“Fresh Start
vs.
Fair and Equitable
Treatment of Claims:”

Ramifications of the Policy Conflict
Inherent in the Code

The Honorable Clifton R. Jessup, Jr. ¹
United States Bankruptcy Judge
Northern District of Alabama

Last Chance Seminar
Madison County Bar Association
December 8, 2016

¹ Presentation materials prepared with the assistance of Melissa H. Brown, law clerk to the Honorable Clifton R. Jessup, Jr.
INTRODUCTION

With the recent suggested revisions to the Bankruptcy Code proposed by the ABI Commission to Study the Reform of Chapter 11 Final Report and Recommendations, it is helpful to revisit the policy considerations that undergird the Bankruptcy Reform Act of 1978 to consider how those policies have or have not contributed to the current system for relief under Title 11 of the United States Code.

This paper will review the inherent policy tensions of fresh start versus fair and equitable distribution to creditors as well as the basis for separation of the judicial and the administrative functions in the current bankruptcy system.

REVIEW OF THE LEGISLATIVE HISTORY OF THE BANKRUPTCY CODE

In 1970, Congress formed the Commission on the Bankruptcy Laws of the United States (the “Commission”) to study and recommend changes to the Bankruptcy Act of 1898 (the “Bankruptcy Act”). Congress instructed the Commission to consider the basic philosophy of bankruptcy, the causes of bankruptcy, and to suggest alternatives to the entire system of bankruptcy administration.

In 1973, the Commission issued a report recommending major changes to the bankruptcy system which focused on balancing the three primary goals of bankruptcy: “(1) equality of distribution among creditors, (2) a fresh start for debtors, and (3) economical administration.”

The Commission found that there was a lack of standards under the system which created variations in court practices throughout the country. These variations caused the unequal treatment of creditors and debtors which contributed “to the lack of relief to debtors, the indifference of many creditors, and the high costs of administration; in short specific practices

---

which [had] negative effects on bankruptcy proceedings.”6 The Commission expressed a need for the substantial reform of the entire bankruptcy system and recommended major changes with respect to: (1) the administrative structure of the bankruptcy court and its jurisdiction; (2) consumer proceedings; (3) business bankruptcies; and (4) the rehabilitation of businesses.7

Under the Bankruptcy Act, “federal district courts served as bankruptcy courts and employed a ‘referee system.’ Bankruptcy proceedings were generally conducted before referees except in those instances in which the district court elected to withdraw a case from a referee.”8 After studying the referee system, the Commission found that bankruptcy referees were performing incompatible duties by performing judicial functions while also supervising the administration of estates which created an inefficient cycle in processing cases.9

The Commission was convinced that participation by bankruptcy referees in the administrative aspects of bankruptcy proceedings impaired the confidence of litigants in the impartiality of their decisions.10 The Commission reported:

In particular, adversaries of the trustee in bankruptcy tend to doubt that the referee who appointed the trustee can insulate himself from at least a suspicion of partiality when he may have previously been involved in any or all of the following actions regarding the same estate: determining that the debtor had committed an act of bankruptcy; the appointment, or approval of the election, of the trustee; the scrutiny of the petition, schedules, statement of affairs, and other papers filed in the case; the conduct of the first meeting of creditors and other meetings at which examination of the debtor and other witnesses took place; and conferences with the trustee regarding collection of the assets of the estate and litigation on its behalf.11

These considerations led the Commission to recommend the severance of administrative functions from judicial functions within the bankruptcy system. To accomplish these objectives, the Commission recommended that “[n]ew bankruptcy courts be created to have jurisdiction of

