings, Judicial Council Form CM-180) is available for this purpose. See Directory for website information. This will discourage violation of the stay and reduce the risk of litigation with third party purchasers at a sale held in violation of the stay.

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§10.16 3. Statutory Damages and Contempt Sanctions

An individual debtor injured by a willful violation of the automatic stay should recover actual damages including attorney fees and, in appropriate circumstances, may recover sanctions or punitive damages from the offending party. 11 USC §362(k) (former 11 USC §362(h)). See *Eskanos & Adler, P.C. v Leetien* (9th Cir 2002) 309 F3d 1210. "Willfulness" is established if (1) the creditor knew of the automatic stay and (2) the actions violating the stay were intentional. *Associated Credit Servs., Inc. v Campion (In re Campion)* (BAP 9th Cir 2003) 294 BR 313, 316. Egregious, intentional misconduct or a showing of reckless or callous disregard for the law or rights of others is required to award punitive damages for a willful violation. *Goichman v Bloom (In re Bloom)* (9th Cir 1989) 875 F2d 224; *Stinson v Bi-Rite Restaurant Supply, Inc. (In re Stinson)* (BAP 9th Cir 2003) 295 BR 109, aff'd in part and rev'd in part on other grounds in *Stinson v Cook Perkiss & Lew (In re Stinson)* (9th Cir 2005) 128 Fed Appx 30. In awarding attorney fees for a stay violation, the court has discretion to determine the number of hours reasonably expended and the proper hourly rate. *Dawson v Washington Mut. Bank, F.A. (In re Dawson)* (9th Cir 2004) 390 F3d 1139, 1152.

NOTE: Creditors as well as debtors have standing to recover damages under 11 USC §362(k)(1) if they are seeking to protect the bankruptcy estate. *In re International Forex of Cal., Inc.* (Bankr SD Cal 2000) 247 BR 284 (creditors awarded attorney fees and punitive damages against corporate debtor's officer and his attorney for willful violation of stay).

For further discussion of damages and sanctions for willful violation of the automatic stay, see §4.13.

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III. RELIEF FROM AUTOMATIC STAY

§10.17 A. Relief Available to Creditors

Unlike in typical injunctions, the burden is generally on the enjoined creditor to move for relief from the automatic stay. However, as discussed in §§4.3-4.6, 10.3, the debtor (or other party in interest) must take affirmative steps to impose the stay when there have been serial bankruptcy filings by the debtor. Federal courts have the final authority to determine the scope and applicability of the automatic stay; consequently, state courts do not have the power to modify or dissolve the stay. *Gruntz v County of Los Angeles (In re Gruntz)* (9th Cir 2000) 202 F3d 1074, 1083. Parties in interest may request that the bankruptcy court terminate, annul, modify, or condition the stay. 11 USC §362(d). Stay relief is ordinarily granted after a noticed hearing (see §§10.30-10.38, 10.43-10.52), but the parties may also stipulate to relief (see §§10.39-10.42). The bankruptcy courts have power to grant relief retroactively or to annul the stay. See §§4.15, 10.14. For example, a bankruptcy court may annul the stay retroactively to validate a foreclosure sale. See *Fjeldsted v Lien (In re Fjeldsted)* (BAP 9th Cir 2003) 293 BR 12, discussed in §4.15.

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§10.18 B. Enforceability of Prepetition Stay Waivers

Anticipatory agreements waiving the automatic stay if a bankruptcy case is commenced are generally invalid as a restraint against filing bankruptcy in violation of public policy. See, *e.g., In re Jenkins Court Assocs. Ltd. Partnership* (Bankr ED Pa 1995) 181 BR 33 (holding waiver unenforceable). See also *In re Pease* (Bankr D Neb 1996) 195 BR 431, 433 (summarizing at length public policy embodied in automatic stay rules).

There is, however, some authority for the enforcement of prepetition agreements to lift the stay in single asset real estate cases (see §§1.64, 4.22, 10.29). See, *e.g., In re University Commons, LP* (Bankr MD Fla 1996) 200 BR 255 (holding, alternatively, that relief from stay was warranted under terms of prepetition settlement with lender on bad faith grounds); *In re University Commons, LP* (Bankr MD Fla 1996) 204 BR 80 (denying reconsideration motion by debtor and unsecured creditor notwithstanding alleged equity in property and prejudice to interests of unsecured creditors). Such clauses are likely to be scrutinized carefully by the court.

Although the Ninth Circuit has not ruled directly on the enforceability of prepetition waivers of the automatic stay, courts in the Ninth Circuit are generally reluctant to enforce prepetition waivers of bankruptcy benefits. See, *e.g., Hayhoe v Cole (In re Cole)* (BAP 9th Cir 1998) 226 BR 647 (refusing to allow state court stipulated judgment to establish nondischargeability of debt because it was impermissible attempt to waive debtor's right to bankruptcy discharge); *Bruder v Peaches Records & Tapes, Inc. (In re Peaches Records & Tapes, Inc.)* (BAP 9th Cir 1985) 51 BR 583, 587 n6 (noting that ipso facto clause, allowing contract to terminate on bankruptcy filing, is not enforceable). See also *Bank of China v Huang (In re Huang)* (9th Cir 2002) 275 F3d 1173.

Some lenders negotiate stay relief for future bankruptcies in reorganization plans. Such provisions are not self-executing or enforceable per se. See *Southwest Ga. Bank v Desai (In re Desai)* (Bankr MD Ga 2002) 282 BR 527; *In re Atrium High Point Ltd. Partnership* (Bankr MD NC 1995) 189 BR 599. See further discussion on debtor agreements not to oppose stay relief motions in §§10.39-10.42.

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C. Grounds for Relief

§10.19 1. Overview

The Bankruptcy Code provides four alternative grounds for obtaining relief from the automatic stay:

(1) If the creditor establishes "cause," including but not limited to lack of adequate protection of the creditor's interest in the property or the debtor's bad faith. 11 USC §362(d)(1). See §§10.20-10.25.

(2) If the debtor holds insufficient equity in the property and the property is not necessary to an effective reorganization. 11 USC §362(d)(2). See §§10.26-10.28.

(3) In single asset real estate cases, if the debtor has not taken specified steps within the earlier of 90 days after the petition date or 30 days after the court determines that the debtor is a single asset real estate concern, whichever is later. 11 USC §362(d)(3). See §10.29.

(4) In cases in which creditors are secured by real estate, if the bankruptcy filing was part of a scheme to delay, hinder, and defraud creditors involving either transfer of the real estate without creditor or court consent or multiple bankruptcy filings affecting the property. 11 USC 362(d)(4). See §§4.3-4.6, 10.3, 10.22 on serial filings.

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2. Cause for Stay Relief

§10.20 a. Lack of Adequate Protection

A secured lender can show lack of adequate protection of its interest in real property and related collateral, such as rents, in several ways. Typically, the lack of adequate protection problem facing the lender is postbankruptcy erosion in the value of the collateral as a result of depreciation, declining market values, unpaid real property taxes secured by a senior lien, waste, deferred maintenance, or other similar circumstances. Another common adequate protection problem arises when the debtor or trustee fails to maintain adequate insurance naming the lender as an additional insured.

In response, a debtor or trustee may try to show that the lender is adequately protected. The Bankruptcy Code sets out the following three nonexclusive examples of what can constitute adequate protection (11 USC §361):

(1) Periodic cash payments, to the extent of the decrease in value of the secured party's interest in the property;

(2) Additional or replacement liens, to the extent of the decrease in value of such entity's interest in such property; or

(3) Other relief (other than an administrative expense priority claim) that will result in the realization by such entity of the "indubitable equivalent" of its interest in the property.

Under the first two illustrations, adequate protection is required only to the extent of the decrease in value of a secured creditor's "interest in such property." This interest is the secured party's allowed secured claim, which cannot exceed the value of the property. 11 USC §506(a). Thus, adequate protection against a decline in value may consist of simply making sufficient regular payments to the lender or granting a lien on other property. In the commercial context, a lender may be compelled to accept rental income as adequate protection of its interest. *Metropolitan Life Ins. Co. v Sunnymead Shopping Ctr. (In re Sunnymead Shopping Ctr.)* (BAP 9th Cir 1995) 178 BR 809. But a secured creditor cannot be adequately protected merely by being granted an administrative priority claim in an amount equal to the decline in collateral value. See 11 USC §361(3). The inadequacy of this approach is most glaring in single asset real property cases when, after disposition of the collateral, there will usually be no assets from which to pay administrative priority claims. There may be other means, however, to provide adequate protection. *In re Eureka S. R.R., Inc.* (Bankr ND Cal 1987) 72 BR 813 (nondebtor third party's guaranty was adequate protection of interest of equipment lessor).

PRACTICE TIP: Some creditors will stipulate to an adequate protection order, typically requiring the debtor to cure defaults and make postpetition principal and interest payments in specified amounts. If the debtor fails to make the payments, the adequate protection order may also permit the creditor to obtain relief from stay within a shorter period of time than ordinarily required.

The existence of an "equity cushion" can also provide adequate protection to a secured creditor. An equity cushion exists if the value of the collateral is greater than the amount of the secured lender's claim plus any senior lien claims secured by the same property. *Pistole v Mellor* (*In re Mellor)* (9th Cir 1984) 734 F2d 1396. Junior liens are disregarded because junior encumbrances do not endanger senior lien claims. A more difficult question is presented in determining how much equity cushion is needed to constitute adequate protection. In *Pistole,* the Ninth Circuit held that an equity cushion of approximately 20 percent above the secured debt sufficed. 734 F2d at 1401. In the Ninth Circuit's view, this was sufficient to ensure that the secured creditor would receive either cash payment (under a plan or through a sale) or property with a value in excess of the secured claim, even though the automatic stay remained in effect. When a substantial equity cushion protects the creditor, the bankruptcy court may deny a stay relief motion even if the debtor is not making postpetition payments on the debt, particularly if the property is necessary to an effective reorganization. *In re Avila* (Bankr ND Cal 2004) 311 BR 81.

The stay might be allowed to continue indefinitely even with no or a negligible equity cushion if the lender is undersecured at the petition date, and therefore not entitled to postpetition interest under 11 USC §506(b), and if the lender's interest in the collateral is not being eroded. *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 108 S Ct 626. However, if the collateral is depreciating, the lender is entitled to adequate protection payments in an amount equal to the actual reduction in the value of the collateral. 484 US at 377, 98 L Ed

2d at 752.

In many situations, a lender will be able to show that the equity cushion (or its interest in the collateral if there is no equity cushion) is declining over time due to depreciation in the collateral's value or accrual of interest and other charges if the lender is oversecured or if there are oversecured senior liens accruing interest and charges (see §10.91 on postpetition accrual of interest and charges for oversecured creditors). If an equity cushion is being eroded, a court may grant the lender stay relief at a future date based on the anticipated shrinkage of the equity cushion. The debtor or trustee may also be forced to provide adequate evidence of insurance and proof of payment of secured property taxes. This approach gives a debtor or trustee a limited opportunity to sell or refinance the property or to confirm a reorganization plan that provides for treatment of the lender's claim consistent with the Bankruptcy Code.

PRACTICE TIP: Generally, courts will grant the lender stay relief before the equity cushion is completely eroded to provide relative certainty that the lender will be paid in full. See *La Jolla Mortgage Fund v Rancho El Cajon Assocs.* (Bankr SD Cal 1982) 18 BR 283, 289. If the lender's interest is eroding and there is no equity cushion, the lender may petition the court for an order requiring the debtor to make payments equal to the reduction in value, citing the reasoning and ruling in *Timbers of Inwood Forest Assocs*.

CAUTION: The calculation of an equity cushion regarding specific collateral for purposes of determining adequate protection under 11 USC §362(d)(1) is not the same as calculating the existence of equity for purposes of 11 USC §362(d)(2). Section 362(d)(2), discussed in §§10.26-10.28, focuses on whether there is any equity in the collateral, and all liens are included in that calculation. *Pistole v Mellor* (*In re Mellor)* (9th Cir 1984) 734 F2d 1396, 1400 n2 (equity, as opposed to equity cushion, is value above all secured claims against property that can be realized from sale of property for benefit of unsecured creditors).

On cause for stay relief generally, see §4.20.

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§10.21 b. Bad Faith

A bankruptcy case filed in "bad faith" may also be cause for stay relief under 11 USC §362(d)(1). See *Idaho Dep't of Lands v Arnold (In re Arnold)* (9th Cir 1986) 806 F2d 937 (affirming denial of stay relief because no clear abuse of bankruptcy process shown); *Trident Assocs. Ltd. Partnership v Metropolitan Life Ins. Co. (In re Trident Assocs. Ltd. Partnership)* (6th Cir 1995) 52 F3d 127 (bad faith found when bankruptcy filing made on eve of foreclosure by newly created debtor after losing motion in state court to enjoin foreclosure). To determine whether a case is filed in bad faith, the trial court should review the "totality of circumstances," including the following factors, rather than focusing solely on the debtor's intent:

- Whether the debtor misrepresented the facts, otherwise unfairly manipulated the Bankruptcy Code, or filed its petition or plan in an inequitable manner;
- The debtor's history of filings and dismissals;
- If the debtor's primary intent was to defeat state court litigation; and
- If the debtor's behavior was egregious.

See *Leavitt v Soto (In re Leavitt)* (9th Cir 1999) 171 F3d 1219, 1224 (affirming dismissal of Chapter 13 petition based on finding that bankruptcy was filed in bad faith).

Given the elasticity of the bad faith doctrine, the conclusion derived from the same facts may vary widely from judge to judge. At one extreme, courts have held that a bankruptcy case filed solely to delay a secured creditor's foreclosure could be bad faith even if the debtor had equity in the property and a reasonable prospect of successful reorganization. *Pacific Rim Invs., LLP v Oriam, LLC* (*In re Pacific Rim Invs., LLP)* (D Colo 2000) 243 BR 768; *In re Colonial Manor Assocs.* (Bankr MD Fla 1989) 103 BR 315. At least one court has rejected the bad faith doctrine as a judicially created, good faith condition for filing a bankruptcy petition that conflicts with the Bankruptcy Code (particularly the provisions governing single asset real estate cases), its legislative history, and case law. *In re Victoria Ltd. Partnership* (Bankr D Mass 1995) 187 BR 54. The Ninth Circuit has not ruled on this issue.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/§10.22 (1) Serial Filings

§10.22 (1) Serial Filings

One of the most vexing problems for secured lenders is the filing of serial bankruptcy cases to block a foreclosure. For example, a debtor may undertake one or more of the following courses of action after a secured party obtains stay relief but before it can foreclose:

- Dismissal of the bankruptcy case without prejudice, with the filing of a new case on the eve of foreclosure;
- Filing a new case in the same or another district, even without dismissal of the old case;
- Conveyance of the property to a third party, with or without bankruptcy court approval, with a new bankruptcy filed by the third party on the eve of foreclosure, or to a third party that is already a debtor in an existing bankruptcy case; or
- Granting a deed in lieu of foreclosure to a junior lienholder affiliated with the debtor, with the new owner arguing that there is now equity in the property because the junior lien no longer encumbers the property.

The courts have properly refused to impose a blanket prohibition on serial bankruptcy filings. *Johnson v Home State Bank* (1991) 501 US 78, 115 L Ed 2d 66, 111 S Ct 2150 (debtor who was discharged from personal liability on mortgage in Chapter 7 case allowed to file subsequent Chapter 13 case to modify mortgage terms); *Elmwood Dev. Co. v General Elec. Pension Trust (In re Elmwood Dev. Co.)* (5th Cir 1992) 964 F2d 508 (serial cases should be tested on individual basis to determine if subsequent bankruptcy is filed in good faith). However, when there is only a short period between the dismissal of a prior bankruptcy case and the filing of a new petition, some courts have placed the burden on the debtor to show that there has been a change in circumstances justifying the new case. See *In re Fuhrman* (Bankr ED Mich 1990) 118 BR 72; *In re Garsal Realty, Inc.* (Bankr ND NY 1989) 98 BR 140. Absent such proof, courts are inclined to give a lender relief. See *Martwick v Agribank, FCB (In re Martwick)* (8th Cir 1995) 60 F3d 482 (no abuse of discretion to deny continuance of relief from stay motion when Chapter 11 petition was filed shortly after entry of Chapter 7 discharge to block lender's sale despite only 4 days' notice and unavailability of debtor's counsel); *In re Rauso* (ED Pa 1997) 212 BR 242 (reopening dismissed Chapter 13 case to authorize lender's foreclosure and bar further filings by debtor who had filed seven Chapter 13 petitions); *Blatnick v Sanders* (*In re Sanders)* (Bankr SD Cal 1996) 198 BR 326 (annulment of stay warranted when Chapter 11 case was filed to block foreclosure sale after debtor obtained Chapter 7 discharge); *In re Huerta* (Bankr CD Cal 1992) 137 BR 356 (second Chapter 13 filing not in good faith); *In re Beswick* (Bankr ND Ill 1989) 98 BR 900 (filing second Chapter 12 case, rather than appealing dismissal of first case, was not in good faith).

The BAPCPA amendments to 11 USC §362(c), discussed in §§4.3-4.6, 10.3, address this issue directly and limit the applicability of the stay when there are serial filings by individual debtors. Existing "bad faith" case law will likely remain relevant to cases filed prior to enactment of the new provisions.

Prior to BAPCPA, it was possible for a lender to obtain "in rem" stay relief, effective against any new owner of the property who obtained title through the debtor, if the facts were especially egregious. Such an order was granted in a case involving serial Chapter 13 and Chapter 7 cases filed by a debtor, his wife, and a related party to block a foreclosure. The bankruptcy court held that its in rem stay relief order was valid without notice to the debtor despite due process concerns. *Fernandez v GE Capital Mortgage Servs.* (*In re Fernandez)* (Bankr CD Cal 1997) 212 BR 361, aff'd (BAP 9th Cir 1998) 227 BR 174, aff'd (9th Cir 2000) 208 F3d 220 (unpublished opinion). BAPCPA effectively codifies in rem relief by making the stay generally inapplicable to acts to enforce a lien or security interest in real property for 2 years after a stay relief order is obtained regarding such property. To qualify for this protection, the order must be recorded with the county recorder. 11 USC §362(b)(20), (d)(4). See §10.8.

The Bankruptcy Code also expressly blocks a second bankruptcy filing by an individual or family farmer debtor if the debtor's bankruptcy case is (1) voluntarily dismissed at the request of the debtor after a motion for stay relief is filed or (2) dismissed for willful failure to abide by court orders or to appear before the court in proper prosecution of the case. 11 USC §109(g)(1)-(2). In either of those circumstances, the debtor is not eligible to be a debtor in a new bankruptcy case for 180 days after the case is dismissed. Section 109(g) is likely to deter attorneys from filing a new case for the

proscribed period. A determined debtor, however, might still file a new case in pro per in violation of §109(g). Before BAPCPA, the Ninth Circuit held under such circumstances that the filing does not reinstitute the automatic stay and that a foreclosure sale conducted after such a filing is still valid. See *Umali v Dhanani (In re Umali)* (9th Cir 2003) 345 F3d 818, withdrawn (9th Cir 2004) 382 F3d 1158. Post-BAPCPA, this rule is codified in 11 USC §362(b)(21). See §§4.3-4.6, 10.8.

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§10.23 (2) New Debtor Syndrome

Another common bad faith scenario is the "new debtor syndrome." In the prototypical case, property is conveyed on the eve of foreclosure to a newly formed or already existing shell entity, and a bankruptcy petition is filed for that entity. Often, the new entity pays no consideration or merely assumes the encumbrances on the property. See, *e.g., United Enters., Ltd. v ACI Sunbow, LLC (In re ACI Sunbow, LLC)* (Bankr SD Cal 1997) 206 BR 213 (court may grant stay relief based on subjective bad faith without finding of objective futility of plan); *California Mortgage Serv. v Yukon Enters. (In re Yukon Enters.)* (Bankr CD Cal 1984) 39 BR 919.

Transferring assets into a shell corporation on the eve of its bankruptcy is not per se bad faith. *Meadowbrook Invs. Group v Thirtieth Place, Inc. (In re Thirtieth Place, Inc.)* (BAP 9th Cir 1983) 30 BR 503. The initial burden to establish bad faith is on the creditor. However, once "a prima facie case is established, the burden shifts to the debtor to demonstrate a good faith business reason for the transfer and the filing." *Duvar Apartments, Inc. v FDIC (In re Duvar Apartments, Inc.)* (BAP 9th Cir 1996) 205 BR 196, 200. Indicia of the new debtor syndrome include the following:

- Transfer of distressed property into a newly created corporation;
- Transfer occurring within a close proximity to the bankruptcy filing;
- Transfer for no consideration;
- Debtor has no assets other than the recently transferred property;
- Debtor has no or minimal unsecured debt;
- Debtor has no employees and no ongoing business; and
- Debtor has no means, other than the transferred property, to service the debt on the property.

BAPCPA addressed "new debtor syndrome" by authorizing stay relief in cases involving real estate collateral if the bankruptcy filing was part of a scheme to delay, hinder, and defraud creditors involving either transfer of the real estate without creditor or court consent or multiple bankruptcy filings affecting the property. 11 USC §362(d)(4). The combination of this provision and new 11 USC §362(b)(20), which generally makes stay relief for lien enforcement against real property effective for 2 years even if a new case is filed (see §10.22), should markedly reduce potential disruption from abusive new debtor cases.

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§10.24 (3) Other Relief Based on Bad Faith

A case filed in bad faith can be grounds for significant relief beyond modification of the automatic stay. The following are additional forms of relief that have been granted:

- Dismissal of entire bankruptcy case. See *Leavitt v Soto (In re Leavitt)* (9th Cir 1999) 171 F3d 1219, 1224; *Marsch v Marsch (In re Marsch)* (9th Cir 1994) 36 F3d 825 (filing used solely as litigation tactic by solvent debtor).
- Conversion of case from one Chapter to another. See *Molitor v Eidson* (*In re Molitor)* (8th Cir 1996) 76 F3d 218 (three Chapter 13 filings evidenced bad faith, supporting conversion to Chapter 7).
- Barring of further bankruptcy filings indefinitely by order dismissing bankruptcy case with prejudice under 11 USC §349(a). See *Casse v Key Bank Nat'l Ass'n (In re Casse)* (2d Cir 1999) 198 F3d 327 (foreclosure sale not invalidated by fourth bankruptcy filing that was void because of dismissal with prejudice of prior case filed in bad faith).
- Imposition of sanctions against the debtor or its attorney. See *Miller v Cardinale (In re DeVille)* (9th Cir 2004) 361 F3d 539 (compensatory and deterrent sanctions properly awarded based on serial filings); *Dressler v Seeley Co. (In re Silberkraus)* (9th Cir 2003) 336 F3d 864 (bankruptcy filing by solvent debtor as litigation tactic in commercial lease dispute held to be filed in bad faith and for improper purpose); *Marsch v Marsch (In re Marsch), supra* (frivolousness and improper purpose must both be examined); *Blake, Barnett, Milman & Bell, Inc. v Chalmers (In re Villa Madrid)* (BAP 9th Cir 1990) 110 BR 919.