---

6 Id. at App. Pt. 4-246.
11 Id. at App. Pt. 4-247, 4-248.
all controversies arising out of a proceeding under the Act.”\textsuperscript{12} The new bankruptcy courts were to serve “no significant administrative functions in the absence of a litigable controversy.”\textsuperscript{13} Instead, the Commission recommended that bankruptcy “judges be removed from the administration of bankrupt estates and restricted to the performance of essentially judicial functions, that is primarily to the resolution of disputes or issues involving adversary parties and matters appropriate for judicial determination.”\textsuperscript{14} The Commission further recommended that administrative responsibilities be carried out by a separate agency created by Congress with the authority to perform all administrative functions previously carried out by referees, and encouraged the creation of a “Bankruptcy Administration empowered to handle almost all matters in proceedings under the Act which do not involve litigation.”\textsuperscript{15}

In addition to recommending the separation of non-judicial administrative tasks in bankruptcy cases from judicial functions, the 1973 Report issued by the Commission advocated reforms that focused on balancing two of the core concepts in bankruptcy: providing debtors with a fresh start, or the basic means of survival, while also providing for the “equality of distribution among unsecured creditors.”\textsuperscript{16} To address problems discovered in consumer bankruptcies and effectuate the fresh start policy, the Commission recommended reforms, including:

1. Allowing indigent debtors to file bankruptcy \textit{in forma pauperis};

2. Adoption of uniform exemptions;

3. Redemption of collateral securing a dischargeable debt;

4. Eliminating the enforcement of reaffirmation agreements;

\textsuperscript{12} \textit{Id.} at App. Pt. 4-248.

\textsuperscript{13} \textit{Id.}

\textsuperscript{14} \textit{Id.} at App. Pt. 4-344.

\textsuperscript{15} \textit{Id.} at App. Pt. 4-251.

\textsuperscript{16} \textit{Id.} at App. Pt. 4-264.
5. Reducing the six-year bar between discharges to five years; and

6. Eliminating the use of false financial statements as a basis for nondischargeability.\(^\text{17}\)

Because Chapter 13 Plans were seldom used in many districts, the Commission also recommended several changes specifically to address problems that had arisen in the administration of consumer wage-earner plans, including:

1. Counseling for debtors with regular income to ensure they are fully informed regarding their options;

2. Availability of Chapter 13 relief despite the debtor having obtained a discharge within the previous five-year period;

3. That confirmation of a composition plan not be a limitation on future relief;

4. That wage earner plans “be subject to approval by the Administrator on his finding” of compliance with the Act without creditor consent;

5. The inclusion of debts secured by liens on a debtor’s residence and the curing of mortgage defaults within a reasonable time; and

6. The payment of creditors secured by personal property, which would protect their interest in collateral, without affording the creditors a veto of the debtor’s plan.\(^\text{18}\)

The Commission further recommended reforms to ensure the equality of distribution of assets among creditors. The Commission explained that an essential feature of any “bankruptcy

\(^{17}\) Id. at App. Pt. 4-254 through 4-256.

\(^{18}\) Id. at App. Pt. 4-257.
law is the inclusion of provisions designed to invalidate secret transfers made by the bankrupt prior to the date of filing the petition and to avoid for the benefit of the estate certain transfers of property made within limited periods of time prior to such filing.”19 To achieve a fair and equitable distribution among creditors, those receiving preferential payments must surrender them for distribution equally among all creditors. Otherwise, the Commission recognized “there would be a scramble amongst the most diligent creditors, those with inside information, and those with the greatest leverage over the debtor to obtain payment immediately before an impending bankruptcy, which would frequently leave nothing for the less favored creditors.”20

The Commission found that the ability of the trustee to recover transfers under the Bankruptcy Act was frustrated by two requirements. The trustee had to prove both the debtor’s insolvency on the date of transfer, and that “the preferred creditor had ‘reasonable cause to believe that the debtor was insolvent’ at the time of transfer.”21 Accordingly, the Commission recommended “there be a presumption of insolvency during the preference period, which must be rebutted by the favored creditor in order for him to retain the payment.”22

The Commission’s statutory proposal was first “introduced as a bill in the House of Representatives in 1973.”23 “Congress was receptive to the need for bankruptcy reform, noting that the governing 1898 Act was enacted ‘in the horse and buggy era of consumer and commercial credit’ and had last been revised in 1938.”24 After years of further debate, study, review, and compromise, the Bankruptcy Reform Act of 1978 was passed by Congress on

19 Id. at App. Pt. 4-261.
20 Id. at App. Pt. 4-262, 4-263.
21 Id. at App. Pt. 4-263.
22 Id. at App. Pt. 4-263.
October 6, 1978 and signed into law by the President on November 6, 1978. The effective date of the Act was October 1, 1979.\textsuperscript{25} Congress “recognized that consumer credit had become a fundamental element of the post-war economy and that the laws needed reform to make ‘bankruptcy law a more effective remedy for the unfortunate consumer debtor.’”\textsuperscript{26} Congress further sought “to include all of the property of the debtor in the bankruptcy case and to allow the trustee more easily to recover property that may have been transferred by the debtor” to promote the equitable distribution of assets to all creditors.\textsuperscript{27}

**Separation of Non-Judicial Administrative Tasks and Judicial Tasks under the Bankruptcy Code**

A primary legislative objective of Congress in passing the 1978 Act, also commonly referred to as the Bankruptcy Code, was to separate non-judicial administrative tasks in bankruptcy cases from judicial functions as recommended by the Commission. Congress recognized that “a bankruptcy judge that participates on one side of a case cannot be expected to resolve disputes fairly, no matter how well-intentioned he is.”\textsuperscript{28} “Without the separation of administrative and judicial functions proposed by the Bill, an expansion of jurisdiction would work to the severe disadvantage of all adverse litigants against the estate.”\textsuperscript{29} Accordingly, Congress eliminated the referee system which had been in place since 1898 and established a bankruptcy court “in each judicial circuit, as an adjunct to the district court for such district.”\textsuperscript{30}

\begin{itemize}
  \item \textsuperscript{25} Pub. L. No. 95-598, 92 Stat. 2549 (1978).
  \item \textsuperscript{26} Webber v. Creditthrift of America, Inc. (In re Webber), 674 F.2d 796, 798 (9th Cir. 1982).
  \item \textsuperscript{27} S. REP. NO. 95-989, at 5 (1978).
  \item \textsuperscript{28} H.R. Rep. No. 95-595, at 37 (1977).
  \item \textsuperscript{29} \textit{Id}.
  \item \textsuperscript{30} Northern Pipe Line Co. v. Marathon Pipe Line Co., 458 U.S. 50, 53 (1982).
\end{itemize}
To effectuate the Commission’s recommendation regarding administrative functions in
bankruptcy, Congress initially created the United States Trustee (“UST”) program as a six-year
pilot program. The UST program now operates in all federal judicial districts except Alabama
and North Carolina which operate under the Bankruptcy Administrator (“BA”) program. The
UST program is located in the executive branch under the Department of Justice, and the BA
program is located in the judiciary under the United States Judicial Conference. The
administrative functions performed by both programs mirror each other, and each program
enjoys “significant authority to control private trustees, credit counseling and educational
agencies, and other professionals operating within the bankruptcy arena.”

One commentator recently suggested that the line between the administrative functions
performed by Trustees and the judicial roles of the bankruptcy courts have become blurred
particularly in Chapter 13 cases because “strongly rooted localized practices for Chapter 13"
persist despite changes Congress implemented under the Bankruptcy Code to resolve the lack of
uniform standards in handling such cases. Some bankruptcy courts delegate the confirmation
process to Chapter 13 Trustees while others act as “such active gatekeepers that they impose
hurdles on Chapter 13 that are difficult to locate in the Bankruptcy Code.” Although Congress
assigned oversight of the Chapter 13 confirmation process to bankruptcy courts, some “debtors
have passed through the bankruptcy system possibly believing that the Chapter 13 trustees are, in
fact, the federal judges.”