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§10.25 c. Other Cause for Stay Relief

Courts have also found other forms of "cause" justifying modification or termination of the stay under 11 USC §362(d)(1). As "cause" is not defined, the particular circumstances of the case will be determinative. See, *e.g., Delaney-Morin v Day (In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (postpetition defaults may constitute cause for stay relief); *Margell v Bouquet Invs. (In re Bouquet Invs.)* (Bankr CD Cal 1983) 32 BR 988 (undue burden on secured creditor because of its financial position).

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§10.26 3. Lack of Equity and Property Not Necessary for Effective Reorganization

An alternative ground for stay relief is establishing that (1) the debtor does not have any equity in the collateral and (2) such property is not necessary to an effective reorganization. 11 USC §362(d)(2). The policy underlying §362(d)(2) is to examine whether any useful purpose is served by maintaining the automatic stay. If the debtor has no equity in the property and has little or no chance of successfully reorganizing, no legitimate purpose is served by delaying the secured creditor's enforcement of its rights, even if the creditor's interest in the property is adequately protected for the moment. On the other hand, if there is significant equity in the property, maintaining the stay gives the debtor an opportunity to maximize the value of the property for its unsecured creditors and interest holders, either through orderly liquidation or retention of the property under a confirmed plan. See *In re Avila* (Bankr ND Cal 2004) 311 BR 81. See also discussion in §4.21.

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§10.27 a. Determining Whether Equity Exists

The process of measuring equity in real property is relatively straightforward in some cases and is complicated in others. All liens against the property are added up, and the total is compared to the fair market value of the property, which is usually determined by analyzing appraisal testimony. *Stewart v Gurley* (9th Cir 1984) 745 F2d 1194. On valuation and appraisal standards, see §§5.34, 5.37, 10.38, 10.88. The creditor has the burden of establishing whether the debtor has equity in the property. 11 USC §362(g)(1).

NOTE: Calculation of equity to establish justification of stay relief under 11 USC §362(d)(2) is a separate and distinct analysis from calculation of the amount of the equity or value "cushion" that will be deemed sufficient to afford a secured creditor "adequate protection" of its interest under 11 USC §363(e) if relief from stay is not granted. See §§10.66-10.67. The relative priority of a lienholder moving for stay relief is not relevant to the former analysis, but it is relevant to the latter. If a senior lienholder is seeking stay relief, junior liens are normally not considered in evaluating the senior lienholder's equity or value cushion. *Stewart v Gurley, supra*.

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§10.28 b. Necessity of Property for Effective Reorganization

The second prong of the test in 11 USC §362(d)(2), whether the debtor's property is necessary to an effective reorganization, arises in cases commenced under Chapters 11 and 12 and sometimes Chapter 13. The second prong is never an issue in Chapter 7 cases, because Chapter 7 provides only for liquidation.

Chapter 13 is available only to individuals with regular income and limited debts. 11 USC §109(e). As a result, the secured real estate lender's focus in a Chapter 13 case is typically on the individual debtor's residence, although rental properties are sometimes involved. Generally, a debtor's residence should not be critical to a Chapter 13 plan, but if the home or other properties generate rental income, they may be an important part of the proposed plan. See *In re Avila* (Bankr ND Cal 2004) 311 BR 81. Notably, a Chapter 13 debtor is required to file a proposed plan within 14 days of the commencement of the case. Fed R Bankr P 3015(b). This requirement usually leads a lender to first examine whether its proposed treatment under the plan is proper, with the initial contest, if any, being over such treatment rather than stay relief.

For secured real estate lenders in Chapter 11 and Chapter 12 cases, the focus is usually on the importance of commercial real estate to the reorganization of a business operation or family farm. The term "effective reorganization" is not defined in the Bankruptcy Code, and the legislative history is equally unavailing. The U.S. Supreme Court has stated that the appropriate test is a determination of whether there is "a reasonable possibility of a successful reorganization within a reasonable time." *United Sav. Ass'n v Timbers of Inwood Forest Assocs.* (1988) 484 US 365, 98 L Ed 2d 740, 751, 108 S Ct 626. The debtor has the burden of establishing a reasonable likelihood of successful reorganization. 11 USC §362(g)(2). To satisfy this test, the debtor must present evidence of the contents of the plan, when it will be proposed and brought to fruition, and that there is a realistic chance that the plan will be confirmed. See *Western Farm Credit Bank v Teresi (In re Teresi)* (Bankr ED Cal 1991) 134 BR 392.

This burden may be less during the first 120 days of a Chapter 11 case because Congress recognized, in granting the debtor the exclusive right (with limited exceptions) to file a plan during that period, that it may take the full 120 days to formulate a reorganization plan that will likely succeed. See 11 USC §1121(b), (e). If the debtor obtains an extension of the exclusivity period pursuant to 11 USC §1121(d), the burden may not be less; generally, the longer a case is pending, the greater the burden should be on the debtor to prove a reasonable likelihood of reorganizing. The exclusivity period for filing a plan can be extended "for cause," but not for longer than 18 months after the petition date. 11 USC §1121(d).

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§10.29 4. Single Asset Real Estate

In a "single asset real estate" case (see §§1.64, 4.22), a creditor whose claim is secured by an interest in the real property may obtain relief from the automatic stay unless, within 90 days after the petition date, the debtor either (1) files a plan of reorganization that has a reasonable possibility of being confirmed within a reasonable time or (2) begins making monthly payments to the secured creditor in an amount equal to interest at the nondefault contract rate on the portion of the claim secured by the real property. 11 USC §362(d)(3). The 90-day period can be extended by the bankruptcy court for cause. Section 362(d)(3) was added to the Bankruptcy Code in 1994 to prevent debtors with little hope of rehabilitation from using Chapter 11 to delay real estate foreclosures indefinitely. See *Kraatz v Oceanside Mission Assocs. (In re Oceanside Mission Assocs.)* (Bankr SD Cal 1996) 192 BR 232.

Under BAPCPA, the deadline for plan filing or making interest payments is 90 days after the petition date or 30 days after the court determines that the case has been filed by a single asset real estate debtor, whichever is later (11 USC §362(d)(3)). The debtor may use prepetition or postpetition rents to make the required interest payments. 11 USC §362(d)(3)(B)(i). A debtor might argue that these payments should be a lender's sole adequate protection (see §§10.19-10.20), but the statutory language does not expressly prevent other supplemental forms of adequate protection of a lender's interest.

Beyond providing grounds for stay relief, the plan filing deadline in §362(d)(3) effectively fast-tracks a single asset real estate case. The notion is that it should not be difficult to assess the business of a small real estate venture and put forward a plan. (On validity of prepetition agreements to modify stay in single asset cases, see §10.18.)

Before BAPCPA, the Bankruptcy Code defined the term "single asset real estate" as "real property constituting a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto having aggregate noncontingent, liquidated secured debts in an amount no more than $4,000,000." 11 USC §101(51B). Courts have differed on how to calculate the debt limit set out in this definition. One view is that the $4 million limit refers to the total amount of all secured claims without regard to the underlying value of the property. *Kraatz v Oceanside Mission Assocs. (In re Oceanside Mission Assocs.)* (Bankr SD Cal 1996) 192 BR 232. The opposing view is that the secured debt cannot exceed the underlying property value. *In re Pensignorkay, Inc.* (Bankr ED Pa 1997) 204 BR 676. This issue disappears in cases governed by BAPCPA, which eliminates the debt limit entirely and excludes family farmers from the definition.

Disputes have also arisen about whether a debtor is a real estate business subject to §362(d)(3). If the debtor generates income from non-real estate businesses, it probably does not satisfy the definition. See, *e.g., Ad Hoc Group of Timber Noteholders v Pacific Lumber Co. (In re Scotia Pac. Co.)* (5th Cir 2007) 508 F3d 214, 217 (timber farm with harvesting business is not single asset case); *Centofante v CBJ Dev. (In re CBJ Dev.)* (BAP 9th Cir 1996) 202 BR 467 (full-service hotel with bar and restaurant is not single asset real estate venture); *In re Kkemko, Inc*. (Bankr SD Ohio 1995) 181 BR 47 (marina was not single asset real estate venture because of its other income-producing activities). See also *In re McGreals* (Bankr ED Pa 1996) 201 BR 736 (two adjacent parcels, only one of which was developed, were not single asset real estate).

NOTE: Section 362(d)(3) is not the exclusive ground for stay relief in a single asset real estate case. See *Duvar Apartments, Inc. v FDIC (In re Duvar Apartments, Inc.)* (BAP 9th Cir 1996) 205 BR 196 (affirming relief based on bad faith filing). Indeed, bad faith has been a frequent basis for both stay relief and other relief in single asset real estate cases. See, *e.g., State St. Houses, Inc. v N.Y. State Urban Dev. Corp. (In re State St. Houses, Inc.)* (11th Cir 2004) 356 F3d 1345.

PRACTICE TIP: The likelihood of a bad faith finding is greatly heightened if the debtor has filed more than one bankruptcy case or if new debtor syndrome exists. See §§10.21-10.24. Some cases appear to conclude that filing a bankruptcy petition on the eve of a foreclosure sale is indicative of bad faith. That factor alone should not be dispositive, because bankruptcy cases are virtually always prompted by stress arising from creditor action that will

impair or encumber a debtor's assets or operations.

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D. Procedure for Obtaining Relief From Stay

1. Motion for Relief From Stay

§10.30 a. Creditor's Pleadings

A "request" for relief from the automatic stay under 11 USC §362(d) is treated as a contested matter and initiated by motion. Fed R Bankr P 4001(a)(1), 9014. In the creditor's moving papers, the creditor must demonstrate to the bankruptcy court that it is the "real party in interest" under Fed R Civ P 17. See *In re Kwan Jin Hwang* (Bankr CD Cal 2008) 393 BR 701, rehearing granted and opinion modified at (Bankr CD Cal 2008) 396 BR 757. See also *In re Jacobson* (Bankr WD Wash 2009) 402 BR 359. Service of the motion must be made on the debtor and its counsel. Fed R Bankr P 4001(a)(1), 7004, 9014. Notice requirements vary with the particular chapter of the Bankruptcy Code involved. In Chapter 7 and 13 cases, the trustee must be served along with any creditors' committee appointed in the case (or its designated agent); in Chapter 11 cases, if no committee exists, notice must be served on the 20 largest unsecured creditors. The court may direct that other creditors (such as junior lienholders) be served. Fed R Bankr P 4001(a)(1).

PRACTICE TIP: Counsel should review the court's docket before any motion is filed to obtain copies of any changes of address and any requests for special notice filed by parties in interest, such as junior lienholders. Too often, motions for stay relief are denied or continued because of a notice problem. If out-of-town counsel will associate local counsel, prepare and file notice of association as required by local rules. See *In re Jacobson, supra*.

Local rules of the bankruptcy court and any guidelines or standing orders issued by a particular judge should be consulted in order to properly format, file, and serve the moving papers. In many districts, the courts, by local rule or otherwise, have encouraged the parties to submit all evidence in the form of declarations and sharply limited the use of live testimony. See Directory for website addresses of local bankruptcy courts where rules and forms may be found. See also *Adair v Sunwest Bank (In re Adair)* (9th Cir 1992) 965 F2d 777. Local court procedures should enable parties to ascertain beforehand whether live testimony will be given at a hearing. See Fed R Bankr P 9014(e).

WARNING: Because Fed R Bankr P 4001(a)(3) provides that an order granting stay relief is stayed for 14 days after entry of the order unless the court orders otherwise, counsel should request in the moving papers that the 14-day period be shortened or that the order become effective immediately on entry.

On stay relief motion procedures, see Moving for Relief From an Automatic Stay in Bankruptcy (Cal CEB Action Guide September 2006), which has numerous sample forms and strategies for stay relief motions.

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§10.31 b. Responsive Pleadings

As discussed in §§10.32-10.38, a motion for relief from the automatic stay regarding property of the bankruptcy estate is given expedited treatment by the Bankruptcy Code and typically involves a preliminary hearing followed by a final hearing. 11 USC §362(e). The requirements and timetable for a debtor or trustee to file responsive papers varies dramatically from district to district in California. Counsel should consult the local rules to comply with requirements for format, service, and filing; see Directory. On strategies for opposing stay relief motions, see §§10.43-10.45, 10.49-10.50.

The Northern District conducts a preliminary hearing, which is treated like a status conference. ND Cal Local Bankr R 4001-1(c) (preliminary hearing held on at least 15 days' notice). Responsive papers may be filed but are not required. ND Cal Local Bankr R 4001-1(f). By contrast, in the Central and Southern Districts, a stay relief motion is a contested matter that requires an evidentiary hearing (see, *e.g.,* CD Cal Local Bankr R 9013-1(a)(1), (o)(2)(B)), and the opposing party is required to file responsive pleadings within a short period of time. See CD Cal Local Bankr R 9013-1(f) (not later than 14 days before the hearing date); SD Cal Local Bankr R 4001-3 (11 days). In the Eastern District, a stay relief motion must be scheduled for a hearing, and the motion may be set on either 28 or 14 days' notice. See ED Cal Local Bankr R 4001-1, 9014-1(f). If the 28-day period is used, then opposing papers are required 14 days before the hearing. ED Cal Local Bankr R 9014-1(f)(1)(ii). If the moving party elects the 14-day period, the time limits of 11 USC §362(e) are waived and any opposition must be presented at the hearing, with the court retaining the power to continue the hearing to permit the filing of evidence and briefs. ED Cal Local Bankr R 9014-1(f)(2)(ii)-(iii).

PRACTICE TIP: Valuation of real property collateral is determinative of equity and adequate protection issues in stay relief motions. As a result, disputes about valuation are common. Trustees and debtors should consider employing an appraiser at the outset of a case involving real property collateral. This will allow a better opportunity to prepare and present valuation evidence when faced with the expedited scheduling of stay relief motions. On valuation standards, see §§5.18, 5.34, 5.37, 10.38, 10.88.

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§10.32 c. Preliminary Hearing

The stay automatically terminates 30 days after a motion is made seeking stay relief against property of the bankruptcy estate unless, before the 30 days run, the court continues the stay in effect pending a final determination of whether relief should be granted. A continuance of the stay should be authorized if there is a reasonable likelihood that the debtor (or other party opposing stay relief) will prevail at the final hearing, although continuances by consent of the parties are also common. Continuance of the stay can only be ordered after notice and a hearing. The initial hearing held within the 30-day period can be a preliminary hearing or consolidated with a final hearing. If a final hearing is set, it must be concluded no later than 30 days after the preliminary hearing unless the parties consent to a longer period or the court extends the time based on compelling circumstances. 11 USC §362(e).

The stay automatically terminates in Chapter 7, 11, and 13 individual debtor cases 60 days after the motion is filed unless the court issues a final decision continuing the stay before the 60 days run or that period is extended by consent of the parties or by the court for good cause described in the findings. 11 USC §362(e)(2).

As noted in §10.31, local procedure often calls for a preliminary hearing on short notice. At the preliminary hearing, the court will determine if the motion is contested. If the motion is not contested, an order granting relief will usually be granted at that time. If the motion is contested, the court will usually sound out the disputed factual and legal issues and any discovery needed by the parties and then set a briefing schedule and a final hearing.

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§10.33 d. Final Hearing

Matters are set for final hearing in stay relief motions involving real property collateral for two primary reasons. First, if there is a substantial dispute regarding the value of the property, the court may wish to hear live testimony to reconcile the discrepancies. Second, the court may wish to allow the debtor or bankruptcy trustee some period of time during which to make a concrete proposal of adequate protection or of a plan of reorganization. However, a court need not hold a hearing on every proposed plan of reorganization before granting stay relief. Rather, the court need only determine whether a successful reorganization is possible within a reasonable time. *Sun Valley Newspapers v Sun World Corp. (In re Sun Valley Newspapers)* (BAP 9th Cir 1994) 171 BR 71.

Courts will sometimes continue hearings on stay relief motions based on representations by the trustee or debtor that a sale or refinancing or other business solution is in process. If pushed by a secured creditor's counsel in these situations, the court may simply deny the motion without prejudice to its being renewed after the debtor has had the opportunity to achieve the business solution.

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§10.34 e. Ex Parte Relief

If necessary to prevent irreparable damage to its collateral before there is an opportunity for notice and a hearing, a lender may seek ex parte stay relief with or without a hearing and without prior notice and before there is opportunity for notice and a hearing. 11 USC §362(f); Fed R Bankr P 4001(a)(2). The facts substantiating such immediate and irreparable harm must be set forth by declaration or in a verified motion, and the lender's counsel must certify her or his efforts to give notice and why notice should not be required. Fed R Bankr P 4001(a)(2). If ex parte relief is obtained, the lender is required to immediately give oral and written notice to the debtor in possession or to the trustee and the debtor, and reinstatement of the stay may be sought on 2 days' notice to the lender. Fed R Bankr P 4001(a)(2). Counsel should also consult the local court rules and practices regarding ex parte procedures.

When the collateral is real property, it is difficult to establish that irreparable harm will result before the usual expedited notice and hearing. See, *e.g., Delaney-Morin v Day* (*In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (tax delinquencies did not provide adequate basis for ex parte relief from stay). However, if the collateral is at immediate risk of destruction, ex parte relief may be warranted. Some courts may also be disposed to grant ex parte relief if the debtor has filed its bankruptcy case in bad faith. This is especially so if the debtor has filed serial bankruptcy cases to block foreclosure, if stay relief has been granted in earlier cases, or if the debtor is not entitled to file the new case under 11 USC §109(g). An argument can be made that denying ex parte relief solely because there is no irreparable harm under such circumstances condones abuse of the bankruptcy process. See §§10.21-10.24 for additional discussion of bad faith filings and provisions of BAPCPA significantly limiting applicability of the stay in such situations.

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§10.35 f. Discovery

The Federal Rules of Bankruptcy Procedure generally adopt the discovery rules set out in the Federal Rules of Civil Procedure. See §§1.28-1.29. The time limits for discovery requests in the Federal Rules of Civil Procedure are, however, totally inconsistent with the expedited nature of stay relief litigation. Thus, counsel must rely either on stipulations with opposing counsel or orders shortening time for discovery. Fortunately, extensive discovery is not necessary. When needed, oral depositions of the other party or its valuation expert usually suffice. If stipulations cannot be reached, discovery issues should be addressed at the preliminary hearing.

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g. Evidence

§10.36 (1) Burden of Proof

The lender moving for stay relief has the burden of proof on the issue of the debtor's equity in the property, and the burden of proof is on the responding party for "all other issues." 11 USC §362(g). Although those are the ultimate burdens, the creditor has the initial burden of establishing a prima facie case for relief under §362(d), after which the burden of persuasion shifts to the trustee or debtor, consistent with the proof allocation in §362(g). See, *e.g., Delaney-Morin v Day (In re Delaney-Morin)* (BAP 9th Cir 2003) 304 BR 365 (reversing order granting stay relief because no competent evidence submitted). *In re Brown* (Bankr SD Ohio 1987) 78 BR 499, 502.

WARNING: The moving party must establish that it is the real party in interest. Loan servicing agents that do not own the note but are the moving parties in stay relief motions may have a problem establishing who is the real party in interest for loans that have been securitized, sold on the secondary market, and assigned to other entities. For more on securitized loans, see California Real Estate Finance Practice: Strategies and Forms, chap 10 (Cal CEB 2000).

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§10.37 (2) Encumbrances

The creditor has the burden of proving lack of equity if that is an issue. To establish lack of equity requires proof of the value of the property and the amount of liens against the property. See §§10.26-10.28. It is easy enough for a lender to testify about the debt secured by its own deed of trust, but it is often difficult to prove the balances secured by other liens. The easiest solution is to stipulate to the other lien amounts with opposing counsel, but debtors are not always cooperative and trustees seldom have easy access to the needed information, especially within the compressed time frame of a stay relief motion.

WARNING: The schedules of liabilities that a debtor is required to file under oath at the commencement of the bankruptcy case may contain admissions of the amounts of other liens. However, those schedules may be incomplete, inaccurate, or state "current balance unknown" rather than a dollar figure. They might also not even have been filed.

For a lender to objectively evaluate encumbrances, a trustee sale guaranty or some other form of title report by a recognized title insurance company that identifies all liens should be obtained. Such a report may be admissible in evidence under the "catch-all" exception to the hearsay rule. Fed R Evid 807. But the title report will prove only the existence and original principal amounts of other liens, not current balances. An argument can be made that the report suffices to create a presumption that the debts are as reflected in the title report, thereby shifting the burden to the debtor to prove that these claims have been reduced—but this argument may be rejected. The creditor is then placed in the unenviable position of having to accept as true the debtor's testimony about the debt. The best evidence of the other liens against the property is a declaration from each of the other creditors. If such declarations cannot be obtained, the creditor's declaration about the current amounts of senior encumbrances may qualify under an exception to the hearsay rule if the creditor has collected such information on a regular basis as part of its business records. If the creditor submits such a declaration, and even if the declaration is inadmissible, most bankruptcy judges will at least shift the burden onto the debtor to submit evidence of the extent of the debt.

PRACTICE TIP: The amount of property tax liens is generally available to the public by contacting the office of the tax collector in the county where the real property is located. Ordinarily, this information can be obtained by phone with just the parcel number.

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§10.38 (3) Value of Property

The creditor must prove value to show that the estate lacks equity in the real estate. 11 USC §362(g)(1). But the debtor or trustee must prove value if adequate protection is the issue. For example, a trustee would have the burden of showing property value if she or he contended that an equity cushion provides adequate protection to the lender. 11 USC §362(g)(2).

Value is usually proved by appraisal testimony, which (with the exception of low- to medium-priced single-family residences) is often unreliable. Substantial divergence in opinion by appraisal experts is not unusual. Differences seem primarily attributable to the volatility of both real property and financing markets and the lack of comparable sales in slow markets. Additionally, the availability and cost of financing greatly influence valuations. On appraisal standards, see §§5.18, 5.34, 5.37, 10.88.

The case involving income-producing property is no different. The standard appraisal technique is to forecast a standardized stream of income (*i.e.,* net operating income equal to gross rents less operating expenses excluding debt service) and divide it by a "capitalization rate." Even when the appraisers agree on a standardized income stream—and they frequently do not—the critical factor is the selected capitalization rate. For example, a property with a projected income stream of $200,000 per year will have a value of approximately $2.2 million at a capitalization rate of 9 or a value of approximately $1.8 million at a capitalization rate of 11. Selection of capitalization rates is one of the more opaque aspects of appraisal technique. Not only can experts' selected capitalization rates be widely divergent, but appraisal theory also provides several alternative methods of selecting capitalization rates (*e.g.,* the "built-up" method, the "band of investment" method, the "Ellwood" method). Because these, in turn, depend on assumptions about the availability of specified types of financing in the marketplace and the rates of return on available alternative investments, the cross-examiner is once again forced into the field of economics. This situation has led some counsel, in cases when enough is at stake to justify it, to retain expert economists as well as appraisers. But some courts have shown reluctance to permit economic-expert testimony on the theory that only an appraiser is an expert on real property value. Counsel should be prepared to qualify their expert under Fed R Evid 703.

PRACTICE TIP: An appraisal prepared specifically for a relief from stay hearing may not be admissible in some courts. The court in *In re Applin* (Bankr ED Cal 1989) 108 BR 253, 260, refused to admit a bank's appraisal, stating that "[a]ppraisals that are obtained for the purpose of litigation and upon which independent business decisions are not routinely made are generally not sufficiently trustworthy to qualify for the business records exception to the hearsay rule." A lender should arrange for the appraiser to be qualified as an expert witness and to testify in person at a final hearing on a motion for relief from stay.