---

31 Rafael I. Pardo & Kathryn A. Watts, The Structural Exceptionalism of Bankruptcy Administration, 60
32 Id. at 398.
33 Melissa B. Jacoby, Superdelegation and Gatekeeping in Bankruptcy Courts, 87 Temple L. Rev. 875, 877
34 Id.
35 Id.
Amendments to the Bankruptcy Code following the 1978 Reform Act are further responsible for distorting the separation between non-judicial administrative tasks and judicial functions. For example, one commentator suggests that the means test implemented under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”) imposes an administrative function on the bankruptcy courts which would be better resolved through the rule-making structure of an administrative agency, rather than the courts. 36 “Congress has exacerbated the degree to which bankruptcy courts must handle an intensely administrative function, which has had the concomitant effect of impairing the ability of such courts to exercise their judicial function.” 37

**POLICY TENSION AND HOW A COURT OF EQUITY BALANCES THE COMPETING INTERESTS**

“The principal purpose of the Bankruptcy Code is to grant a fresh start to the honest but unfortunate debtor.” 38 In addition to promoting a debtor’s fresh start, bankruptcy policy must also concern itself with the equally fundamental goal of “providing an orderly, collective proceeding pursuant to which assets and/or income of the debtor are distributed to creditors.” 39

The Bankruptcy Code effectuates the fresh start policy “through the discharge of the debtor’s in personam liability for prebankruptcy debts.” 40 Additionally, one of the most important aspects underlying the fresh start policy involves the area of exempt property, that is property retained for the debtor’s fresh start. 41 A debtor must exit bankruptcy with adequate

---

37 Id.
40 Id. at 402.
property for “the basic necessities of life so that even if his creditors levy on all of his nonexempt property, the debtor will not be left destitute and a public charge.”\textsuperscript{42} Accordingly, “exemptions in bankruptcy cases are part and parcel of the fundamental concept of a ‘fresh start.’”\textsuperscript{43}

The limitations imposed on the type and amount of exemptions debtors may claim reflect the balance chosen by Congress between ensuring debtors retain sufficient assets to satisfy their basic needs and that creditors receive fair treatment. Congress has “balanced the difficult choices that exemption limits impose on debtors with the economic harm that exemptions visit on creditors[.]”\textsuperscript{44}

To further promote the orderly distribution of assets to creditors and avoid the race to the courthouse, Congress revised the preference laws in 1978 “to omit the requirement that the trustee establish that the creditor had reasonable cause to believe the debtor was insolvent, in exchange for the reduction of the non-insider reachback period from 120 to 90 days and the addition of a 90-day presumption of insolvency.”\textsuperscript{45} “[T]he trustee could recover payments or property transferred to creditors prepetition to the extent those transfers preferred such creditors over other similarly situated creditors . . . then distribute the recovered value to all similarly situated creditors.”\textsuperscript{46}

The balance Congress originally sought to ensure between the fresh start policy and the goal of providing for the fair and equitable treatment of claims by the equitable distribution of assets has eroded with amendments to the Bankruptcy Code. Congress enacted BAPCPA in April of 2005 and imposed substantial revisions to both consumer and business provisions of the

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{42} Id.
\item \textsuperscript{43} Schwab v. Reilly (In re Reilly), 130 S. Ct. 2652, 2667 (2010).
\item \textsuperscript{44} Id.
\item \textsuperscript{45} 23 Am. Bankr. Inst. L. Rev. 1, *162.
\item \textsuperscript{46} Id.
\end{itemize}
\end{footnotesize}
Bankruptcy Code. The Final Report and Recommendations issued by the ABI Commission found that such amendments “have in some respected altered the Bankruptcy Code’s original careful balance between a debtor’s need to rehabilitate and its creditors’ rights to recoveries on their claims against the debtor.”