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2. Agreement for Relief From Stay

§10.39 a. Overview and Approval

A lender may be able to negotiate a stipulation modifying the automatic stay with a trustee or a debtor. Typical agreements concerning real property collateral will (1) limit the duration of the stay (the "drop dead date" settlement) or (2) provide for a schedule of periodic payments, with relief automatically given upon default. These types of agreements give a trustee or debtor an opportunity to realize value from the collateral either through sale or as part of a reorganization plan.

A standard requirement in a stay relief agreement is that the trustee or debtor maintain insurance in an amount sufficient to protect the creditor's interest. The policy should name the lender as an additional insured. Often, the loan documents will provide some guidance on the appropriate level of insurance. In addition, if the lender has not already recorded a notice of default, a lender may be able to negotiate to allow itself to take that preliminary step without further delay.

Court approval of a stay relief stipulation is required. Fed R Bankr P 4001(d). Notice of the motion seeking approval is served on the same persons who are served with a stay relief motion and such other persons as the court may direct. Fed R Bankr P 4001(d)(2). Rule 4001 sets out minimum time requirements for notice, but local rules should also be consulted to confirm that they are not stricter. Fed R Bankr P 4001(d)(2)-(3). If no objection is filed, the stipulation may be approved without a hearing. Fed R Bankr P 4001(d)(3).

Sometimes, stay relief agreements are reached after the lender files a stay relief motion. Such agreements may be approved without bringing a separate motion if the court determines that the stay relief motion was sufficient to afford reasonable notice of the material provisions of the stay relief agreement. Fed R Bankr P 4001(d)(4).

PRACTICE TIP: If other secured parties have an interest in the real property, a court may require notice to such parties. Of particular concern are junior creditors who will be wiped out if stay relief authorizes a senior lienholder to foreclose. Therefore, to avoid delay, parties should consider giving notice of stay relief motions or motions seeking approval of a stay relief agreement to the other entities or persons asserting liens on the real property.

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§10.40 b. "Drop Dead" Agreement

The concept of a "drop dead date" is that the lender and debtor or bankruptcy trustee agree that if the debt is not paid in full, or reinstated by a stipulated date certain, the creditor is free to foreclose. In drafting the agreement, counsel should particularly focus on the following two issues:

(1) When is the creditor permitted to take preliminary steps toward foreclosure? If the stay remains in effect until the "drop dead date," such steps will be enjoined unless the settlement documents provide for an earlier partial modification of the stay to allow recordation of a notice of default or publication of notices of sale.

(2) Is this agreement intended to be a final settlement of all injunctive rights against foreclosure, or are there circumstances under which a further injunction may issue? If the latter, what are those circumstances? Many debtors' counsel believe that even if an absolute date is agreed on, the court retains jurisdiction under 11 USC §105(a) to issue an affirmative injunction on a proper showing. If a final settlement is intended, creditor's counsel should make that fact known to debtor's counsel and to the court, and the agreement should clearly provide that it is final.

One common variation on the simple "drop dead date" settlement is an agreement that the creditor may foreclose on a date certain unless an escrow is opened for the sale of the property. From a creditor's point of view, such agreements frequently prove illusory no matter how much care is taken in drafting, and the creditor may find it preferable to agree to a longer period of time in the first place in exchange for an absolute "drop dead date." For example, an agreement to continue the stay if a "bona fide" escrow is opened frequently results in litigation over whether a given escrow is bona fide. On the other hand, a sale by the trustee or debtor can result in a relatively simple payoff to the lender. At the very least, the following questions should be addressed:

- When must the escrow close?
- If escrow does not close by the date agreed, can the debtor get a further injunction by showing that it will close soon?
- What types of contingencies, if any, may remain open if the debtor is allowed further time?
- Must the sale contemplated by the escrow provide that the creditor will be paid in full upon close? If not, is this settlement a waiver of whatever due-on-sale rights the creditor may have?
- Must the proposed buyer meet with the creditor's approval? If so, what are the criteria for approval?
- Will the default in the creditor's obligation be cured by cash payment on close of escrow?
- If the note provides for a higher rate of interest after default, will the new buyer pay at the default rate or at the original contract rate?
- If the proposed sale provides for neither payment in full to the creditor nor reinstatement and assumption of the creditor's obligation, but rather for the creditor's lien to attach to the proceeds of sale in the form of a down payment and new purchase money financing, who gets what portion of the down payment, and who collects the new purchase money obligation?
- Who has the burden of going to court if a dispute arises over whether an escrow is bona fide? Who bears the burden of proof in such litigation?

PRACTICE TIP: For the sake of certainty, the preferable procedure in any "drop dead date" settlement is to provide that the automatic stay terminates immediately, with the lender agreeing to restrain its conduct on the agreed terms. Generally, a carefully drafted stipulated stay relief order will suffice as a settlement agreement.

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§10.41 c. Periodic Payment Agreement

The second common method of settling stay litigation is to agree on a schedule of periodic adequate protection payments to the lender. Again, to avoid future litigation, the usual format is a stipulated order terminating the stay, with the lender agreeing to restrain its conduct conditioned on receipt of the agreed payments.

The agreement should indicate whether acceptance of the periodic payments constitutes a waiver of earlier defaults or vitiates any prior notice of default and election to sell or notice of trustee sale. Acceptance of periodic adequate protection payments pursuant to a court order compelling such payments should not cause a waiver of prior defaults, absent reinstatement of all arrearages.

In *Harvis Trien & Beck, P.C. v Federal Home Loan Mortgage Corp. (In re Blackwood Assocs.)* (2d Cir 1998) 153 F3d 61, the lender agreed to a cash collateral stipulation (see, *e.g.,* §§10.64-10.65) providing for both adequate protection payments to the lender and payments of the debtor's attorney fees. Debtor's counsel later sought to have the lender disgorge adequate protection payments to pay fees of over $500,000. The request was denied because the stipulation did not give attorney fees priority over the lender's adequate protection payments. To avoid this type of dispute, counsel should clearly define the priority of authorized payments from cash collateral in the agreement.

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§10.42 d. Protection of Junior Lienholder

When a junior lienholder makes a stay relief agreement, it should include a provision that terminates the stay immediately if stay relief is granted to the holder of any senior encumbrance, in order to avoid having the senior lender foreclose first and wipe out the junior lien.

When senior encumbrances are not in default, the debtor should be willing to keep them current and pay real property taxes before penalties accrue. An impound account with the creditor is the best method of keeping these amounts current. If senior encumbrances are in default, counsel should be careful in agreeing on how they are to be handled. If possible, the debtor should be encouraged to make some proposal acceptable to the holder of such senior encumbrances to bring or keep them current.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/ E. Practical Considerations and Planning/ 1. Debtor Considerations/§10.43 a. Client Interview; Anticipating Requests for Relief From Stay

E. Practical Considerations and Planning

1. Debtor Considerations

§10.43 a. Client Interview; Anticipating Requests for Relief From Stay

When representing a debtor, counsel should interview the client before the bankruptcy case is filed to explore all facts necessary to defend or settle any anticipated stay relief motion. Preferably before the interview, counsel should obtain the following documents (see also workout checklist in California Mortgages, Deeds of Trust, and Foreclosure Litigation §10.2 (4th ed Cal CEB 2009)):

- All loan documents of all secured parties, including notices of default and notices of sale;
- A recent title report, if available, on all properties owned by the client (if unavailable, it should be ordered);
- Prior appraisal reports, if any; and
- Written proof of insurance.

Objectives of the client interview should include the following:

- Review the loan documents for any violations of lending statutes or regulations or other irregularities. See Mortgage Deed of Trust Foreclosure, chap 12.
- Determine the client's opinion of value and the basis for it. The client should be thoroughly "cross-examined" on value to avoid future surprises. See §10.38.
- Ascertain the current balances owed to each secured creditor, including real property taxes. See §10.37.
- Determine what the client expects to accomplish by the bankruptcy filing with respect to each property. If the filing is on the eve of foreclosure, the client should be advised that the secured party may seek relief from the stay almost immediately and that there may be a trial or other resolution of creditor's rights as soon as 30 days after the bankruptcy case is filed. In addition, if a prior case was filed, the stay may be limited or not go into effect at all. See §§10.3, 10.22 (serial filings, "in rem" stay relief), 10.21-10.24 (bad faith).
- Encourage the client to retain an appraiser prior to the filing of the bankruptcy case. See §10.38. Otherwise, court approval will be necessary (11 USC §327), which will delay the appraisal process. If the client will not or cannot retain an appraiser before the bankruptcy case is filed, the client should obtain and set aside enough money to do so. In any event, the appraiser should be contacted at the earliest possible date so that an appraisal may be performed and submitted in time to respond to any motion for relief from the stay.
- Inform the debtor of the costs of filing and pursuing the case to completion, including expected adversary proceedings, stay relief motions, and the possibility of unexpected proceedings initiated by a creditor. The debtor must bear not only its attorney and appraiser fees in litigation but also quite probably the lender's attorney and appraiser fees if the lender is oversecured and the loan documents support such a recovery. The filing of a bankruptcy case should usually be considered only as a last resort because of the high costs that the process entails. If possible, counsel should attempt to negotiate a settlement even before the bankruptcy case is filed or, if that is impossible, immediately after the case is filed but before a motion for relief from stay is filed. See, *e.g.,* §10.41.
- Advise the client that the delay accomplished by a bankruptcy case will not be indefinite and may be very brief. Whether a plan should be filed even before stay litigation commences should be explored. The early filing of a plan, if the plan is realistic, should add credibility to the use of the bankruptcy alternative and should remove the force of any argument by the secured party that the bankruptcy is interposed solely for an indefinite delay. The filing of a realistic plan is the best evidence that the debtor has a reasonable chance of reorganizing within a reasonable time and, therefore, that an undersecured creditor is not entitled to relief from the stay under 11 USC §362(d)(3). See §§10.17, 10.26-10.28.
- Make clear to the debtor that it is the debtor's duty to propose adequate protection and not the court's duty to

fashion it. See, *e.g., In re Colrud* (Bankr D Alaska 1984) 45 BR 169, 173 n3; *Big Bear Super Market No. 3 v Princess Baking Corp. (In re Princess Baking Corp.)* (Bankr SD Cal 1980) 5 BR 587. Despite these decisions, courts frequently fashion what they deem to be adequate protection and order continuation of the automatic stay only if the debtor provides such protection. See §10.20.

When representing a trustee, most of the same considerations noted for a debtor apply but, because the trustee is appointed after the bankruptcy case is filed, time pressures may be much greater.

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§10.44 b. Checklist: Preliminary Hearing

Although most courts schedule preliminary hearings at which no live testimony is introduced, they often make dispositive orders at the conclusion of the hearing. Therefore, debtor's counsel should fully prepare for the preliminary hearing and should not assume that the existence of a factual dispute will always result in a final hearing. The following are essential preparatory steps:

- Examine the moving party's papers to determine if the moving party has adequately proved a prima facie case for stay relief, including proof of standing. See §§10.19-10.29.
- Be prepared to object to moving party's claimed interest in the debt if it does not produce the original note and deed of trust at the hearing. See Fed R Evid 1002. See §§10.36-10.38.
- Prepare a declaration containing the appraiser's report and qualifications as an expert. To the extent possible, the declaration should explain the most important differences between the debtor's appraisal and the secured creditor's appraisal.
- If there is a dispute about the amount of any encumbrance, prepare or request and assemble declarations of the debtor and of any cooperative secured lender to support the debtor's position.
- Be prepared to state the debtor's adequate protection offer, if any, in responsive papers filed before the hearing or at the commencement of the hearing.
- Prepare a declaration by the debtor explaining the intended use or disposition of the property and the efforts being made to implement the debtor's business plan.
- In Chapter 11 cases, if lack of equity is an issue, assemble evidence of the necessity of the property for an effective reorganization and of the existence of a reasonable likelihood that reorganization is possible. See §§10.26-10.28.
- Prepare, and timely file and serve, a memorandum of points and authorities and any other pleadings required by the court's local rules or the judge's special orders. See §10.31.

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§10.45 c. Final Hearing

In addition to the checklist items in §10.44, counsel for a debtor in possession or trustee should take the following considerations into account if there is to be a final hearing:

- All witnesses who will testify with respect to disputed facts should be available at the final hearing and should be properly prepared. If possible, minimize the need for witnesses (and their related costs and inconvenience) by stipulating to undisputed facts.
- The debtor's appraiser should review all appraisal reports submitted by the creditor. Counsel should review all discrepancies in the reports with the appraiser to properly prepare the appraiser to testify and counsel to cross-examine the creditor's appraiser.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/ 2. Secured Creditor's Considerations/§10.46 a. Gathering Information From Creditor

2. Secured Creditor's Considerations

§10.46 a. Gathering Information From Creditor

Counsel for the secured creditor should obtain the following documents (see also checklist in California Mortgages, Deeds of Trust, and Foreclosure Litigation §10.2 (4th ed Cal CEB 2009)):

- All of the client's loan documents and, to the extent available, the documents of all other creditors secured by the same property, including all notices of default and notices of sale;
- A recent title report (if unavailable, it should be ordered);
- Prior appraisal reports, if any;
- Any notices or pleadings received from the debtor; and
- Background information (including relevant pleadings and orders) regarding prior bankruptcy filings by the debtor or involving the same property.

Counsel should also ascertain the bankruptcy case number and identity and addresses of counsel for the debtor, for the bankruptcy trustee, and for the debtor in possession or trustee (for purposes of service).

A current appraisal report is necessary if there is any dispute over the value of the real property collateral. Evidence of value must be submitted with the moving papers if the creditor intends to rely on lack of adequate protection or lack of equity in the collateral. Although that evidence can consist of the value given by the debtor in the schedules or evidence of a recent sale, it will usually be necessary to submit the declaration of an expert appraiser. See §10.38. If the creditor intends to rely solely on some other "cause" for lifting the stay (*e.g.,* serial or bad faith filing by the debtor (see §§10.3, 10.8, 10.21-10.25, 10.29)), it may not be necessary to submit any evidence of value. In unusual cases, it may be possible to rely on the earlier appraisal obtained for the loan. The primary advantages of using the earlier appraisal include lower expert witness fees and a greater likelihood of having the appraisal work completed at an early date. These advantages are usually outweighed by the disadvantages: vulnerability to cross-examination if the appraisal for trial differs materially from the loan appraisal (the loan appraisal usually shows that the value of the property exceeds the secured debt, or the creditor would not have made the loan); the appearance of bias by an "in-house" appraiser; the inexperience of most institutional lenders' appraisers as expert witnesses if live testimony becomes necessary; and the lower qualifications of most "in-house" appraisers.

If the property produces income, consideration should be given to how the lien on rents is to be enforced. See §§10.53-10.56.

The client should prepare an exact breakdown of the debt—delineating principal, accrued interest, and all other charges—and be prepared to update this information as of the preliminary hearing on the motion. Although getting this information is seldom difficult for institutional lenders, it is often difficult for loan servicing companies handling securitized loans and private holders of purchase money obligations, who frequently give counsel merely an accounting of arrearages. To calculate equity and determine a lack of adequate protection, the creditor must account for the total encumbrances against the property. Counsel should prepare a declaration setting forth the amount of the claim and the extent of the arrearages and verifying the creditor's loan documents.

The issue of how to prove the amount of other encumbrances should be addressed immediately. See §10.37.

If there is a serial filing or bad faith issue, counsel should gather relevant information regarding, *e.g.,* prior bankruptcy filings involving the real property collateral, the date of conveyance to a new debtor, and the date of the new debtor's formation. The debtor's schedules and the title report may be good sources of such information.

Clients frequently want to know how long to continue a trustee sale, if one had previously been scheduled. About 50 days following the filing of the motion is optimum because it allows time for the matter to come to the first hearing and, if the creditor prevails, an order to be prepared and lodged, objections about form to run, and the order to be entered. On postponing trustee sale, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chap 2 (4th ed Cal CEB 2009). If there is a good prospect that the stay will only be effective for 30 days or not go into effect at all because of serial filings or stay relief in a prior case (see §§10.3, 10.8), then a shorter time period may be appropriate.

If discovery is contemplated, counsel should make immediate arrangements to obtain orders shortening time or stipulations from opposing counsel. See §10.35.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/§10.47 b. Checklist: Preliminary Hearing

§10.47 b. Checklist: Preliminary Hearing

In preparing for the preliminary hearing, counsel for the lender should see to it that the following steps are taken:

- Interview the appraiser and review the appraisal report. If appraisal reports have been exchanged, the opposing party's appraisal report should be examined by the creditor's expert so that the expert's declaration can explain the differences and why the opinion of the creditor's expert is more reliable.
- Prepare a declaration from a client representative with knowledge of the loan, stating the amount of the claim secured by the deed of trust. Assemble evidence of the amounts of other encumbrances, unless appropriate stipulations can be reached. See §§10.36-10.38.
- Obtain certified copies of other bankruptcy petitions, deeds to a new debtor, and other appropriate evidence in cases involving bad faith issues.
- If the debtor in possession or trustee has tendered or delivered adequate protection, discuss it with the client and ascertain the client's position before the hearing.
- If the debtor in possession or trustee has not opposed the motion, have a file-stamped copy of the certificate of the proof of service of the motion papers available at the hearing, in the event the judge does not yet have a copy in the court file.
- Comply with all applicable procedures, including local rules or orders of the court, because noncompliance often results in unnecessary delay.
- Coordinate any consensual extension of the time for a preliminary or final hearing not only with opposing counsel but also with the court.
- If a creditor commits some procedural error defeating its right to a hearing in 30 days, and if a limited waiver and short extension cannot be negotiated, consider dismissing the defective motion without prejudice and filing a new motion rather than accepting a long continuance.

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F. Enforcing and Challenging Stay Relief Orders and Agreements

§10.48 1. Enforcing Orders and Agreements

A stipulated order lifting the automatic stay and incorporating a settlement does not bar a later action for breach of the stipulation and settlement. Nor, absent a provision retaining jurisdiction, does the bankruptcy court have exclusive jurisdiction over such an action. *Hinduja v Arco Prods. Co.* (9th Cir 1996) 102 F3d 987.

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§10.49 2. Vacating Order on Changed Circumstances

In the right circumstances, a bankruptcy trustee or debtor may be able to have an order lifting the stay vacated. See Fed R Bankr P 9024. In one case, an order entered 10 months previously was vacated based on changed circumstances. *State Bank v Gledhill (In re Gledhill)* (10th Cir 1996) 76 F3d 1070. During the intervening period, the case had been converted from Chapter 11 to Chapter 7, the value of the property had increased greatly, and it was likely that the estate would distribute more money to creditors if the trustee sold the property on the open market.

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§10.50 3. Modifying Stay Relief Agreement in Plan

A debtor in possession may propose a reorganization plan that provides for treatment of a lender's claim under a previously negotiated stay relief agreement. If the agreement requires that any proposed plan incorporate the terms of the agreement, the plan must do so, absent a showing of special circumstances. *Meyer v Lenox (In re Lenox)* (9th Cir 1990) 902 F2d 737. If the agreement does not require incorporation, then the debtor in possession is free to propose a plan that provides for treatment of the lender that is inconsistent with the agreement but otherwise confirmable under the Bankruptcy Code. *Atalanta Corp. v Allen (In re Allen)* (9th Cir 2002) 300 F3d 1055 (stay relief agreement provided for right to foreclose; plan retained property and modified payment terms). Thus, lender's counsel should always consider the merits of including a provision blocking inconsistent treatment under a plan, even if a plan is unlikely.

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§10.51 4. Preclusive Effect of Findings in Stay Relief Litigation

The First Circuit held that the findings a court makes in a relief from stay hearing do not collaterally estop the bankruptcy trustee or a debtor from later challenging the validity or perfection of a lender's security interest. *Grella v Salem Five Cent Sav. Bank* (1st Cir 1994) 42 F3d 26.

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§10.52 5. Appeals

Unless the court orders otherwise, the effectiveness of an order granting stay relief is automatically stayed for 14 days. Fed R Bankr P 4001(a)(3). This rule is designed to give the trustee or debtor in possession an opportunity to seek a stay of the order pending appeal; failure to obtain a stay of the order permitting a sale moots the appeal. On appeals, see §§10.95-10.101.

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IV. ENFORCING LIEN ON RENTS

§10.53 A. Perfection of Lien on Rents

Generally, a lender obtains a "lien" on rents by either (1) a true absolute assignment of rents or (2) an assignment for "additional security." Whether the assignment is designated "absolute" or for "additional security" affects the requirements for perfection. In the case of a true absolute assignment, there may be no need to perfect the lien because the lender's interest in the rents is unconditional. The more common approach of an assignment for additional security, however, requires perfection. Pursuant to 11 USC §544(a), a trustee would prevail against the unperfected lienholder in rents. On liens on rents generally, see California Real Estate Finance Practice: Strategies and Forms, chap 5 (Cal CEB 2000).

California comprehensively revised its law regarding assignments of rents effective for assignments entered into on or after January 1, 1997. Stats 1996, ch 49. The revised CC §2938(c) arguably puts the parties' rights to rents on a cash basis, measured as of the date of the enforcement of the assignment by one or more prescribed actions. Thus, the borrower should claim ownership of rents collected prior to enforcement (even if traceable to the mortgaged property), leaving to the lender rents, including delinquent rents, collected after enforcement of the assignment.

PRACTICE TIP: A lender that desires clearer pre-enforcement rights in, and control over, rents will take a security interest in property operating accounts (with perfection under Com C §§9310(b)(8), 9314) and will likely require a "lockbox" to maintain practical control. Com C §§9312-9313. See Real Estate Finance §§1.98, 1.107, 4.33, 4.73, 5.9.

A lockbox may take the form of a depository account into which gross rents are collected, with periodic disbursements to the borrower's property operating account only as authorized by the lender in conformity with an approved budget. Through such a tight cash management regime (more typical of a loan workout or the administration of a high-risk loan), the lender can implement an agreement that all net operating income be dedicated to debt service, property reserves, and accumulation of cash collateral. Alternative lockbox arrangements can give the borrower greater autonomy in managing property income until the lender declares a default.

WARNING: The lien of a deed of trust covers only rents and, perhaps, rental proceeds but not the proceeds or profits of a business operated on the real property. See *Financial Sec. Assur., Inc. v Days Cal. Riverside Ltd. Partnership (In re Days Cal. Riverside Ltd. Partnership)* (9th Cir 1994) 27 F3d 374 (hotel room charges are rents, but revenues from food and beverage service are not). Thus, if the cash generated by a business could be characterized as business receipts rather than rents, a secured lender should take care to perfect its interest in receipts by obtaining a security interest under the Uniform Commercial Code at the time the loan is made. See Secured Transactions in California Commercial Law Practice (2d ed Cal CEB 2001).

Additionally, CCP §564(b)(12) provides that the court may appoint a receiver in a case brought by an assignee who has previously enforced its assignment by obtaining or demanding turnover of rents in accordance with CC §2938(g). Code of Civil Procedure §564(b)(11) provides that receiver appointment is authorized in an action by a secured lender for specific performance of an assignment of rents.

Although the systematic approach to rental assignments embodied in CC §2938 will likely influence a court's analysis of any rental assignment in dispute, the current code section expressly applies only to contracts entered into on or after January 1, 1997. Accordingly, the law governing assignments of California rents is as follows:

"Absolute" Assignments

Contract Date	*Governing Law*
Before Jan. 1, 1992	Case law
Jan. 1, 1992-Dec. 31, 1996	Former CC §2938*

Jan. 1, 1997, and later	Current CC §2938

"As Security" Assignments

Contract Date	*Governing Law*
Before Jan. 1, 1993	Case law
Jan. 1, 1993-Dec. 31, 1996	Former CC §2938.1
Jan. 1, 1997, and later	Current CC §2938**

*According to legislative comment, former CC §2938 was "declarative of existing law."

**Current CC §2938 provides that *all* assignments are for security purposes.

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§10.54 B. Impact of Bankruptcy on Perfection

If a bankruptcy case is filed before the lien on rents is perfected, the automatic stay prohibits the lender from seeking perfection through the appointment of a receiver. 11 USC §362(a). Bankruptcy Code §546(b), however, provides an alternative means of perfection by notice, which may be given without violating the automatic stay. 11 USC §362(b)(3). Sections 546(b) and 362(b)(3) expressly permit a creditor to perfect and to maintain or continue perfection of a security interest without stay relief by giving notice under state law or, as appropriate, by giving notice in lieu of enforcement. See, *e.g., In re 201 Forest St., LLC* (Bankr Mass 2009) 404 BR 6 (lender lost right to foreclose because it failed to record extension of mortgage or acknowledgment that mortgage was not satisfied as required by state law before borrower filed petition). Giving such notice will suffice to perfect the creditor's assignment of rents, if that assignment is valid and enforceable in all respects other than perfection.

For real estate lenders who filed prepetition UCC financing statements in addition to their deeds of trust (*e.g.,* to cover accounts receivable from property income other than rents), the provisions authorizing actions to maintain a security interest permit the filing of UCC continuation statements without the need for stay relief. These provisions should have no effect, however, on creditors' rights under assignments of rents.

PRACTICE TIP: The Bankruptcy Code and Federal Rules of Bankruptcy Procedure do not prescribe a form or procedure for giving notice under §546(b). Traditional practice has been to file some form of request for "sequestration" of rents. Such a request can be incorporated into a motion for stay relief. When the secured party is not seeking relief from the stay immediately, however, §546(b) permits the filing of a simple notice of perfection of the lien on rents with the bankruptcy court. The notice should be filed and served on the trustee or debtor in possession immediately after learning of the bankruptcy to perfect the lien on rents as early as possible. For a sample notice, see §9.70.

When a prepetition deed of trust or other security agreement covers rents generated by the collateral, then those rents, including room rents, will be cash collateral in the borrower's bankruptcy case, even if generated after the petition is filed. 11 USC §552(b)(2). The cross-reference in §552(b)(2) to 11 USC §546(b) should not be read to alter creditors' rights under rental assignments governed by CC §2938, under prior absolute assignments, or under post-1992 "additional security" assignments of rents. Rather, §552(b)(2) should be read to clarify that, after recordation, the lender's interest in rents under such assignments requires no further notice under §546(b) for that interest to extend to postpetition rents. See §10.53.

For the lender holding a pre-1993 "additional security" assignment of rents that was recorded but not enforced prepetition, §552(b)(2) supports the view that notice under §546(b) should not be required to protect the lender's interest in postpetition rents; nonetheless, the interplay of §552(b)(2) with California mortgage law is not abundantly clear, and the customary §546(b) notice is easily given.

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§10.55 C. Impact of Bankruptcy on Existing Receivership

When a bankruptcy case is filed, a receiver—as a custodian of property of the bankruptcy estate—has a duty to account and to turn over the real property and the net rents in the receiver's possession. 11 USC §543(a)-(b). See 11 USC §101(11) ("custodian" includes receiver). Section 543(a) is extremely broad, but essentially it prohibits the receiver, after learning of the bankruptcy case, from distributing any of the debtor's property, or the proceeds or rents from such property, or from otherwise taking "any action in the administration of" such property, except as necessary to preserve the property. Section 543(b) requires the receiver (1) to deliver to the debtor in possession (or trustee if one has been appointed) all property of the debtor in the receiver's control on the date the receiver acquires knowledge of the bankruptcy case and (2) to file an accounting of all property of the debtor, or proceeds or rents from such property, that are in the receiver's control. Thus, the receiver must turn over not only the real property itself but also any undisbursed rents or profits that had been collected.

Under 11 USC §543(c), the bankruptcy court is required to do the following:

- "Protect" all entities to which the receiver has become obligated;
- Provide for payment of reasonable compensation and expenses to the receiver; and
- Surcharge the receiver for "any improper or excessive disbursement, other than a disbursement that has been made in accordance with applicable law or that has been approved, after notice and a hearing, by a court of competent jurisdiction before the commencement" of the bankruptcy case.

Given the limits of §543(c), it is prudent to try to include in the receiver's original appointment order provisions allowing payment of the receiver's fees and expenses, payment of taxes and senior liens, and authorization to make any out-of-the-ordinary disbursements that can be anticipated and specifically identified in the order. The receiver should pay those items as soon as possible because a subsequent bankruptcy will prohibit even previously authorized payments, except as needed for preservation of the property. Similarly, if a receiver must make an extraordinary disbursement before the bankruptcy case, it would seem prudent for that receiver to seek authorization from the appointing court in order to insulate the disbursement from later attack.

WARNING: The same considerations suggest including provisions in the appointment order directing payment of surplus rents to the secured party, but concerns over a potential one-action violation under CCP §726 often deter lenders from collecting preforeclosure payments through the receivership. See California Mortgages, Deeds of Trust, and Foreclosure Litigation §6.41 (4th ed Cal CEB 2009).

The bankruptcy court may excuse the receiver from compliance with §543(a), (b), or (c). The applicable statutory standard is vague: The court may excuse compliance "if the interests of creditors and, if the debtor is not insolvent, of equity security holders would be better served by permitting a custodian to continue in possession, custody, or control of such property." 11 USC §543(d). The statute does not specify who may request an excuse from compliance. Presumably, a secured lender, the receiver, or some other party in interest could do so. Such a request would usually be brought by motion. Fed R Bankr P 9013-9014. Nothing in the Bankruptcy Code excuses the receiver from the obligation to turn over assets while a motion to excuse compliance is pending. When a prompt request to excuse compliance is made, the moving party may argue that subsections (b) and (d) of §543 should be read together to allow the receiver to retain possession while the request is pending.

A receiver's turnover of real property and rents in compliance with §543 should not defeat perfection of the lender's interest in either rents collected by the receiver or future rents collected by the debtor in possession or trustee. 11 USC §552(b). Nevertheless, in that situation, a lender should consider serving and filing a notice under 11 USC §546(b) (see §10.54) to avoid any argument that its lien on future rents is not perfected.

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§10.56 D. Application of Rents

It is common for a secured lender with a lien on rents to be paid postbankruptcy rents net of operating expenses as a form of adequate protection. See §10.20 on adequate protection and §§10.64-10.66 on cash collateral use. Indeed, after enactment of BAPCPA, the Bankruptcy Code expressly provides that in a single asset real estate case the debtor is authorized to use rent to make monthly payments to the lender. 11 USC §362(d)(3)(B)(i). See §10.29. Rents accumulated during the case that are subject to the secured lender's lien are additional security for the lender's claim. Therefore, the total value of the secured creditor's collateral is the value of the real estate collateral plus accumulated rents. *Liberty Nat'l Enters. v Ambanc La Mesa Ltd. Partnership (In re Ambanc La Mesa Ltd. Partnership)* (9th Cir 1997) 115 F3d 650. Under this view, net rents paid to a lender during a bankruptcy case should, arguably, simply be applied to the portion of the lender's claim secured by rents. See *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284 (postpetition adequate protection payments were properly applied to reduce secured portion of creditors' claim when collateral did not diminish in value during case).

The lower courts, however, are divided on the issue. See *In re Union Meeting Partners* (Bankr ED Pa 1995) 178 BR 664 (discussing cases). One view is that, under 11 USC §552(b), the claim secured by accumulated rents is decreased by the amount of net rents paid to the lender, resulting in a "wash." 178 BR at 674; *In re Gramercy Twins Assocs.* (Bankr SD NY 1995) 187 BR 112. Another view is that the net rents received must be subtracted from the portion of the claim secured by the value of the real estate. *In re 354 E. 66th St. Realty Corp.* (Bankr ED NY 1995) 177 BR 776. A third view adopts a "dual valuation" approach. Use and application of rents is determined at each valuation point. The secured claim is first valued as of the petition date for adequate protection purposes. Accumulated postpetition rental proceeds increase the collateral securing the claim but do not increase the secured claim amount for adequate protection purposes. If adequate protection payments to the lender are not required because the real estate collateral is not declining in value, then, subject to court approval, the debtor may use the rents to pay administrative expenses, maintain or improve the real estate, pay real property taxes, or make payments to the lender. Later, at the time of plan confirmation, the lender's secured claim is revalued and the real estate is reappraised. The secured claim is reduced by postpetition rent payments received by the lender. Accumulated rental proceeds that are not necessary to pay expenses incurred by the trustee to preserve the real property collateral for the creditor's benefit, which can be surcharged under 11 USC §506(c), increase the amount of the secured claim. *In re Duval Manor Assocs.* (Bankr ED Pa 1996) 191 BR 622.

On valuation and appraisal standards, see §§5.18, 5.34, 5.37, 10.38, 10.88.

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V. OBTAINING CREDIT SECURED BY ESTATE ASSETS

§10.57 A. Overview

In any commercial real estate case, the debtor in possession or trustee will need to finance the operation of the business. Funding usually consists of use of cash collateral (rents or business receipts from the project), new loans, or some combination of the two. This section reviews the debtor in possession's ability to obtain new loans. On use of cash collateral, see §§10.64-10.66. At the commencement of the case, the debtor in possession may be a party to unfunded or partially funded loan agreements. However, the debtor will not be able to draw new funds under those loans because they are unenforceable after the petition is filed. 11 USC §365(c)(2). The Bankruptcy Code counterbalances this restriction by authorizing new unsecured and secured credit to be obtained for the bankruptcy estate. See §§10.58-10.62. Existing secured lenders need to be particularly aware of attempts to obtain new secured financing because it may directly or indirectly impact their security. 11 USC §364.

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§10.58 B. Unsecured Administrative Priority Debt

A debtor in possession or trustee authorized to operate the debtor's business may obtain unsecured credit in the ordinary course of business without court approval. Such indebtedness will be accorded administrative priority under 11 USC §503(b)(1). 11 USC §364(a). The Bankruptcy Code does not define "ordinary course," but the courts will likely evaluate ordinary course based on the size of the transaction relative to the debtor's business and creditors' objective expectations about risks that such a business would usually undertake. See *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700 (determining whether postpetition lease transactions were "ordinary course" for purposes of 11 USC §363). For example, trade credit from companies or persons providing ordinary course property maintenance services might be obtained under this provision. Unsecured credit may also be incurred outside the ordinary course of business if approved by the court "after notice and a hearing." 11 USC §364(b). Such debt is also accorded administrative expense priority under §503(b)(1).

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§10.59 C. Unsecured Superpriority Debt and Debt Secured by Unencumbered Property or Junior Liens

If unsecured debt with administrative priority cannot be obtained or is insufficient to finance the business, the Bankruptcy Code provides three alternative credit enhancements to entice a lender to extend credit. The first is to authorize unsecured credit with "superpriority" administrative status that is senior to other administrative debts under the Bankruptcy Code. 11 USC §364(c)(1). Alternatively, the trustee can obtain credit secured by a lien on unencumbered property or by a junior lien on property that is already encumbered. 11 USC §364(c)(2)-(3). These provisions will not directly impact existing holders of security interests because any lien granted under §364(c) is subordinate to existing liens.

Credit obtained under §364(c) must be approved by the bankruptcy court after "notice and a hearing," which is defined at 11 USC §102(1). This notice requirement is primarily for the protection of unsecured creditors, who may wish to oppose dilution of their ultimate share in the estate by new, senior indebtedness. The scope of such notice is governed by Fed R Bankr P 2002(a)(2) and 4001(c)(3).

WARNING: Because of misstatements or lax diligence, lenders may make a secured loan without knowing that the borrower is a debtor in bankruptcy, which can be problematic. See *Thompson v Margen (In re McConville)* (9th Cir 1997) 110 F3d 47.

In *Thompson,* the lender financed an individual's purchase of real property and obtained a deed of trust without knowing that its borrower had filed for Chapter 11 relief. The trustee, who was appointed later, sued to avoid the deed of trust as an unauthorized postpetition transfer of estate property under 11 USC §549. Withdrawing a prior decision based on §549, and ignoring that section entirely on the basis that precedent held that creation of a lien does not transfer property for purposes of §549, the Ninth Circuit panel ruled that the borrowing violated 11 USC §364(c)(2) because the bankruptcy court had not approved it. "An appropriate remedy for this disregard is cancellation by the court of the transaction.... It is within the power of that court to rescind the contract unlawfully made." 110 F3d at 50. Exercise of this corrective power, however, is subject to the "equities of the situation." The panel then concluded, apparently as a matter of law, that the lender should have a lien for the full principal amount of its loan, less the loan fee it charged, without interest. This decision, which is difficult to follow, implicitly holds that the "remedy" under §364 trumps avoidance of the lender's deed of trust under §549. Some of the confusion stems from the panel's failure to explore (or explain) why real estate bought after the bankruptcy filing by a postpetition loan to an individual debtor should be considered estate property at all. The bankruptcy estate generally consists of all the debtor's interests at the commencement of the case, not property acquired postpetition. 11 USC §541(a). In Chapter 13 cases, however, property of the estate *does* include property (including earnings) acquired by the debtor after the petition and before closure, dismissal, or conversion of the case. 11 USC §1306. BAPCPA added the same rule in Chapter 11 individual debtor cases. 11 USC §1115. Nevertheless, in situations in which after-acquired property is not part of the estate, a lender may still argue that neither §364 nor §549 applies and that the loan is enforceable in full.

The *Thompson* holding that creation of a lien by the granting of a mortgage does not constitute a "transfer" subject to §549 is suspect. In any event, BAPCPA revised the definition of "transfer" so that it expressly includes "creation of a lien." 11 USC §101(54)(A). It also revised the §549(c) safe harbor to include transfer of "an interest in" real property. These changes, discussed in §10.84, appear to legislatively overrule the *Thompson* decision.

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§10.60 D. Debt Secured by Equal or Senior Liens

The court may also authorize the estate to obtain credit secured by a lien senior or equal to a preexisting lien on the property, but only if (1) the credit is unavailable on any other basis and (2) there is adequate protection of the existing lienholder's interest in such property. 11 USC §364(d). It is unlikely that a sufficient equity cushion exists to provide the existing lienholder adequate protection; otherwise, the new lender should be satisfied with a junior lien. To establish adequate protection, the debtor or trustee will usually show that the new loan funds will be used to enhance or preserve the existing lenders' collateral to an extent at least equal to the new borrowing. The burden of establishing adequate protection falls on the debtor or trustee. *In re Mosello* (Bankr SD NY 1996) 195 BR 277, 292.

Procedurally, court authorization "after notice and a hearing" is required for this type of loan. See 11 USC §102(1); Fed R Bankr P 2002(a), 4001(c). The phrase "after notice and a hearing" requires an actual hearing only if a timely request is made by a party in interest. 11 USC §102(1)(B). Thus, court approval may be obtained without a hearing unless there is an objection.

The Bankruptcy Code and Federal Rules of Bankruptcy Procedure recognize that prompt approval of a postpetition loan may be necessary to keep the business alive. See 11 USC §364; Fed R Bankr P 4001. Applications to obtain secured credit, therefore, are often heard on shortened time because of the debtor's or trustee's need to obtain credit immediately to preserve existing operations. Accordingly, counsel for secured creditors should caution their clients to contact counsel immediately if any notice seeking authority to borrow funds is received. Counsel should also consider filing a request for special notice in the case so that counsel will also receive notices. See Fed R Bankr P 2002(i). If the existing lender fails to oppose a requested financing on a timely basis, the priority of its lien or the recovery on its claim may be affected. But see *Owens-Corning Fiberglas Corp. v Center Wholesale, Inc. (In re Center Wholesale, Inc.)* (9th Cir 1985) 759 F2d 1440 (cash collateral order void on due process grounds because junior lien creditor was not given sufficient notice).

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§10.61 E. Postpetition Advances on Secured Guaranty

The Ninth Circuit has ruled that advances can be made on a secured guaranty after the guarantor files a bankruptcy petition. See *Beeler v Jewell (In re Stanton)* (9th Cir 2002) 303 F3d 939, involving a lender that made advances to a corporate borrower that were guaranteed by the shareholders of the corporation. The corporation was not in bankruptcy at the time of the advances, but the individual guarantors were. The guaranty was secured by residential real property owned by the individuals. The Ninth Circuit found that the lien against the guarantors' house was created when they gave the lender a second mortgage prior to the bankruptcy filing. The subsequent advances merely affected how much money the lien secured. Consequently, the court ruled that the advances to the corporation did not, with respect to the individual debtors' bankruptcy cases, violate the automatic stay or require court approval under 11 USC §364. As a result, the advances were validly secured by the guarantors' real property. For commentary on *Beeler*, see 25 CEB Real Prop L Rep 137 (May 2002).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/§10.62 F. Appeals From Borrowing Orders

§10.62 F. Appeals From Borrowing Orders

A party that appeals from an order authorizing a borrowing or the granting of a lien must obtain a stay pending appeal, or the appeal will become moot as long as the lender extends credit in good faith. 11 USC §364(e). To ensure that §364(e) applies, counsel should request that the court make an express finding that the lender acted in good faith. See §§10.95-10.101 on appeals generally and on mootness rules regarding appeals from borrowing orders.

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VI. USE, SALE, LEASE, OR ABANDONMENT OF PROPERTY

§10.63 A. Overview of Debtor in Possession or Trustee Authority

A debtor in possession or trustee authorized to operate the debtor's business may use, sell, or lease property of the bankruptcy estate other than "cash collateral" in the ordinary course of business. 11 USC §363(c). Because of its unique characteristics, cash collateral may be used only in the more limited circumstances described in §10.64. On occasion, it is unclear whether the debtor owns the property to be sold. A dispute about ownership of property to be sold may need to be decided before the sale can be authorized. *Darby v Zimmerman (In re Popp)* (BAP 9th Cir 2005) 323 BR 260. This decision, however, rests on *Warnick v Yassian (In re Rodeo Canon Dev. Corp.)* (9th Cir 2004) 362 F3d 603, withdrawn (9th Cir 2005) 2005 US App Lexis 3802, and may no longer be persuasive. Finally, bear in mind that 11 USC §363 is not limited to real property collateral, and a good many of its provisions will apply primarily in the context of personal property.

In a commercial real estate case, continued leasing of space would usually be "ordinary course" as long as the lease terms were typical of the project. Selling parts of a real estate project might be ordinary if, *e.g.,* it was a residential real estate project and lots or homes were being sold at typical prices. A side business, such as a bar or restaurant, will usually involve use or sale of property that is considered ordinary. The Bankruptcy Code does not define "ordinary course," but the courts will evaluate ordinary course based on the size of the transaction relative to the debtor's business and creditor's objective expectations about risks that such a business would usually undertake. *Burlington N. R.R. Co. v Dant & Russell, Inc. (In re Dant & Russell, Inc.)* (9th Cir 1988) 853 F2d 700 (determining whether postpetition leases were "ordinary course").

A debtor or trustee may also use, sell, or lease property out of the ordinary course of business after "notice and a hearing," regardless of whether the debtor's business is authorized to be operated. 11 USC §363(b)(1). The phrase "after notice and a hearing" requires an actual hearing only if a timely request is made by a party in interest. 11 USC §102(1)(B); Fed R Bankr P 2002(a), 6004. Thus, counsel for secured creditors should caution their clients to contact counsel immediately if any notice seeking authority to use, sell, or lease property is received. Counsel should also consider filing a request for special notice in the case so that counsel will also receive notices. See Fed R Bankr P 2002(i).

The Bankruptcy Code prohibits any use, sale, or lease of collateral that would be inconsistent with any prior order granting relief from the automatic stay. 11 USC §363(d). See *240 N. Brand Partners v Colony GFP Partners, LP (In re 240 N. Brand Partners)* (BAP 9th Cir 1996) 200 BR 653 (rejecting modification of above-market lease on eve of lender's foreclosure because debtor failed to provide valid justification for transaction and because it appeared to be bad faith attempt to jeopardize lender's security).

The Bankruptcy Code allows the trustee or debtor in possession to use, sell, or lease property despite the existence of contractual "bankruptcy" clauses (sometimes called "ipso facto" clauses) that might otherwise give a contracting party a right to forfeit, modify, or terminate the debtor's interest in the property. 11 USC §363(*l*). *DB Structured Prods., Inc. v American Home Mortgage Holdings (In re American Home Mortgage Holdings)* (Bankr Del 2009) 402 BR 87. Although a clause prohibiting the debtor from assigning property that is not conditioned on the debtor's insolvency is enforceable, its breach gives rise to a claim for damages and does not affect the trustee's power to sell the property under §363. 402 BR at 101. For additional discussion of ipso facto clauses, see §6.53.

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§10.64 B. Use of Cash Collateral

In any commercial real estate case, the debtor in possession or trustee will need to finance the continuing operation of the business. Ordinarily, cash on hand as well as cash generated by the property is the most readily available source of operating funds. As discussed in §10.57, new loans can also be obtained, but such financing is often entirely unavailable or not ready at the beginning of a case. As a consequence, authority to use cash generated by the project is almost always sought.

If a real estate lender has a security interest in rents and profits generated by the property, the filing of a bankruptcy petition does not cut off the lender's security interest in such rents or profits. 11 USC §552(b)(2). Thus, cash generated by real estate projects ordinarily falls within the Bankruptcy Code definition of "cash collateral," which includes "cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest." 11 USC §363(a). Also included in the definition are "rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in §552(b)… whether existing before or after the commencement of a case."

Use of cash collateral is conditioned on the debtor in possession's or trustee's first obtaining either (1) the consent of the secured lender(s) with an interest in the cash or (2) a court order. 11 USC §363(c)(2). There is express authorization in §362(d)(3) for a debtor in a single asset real estate case to use rents or other project income to make monthly payments to creditors secured by the real estate. See §10.29. In addition, unless the lender otherwise permits, debtors and trustees must segregate and account for any cash collateral in their control. 11 USC §363(c)(4). If the debtor has not acknowledged these statutory limits, it may be prudent for lender's counsel to file and serve a notice confirming that the lender has not consented to cash collateral use, objecting to any such use absent its consent or a court order, and requesting that cash collateral be segregated. If the debtor in possession uses cash collateral without authorization, the burden of tracing the cash collateral shifts to the debtor in possession (or subsequently appointed trustee). *Freightliner Market Dev. Corp. v Silver Wheel Freightlines, Inc.* (9th Cir 1987) 823 F2d 362. See *In re Qmect, Inc.* (Bankr ND Cal 2006) 2006 Bankr Lexis 1489.