To maintain this balance, bankruptcy courts must resolve “the meaning of ambiguities at the heart of the Bankruptcy Code” left unanswered by Congress. For instance, the Code does not define what constitutes “cause” for dismissing a case. Instead, the Code sets out a “non-exhaustive list of factors that could constitute cause for dismissal” leaving bankruptcy courts with flexibility and discretion when determining whether a case should be dismissed “for cause.” When determining whether cause exists to dismiss a case, whether the automatic stay should be lifted “for cause,” or any of the other ambiguities left open for judicial determination under the Bankruptcy Code, bankruptcy courts should remain cognizant of the twin policies underlying the Bankruptcy Code, as well as the separation of functions intended under the Code to ensure the efficient administration of the entire system.

**AREAS WHERE POLICY TENSION IS MANIFESTED**

**A. Relief from Stay – “For Cause”**

Bankruptcy courts are empowered under the Bankruptcy Code to lift the automatic stay “for cause” under 11 U.S.C. § 362(d)(1). The automatic stay “immediately takes effect upon the

---

48 ABI Commission to Study the Reform of Chapter 11, p. 17 (2014).
50 See 11 U.S.C. §§ 707(a), 1112(b)(1), 1208(c), 1307(c).
filing of a bankruptcy petition, and enjoins, among other things, creditor attempts to collect prebankruptcy debts from the debtor.”52 “Because of the breathing room it provides to the debtor, the automatic stay represents the first step in facilitating a path to relief from the financial distress that prompted the debtor to seek respite in the bankruptcy forum.”53 Thus, bankruptcy courts must carefully consider whether cause exists to lift the stay given the competing interest between the debtor’s fresh start and the uniform collection remedies designed by the Code to facilitate the orderly administration and distribution of estate assets.

(1) State of Florida v. Diaz (In re Diaz), 647 F.3d 1073, 1085 (11th Cir. 2011): Chapter 13 Debtor filed a Motion for Contempt and Sanctions in a reopened case for violation of the automatic stay and/or discharge injunction. The Eleventh Circuit explained that the automatic stay “facilitates the orderly administration and distribution of the estate by “protect[ing] the bankrupt’s estate from being eaten away by creditors’ lawsuits and seizures of property before the trustee has had a chance to marshal the estate’s assets and distribute them equitably among the creditors.”54 The Court of Appeals explained that the automatic stay is a “fundamental procedural mechanism” that allows bankruptcy courts to carry out the core in rem functions of “exercising jurisdiction over the bankruptcy estate and the equitable distribution of the estate’s property among the debtor’s creditors.”55

(2) Disciplinary Board of the Supreme Court of Pennsylvania v. Feingold (In re Feingold), 730 F.3d 1268 (11th Cir. 2013): The Eleventh Circuit determined that a claim’s nondischargeability, without more, is not cause for stay relief.

52 Id. at 406.
53 Id.
54 State of Florida v. Diaz (In re Diaz), 647 F.3d 1073, 1085 (11th Cir. 2011) (quoting Martin-Trigona v. Champion Fed. Sav. & Loan Ass’n, 892 F.2d 575, 577 (7th Cir 1989)).
55 Id. at 1085.
Prepetition, Chapter 7 Debtor was disbarred from the practice of law. The Disciplinary Board of the Supreme Court of Pennsylvania obtained a judgment against Debtor appointing a conservator to take over his client files, and to take other steps to protect his clients. Postpetition, the Board filed a Motion to Lift Stay to enforce its judgment. The bankruptcy court denied the Motion finding that the judgment was not a debt excepted from discharge pursuant to § 523(a)(7). Had the claim been nondischargeable, the bankruptcy court explained that cause may have existed to lift the stay. The District Court reversed finding that the debt was nondischargeable and lifted the stay “for cause” pursuant to § 362(d)(1).

The Eleventh Circuit reversed in part and affirmed in part finding that the debt was nondischargeable, but holding that nondischargeability alone does not constitute “cause” under § 362(d)(1) to lift the stay. The Court of Appeals remanded the case for further findings based on the totality of the circumstances as to whether the Board was entitled to relief from the stay.