Usually, discussions regarding consensual use of cash collateral occur shortly before or immediately after the bankruptcy filing. Debtors and trustees who anticipate this issue have a better chance of reaching a stipulation (see §10.65) or, if that is not possible, obtaining timely court approval of necessary cash usages (see §10.66). Lenders are usually inclined to agree to some reasonable use of cash collateral so that the property can be properly maintained, operated, and insured and so that senior liens and property taxes can be paid. On use of cash collateral for debtor's attorney fees, see *Harvis Trien & Beck, P.C. v Federal Home Loan Mortgage Corp. (In re Blackwood Assocs.)* (2d Cir 1998) 153 F3d 61, discussed in §10.41. On use of rents and profits, see §§10.53-10.56.

NOTE: A threshold issue might exist if a lender holds a binding and presently effective absolute assignment of rents. In that situation, the rents would not be property of the bankruptcy estate that the debtor or trustee could use. See *First Fid. Bank v Jason Realty (In re Jason Realty)* (3d Cir 1995) 59 F3d 423 (affirming relief from stay order based on finding that rents validly assigned to lender did not constitute property of estate).

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§10.65 1. Stipulated Authority

The parties are often able to negotiate a stipulation allowing use of cash collateral for a set period based on a budget detailing approved uses of cash. It generally makes sense to build some "flex" into a stipulation. This can be accomplished by providing a cushion for approved budget items or by establishing a discretionary amount that can be spent on approved budget categories. Alternatively, the stipulation might provide a procedure for the lender to approve expenditures above or not included in a budget without additional court approval required. Whatever the agreed terms are, clarity in drafting is important to avoid future disputes.

Court approval of a cash collateral stipulation is required. Fed R Bankr P 4001(d)(1). Notice of the motion seeking approval must be served together with a copy of the proposed stipulation on any creditors' committee appointed in the case and, in Chapter 11 cases that have no committee, on the 20 largest unsecured creditors. Fed R Bankr P 4001(a)(1). Rule 4001 sets out minimum time requirements for notice, but local rules should also be consulted to confirm that they are not stricter. Fed R Bankr P 4001(d)(2)-(3). If no objection is filed, the stipulation may be approved without a hearing. Fed R Bankr P 4001(d)(3). Cash collateral stipulations are often reached after a motion seeking authority to use such collateral is filed. Such stipulations may be approved without bringing a separate motion if the court determines that the motion filed was sufficient to afford reasonable notice of the material provisions of the stipulation. Fed R Bankr P 4001(d)(4).

WARNING: Bankruptcy courts are wary of cash collateral stipulations with overreaching provisions favoring a lender, especially when stipulations are presented very early in a case before unsecured creditors have had a chance to organize and when a debtor may have little leverage in a negotiation with the lender. See, *e.g.,* Northern District of California Bankruptcy Court, Guidelines for Cash Collateral and Financing Motions and Stipulations (Jan. 1, 2006) (confirming that court will not usually approve stipulations containing, *e.g.,* cross-collateralization provisions, findings that liens are perfected, or waivers of right to surcharge secured lender's collateral). See Directory for link to local rules and guidelines.

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§10.66 2. Court Approval

A debtor or trustee should promptly bring a motion seeking authority to use cash collateral if a stipulation with the lender cannot be reached. Recognizing the critical role of cash collateral in operating a business, the Bankruptcy Code provides that a motion to use cash collateral must be scheduled "in accordance with the needs of the debtor" and that the court "shall act promptly" on the motion. 11 USC §363(c)(3). A "preliminary" and "final" hearing may be held on the motion. Fed R Bankr P 4001(b)(2). The final hearing cannot be heard on less than 14 days' notice, but the court can authorize use of cash collateral at the preliminary hearing to avoid immediate and irreparable harm to the estate pending the final hearing.

Similarly, a lender may respond to a debtor's improper, unauthorized use of cash collateral by affirmatively moving the court for an order prohibiting or conditioning use of cash collateral as necessary to adequately protect the lender's interest in the collateral. 11 USC §363(e). Such a request may be made "at any time" and the court, with or without a hearing, is required to condition or prohibit the use on such terms as will provide the lender with adequate protection.

Litigation over use of cash collateral will typically focus on adequate protection of the lender's interest under 11 USC §361. On adequate protection of lender's interest in noncash collateral, see §10.67. On adequate protection in the context of stay relief proceedings, see §10.20. In cash collateral litigation, the trustee will have the burden of showing adequate protection, and the lender will have the burden of showing it has a valid security interest in the cash collateral. 11 USC §363(p). In *Security Leasing Partners, LP v ProAlert, LLC (In re ProAlert, LLC)* (BAP 9th Cir 2004) 314 BR 436, the court rejected an undersecured creditor's argument that a debtor in possession's proposed use of cash collateral to pay professionals could not be authorized unless requirements for a §506(c) surcharge were met. The court ruled that §363 controlled the question and that use of cash collateral was authorized so long as adequate protection was provided. 314 BR at 444. On surcharge of collateral, see §10.75.

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§10.67 C. Adequate Protection of Secured Lender's Interest in Noncash Collateral

At any time, a lender may request adequate protection of its interest in noncash collateral that is proposed to be used, sold, or leased. Absent an emergency, a secured lender can combine a request for adequate protection with a stay relief motion. The court must prohibit or condition such use, sale, or lease as necessary to provide adequate protection of the lender's interest. 11 USC §363(e). Adequate protection may be provided by any of the methods allowed in 11 USC §361, discussed in §10.20 (adequate protection in context of stay relief).

A secured party's interest is also adequately protected when the value of the property sufficiently exceeds the amount of the secured claim to create an "equity cushion." See §10.20.

With respect to real estate secured loans, adequate protection issues may arise in a number of contexts, but perhaps the most common involves real property that is declining in value. Assuming the lender is undersecured and the real property collateral is declining while the debtor in possession or trustee continues using the property, the lender will usually be awarded cash payments as adequate protection, but replacement liens on other property may sometimes be offered.

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§10.68 D. Superpriority Claim for Insufficient Adequate Protection

Sometimes, the "adequate protection" provided to the lender turns out to be inadequate. In those situations, the lender can assert a superpriority administrative claim for the deficiency, which is senior to all other administrative claims, including the fees of counsel for the debtor or trustee. 11 USC §507(b). This scenario occurs most often when real property value declines precipitously. Nevertheless, counsel should be aware of this possibility when litigating about or stipulating to the value of the real property, the amount of the creditor's claim, or the form and amount of adequate protection payments, because such facts will be relevant to whether a §507(b) superpriority claim is allowed.

If the lender's superpriority claim arises in a Chapter 11 case that is later converted to Chapter 7, the superpriority claim is subordinated to administrative claims in the Chapter 7 case. 11 USC §348(d); *Citibank, N.A. v Transamerica Commercial Fin. Corp. (In re Sun Runner Marine, Inc.)* (BAP 9th Cir 1991) 134 BR 4. A lender with an allowed superpriority claim is not entitled to postpetition interest on its claim. *Gill v CBS Records, Inc. (In re Peaches Records & Tapes, Inc.)* (BAP 9th Cir 1989) 102 BR 193.

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E. Bankruptcy Sales of Collateral

§10.69 1. Overview; Employment of Real Estate Broker

As discussed in §10.63, assets of the bankruptcy estate may be sold in the ordinary course without court approval or out of the ordinary course pursuant to a "notice and hearing" procedure. If the debtor's business involves the sale of real property (*e.g.,* lots or homes being sold at a development), sales may be conducted in the ordinary course. However, it may not be possible to obtain title insurance without providing notice and a hearing and obtaining a court order approving the sales.

Estate assets are often sold through an auction process, but there is no requirement that a sale be made by auction. Assets can also be sold by public sale or by private sale subject to overbids. Fed R Bankr P 6004(f). The process and procedures for sales are governed by the Bankruptcy Code and Federal Rules of Bankruptcy Procedure as well as by local bankruptcy court rules, procedures, and guidelines and the circumstances of the case. One advantage of the auction process, when conducted in a fair and reasonable manner, is to avoid charges of collusion between the debtor and proposed purchaser. On collusive sales, see §10.72.

In structuring a sale of encumbered real property, a debtor or trustee may use ordinary methods for selling the collateral, by which liens are paid through escrow or the buyer takes the property subject to existing liens. Alternatively, as discussed in §10.70, the Bankruptcy Code allows the trustee or debtor in possession to sell property free and clear of liens and other interests. Because a bankruptcy sale is a voluntary sale, an oversecured lender can collect a prepayment premium if the loan documents provide for one. 11 USC §506(b); *Imperial Coronado Partners v Home Fed. Sav. & Loan Ass'n (In re Imperial Coronado Partners)* (BAP 9th Cir 1989) 96 BR 997. For more on 11 USC §506(b), see §10.91.

Real estate brokers and other related representatives and consultants are treated as professionals under the Bankruptcy Code; therefore, approval of their employment and compensation must usually be sought when they are retained. 11 USC §§327-328, 330; Fed R Bankr P 2014, 2016. In certain circumstances, a broker who fails to file a timely employment application may be allowed to seek retroactive authorization. Compare *Mehdipour v Marcus & Millichap (In re Mehdipour)* (BAP 9th Cir 1996) 202 BR 474, aff'd (9th Cir 1998) 139 F3d 1303 (retroactive authorization appropriate when debtor assured broker that approval of employment would be sought but it was not), with *In re Jarvis* (1st Cir 1995) 53 F3d 416 (post facto employment not authorized because of mere oversight). If a broker provided services before the bankruptcy, the commission will be treated as a general unsecured claim rather than an administrative priority claim earned postpetition. *Marcus & Millichap, Inc. v Munple, Ltd. (In re Munple, Ltd.)* (9th Cir 1989) 868 F2d 1129.

PRACTICE TIP: To avoid conflicts of interest, always refer debtors to independent real estate or loan brokers and other professionals on real property bankruptcy sales. See *Price v Lehtinen (In re Lehtinen)* (9th Cir 2009) 564 F3d 1052.

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§10.70 2. Sales Free and Clear of Liens

The power of a debtor in possession or trustee to sell a lender's collateral free and clear of liens and other interests is particularly important to the secured real estate lender whose lien will be impacted. If a sale is to be made subject to the lender's lien or if the lender might acquire the property by credit bid (see §10.73), the lender must focus on how the proposed sale will impact other liens and interests in the property. In particular, attention should be paid to what liens will not be removed by the sale and what leases will be included in or removed from the sale. See *C.H.E.G., Inc. v Millennium Bank* (2002) 99 CA4th 505, 121 CR2d 443 (order selling property free and clear of lease terminated lease, thereby defeating broker's claim that commission due under lease could be charged to lender that acquired property by credit bid). See also *Precision Indus., Inc. v Qualitech Steel SBQ, LLC (In re Qualitech Steel Corp.)* (7th Cir 2003) 327 F3d 537 (sale terminated debtor's lease to lessee and lessee lost right to continued possession and to compensation for value of lost lease when it failed to demand "adequate protection" of its leasehold interest under 11 USC §363(e)).

When sale free and clear is permitted. The Bankruptcy Code, in 11 USC §363(f), authorizes a free and clear sale in a Chapter 7, 11, 12, or 13 case under any of the following circumstances:

- Applicable nonbankruptcy law permits sale of the property free and clear of the lien or other interest (§363(f)(1));
- The entity with the interest in the property consents (§363(f)(2));
- The interest is a lien and the sale price of the property is greater than the aggregate value of all liens on the property (§363(f)(3));
- The interest is in bona fide dispute (§363(f)(4)); or
- The entity with the interest in the property could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of its interest (§363(f)(5)).

Sales under 11 USC §363(f)(2)-(4). Power to sell free and clear of a secured lender's deed of trust is generally obtained by consent under §363(f)(2) (*e.g.,* an undersecured lender may support a sale at a fair price even if the lender will not be paid in full) or by a showing under §363(f)(3) that the proceeds of the sale are sufficient to pay all lien claims. On occasion, the validity of the lender's lien may be sufficiently in dispute to justify a sale based on the bona fide dispute provision in §363(f)(4). In *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25, 40, the Ninth Circuit bankruptcy appellate panel held that §363(f)(3) does not authorize a sale free and clear of liens if the sale price is equal to or less than the total face amount—as distinct from the total allowed amount—of all claims held by the creditors holding a lien or security interest in the property to be sold. Thus, the liens of undersecured junior creditors cannot be stripped under §363(f)(3).

Sales under 11 USC §363(f)(5). In examining the mechanics of 11 USC §363(f), the bankruptcy appellate panel (BAP) in *Clear Channel* also concluded that nonconsensual lien-stripping under §363(f)(5) is rarely, if ever, permitted. In *Clear Channel*, the bankruptcy court entered an order confirming a sale of assets free and clear of liens to a credit-bidding senior lienholder, which it found to be a good faith purchaser under 11 USC §363(m). The BAP reversed and remanded. In analyzing §363(f)(5), the BAP held (1) that the term "interest" in §363(f)(5) did include liens and (2) that, to order a sale under §363(f)(5), the bankruptcy court must make findings that (a) a legal mechanism exists by which the creditor could be compelled to accept less than the full amount of its secured claim to extinguish its lien, and the bankruptcy trustee must show how extinguishment of the lien could be compelled, and (b) there exists, or exists a possibility of, a legal or equitable proceeding in which the creditor could be forced to accept money in satisfaction of its lien.

PRACTICE TIP: A buyer who purchases assets from an estate for less than the "aggregate value of all liens" should not close before the order confirming the sale becomes final.

Sales free and clear in Chapter 12. In Chapter 12 cases, the power to sell free and clear is broader and allows a sale of farmland or farm equipment free and clear of any lien or other interest, without satisfying any of the other conditions of §363(f), with the proceeds of such a sale automatically subject to the lien or interest that has been shed.

11 USC §1206. Subject to first refusal rights, property may also be sold free and clear of any vested or contingent right in the nature of dower or curtesy, and the interest of the estate and a co-owner may be sold when property is not easily partitioned. 11 USC §363(g)-(i).

Adequate protection required. A lienholder must be given adequate protection if its lien is shed in a free and clear sale. 11 USC §363(e); *Clear Channel Outdoor, Inc.,* 391 BR at 47 n24. This is ordinarily done by providing that the lien attach to the sale proceeds. See 11 USC §361, discussed in §10.20. Such proceeds will nearly always be in the form of cash, a purchase money note, or a combination of the two. As such, they will constitute cash collateral, the use of which is restricted. See §10.64. The proceeds need not be all cash, but they must be sufficient to constitute adequate protection to the transferred lien unless, of course, some other or additional form of adequate protection is provided. If a purchase money note is part of the consideration from the buyer, the creditworthiness of the buyer should be examined carefully. If lien claims are undisputed and a cash sale is involved, the trustee or debtor will often seek court authorization to pay cash proceeds to secured lenders in order of seniority as part of a strategy to pay down debt and reduce or eliminate interest accruals. If the lien claim is disputed, the common approach is to reserve proceeds sufficient to cover the full amount of the claim pending resolution of the dispute.

NOTE: A bankruptcy sale free and clear of liens under 11 USC §363(f) is not the equivalent of a judicial or nonjudicial foreclosure sale under California law. As a result, the fair value provisions applicable to foreclosure sales under CCP §§580a and 726 do not apply. *Coppola v Superior Court* (1989) 211 CA3d 848, 259 CR 811. On judicial and nonjudicial foreclosures and related California statutes, see California Mortgages, Deeds of Trust, and Foreclosure Litigation (4th ed Cal CEB 2009).

Enforceability of successor liability claims against buyer. Buyers at a bankruptcy sale typically seek to block claims against the debtor, whether secured or unsecured, from following the assets or the buyer (usually referred to as "successor liability" claims) unless the buyer agrees to expressly assume such a claim. Section 363(f) permits a sale free and clear of "interests… in property." It is generally agreed that this language covers claims secured by the property being sold, but courts are divided on whether a sale can be made free and clear of the debtor's unsecured claims. The more expansive view is that "interests in… property" covers both "in rem" interests in property and unsecured claims arising from the debtor's property and assets. See *EEOC v Knox-Schillinger (In re Trans World Airlines, Inc.)* (3d Cir 2003) 322 F3d 283 (involving employees' unsecured claims arising out of employment with debtor brought against buyer of debtor's assets). In *Trans World Airlines,* the Third Circuit ruled alternatively that barring successor liability claims was appropriate because allowing unsecured creditors to seek full recovery from a buyer under successor liability theories, while limiting lien creditors to sales proceeds and other estate assets, would be inconsistent with the Bankruptcy Code's normal priority scheme and contrary to the underlying policy that one creditor should not be preferred over others unless such preference is expressly authorized by the Code.

Other cases are contrary to *Trans World Airlines'* expansive interpretation. See, *e.g., Folger Adam Sec., Inc. v DeMatteis/MacGregor, J.V.* (3d Cir 2000) 209 F3d 252 (affirmative defense such as recoupment does not constitute "interest" under §363(f) and therefore is not extinguished by free and clear sale); *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v Tasemkin, Inc.* (7th Cir 1995) 59 F3d 48 (no per se rule that bankruptcy sale prevents successor liability). Similarly, the Ninth Circuit concluded that a valid successor product liability tort claim exists if the buyer and seller make a collusive agreement to use bankruptcy proceedings to shield the successor corporation from the predecessor's liabilities. *Nelson v Tiffany Indus., Inc.* (9th Cir 1985) 778 F2d 533 (interpreting California successor liability principles). However, the court also stated that this would not be the case when "there is a good faith dissolution in bankruptcy which is not intended to avoid future tort claims against the predecessor." 788 F2d at 538.

NOTE: If the Third Circuit's interpretation of §363(f) in *EEOC v Knox-Schillinger (In re Trans World Airlines, Inc.), supra,* is adopted by the Ninth Circuit or the U.S. Supreme Court, *Nelson*'s interpretation of California law may be superseded entirely under the Supremacy Clause.

PRACTICE TIP: When the real estate being sold is a hotel, shopping center, office building, or other operating business, a prospective buyer should carefully assess the potential for successor liability claims under state and federal law to reduce exposure to such claims. A buyer should consider taking affirmative steps, such as the following, to cut off successor liability claims:

- Including express provisions in the sale agreement confirming that the buyer is assuming either no claims or only specified claims;
- Adding express provisions in the order of the court approving the sale that the sale is made free and clear of as broad a range of claims as possible (see §10.71 on need for giving proper notice of sale to claimants to make such provision effective); and
- Making it clear in communication with vendors and other claimants that the buyer is a different entity than the debtor and that it has not assumed claims against the debtor.

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§10.71 3. Procedure Governing Sales

A motion seeking authority to sell property free and clear is a contested matter. Fed R Bankr P 6004(c), 9013-9014. See generally §§4.43-4.44. The motion must be served on all parties who have liens or interests in the property being sold. Fed R Bankr P 6004(c). Although the trustee may sell free and clear of one of more liens or interests but subject to others, Rule 6004 does not distinguish between the two. Notice of the sale must also be provided to unsecured creditors for sales out of the ordinary course of business. See §10.63.

Failure to provide adequate notice to a lienholder will justify setting aside the sale order for lack of due process. *Hasso v Mozsgai (In re La Sierra Fin. Servs., Inc.)* (BAP 9th Cir 2002) 290 BR 718; *GMAC Mortgage Corp. v Salisbury (In re Loloee)* (BAP 9th Cir 1999) 241 BR 655. Consequently, it is very important that counsel for sellers and buyers conduct appropriate diligence to determine who has liens against, or other interests in, the property. A title report should disclose claimants of record, but counsel should also assess whether there might be "secret liens" (not of record). If there is personal property involved, a lien search with the Secretary of State should be obtained. Buyers should also review the proposed service list for the motion in advance of it being served and obtain a file-endorsed copy. Secured lenders should also be aware that if they acquire property by credit bid at an 11 USC §363 sale, the sale alone will not wipe out junior liens as a foreclosure would. California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 2-5 (4th ed Cal CEB 2009). Therefore, it is important that the sale order specify which liens and interests are being removed.

PRACTICE TIP: Check local rules, guidelines, and orders providing court-specific notice and other procedures applicable to motions to sell free and clear of liens, including an approved model form of order. See, *e.g.,* Northern District of California Bankruptcy Court, Guidelines re Sale Orders. See Directory for website information (click on the Rules & Procedures tab, then the Guidelines link, then the article link).

It is common for buyers to ask for comprehensive language in a sale order confirming that the property being sold is free and clear of any and all liens, claims, or other interests. The motivation for this request is understandable—buyers do not want to have any claims against the debtor to follow the property. Although some courts will sign off on such sweeping language, the order should not be enforceable against lien or interest holders who do not receive notice of the motion, because of the failure to provide due process.

PRACTICE TIP: Counsel should conduct due diligence so that parties holding liens and other interests are properly identified and served with notice of the motion in the first instance, ensuring that the sale order will include and be effective regarding all such parties. Giving notice to all (or a large number) of the creditors should help avoid notice gaps and may convince a court to include broader "free and clear" language in the sale order.

WARNING: Counsel may encounter motions to sell property free and clear that also include a request that the court set lien priorities with respect to the proceeds. Such a request raises due process issues. Ordinarily, an adversary proceeding (*i.e.,* formal litigation initiated by a complaint) is required to establish the validity, priority, or extent of a lien or other interest in property. Fed R Bankr P 7001(2). Failure to follow the proper procedure can result in the sale order, or at least the portion attempting to set priorities, being vacated. *GMAC Mortgage Corp. v Salisbury (In re Loloee), supra*.

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§10.72 4. Collusive and Other Improper Sales

The consequences of collusive or other improper conduct at a bankruptcy sale are significant. Under 11 USC §363(n), a debtor in possession or trustee may do either of the following:

- Avoid a sale if the sale price was controlled by an agreement among potential bidders at the sale; or
- Recover from a party to such an agreement any amount by which the value of the property sold exceeds the price at which the sale was consummated.

The debtor in possession or trustee may also recover any costs, attorney fees, or expenses incurred in avoiding the sale or recovering damages. In addition, the court may award punitive damages against any party that entered into such an agreement in willful disregard of §363(n).

Although the language of §363(n) is broad, it has been interpreted narrowly. The trustee must prove the existence of a secret agreement among potential bidders with the intent to control the price; it is not enough to show an agreement that simply affected the bidding. *Lone Star Indus. v Compania Naviera Perez Companc (In re New York Trap Rock Corp.)* (2d Cir 1994) 42 F3d 747. See *Landscape Props., Inc. v Vogel* (8th Cir 1995) 46 F3d 1416 (jury verdict dismissing action upheld despite agreement by third party to pay fee to buyer and withdraw higher offer in return for assignment of buyer's rights).

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§10.73 5. Credit Bidding at Bankruptcy Sale

Unless the court orders otherwise for cause, a secured lender may credit-bid at a sale that is made out of the ordinary course of business to the extent of its allowed secured claim, whether or not the sale is free and clear of liens. 11 USC §363(k). A court will usually prevent a secured lender from credit bidding only if there is a bona fide dispute over the lender's claim amount or the validity or extent of its lien. On credit bidding at state-regulated foreclosure sales, see California Mortgages, Deeds of Trust, and Foreclosure Litigation, chaps 2-3 (4th ed Cal CEB 2009).

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§10.74 F. Abandonment of Collateral

Property of the bankruptcy estate that is burdensome or of inconsequential value and benefit to the estate may be abandoned after notice and a hearing. 11 USC §554. A motion to abandon property may be brought by a trustee, a debtor in possession, or a third party. It is common for a trustee to seek to abandon property that is overencumbered. Abandonment effects a divestiture of the estate's interest in the property. *In re Dewsnup* (10th Cir 1990) 908 F2d 588, 590, aff'd sub nom *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773. Once abandoned, title to the property reverts back to the debtor, subject to any liens against or interests in the property.

PRACTICE TIP: The automatic stay prevents a lender from enforcing a lien securing a prepetition claim against property of the debtor. 11 USC §362(a)(5). Thus, abandonment will not obviate the need for a prepetition secured lender to seek relief from the automatic stay if the stay has not already terminated. See §§10.2-10.3. However, the grounds for abandonment (*e.g.,* lack of equity) may provide the lender with "cause" to seek stay relief.

See general discussion of abandonment of estate property in §§2.83-2.84.

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§10.75 G. Surcharge of Secured Creditor's Collateral

A debtor in possession or trustee "may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim." 11 USC §506(c). See *Poonja v Alleghany Props. (In re Los Gatos Lodge, Inc.)* (9th Cir 2002) 278 F3d 890 (denying surcharge against secured lender after lender's claim disallowed). In essence, this provision is intended to block a secured lender from receiving a "free ride" while the bankruptcy estate incurs costs taking care of the lender's collateral. Section 506(c) also provides that surchargeable costs include ad valorem property taxes.

Section 506(c) issues may arise in a number of circumstances, but they are usually most contentious when the value of the collateral turns out to be less than the amount of the claims secured by it. As a result, counsel sometimes attempt to negotiate §506(c) rights early in the case as part of cash collateral or other financing agreements. Lenders often seek waiver or limitations on §506(c) rights, while debtors and trustees prefer to keep these rights available. Some courts have expressed antipathy toward §506(c) waivers. See Northern District of California Bankruptcy Court, Guidelines for Cash Collateral and Financing Motions and Stipulations (Jan. 1, 2006) (waiver usually not allowed unless effective only during period in which debtor is authorized to use financing—this avoids problem of later-appointed trustee, forced to care for lender's collateral, having no recourse); see Directory (click on the Rules & Procedures tab, then the Guidelines link, then the article link). See also Warning in §10.65. The terms of a §506(c) stipulation should be clear to avoid subsequent litigation. See *Daniel v AMCI, Inc. (In re Ferncrest Court Partners, Ltd.)* (6th Cir 1995) 66 F3d 778 (broker fee could be surcharged against lender because lender consented to commission even though sale later failed to close with buyer procured by broker).

Only a bankruptcy trustee or debtor in possession may pursue a §506(c) surcharge against a secured lender. *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942 (denying claim by insurer). In the Ninth Circuit, the trustee may seek a surcharge and pay the party providing the benefit directly. *Debbie Reynolds Hotel & Casino, Inc. v Calstar Corp. (In re Debbie Reynolds Hotel & Casino, Inc.)* (9th Cir 2001) 255 F3d 1061, 1067. Other courts hold that any surcharge recovery is payable only to the estate. *Ungaretti & Harris, LLP v Steinberg (In re Resource Technol. Corp*.) (ND Ill 2006), 356 BR 435 (prohibiting payment to trustee's counsel). In addition, a §506(c) surcharge is limited to those expenses that the secured lender would have incurred had it foreclosed and used the foreclosed property. *Compton Impressions, Ltd. v Queen City Bank, N.A. (In re Compton Impressions, Ltd.)* (9th Cir 2000) 217 F3d 1256 (denying surcharge for legal fees and marketing costs above amounts agreed to by lender in cash collateral budget and that did not benefit lender); *Golden v Chicago Title Ins. Co. (In re Choo)* (BAP 9th Cir 2002) 273 BR 608 (denying surcharge because trustee failed to quantify benefit to secured creditor of avoiding costs of foreclosure sale and subsequent disposition).

There is no per se rule that an oversecured creditor may not be surcharged for expenses of preserving collateral. While facts may show that an oversecured creditor does not benefit from efforts to preserve collateral (because the creditor would be paid in any event), evidence could show that the creditor would have become undersecured if the services had not been provided. See *Debbie Reynolds Hotel & Casino, Inc. v Calstar Corp. (In re Debbie Reynolds Hotel & Casino, Inc.)* (9th Cir 2001) 255 F3d 1061. A secured creditor can stipulate to payment of a surcharge directly to debtor's counsel who provides a "quantifiable" benefit in preservation of collateral. Such a payment does not have to be paid into the estate for ratable distribution among administrative claimants. 255 F3d at 1067.

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§10.76 H. Appeals

A party that appeals from an order authorizing a sale or lease of property must obtain a stay pending appeal or the appeal will become moot as long as the purchaser or lessor acted in good faith. 11 USC §363(m). *Official Committees of Unsecured Creditors v Anderson Senior Living Prop., LLC (In re Nashville Senior Living, LLC)* (BAP 6th Cir 2009) 407 BR 222. See §10.99. To ensure that §363(m) applies, counsel should request that the court make an express finding that the purchaser or lessor acted in good faith. Unless the court orders otherwise, the effectiveness of an order authorizing the use, sale, or lease of property other than cash collateral is automatically stayed for 14 days. Fed R Bankr P 6004(h). See §§10.95-10.101 for further discussion of appeals generally and mootness rules regarding appeals from sale or lease orders.

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VII. AVOIDANCE

§10.77 A. Legal Basis; Limitations

Chapter 5 of the Bankruptcy Code creates actions allowing a trustee (or debtor in possession) to avoid certain types of transactions. In general terms, the avoiding powers can be broken into two groups:

(1) "Strong arm" powers vesting the trustee with power to avoid transfers or obligations that would be voidable by certain specified types of creditors under state law (see 11 USC §544), discussed generally in §§2.32-2.33; and

(2) Avoidance actions created by the Bankruptcy Code (see 11 USC §§522, 547-549), discussed generally in §§2.34-2.70.

Avoiding powers have been used to avoid liens or security interests granted to lenders, payments to lenders, and obligations to lenders. This chapter focuses on avoiding powers that are most likely to have an impact on secured real property financing transactions. See §§2.32-2.70 for a comprehensive review of the trustee's avoiding powers.

All avoiding powers sections in the Bankruptcy Code state that "the trustee" may bring the avoidance action. Debtors in possession have the powers of a trustee and, therefore, can also bring avoidance actions. See §1.15. For decades, it had been widely accepted that a creditors' committee or individual creditor could also bring an avoidance action if the trustee or debtor in possession refused to bring the action and a good faith basis existed for the action. The U.S. Supreme Court's holding that creditors cannot bring §506(c) surcharge claims (see §10.75), because the section only grants surcharge rights to the trustee, casts doubt on that practice. See *Hartford Underwriters Ins. Co. v Union Planters Bank* (2000) 530 US 1, 147 L Ed 2d 1, 120 S Ct 1942. This issue will likely be resolved through further litigation. See, *e.g., Official Comm. of Unsecured Creditors of Cybergenics Corp. ex rel Cybergenics Corp. v Chinery* (3rd Cir 2003) 330 F3d 548 (court's equitable powers support authorization of creditors' committee's derivative action to avoid fraudulent transfer); *United Phosphorous, Ltd. v Fox (In re Fox)* (BAP 10th Cir 2004) 305 BR 912 (reaching opposite result). However, a trustee may assign the estate's avoidance powers to third parties. *Duckor Spradling & Metzger v Baum Trust (In re P.R.T.C., Inc.)* (9th Cir 1999) 177 F3d 774.

The statute of limitations for most bankruptcy avoidance actions is the earlier of (11 USC §546(a)(1)):

- 2 years after the case is begun, or 1 year after appointment of the first trustee if the appointment is made during the initial 2 years of the case; or
- The date that the bankruptcy case is closed or dismissed.

The statute of limitations can be tolled by inequitable conduct. *Olsen v Zerbetz (In re Olsen)* (9th Cir 1994) 36 F3d 71.

Bankruptcy Code §550 gives the avoidance powers their teeth. It provides that the trustee can recover the property transferred or the value of such property from the initial transferee of an avoided transfer, the entity for whose benefit the transfer was made, or any "immediate or mediate" transferee of the initial transferee liable for an avoided transfer. 11 USC §550(a). The immediate or mediate transferees of the initial transferee have no liability if they took for value, in good faith, and without knowledge of the voidability of the avoided transfer. 11 USC §550(b)(1). Any transferee of an immediate or mediate transferee that takes in good faith is also shielded from liability. 11 USC §550(b)(1). The essential concepts are that property may be transferred a number of times and only persons aware of the tainted original transfer should have liability.

Transferee status has been heavily litigated because of the greater defenses accorded downstream transferees. The courts have interpreted the term "transferee," which is not defined by the Bankruptcy Code, to mean one who exercises "dominion" over the property transferred. *Danning v Miller (In re Bullion Reserve)* (9th Cir 1991) 922 F2d 544, 549. Application of this definition, however, is not always clear cut. In *General Elec. Capital Auto Lease, Inc. v Broach (In re Lucas Dallas, Inc.)* (BAP 9th Cir 1995) 185 BR 801, an insider of a corporate debtor wrote a check on the debtor's account to pay the insider's personal mortgage. The appellate court rejected the argument of the lender receiving the mortgage payment that the insider, rather than the lender, was the initial transferee. 185 BR at 809. See also *Richardson v FDIC (In re M. Blackburn Mitchell, Inc.)* (Bankr ND Cal 1994) 164 BR 117 (reaching same conclusion on

insider transferee status but collecting opposing cases).

An action under §550 may not be brought after the earlier of 1 year after avoidance of the transfer or the time the case is closed or dismissed. 11 USC §550(f). Because a complaint seeking to avoid a transaction almost always asserts a separate claim under §550 for recovery of the avoided transaction, this limitation period is rarely an issue. But if the trustee brings a separate action for recovery under §550 against a subsequent transferee based on a stipulated judgment, the subsequent transferee may have a right to litigate the merits of the avoidance claim. *Dye v Sachs (In re Flashcom, Inc.)* (Bankr CD Cal 2007) 361 BR 519. Though multiple parties may have liability under §550, the trustee can only obtain a single recovery. 11 USC §550(d).

Section 550(e) may buffer the plight of a secured lender that suffers an avoidance judgment. Under §550(e)(1), a good faith transferee from whom a trustee recovers is given a lien on the property recovered to secure the lesser of (1) the cost of improvements made after the transfer less any profit realized or accrued to the transferee or (2) the increase in the value of the property from the improvements. "Improvements" are defined to include payment of any debt secured by the property that is superior to the rights of the trustee and payment of taxes on the property. 11 USC §550(e)(2). The courts are divided on whether this provision protects a secured lender who does not have possession of the property that is the subject of the avoidance action. Compare *Black & White Cattle Co. v Granada Cattle Servs., Inc. (In re Black & White Cattle Co.)* (9th Cir 1986) 783 F2d 1454, 1462 (§550(e) (former 11 USC §550(d)) protects nondebtor transferee who did not receive possession of property even though debtor successfully avoided transfer of title), with *Suhar v Burns (In re Burns)* (6th Cir 2003) 322 F3d 421 (secured lender whose lien was avoided because of defective documentation under state law not protected by §550(e)).

When a payment to a secured lender is avoided and the lender returns the avoided payment to the bankruptcy estate pursuant to §550, the lender should have a revived prepetition claim for the amount returned. 11 USC §502(h). A proof of claim for the revived debt must be filed within 30 days of the avoidance judgment becoming final. Fed R Bankr P 3002(c)(3) (Chapter 7, 12, or 13), 3003(c)(3) (Chapter 11). (For an example of when judgment is final, see *Prestige Ltd. Partnership—Concord v East Bay Car Wash Partners (In re Prestige Ltd. Partnership—Concord)* (Bankr ND Cal 1998) 223 BR 203, aff'd (9th Cir 2000) 234 F3d 1108.) Section 502(h), however, does not speak to interest on, or security for, such a claim. A debt "revival" provision in the loan documents covering payments that are disgorged pursuant to the Bankruptcy Code might be helpful in clarifying these issues. More difficult issues may arise if the lender has previously released its collateral.

PRACTICE TIP: If a settlement of an avoidance action is reached, counsel should expressly state whether the lender will have a claim as a result of the settlement and, if so, the amount and secured status of the claim.

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§10.78 B. Unrecorded Deeds of Trust: 11 USC §544

As discussed in §10.4, the automatic stay blocks a lender holding an unrecorded deed of trust from recordation after a bankruptcy case is filed. The lender in this situation should also expect the trustee to seek avoidance of the unrecorded deed of trust using the trustee's 11 USC §544 "strong arm" powers.

A trustee's "strong arm" powers under 11 USC §544(a) (see §10.77) include the power to avoid any transfer of the debtor's property that is voidable by any of the following:

- A hypothetical judicial lien creditor as of the commencement of the case;
- A hypothetical creditor with an execution against the debtor that is returned unsatisfied as of the commencement of the case; or
- A hypothetical bona fide purchaser of real property, other than fixtures, from the debtor against whom applicable state law permits such transfer to be perfected, that obtains the status of a bona fide purchaser (BFP) and has perfected such transfer at the time of the commencement of the case. This allows a trustee to avoid unrecorded deeds of trust, and the analysis requires application of state law regarding the rights of a subsequent BFP against the holder of a prior, unrecorded deed of trust.

In a "race-notice" jurisdiction such as California (permitting a later-created lien to take priority over an earlier created one if (1) the earlier lien was not recorded, (2) the later lienholder was without notice of the earlier lien, (3) the later lienholder gave value for the lien, and (4) the later lien was recorded first), a subsequent BFP is protected against a prior unrecorded interest if the subsequent BFP records first. CC §1214. The Bankruptcy Code, however, states only that the trustee in bankruptcy is deemed to be a BFP, not a BFP who records first or at all. The meaning of this provision, if any, requires clarification through court decision, although it appears that Congress intended to empower the trustee to defeat an unrecorded interest. In most "race-notice" and "pure notice" jurisdictions, the status of a BFP is defeated by the existence of facts giving rise to "inquiry notice." The most common example is possession consistent with record title. See *Natural Resources, Inc. v Wineberg* (9th Cir 1965) 349 F2d 685; *Fry Bros. Co. v Van Waters & Rogers (In re Fry Bros. Co.)* (Bankr SD Ohio 1985) 52 BR 169; *High Fid. Enters. v Hull* (1962) 210 CA2d 279, 26 CR 654.

In determining whether a trustee is entitled to BFP status, the trustee is charged with the knowledge of a "prudent purchaser" on the basis of information reasonably available to such a purchaser. *Robertson v Peters (In re Weisman)* (9th Cir 1993) 5 F3d 417. Pushing the limits of inquiry notice, the Ninth Circuit held that an involuntary petition that referred to an unrecorded deed of trust was sufficient to put the trustee on inquiry notice and block avoidance. *Briggs v Kent (In re Professional Inv. Props.)* (9th Cir 1992) 955 F2d 623. This decision, however, has been limited to its specific facts. Unrecorded interests listed in the schedules or statement of affairs in a voluntary case do not put the trustee on inquiry notice and are avoidable. *Taxel v Chase Manhattan Bank (In re Deuel)* (BAP 9th Cir 2006) 361 BR 509.

If a deed of trust is avoided under §544, the lender becomes an unsecured creditor and the avoided lien position is preserved for the benefit of the bankruptcy estate. 11 USC §551. Sometimes, an unrecorded deed of trust passes through a Chapter 7 bankruptcy case without being avoided. In that scenario, the discharge injunction granted to the debtor, which results in the termination of the automatic stay (11 USC §362(c)(2)(C)), does not prevent recordation of that deed of trust or foreclosure on the property, but the creditor is barred from seeking a deficiency judgment. *Cortez v American Wheel, Inc. (In re Cortez)* (BAP 9th Cir 1995) 191 BR 174.

A trustee may also use §544 to avoid a trustee's deed that is not recorded as of the bankruptcy petition date. *Walker v California Mortgage Serv. (In re Walker)* (9th Cir 1988) 861 F2d 597. California foreclosure law provides for "deemed perfection" of a trustee's deed as of 8 a.m. on the actual date of the foreclosure sale if that deed is recorded within 15 calendar days after the date of sale, or the next business day following the 15th day if the county recorder's office is closed on the 15th day. CC §2924h(c). A trustee's deed recorded after the bankruptcy filing but within this 15-day period does not violate the automatic stay (see §10.6) and is not avoidable under 11 USC §544 or §549. *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820. A trustee's deed recorded after both the

bankruptcy filing and this 15-day period is avoidable under the ruling in *Walker*.

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/ C. Avoidable Preferences: 11 USC §547/§10.79 1. Prima Facie Preference Action

C. Avoidable Preferences: 11 USC §547

§10.79 1. Prima Facie Preference Action

The power to avoid transfers that "prefer" one creditor over another acts as a check on abuses by debtors and creditors prior to the filing of a bankruptcy petition. The risk of having a transfer avoided (*i.e.,* set aside and recovered back into the bankruptcy estate) as a preference:

- Encourages creditors to maintain ordinary credit terms with distressed customers;
- Facilitates the bankruptcy policy of equality of distribution among creditors; and
- Discourages creditors from seeking or debtors from granting secret liens.

The Bankruptcy Code defines an "avoidable preferential transfer" as a transfer of an interest of the debtor in property (11 USC §547(b)):

- To or for the benefit of a creditor;
- For or on account of an antecedent debt owed by the debtor before such transfer was made;
- Made while the debtor was insolvent;
- Made either (1) on or within 90 days of the date of filing of the petition or (2) between 90 days and 1 year if the creditor was an "insider"; and
- That enables the creditor to receive more than such creditor would receive if (1) the case were a case under Chapter 7; (2) the disputed transfer had not been made; and (3) the creditor receives payment of its debt as provided by the Bankruptcy Code.

Transfers can include a cash payment, the grant of a deed of trust or other consensual lien, a conveyance of title to realty, or the creation of a judgment or other involuntary lien. See 11 USC §101(54).

Most preference claims against secured real estate lenders focus on either the lender's receipt of payment(s) or the validity of the grant of the deed of trust, both of which are transfers of an interest of the debtor in property. When the challenged transaction is a payment, an oversecured lender should be protected by the last prong of the preference test (*i.e.,* the lender would have received just as much in a Chapter 7 case even if the payment had not been made). This is because, in a Chapter 7 case, the claim of an oversecured lender would be paid from the collateral ahead of other creditors anyway. Thus, the oversecured lender who receives regular prepetition loan payments or is fully paid by a prepetition foreclosure sale does not receive a preference. The loan payments and the sale simply convert the secured lien into cash and do not improve the lender's position.

Payments received by an undersecured lender, however, are more vulnerable to attack. For example, prepetition payment in full of a lender owed $100,000 that is secured by real property worth $75,000 allows the lender to receive $25,000 more than the lender would receive in a Chapter 7 case. See 11 USC §506(a) (limiting the secured claim to the lesser of the claim or the value of the collateral). Regular loan payments would also be vulnerable to the same attack, but the lender may well have an "ordinary course of business" defense as described in §10.80.

Whether oversecured or undersecured, a lender who purchases a debtor's house by credit bidding (see §10.73) at a prepetition, regularly conducted, noncollusive, nonjudicial foreclosure sale does not receive a preference because it will not receive more than it would have in a Chapter 7 liquidation. See *Ehring v Western Community Moneycenter (In re Ehring)* (9th Cir 1990) 900 F2d 184. (On acts constituting collusion or bid-chilling, see §10.72.) Arguably, a judicial foreclosure sale should also be immune because the proceeds only reduce the secured portion of the lender's claim and the deficiency is retained as an unsecured claim. Finally, proceeds received from the full or partial disposition of the collateral by the debtor arguably should be protected because the payment will reduce the secured portion of the claim (as the value of the collateral is reduced by the disposition) but not the unsecured portion of the claim.

A trustee may also attack the grant of a deed of trust as a transfer if it is made during the preference period. Section 547 contains several rules to determine when a transfer by deed of trust occurs. If the deed of trust is recorded within 30 days of its execution, the transfer is treated as being made on the date it is signed. 11 USC §547(e)(1)(A), (e)(2)(A).

If the recordation occurs more than 30 days later, the transfer date is the date of recordation. 11 USC §547(e)(2)(B). If the deed of trust has not been recorded by the later of the petition date or 30 days after the deed of trust is signed, then it is deemed to be a transfer made "immediately before the date of the filing of the petition." 11 USC §547(e)(2)(C). Finally, there can be no transfer until the debtor has acquired rights in the property transferred. 11 USC §547(e)(3).

If the deed of trust is recorded before the loan is advanced, arguably the grant of the deed of trust should be immune from attack because it is not made because of antecedent debt (*i.e.,* an obligation already owing), and therefore one of the prima facie elements of the preference claim is missing. See 11 USC §547(b)(2). It follows that a lender is most at risk when it delays recordation of a deed of trust until after a loan is made or receives new collateral after having previously made loans. The latter can occur in converting an unsecured loan to a secured loan or in a restructuring of a secured loan. If the delay in recordation is not too great, the lender's best argument is the defense afforded contemporaneous transfers that are, in fact, substantially contemporaneous. See §10.80. But if the delay is significant, or if the lender is converting unsecured debt to secured debt, it will be difficult to defend a preference action seeking to avoid the grant of the deed of trust. With a restructuring involving a change in collateral that does not improve the lender's collateral position, arguably the lender should not have exposure because it would have received the same value in a Chapter 7 case.

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§10.80 2. Defenses to Preference Actions

There are several statutory defenses to a preference claim, discussed generally in §§2.45-2.55. Two of these defenses are relevant to a lender making a new loan secured by real property. Standard purchase money financing secured by a deed of trust should be protected as long as the deed of trust is recorded within 30 days (20 days prior to BAPCPA) of the debtor obtaining possession of the collateral. 11 USC §547(c)(3). Non-purchase money financing may be protected by the defense provided for contemporaneous exchange transfers made for new value. 11 USC §547(c)(1). See §10.79 on the rules for determining the time of transfer. This defense is particularly relevant to deeds of trust granted in connection with a new loan. The longer a lender delays the recordation of its deed of trust, the less likely the defense will be available. *Dye v Rivera (In re Marino)* (BAP 9th Cir 1996) 193 BR 907, aff'd (9th Cir 1997) 117 F3d 1425 (unpublished opinion) (deed of trust recorded 14 days after funding of loan not preferential; trial court must inquire into facts and circumstances of particular transaction to determine whether perfection was substantially contemporaneous).

Another defense shields transfers made in payment of debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the lender. See 11 USC §547(c)(2). To assert an ordinary course defense, a lender must establish one of the following:

- The payment was *made in the ordinary course* of business or financial affairs of the debtor and lender, or
- The payment was made *according to* ordinary business terms.

The ordinary course defense applies to regularly scheduled payments on long-term debts. *Union Bank v Wolas* (1991) 502 US 151, 116 L Ed 2d 514, 112 S Ct 527. The following types of payments have been considered to be in the ordinary course of business:

- A secured loan payoff consistent with the broad range of industry practices. *Ganis Credit Corp. v Anderson (In re Jan Weilert RV, Inc.)* (9th Cir 2003) 315 F3d 1192, amended 326 F3d 1028.
- Late payments if payments were regularly late and late payments are commonly accepted in the industry. See *Sulmeyer v Pacific Suzuki (In re Grand Chevrolet, Inc.)* (9th Cir 1994) 25 F3d 728.
- Payments pursuant to a restructuring agreement if such agreements are regularly made in the industry. See *Arrow Electronics, Inc. v Justus (In re Kaypro)* (9th Cir 2000) 218 F3d 1070; see also *In re Tolona Pizza Prods. Corp.* (7th Cir 1993) 3 F3d 1029.
- Payment that is the first transaction between the debtor and the transferee. See *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118.
- Payment of rents from a mortgaged property into a lockbox or escrow controlled by the lender (see §10.53). Compare *Galloway v First Ala. Bank (In re Wesley Indus., Inc.)* (11th Cir 1994) 30 F3d 1438 (ordinary course) with *Clark v Balcor Real Estate Fin*. (*In re Meridith Hoffman Partners)* (10th Cir 1993) 12 F3d 1549 (not ordinary course).

When the payment agreement between the debtor and the creditor has been revised or restructured, the court may consider both the revised agreement and the original transaction in applying §547(c)(2). *Wood v Stratos Prod. Dev., LLC (In re Ahaza Sys., Inc.)* (9th Cir 2007) 482 F3d 1118, 1127.

In cases that do not involve primarily consumer debt, the minimum preferential transfer (in the aggregate) that can be avoided is $5475. 11 USC §547(c)(9). Moreover, venue of an action to recover nonconsumer debt of less than $10,950 can only be brought in the district in which the defendant resides. 28 USC §1409(b).

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§10.81 3. Insider Preferences

If transfers are made to an insider, the avoidance period is extended from 90 days to 1 year. 11 USC §547(b)(4). Insiders are generally relatives or partners of individual debtors and directors, officers, general partners, or other persons in control of a corporate or partnership debtor. 11 USC §101(31). See generally §2.42. On first impression, most secured real estate lenders would not appear to be insiders. However, in 1989 the extended insider preference period was held to be applicable to lenders holding a personal guaranty from an insider of the debtor. See *Levit v Ingersoll Rand Fin. Corp. (In re V.N. Deprizio Constr. Co.)* (7th Cir 1989) 874 F2d 1186. See also *Official Unsecured Creditors Comm. of Suffola, Inc. v U.S. Nat'l Bank (In re Suffola, Inc.)* (9th Cir 1993) 2 F3d 977 (adopting *Deprizio*). These rulings caused significant distress in the lending community.

In 1994, Congress attempted to overrule *Deprizio* by enacting 11 USC §550(c), which provides that if the transfer is made between 90 days and 1 year before the petition date for the benefit of an insider, the trustee cannot recover the property or the value of the property transferred from a transferee that is not an insider. However, the amendment did not appear to shelter security interests (which would include deeds of trust), because avoidance of a security interest does not involve recovery of property held by the debtor or the value of such property. The BAPCPA amendments to the Bankruptcy Code were intended to lay the issue to rest. Under 11 USC §547(i), avoidance of a transfer to a noninsider that was made for the benefit of an insider is effective only against the insider. Unlike most of BAPCPA, this change is effective for existing and future cases. Pub L 109-8, §1213(b), 119 Stat 23. This change should alleviate lenders' concerns about taking insider guaranties.

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§10.82 4. Effect of Avoided Preferential Transfer

Once a preferential transfer is avoided, by court order or settlement, the underlying debt on which the preferential payment was made, along with any guaranty of the debt, is revived as a matter of law, absent a contractual provision to the contrary. *Centre Ins. Co. v SNTL Corp. (In re SNTL Corp.)* (BAP 9th Cir 2007) 380 BR 204. The revived claim against the debtor's estate will be subordinated or barred, however, unless the creditor files a proof of claim on it within 30 days of entry of the judgment against the creditor. Fed R Bankr P 3002(c)(3).

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Source: Real Property/California Real Estate Bankruptcies: Law and Litigation/10 Real Property Secured Loans/§10.83 D. Fraudulent Transfers: 11 USC §§544, 548

§10.83 D. Fraudulent Transfers: 11 USC §§544, 548

A trustee may also avoid transfers of the debtor or obligations incurred by the debtor that are fraudulent. Under the Bankruptcy Code, either of the following transfers may be avoided:

- **Actually fraudulent.** The debtor "made such transfer or incurred such obligation with actual intent to hinder, delay, or defraud any entity" to which the debtor was or became indebted "on or after the date that such transfer was made or such obligation was incurred" (11 USC §548(a)(1)(A)); or
- **Constructively fraudulent.** The debtor "received less than a reasonably equivalent value in exchange for such transfer or obligation" and there is evidence the debtor was financially unsound (11 USC §548(a)(1)(B)).

Alternatively, the trustee may pursue a fraudulent transfer action under California's version of the Uniform Fraudulent Transfer Act (UFTA) (CC §§3439-3439.12), which is incorporated into the trustee's avoidance powers under 11 USC §544. See Debt Collection Practice in California §§8.7, 8.31, 8.33, 12.66 (2d ed Cal CEB 1999).

The tests for determining a fraudulent transfer under §548 are virtually identical to the tests under California's version of UFTA. The primary difference is that §548 only reaches transfers made within 1 year of the bankruptcy. 11 USC §548(a)(1). Under BAPCPA, this reach-back period has been extended to 2 years but applies only to cases filed 1 year after the BAPCPA enactment date, *i.e.,* cases filed after April 20, 2006. Pub L 109-8, §1406(b)(2), 119 Stat 23.

With some exceptions (see, *e.g.,* CC §3439.08(a)), California law allows transfers to be avoided within 4 years after they are made and up to 7 years if the later-discovery rule applies. CC §3439.09; CCP §338. See *Macedo v Bosio* (2001) 86 CA4th 1044, 104 CR2d 1. Additionally, depending on the particular provision of the UFTA on which the trustee relies, there may be a need to prove the existence of a pretransfer creditor. Section 548 does not contain a similar requirement.

Extensive fraudulent transfer litigation has occurred in connection with foreclosure sales. The standard for determining when a prebankruptcy foreclosure sale can be set aside as a fraudulent transfer was established in *BFP v Resolution Trust Corp.* (1994) 511 US 531, 128 L Ed 2d 556, 114 S Ct 1757. In *BFP,* the U.S. Supreme Court held that the price received at a noncollusive real estate mortgage foreclosure sale constitutes reasonably equivalent value for the purposes of 11 USC §548(a)(2), provided that the foreclosure was conducted in full compliance with all requirements of applicable state law. The Court rejected a fair market value test and was not persuaded that the 1984 Bankruptcy Code amendments, which expanded the definition of "transfers" under 11 USC §101(54) to include foreclosure of the debtor's equity of redemption, were intended to codify a different rule.

Adhering to the U.S. Supreme Court's *BFP* decision, the Ninth Circuit rejected the argument that gross inadequacy of price or commercial reasonableness could be grounds for setting aside a foreclosure sale unless state law so provides. See *Lindsay v Beneficial Reins. Co.* (*In re Lindsay)* (9th Cir 1995) 59 F3d 942, 948. See also *C.F. Brookside, Ltd. v Skyview Mem. Lawn Cemetery (In re Affordable Hous. Dev. Corp.)* (BAP 9th Cir 1994) 175 BR 324 (no separate federal standard of commercial reasonableness applicable to foreclosure sale after plan confirmation). *Lindsay* also held that the applicable state law should be determined by federal (rather than forum state) choice-of-law rules. Texas law controlled in *Lindsay* because the real property at issue was located there.

A lender who receives a deed in lieu of foreclosure may have greater exposure to fraudulent transfer claims because there is no foreclosure sale to establish the value of the property. See *Main v Brim (In re Main)* (Bankr D Ariz 1987) 75 BR 322 (deed in lieu may be fraudulent transfer even if it is assumed that noncollusive foreclosure sale cannot be fraudulent transfer).

The grant of a deed of trust may be attacked as a fraudulent transfer if the debtor granting the trust deed receives no consideration. This problem might arise in a loan transaction if an affiliate of the debtor receives the loan funds. *Wood v Delury, Pomares & Co. (In re Fair Oaks, Ltd.)* (BAP 9th Cir 1994) 168 BR 397 (avoiding deed of trust to partnership real property in California given as security for preexisting debts of partnership's principal and its affiliates). See also *Pajaro Dunes Rental Agency, Inc. v Spitters (In re Pajaro Dunes Rental Agency, Inc.)* (Bankr ND Cal 1994) 174 BR 557 (debtor's obligation on $1 million note avoided as fraudulent obligation because loan funded to debtor's

parent corporation).

Securitized lending and other underwriting practices among lending entities may give rise to fraudulent transfer litigation when one of the lenders files for bankruptcy relief. See, *e.g., Henry v Lehman Commercial Paper, Inc. (In re First Alliance Mortgage Co.)* (9th Cir 2006) 471 F3d 977 (trustee did not succeed in avoiding prepetition payments to creditor-lender by debtor-lender under their revolving credit and securitization agreements).

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§10.84 E. Unauthorized Postpetition Transfers: 11 USC §549

A trustee may avoid postpetition transfers by the debtor of property of the bankruptcy estate that are not authorized by the Bankruptcy Code or the bankruptcy court. 11 USC §549. Absent the required authorization, postpetition loan payments made with estate funds can be avoided under §549. *Mora v Vasquez (In re Mora)* (9th Cir 1999) 199 F3d 1024. In commercial real estate cases, postpetition payments to lenders usually consist of adequate protection payments that are authorized by the Bankruptcy Code (see §10.20), approved by the court (see §§10.41, 10.43, 10.67, 10.70, 10.91), or made pursuant to a reorganization plan approved by the court (see chap 5). Such payments should not be at risk. In Chapter 13 cases, a debtor is required to start funding payments under the proposed plan within 30 days of filing the plan. 11 USC §1326. See §5.27. These payments should not be at risk either.

Section 549 cannot be used to avoid a deed of trust recorded prepetition that secures a debtor's guaranty of future advances to a corporate borrower under a factoring agreement (including postpetition advances) because the priority of the deed of trust dates from its recordation. *Beeler v Jewell (In re Stanton)* (9th Cir 2002) 303 F3d 939. Section 549 also cannot be used to avoid a deed of trust recorded before the bankruptcy merely because the lender assigns the deed of trust to another lender postpetition. *Kapila v Atlantic Mortgage & Inv. Corp. (In re Halabi)* (11th Cir 1999) 184 F3d 1335.

The trustee may also try to use §549 to avoid a trustee's deed for a prepetition foreclosure sale that is not recorded as of the bankruptcy petition date. However, a trustee's deed recorded within 15 days of the sale is deemed perfected as of the sale date. CC §2924h(c). If the trustee's deed is recorded within the 15-day period, it is not a postpetition transfer avoidable under §549. *Bebensee-Wong v FNMA (In re Bebensee-Wong)* (BAP 9th Cir 2000) 248 BR 820.

Moreover, unless the bankruptcy petition or a notice of the petition was recorded, §549 cannot be used to avoid a transfer of real property sold at foreclosure for a present fair equivalent value to a good faith purchaser without knowledge of the commencement of the bankruptcy case. 11 USC §549(c). If the foreclosure purchaser pays less than fair equivalent value, the transfer may be avoided but the purchaser will have a lien for the value given. See also *40235 Wash. St. Corp. v Lusardi* (9th Cir 2003) 329 F3d 1076, discussed in §10.15 (§549(c) does not create safe harbor for bona fide purchaser at foreclosure sale held in violation of automatic stay).

However, BAPCPA created an exception to the stay for a bona fide purchaser by revising the definition of "transfer" to include the "creation of a lien." 11 USC §101(54). It also revises 11 USC §549(c) to cover the transfer of "an interest" in real property. As a result, a lender who receives a deed of trust postpetition in good faith, for value, and without knowledge of the bankruptcy case should be protected by the §549(c) safe harbor. These changes appear to overrule the contrary view taken in *Thompson v Margen (In re McConville)* (9th Cir 1997) 110 F3d 47 (discussed in §10.59). A transferee with knowledge of the bankruptcy case, however, will have no defense or offset to avoidance under 11 USC §549(a) or to recovery under 11 USC §550(a). *Aalfs v Wirum (In re Straightline Invs.)* (9th Cir 2008) 525 F3d 870.

PRACTICE TIP: To avoid application of §549(c), on the petition date or as soon thereafter as possible, counsel for trustees and debtors in possession should record notice of the bankruptcy filing in counties where the debtor's real estate is located and, if possible, have a process server attend the foreclosure sale and announce the bankruptcy filing, especially if the notice recordation date is close to or on the sale date.

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§10.85 F. Judicial Liens Impairing Homestead Exemption: 11 USC §522

A debtor may avoid a judicial lien impairing the debtor's interest in a homestead exemption. 11 USC §522(b). This provision does not affect a lienholder secured by a deed of trust because the deed of trust is not a judicial lien. See 11 USC §101(36) ("judicial lien" means lien obtained by legal process). However, a judgment lien securing a judgment obtained in an action directly on the note by a sold-out junior trust deed holder may be avoided if it impairs a debtor's homestead exemption. See *California Cent. Trust Bankcorp v Been (In re Been)* (9th Cir 1998) 153 F3d 1034 (exception in 11 USC §522(f)(2)(C) to avoidance of transfer for mortgage foreclosure judgment does not apply to sold-out junior). The amount of the homestead exemption is capped at $136,875 if the debtor elects state law exemptions. See 11 USC §522(p).

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§10.86 VIII. COMMON ISSUES OF SECURED CLAIMS IN BANKRUPTCY

Secured and unsecured claims (including filing proofs of claim, bar dates, burdens of proof, objections to claims, and contingent, unliquidated, or disputed claims) are discussed in great detail in chap 3. This chapter deals specifically with issues that commonly arise with respect to real property secured claims.

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A. Allowance of Secured Claims: 11 USC §506

§10.87 1. Oversecured and Undersecured Lien Claims

A claim is treated as being secured, assuming it is validly perfected, only to the extent of the value of the creditor's interest in the collateral. 11 USC §506(a). Depending on the value of the collateral and the presence or absence of other lien claims against the collateral, a lender may be oversecured, undersecured, or unsecured. If the collateral value net of any senior lien claims is greater than the lender's claim, the lender is oversecured. If the collateral value net of senior liens is equal to only a portion of the lender's claim, the lender is undersecured or, stated another way, partly secured. If the collateral value does not exceed senior liens (or has no value if there are no senior liens), the lender is unsecured. The distinction among oversecured, undersecured, and unsecured claims is important. The oversecured lender can recover postpetition interest and reasonable attorney fees and other loan charges, while the undersecured and unsecured creditor cannot. See §§10.91-10.92. Moreover, with some exceptions, undersecured lien claims can be stripped down to their collateral value in Chapter 11, 12, and 13 plans. See chap 5.

NOTE: If the underlying claim is disallowed, the lien is deemed void unless the disallowance is solely the result of the lender's failure to file a proof of claim or other limited reasons. 11 USC §506(d); *Hamlett v Amsouth Bank (In re Hamlett)* (4th Cir 2003) 322 F3d 342, 349 (failure to file timely claim, like failure to file claim, does not constitute sufficient grounds for extinguishing valid lien).

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§10.88 2. Valuation of Lien Claims

The valuation of collateral needed to establish a creditor's secured status is "determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 USC §506(a). This provision enables the parties and the court to make appropriate adjustments in determining a secured creditor's claim if the collateral value changes over time, as may happen in protracted cases. On valuation standards, see §§5.18, 5.34, 5.37, 10.38.

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§10.89 3. Undersecured Claims; Lien-Stripping

Under 11 USC §506(a), in certain cases, the amount of a secured claim may be reduced or "stripped down" to the fair market value of the collateral as of the petition date. See also 11 USC §506(d). Section 506(a)(1) provides that

> an allowed claim of a creditor secured by a lien on property in which the estate has an interest… is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property,… and is an unsecured claim to the extent that the value of such creditor's interest… is less than the amount of such allowed claim.

If the debtor is permitted to strip a secured creditor's claim down to the value of the collateral, the claim will be bifurcated into secured and unsecured portions. The creditor is treated as a secured creditor to the extent of the value of the collateral and as an unsecured creditor to the extent of the remainder of the amount owed.

Despite the language of §506(a)(1), lien-stripping has been significantly restricted as a strategy for bankruptcy debtors. Lien-stripping is prohibited in both Chapter 11 and Chapter 13 cases for liens on a debtor's principal residence. 11 USC §§1123(b)(5), 1322(b)(2). See §§5.10, 5.31. Under 11 USC §506(a)(2), lien-stripping has been limited for personal property collateral in individual Chapter 7 and 13 cases. Section 506(a)(2) requires the value of personal property securing an allowed claim to be determined based on the replacement value of the property as of the petition date without deduction for costs of sale or marketing. If the property was acquired for personal, family, or household purposes, the replacement value is its retail replacement value, taking into account its age and condition. Further, 11 USC §1325(a) was amended by BAPCPA to prohibit lien-stripping altogether in Chapter 13 cases with regard to purchase money security interests in (1) motor vehicles acquired for the debtor's personal use within 2½ years before the petition date and (2) any other type of property acquired within 1 year before the petition date. See §5.29.

Even before BAPCPA, in *Dewsnup v Timm* (1992) 502 US 410, 116 L Ed 2d 903, 112 S Ct 773, the U.S. Supreme Court held that 11 USC §506 was ambiguous and that a debtor in Chapter 7 could not strip a creditor's real estate lien down to the value of the real property collateral when the creditor's claim had already been allowed as a secured claim. *Dewsnup* is generally understood to prohibit lien-stripping in Chapter 7 cases only. See *Enewally v Washington Mut. Bank (In re Enewally)* (9th Cir 2004) 368 F3d 1165; *In re Castro* (Bankr D Ariz 2002) 285 BR 703, 705. The prohibition against lien-stripping in Chapter 7 cases applies to nonconsensual as well as consensual liens. *Concannon v Imperial Capital Bank (In re Concannon)* (BAP 9th Cir 2006) 338 BR 90 (judgment lien).

For further discussion of lien-stripping, see §3.7, chap 5. On undersecured claims in Chapter 11, see §10.90.

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§10.90 B. Undersecured Claims in Chapter 11 Cases

Chapter 11 contains two special provisions in 11 USC §1111(b) dealing with allowance of undersecured creditor claims under a proposed plan of reorganization:

- The first allows the creditor an unsecured deficiency claim under §1111(b)(1)(A); and
- The second allows the creditor to elect to be treated as fully secured under §1111(b)(2).

In the first provision, the lender holding an undersecured, nonrecourse claim is deemed to have recourse, *i.e.,* to have an allowed unsecured deficiency claim. 11 USC §1111(b)(1)(A). It does not matter whether the nonrecourse aspect of the loan arose under the original contract or by operation of law. There are two exceptions to this rule. The first applies if the lender (or the class in which the lender is a member) elects, in conjunction with a proposed plan, to have its claim treated as fully secured under §1111(b)(2). See 11 USC §1111(b)(1)(A)(i). The second exception applies if the collateral is sold under 11 USC §363 or under the plan. 11 USC §1111(b)(1)(A)(ii).

The second provision, §1111(b)(2), permits an undersecured lender (or the class in which the lender is a member), whether the debt is recourse or not, to elect to have its "allowed secured claim" equal the full amount of its allowed claim notwithstanding 11 USC §506(a) and the fact that its claim is greater than the value of the collateral. Note that plans usually place each secured claim in a separate class. The election is not available if the lender has a recourse claim and the collateral is sold under §363 or is to be sold under the plan or if the collateral is "of inconsequential value." See §1111(b)(1)(B).

Section 1111(b) can be a powerful tool for the undersecured lender and requires the lender to evaluate a proposed plan carefully. If the lender does not elect to be treated as fully secured under §1111(b)(2), it may receive some distributions on account of its deficiency claim. *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284. In addition, a lender may have substantial negotiating "leverage" in plan formulation if the deficiency claim is sufficiently large to determine whether the class of unsecured creditors will accept or reject the proposed plan. On the other hand, a lender may believe that the debtor is undervaluing the collateral either in the near term or long term. In such a situation, depending on the proposed treatment of unsecured creditors under the plan, a lender may believe that its best recovery will be to elect to have its claim treated as being fully secured. If the election is made and the collateral appreciates in value, the lender benefits from that increase up to the full amount of its claim. 227 BR at 295 n12.

Undersecured lenders are not accorded special treatment under §1111(b) in the context of a sale of the collateral because the lender will have the opportunity to "credit-bid" at a sale (see §10.73), pursuant to 11 USC §363(k). However, if a lender is denied the right to credit-bid, the lender may assert a deficiency claim under §1111(b). *In re California Hancock, Inc.* (BAP 9th Cir 1988) 88 BR 226.

Lenders must elect to be treated under §1111(b)(2) prior to the conclusion of the hearing on the disclosure statement regarding the plan or within such later time as the court may fix. Fed R Bankr P 3014. The election must be made in writing and signed unless made at the hearing on the disclosure statement.

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C. Recovery of Interest and Reasonable Attorney Fees and Costs

§10.91 1. By Oversecured Creditor

An oversecured lender is entitled to postbankruptcy interest and "reasonable fees, costs, or charges provided for under the agreement under which [the] claim arose." 11 USC §506(b). Although §506(b) seems straightforward, the courts have been required to fill in a number of gray areas.

Predefault interest. A preliminary issue is the allowable interest rate. For consensual lienholders, the proper rate of interest is the contract rate. *P.S. Taggares Co. v Glenn (In re Glenn)* (9th Cir 1986) 796 F2d 1144. See *U.S. v Ron Pair Enters., Inc.* (1989) 489 US 235, 103 L Ed 2d 290, 109 S Ct 1026 (oversecured, nonconsensual lienholder also entitled to interest).

Default interest. A more contentious issue involves allowance of default interest provided by the loan documents. Generally, postpetition interest is not paid until the court determines that the creditor is oversecured, which may not occur until a sale of collateral, confirmation of a plan, or other conclusion of the case, although a creditor may receive interim adequate protection payments to protect against decline in the value of its collateral. *Orix Credit Alliance, Inc. v Delta Resources, Inc. (In re Delta Resources, Inc.)* (11th Cir 1995) 54 F3d 722. A reorganization plan may provide for the cure of defaults and thereby nullify the consequences of default, including default penalties such as higher interest. In the Ninth Circuit, an oversecured creditor is not entitled to interest at the default rate if its claim is paid in full in accordance with the terms of a Chapter 11 plan. *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc*. (*In re Entz-White Lumber & Supply, Inc.)* (9th Cir 1988) 850 F2d 1338, 1342. See §§5.35 (Chapter 13), 5.46 (Chapter 12). Alternatively, the debtor may impair the creditor's claim and propose a market rate of interest in a "cramdown" plan. See §§5.17 (Chapter 11), 5.37 (Chapter 13), 5.48 (Chapter 12).

A default interest rate will apply, however, when the collateral is sold under 11 USC §363, outside the context of a Chapter 11 plan. *General Elec. Capital Corp. v Future Media Prods., Inc*. (9th Cir 2008) 536 F3d 969. In *General Elec. Capital Corp.,* the Ninth Circuit held that *Great W. Bank & Trust v Entz-White Lumber & Supply, Inc*. (*In re Entz-White Lumber & Supply, Inc.), supra,* did not establish a per se rule against default interest and that there is a presumption that the default rate should be enforced, subject only to any contrary provision of the Bankruptcy Code and to applicable nonbankruptcy law. 536 F3d at 973. See *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199, 1204.

Even if default interest is allowed, the lender's failure to provide notice of acceleration may result in denial of that interest for the period before actual notice. See *Beal Bank v Crystal Props., Ltd. (In re Crystal Props., Ltd.)* (9th Cir 2001) 268 F3d 743. Moreover, an unreasonably high default interest rate may be challenged as a penalty under applicable nonbankruptcy law. See CC §3275; *Ridgley v Topa Thrift & Loan Ass'n* (1998) 17 C4th 970, 977, 73 CR2d 378.

Reasonable attorney fees, costs, charges. Section 506(b) also permits a secured lender to recover reasonable fees, costs, or charges if the parties' agreement or applicable state law provides for such recovery. Recoverable costs may include attorney fees, even when the fees were incurred in connection with litigation of issues peculiar to bankruptcy law, provided that the fees and costs were reasonable and provided for in the lender's loan documents. *Kord Enters. II v California Commerce Bank (In re Kord Enters. II)* (9th Cir 1998) 139 F3d 684. Lenders often include provision for recovery of fees of in-house counsel in their loan documentation. Recovery of such fees appears supportable under §506(c) and, to the extent applicable, under California law. *PLCM Group, Inc. v Drexler* (2000) 22 C4th 1084, 95 CR2d 198 (company using salaried in-house counsel may recover fees at prevailing, private hourly rates multiplied by hours expended). See also *Travelers Cas. & Sur. Co. of Am. v PG&E* (2007) 549 US 443, 167 L Ed 2d 178, 127 S Ct 1199; *Qmect, Inc. v Burlingame Capital Partners II, LP (In re Qmect, Inc.)* (Bankr ND Cal 2007) 368 BR 882.

Often an agreement or state law permits only the prevailing party to recover its attorney fees, and the definition of "prevailing" may be too narrow to allow an award of attorney fees to the oversecured creditor, even if the creditor is

paid in full on its claim. See, *e.g., Hoopai v Countrywide Home Loans, Inc. (In re Hoopai)* (9th Cir 2009) 581 F3d 1090 (allowing award of attorney fees incurred by creditor before plan confirmation by denying post-confirmation attorney fees because court concluded debtor was prevailing party under Hawaii law on main disputed issues; neither validity of lien nor prospect for full payment were ever disputed because of substantial equity cushion, and lender was losing party on contested proceedings that it initiated to prevent sale free and clear of lien).

Unreasonable fees and costs may be reduced or may not be allowed as part of the lender's secured claim. *Hoopai v Countrywide Home Loans, Inc. (In re Hoopai), supra; First Bank v Brunswick Apartments (In re Brunswick Apartments)* (6th Cir 1999) 169 F3d 333 (consultant fees denied because consultant was bank insider with no bankruptcy experience and kept inadequate records; attorney fees reduced by $61,500 (84 percent) because bank pursued unreasonable demands in litigation); *CityBank v Udhus (In re Udhus)* (BAP 9th Cir 1998) 218 BR 513 (loan loss reserves and employee costs disallowed); *In re Irick* (Bankr ED Cal 1997) 216 BR 433 ($72,521 fee request reduced to $28,651 when lender engaged three law firms regarding $1.2 million secured debt). But a lender may be able to assert an unsecured claim for unreasonable fees and costs. *Welzel v Advocate Realty Invs., LLC (In re Welzel)* (11th Cir 2001) 275 F3d 1308.

Section 506(b) is not applicable to fees incurred by a lender after plan confirmation unless the plan specifically provides otherwise. Instead, the recovery of such fees should be governed by the mortgage terms and applicable state law. *Telfair v First Union Mortgage Corp.* (11th Cir 2000) 216 F3d 1333.

CAUTION: Some courts have held that until the court reviews an application and issues an order modifying the payment allocation scheme under a Chapter 13 plan, a mortgage lender may not collect reimbursable expenses (such as attorney fees and costs) without violating the order confirming the debtor's plan. *Wilborn v Wells Fargo Bank, NS (In re Wilborn)* (Bankr SD Tex 2009) 401 BR 872 (certifying class action on behalf of all Chapter 13 debtors in the Southern District of Texas who were charged by Wells Fargo Bank for attorney fees and costs that were not disclosed under Fed R Bankr P 2016(a) or approved by court).

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§10.92 2. By Unsecured Creditor

Although an unsecured creditor may not recover interest unless there are sufficient funds in the bankruptcy estate to pay all claims in full, it may recover postbankruptcy attorney fees as part of its unsecured claim to the extent allowed under its prepetition contract. *Centre Ins. Co. v SNTL Corp. (In re SNTL Corp.)* (BAP 9th Cir 2007) 380 BR 204.

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IX. EFFECT OF BANKRUPTCY DISCHARGE

§10.93 A. Effect of Discharge

The effect of a discharge in bankruptcy is governed by 11 USC §524 in combination with specific provisions in Chapters 7, 11, 12, and 13. See 11 USC §§727, 1142, 1228, 1328. Section 524(a) provides that the discharge (1) voids any judgment against the debtor to the extent it is an adjudication of the debtor's personal liability and (2) operates as an injunction against the commencement or continuation of an action to collect or offset a debt. A debtor's discharge in bankruptcy, however, may not prevent a party from filing an action against the debtor seeking only equitable relief. See *Irizarry v Schmidt (In re Irizarry)* (BAP 9th Cir 1994) 171 BR 874 (equitable remedies sought by plaintiff to cancel grant deed given to debtor and related liens were neither "claim" nor "debt" under Bankruptcy Code and therefore were not affected by debtor's discharge).

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§10.94 B. Exceptions to Discharge

Certain debts, detailed in 11 USC §523, are nondischargeable. Among them are loans obtained by means of material false representations or omissions made by the debtor to induce the loan. 11 USC §523(a)(2). The lender will need to show, however, that its reliance on the misstatements or omissions was justifiable. *Field v Mans* (1995) 516 US 59, 133 L Ed 2d 351, 116 S Ct 437; *Candland v Insurance Co. of N. Am. (In re Candland)* (9th Cir 1996) 90 F3d 1466 (material misrepresentations are "substantial inaccuracies" that would generally affect lender's credit decision). The circumstances that may give rise to grounds for objection to a debtor's discharge vary. See, *e.g., Field v Mans* (*In re Mans)* (1st Cir 1998) 157 F3d 35 (fraudulent concealment of debtor's sale of mortgaged property frustrated lender's right to accelerate debt under due-on-sale clause); *Sanford Inst. for Sav. v Gallo* (1st Cir 1998) 156 F3d 71 (despite bank's negligence, it justifiably relied on debtor's fraudulent acts because of bank's long and successful loan history with debtor); *Norris v First Nat'l Bank (In re Norris)* (5th Cir 1995) 70 F3d 27 (misrepresentation of debtor's cash flow in annual renewal of mortgage note constituted fraud); *Loomas v Evans* (*In re Evans)* (Bankr SD Cal 1995) 181 BR 508 (debtor real estate broker falsely represented that lot could be developed). But see *Enterprise Nat'l Bank v Jones* (*In re Jones)* (Bankr MD Ga 1996) 197 BR 949 (40-percent decline in value of real property between loan application and bankruptcy filing did not prove fraudulent representation).

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X. APPEALS FROM BANKRUPTCY COURT DECISIONS

§10.95 A. Overview

Jurisdiction regarding appeals from bankruptcy court decisions is set forth in 28 USC §158. Procedural rules for bankruptcy appeals are set out in Part VIII of the Federal Rules of Bankruptcy Procedure and the Ninth Circuit's Amended Order Continuing the Bankruptcy Appellate Panel of the Ninth Circuit effective November 18, 1988, as amended through May 9, 2002, discussed in §10.97. Other local rules may apply depending on whether the appeal is taken to the district court or the bankruptcy appellate panel of the Ninth Circuit. This discussion highlights basic appellate procedure and issues most applicable to secured loans. It is not intended to be a comprehensive discussion.

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§10.96 B. Expedited Timing for Notice of Appeal

The time to appeal a bankruptcy court decision is abbreviated. The notice of appeal must be filed with the bankruptcy court within 14 days of entry of the order or judgment. Fed R Bankr P 8002(a). The 14-day period includes intervening weekends and holidays, but if the last day falls on a weekend or holiday, the period continues to run until the end of the next business day. See Fed R Bankr P 9006(a). Failure to file a timely appeal is jurisdictional and grounds for dismissal of the appeal.

The 14-day period is tolled by the filing of a motion (1) to amend or make additional findings, (2) to alter or amend the judgment, (3) for a new trial, or (4) for relief under Rule 9024. See Fed R Bankr P 8002(b). In addition, Rule 8002(c) permits the bankruptcy court to grant a brief extension of the time to file an appeal unless the decision appealed from (1) grants relief from the automatic stay, (2) authorizes the sale or lease of property, (3) authorizes the obtaining of credit, (4) authorizes assumption or assignment of executory contracts or unexpired leases, (5) approves a Chapter 11 disclosure statement, or (6) confirms a plan under Chapter 9, 11, 12, or 13.

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§10.97 C. Appeal to Bankruptcy Appellate Panel or District Court

The judicial council of each circuit is required to establish a bankruptcy appellate panel to hear bankruptcy appeals unless the circuit has insufficient resources or unless establishing a panel would unduly delay or increase the cost to parties in bankruptcy cases. 28 USC §158(b). The Ninth Circuit has established a bankruptcy appellate panel. See Amended Order Continuing the Bankruptcy Appellate Panel of the Ninth Circuit effective November 18, 1988, as amended through May 9, 2002 (the "BAP Order"). The BAP Order is available on the panel's website. See Directory.

All appeals from the bankruptcy court in the Ninth Circuit are automatically referred to the bankruptcy appellate panel. BAP Order §2. Any party may elect, however, to have the appeal heard by the district court instead of the bankruptcy appellate panel. BAP Order §3. The appellant must make such an election at the time the notice of appeal is filed, and any other party must make the election within 30 days after service of the notice of appeal. BAP Order §3. If the appeal is taken to the district court, counsel should become familiar with the local rules of bankruptcy appellate procedure. See Directory for website information for local courts. The bankruptcy appellate panel has also adopted local rules, which are available on the panel's website; see Directory.

An appeal from a final decision by either the district court or the bankruptcy appellate panel is taken to the circuit court of appeals. 28 USC §158(d).

BAPCPA added a procedure for direct appeal of a bankruptcy court decision to the circuit court of appeals, subject to its consent, on certification of any of the following (see 28 USC §158(d)(2)):

- The decision involves a question of law about which there is no controlling decision in the circuit or by the U.S. Supreme Court, or the decision involves a matter of public importance;
- The decision involves a question of law that requires resolution of conflicting decisions; or
- An immediate appeal may materially advance the underlying case.

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§10.98 D. Mootness as Grounds for Dismissal

Mootness poses particular difficulties in bankruptcy appeals because the contested decision often involves multiple parties or authorizes actions that are difficult to unwind if an appeal is successful. As a result, if an appellant fails to obtain a stay during the pendency of an appeal, the appeal may be dismissed as moot.

Unless the bankruptcy court orders otherwise, an automatic 14-day stay applies to many decisions of the bankruptcy court. See, *e.g.,* Fed R Bankr P 3020(e) (order confirming Chapter 11 plan), 4001(a)(3) (stay relief order), 6004(h) (order authorizing use, sale, or lease of property), 7062 (on actions to enforce judgment in adversary proceeding, 10-day stay applies). These rules are designed to give an aggrieved party an opportunity to seek a stay during the full pendency of the appeal. A motion for such a stay must first be brought before the bankruptcy court that issued the disputed decision. Fed R Bankr P 8005. If the motion is denied or if a party seeks to contest a stay order, recourse may be had to the district court or bankruptcy appellate panel, whichever is hearing the appeal. Fed R Bankr P 8005.

On various standards for granting stay pending appeal, compare *In re General Credit Corp.* (SD NY 2002) 283 BR 658 (applying "substantial possibility" of success on merits test) with *Lutin v U.S. Bankruptcy Court (In re Advanced Mining Sys., Inc.)* (SD NY 1994) 173 BR 467 (applying "strong likelihood" of success on merits test) and *In re Crosswinds Assocs.* (SD NY, June 25, 1996, No. 96 Civ 4572) 1996 US Dist Lexis 8882 (following *Lutin* and denying stay pending appeal of order granting lender relief from automatic stay).

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§10.99 1. Appeals From Asset Sale Orders

A party that appeals from an order authorizing a sale of property must obtain a stay pending appeal or the appeal will become moot if the purchaser acted in good faith. See 11 USC §363(m). To ensure that §363(m) applies, counsel should request that the court make an express finding that the purchaser acted in good faith. See *T.C. Investors v Joseph (In re M Capital Corp.)* (BAP 9th Cir 2003) 290 BR 743 (factual record must support good faith finding); *Thomas v Namba (In re Thomas)* (BAP 9th Cir 2002) 287 BR 782. Moreover, because facts showing that the buyer did not act in good faith often surface later, a bankruptcy court may decline to make a good faith finding at the time of the sale. *Thomas v Namba (In re Thomas), supra.*

Even if no good faith finding is made, the sale may be protected by mootness principles. The Ninth Circuit has repeatedly ruled that failure to obtain a stay pending appeal from an order permitting a sale of a debtor's assets, or from an order granting relief from the automatic stay to permit such a sale, moots the appeal regardless of whether the purchaser has taken irreversible steps following the appeal or whether the buyer—which is often the secured creditor—is a party to the appeal. *National Mass Media Telecommunication Sys. v Stanley (In re National Mass Media Telecommunication Sys.)* (9th Cir 1998) 152 F3d 1178; *Onouli-Kona Land Co. v Estate of Richards (In re Onouli-Kona Land Co.)* (9th Cir 1988) 846 F2d 1170. This rule has been extended to the appeal of an order confirming a secured creditor's plan and the subsequent auction sale of the debtor's sole asset under the plan. *Vista Del Mar Assocs. v West Coast Land Fund (In re Vista Del Mar Assocs.)* (BAP 9th Cir 1995) 181 BR 422.

There are two recognized exceptions to the mootness rule regarding property sales. The first applies when the debtor has a statutory right of redemption, and the second applies when other state law would permit the sale to be set aside. *Ewell v Diebert (In re Ewell)* (BAP 9th Cir 1992) 958 F2d 276, 280.

In addition to the exceptions mentioned above, the mootness rule of 11 USC §363(m) is limited by its express terms according to Ninth Circuit authority. In *Clear Channel Outdoor, Inc. v Knupfer (In re PW, LLC)* (BAP 9th Cir 2008) 391 BR 25, the bankruptcy appellate panel held that the mootness rule does not apply to lien-stripping under 11 USC §363(f) because §363(m) only applies to sales and leases. Thus, a nonconsenting creditor may appeal a bankruptcy court order authorizing a sale of property free and clear of the creditor's lien under §363(f) even after the sale to a good faith purchaser. But see *Official Committees of Unsecured Creditors v Anderson Senior Living Prop., LLC (In re Nashville Senior Living, LLC)* (BAP 6th Cir 2009) 407 BR 222.

Unless the court orders otherwise, the effectiveness of an order authorizing the use, sale, or lease of property (other than cash collateral) is automatically stayed for 14 days. Fed R Bankr P 6004(h). This gives an aggrieved party an opportunity to seek a stay pending appeal to avoid having the appeal mooted.

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§10.100 2. Appeals From Plan Confirmation Orders

Absent a stay during the pendency of the appeal, an appeal from a plan confirmation order may be dismissed as moot if the plan has been "substantially culminated." *Baker & Drake, Inc. v Public Serv. Comm'n of Nev. (In re Baker & Drake, Inc.)* (9th Cir 1994) 35 F3d 1348. Mootness in the plan confirmation context derives from the fact that it is difficult to "unscramble the eggs" after implementation of a plan begins. It is the appellant's burden to obtain a stay if postconfirmation events could render the appeal moot. *Ederel Sport, Inc. v Gotcha Int'l L.P. (In re Gotcha Int'l L.P.)* (BAP 9th Cir 2004) 311 BR 250.

Failure to obtain a stay may not be fatal, even when it is no longer possible for the appellate court to restore the parties to the positions they previously occupied, if the court can fashion some form of meaningful relief. See *Varela v Dynamic Brokers, Inc. (In re Dynamic Brokers, Inc.)* (BAP 9th Cir 2003) 293 BR 489 (plan appeal not moot if effective relief can be fashioned by modifying payments to creditor provided by plan); *Platinum Capital, Inc. v Sylmar Plaza, LP (In re Sylmar Plaza, LP)* (9th Cir 2002) 314 F3d 1070, 1074 (plan appeal not moot if appealing creditor has monetary claim against solvent debtor); *Lowenschuss v Selnick (In re Lowenschuss)* (9th Cir 1999) 171 F3d 673 (appeal not moot if transactions are not complex or difficult to unwind; court granted effective relief by simply ordering return of plan payments received by appealing creditor); *First Fed. Bank v Weinstein (In re Weinstein)* (BAP 9th Cir 1998) 227 BR 284 (appeal not moot despite transfers of certain property); *Connecticut Gen. Life Ins. Co. v Hotel Assocs. (In re Hotel Assocs.)* (BAP 9th Cir 1994) 165 BR 470 (appeal not moot despite full payment to four classes of creditors before stay obtained, because creditors would have been paid under either of competing plans). However, if the appeal would directly and materially have an impact on the vested rights of third parties under the plan, then the appeal is moot absent a stay. *Ederel Sport, Inc. v Gotcha Int'l L.P. (In re Gotcha Int'l L.P.), supra* (appellant proposed delaying payments to members of another creditor class but third parties had made financing commitments based on that stream of payments).

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§10.101 3. Appeals From Borrowing Orders

A party appealing from an order that authorizes either a borrowing or the granting of a lien must obtain a stay pending appeal. If a stay is not obtained, a reversal or modification of the order on appeal will not affect the validity of the borrowing or the lien if the lender extended the credit in good faith. See 11 USC §364(e); *Weinstein, Eisen & Weiss, LLP v Gill (In re Cooper Commons, LLP)* (9th Cir 2005) 430 F3d 1215 (finding of good faith was supported by evidence of need for additional financing to complete building, analysis of amount necessary to complete work, and parties' beliefs that loan was negotiated at arm's length and promoted best interests of estate and creditors); *Sulmeyer v Karbach Enters. (In re Exennium, Inc.)* (9th Cir 1983) 715 F2d 1401. To ensure that §364(e) applies, counsel for the lender should request that the court make an express finding that the lender acted in good faith. See *New York Life Ins. Co. v Revco D.S., Inc. (In re Revco D.S., Inc.)* (6th Cir 1990) 901 F2d 1359.

WARNING: The statutory mootness rule codified in §364(e) does not protect authorized loans not yet funded. *Transamerica Commercial Fin. Corp. v Citibank, N.A. (In re Sun Runner Marine, Inc.)* (9th Cir 1991) 945 F2d 1089, 1095. This limitation is particularly important if revolving financing is contemplated.

Another decision, *Resolution Trust Corp. v Swedeland Dev. Group, Inc. (In re Swedeland Dev. Group, Inc.)* (3d Cir 1994) 16 F3d 552, undermines the clarity of the safe harbor that §364(e) affords. In *Swedeland,* the Third Circuit held that an appeal from a borrowing order should not be dismissed as moot if the appellate "court can fashion *some* form of meaningful relief" (quoting from *Church of Scientology v U.S.* (1992) 506 US 9, 121 L Ed 2d 313, 319, 113 S Ct 447), even if it only partially satisfies the prevailing party and cannot return the parties to their exact original positions. 16 F3d at 560.

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§§1.21, 1.40, 1.69, 5.55

The website for the Office of the U.S. Trustee is http://www.usdoj.gov/ust.

§§1.35-1.36, 1.38, 1.41-1.42, 1.45, 1.49, 2.77, 2.84, 3.53, 4.17, 4.27, 4.44, 4.52, 4.68-4.69, 4.84, 4.97, 5.11-5.12, 7.16, 7.18, 7.26-7.27, 7.32, 7.69-7.70, 7.73, 9.70, 10.12, 10.30-10.31, 10.65, 10.71, 10.75, 10.97

The Official Forms of the Federal Rules of Bankruptcy Procedure are available for download at http://www.uscourts.gov/bkforms.

Local bankruptcy rules, mandated local forms, and the Official Forms (including customized local versions of the Official Forms) are also available at local bankruptcy court websites:

Central District:	http://www.cacb.uscourts.gov
Eastern District:	http://www.caeb.uscourts.gov
Northern District:	http://www.canb.uscourts.gov
Southern District:	http://www.casb.uscourts.gov

For an online manual explaining the procedure for using the electronic filing system to make a request for notice in the Northern District, see http://www.canb.uscourts.gov/files/sec6cm.pdf.

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The website of the American Bankruptcy Institute (ABI) is http://www.abiworld.org.

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The Klee article entitled *The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005—Business Bankruptcy Amendment* is available online at http://www.ktbslaw.com/news.html.

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For online access to the two U.S. Bankruptcy Court articles, go to http://www.canb.uscourts.gov; click on the Rules & Procedures tab; click on the following two links, in order: District Procedures, Guidelines; then click on the "*Guidelines for Early Disposition…*" article.

§§3.30-3.31, 3.33, 7.71

For online access to Official Form 10 of the Judicial Conference of the United States, see http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Forms_Official_2010/B_010_0410.pdf.

§4.32

For online access to U.S. Trustee, Central District of California, *Notice of Requirements for Chapter 11 Debtors in Possession* (rev Apr. 2008), see http://www.justice.gov/ust/r16/pdfdocs/ch11_ntc_req.pdf.

§4.68

For online access to the BAP's attorneys' handbook concerning BAP appeals (*Appeals Before the Bankruptcy Appellate Panel of the Ninth Circuit: A Manual for Litigants*), go to http://www.ce9.uscourts.gov/bap, click on the link for the litigant's manual, then click on the attachment for the full text of the manual.

§§4.82, 4.84, 5.54

Official Form B22A (Chapter 7 Statement of Current Monthly Income and Means-Test Calculation) is available for download from the U.S. Court's website at http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/BK_Forms_Official_2010/B_022A_0410.pdf.

§7.19

For online access to the California State Sheriffs' Association, Civil Procedural Manual, see http://www.calsheriffs.org/index.php/resource-center/civil-procedures-manual-cpm.

§§7.68, 7.74, 10.15

For the preprinted state court litigation forms issued by the California Judicial Council, see http://www.courtinfo.ca.gov/forms/.

§10.97

For the Amended Order Continuing the Bankruptcy Appellate Panel of the Ninth Circuit effective November 18, 1988, as amended through May 9, 2002 (the "BAP Order"), see http://207.41.19.15/web/bap.nsf/BAPDocumentView/judicial+council+order/$file/baporderrevised.pdf.

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