To determine cause exists to lift the stay, courts have looked to a variety of case-specific factors: (1) whether the debtor has acted in bad faith; (2) the hardships imposed on the parties; and (3) pending state court proceedings. The District Court focused solely on the debt’s dischargeability, but a majority of courts have concluded that a debt’s nondischargeability, standing alone, does not constitute cause to lift the stay. To rule otherwise, the statutory exceptions for the enumerated nondischargeable debts like domestic support obligations found in 11 U.S.C. § 362(b) would be meaningless.

Nondischargeability may be a factor, even a weighty factor, but without more nondischargeability does not constitute cause. The Eleventh Circuit found that the bankruptcy court should have instead looked at the totality of the circumstances to determine if stay relief was warranted.
(3) In re Alexandra Trust, 526 B.R. 668 (Bankr. N.D. Tex. 2015): Bankruptcy court lifted the stay “for cause” under § 362(d)(1) finding Chapter 11 Debtor filed its petition in bad faith as a litigation tactic one day before the Debtor’s Answer was due in a state court lawsuit. The Bankruptcy Code does not define the term “cause . . . so as to afford flexibility to the bankruptcy courts.” Although not expressly listed in § 362(d)(1), a debtor’s lack of good faith in filing its petition may constitute “cause” to lift the stay. As explained by the Fifth Circuit:

Such a standard furthers the balancing process between the interests of debtors and creditors which characterizes so many provisions of the bankruptcy laws and is necessary to legitimize the delay and costs imposed upon parties to a bankruptcy. Requirement of good faith prevents abuse of the bankruptcy process by debtors whose overriding motive is to delay creditors without benefitting them in any way or to achieve reprehensible purposes. Moreover, a good faith standard protects the jurisdictional integrity of the bankruptcy courts by rendering their powerful equitable weapons (i.e. avoidance of liens, discharge of debts, marshalling and turnover of assets) available only to those debtors and creditors with “clean hands.”

Courts must look at a multiple factors when determining whether a petition was filed in good faith such as “the Debtor’s financial condition, its motives, and the local financial realities of the case, and not on any single factor.” In this instance, the bankruptcy court determined that the Debtor did not have a good faith reason to file its bankruptcy and the stay should be lifted “for cause” based on the following: (1) Debtor had no employees, no operations, and no income for three years; (2) Debtor had $940 in its bank account; (3) Debtor had been involved in a long and acrimonious lawsuit with Movant; (4) termination of the stay would not prejudice the other creditors involved in the case; and (5) judicial economy favored lifting the stay to permit

---

56 In re Alexandra Trust, 526 B.R. 668, n. 11 (Bankr. N.D. Tex. 2015).
57 Id. at 681 (quoting Little Creek Dev. Co. v. Commonwealth Mortg. (In re Little Creek Dev. Co.), 779 F.2d 1068, 1072 (1986)).
58 Id.
the pending state court action to proceed. Finally, the bankruptcy court noted that the “impact of
the stay on the parties and the balance of the hurt, favors terminating the stay” given the history
of the parties state court litigation.59

B. Dismissal or Conversion - “For Cause”

(1) In re Johnson, 546 B.R. 83 (Bankr. S.D. Ohio 2016): Bankruptcy court denied
Chapter 11 professional hockey player’s Motion to Convert to Chapter 7 finding that Debtor’s
conduct, if committed by a Chapter 7 debtor, would have provided “cause” for dismissal under
Chapter 7. Debtor’s conduct prevented him from voluntarily converting to Chapter 7.

Section 707(a) permits dismissal of a case under Chapter 7 “only for cause,” and lists
three examples of cause, “including —”

(1) unreasonable delay by the debtor that is prejudicial to creditors;

(2) nonpayment of any fees or charges required under chapter 123 of title 28; and

(3) failure of the debtor in a voluntary case to file within fifteen days or such additional
time as the court may allow after the filing of the petition commencing such case, the
information required by paragraph (1) of section 521(a), but only on a motion by the
United States trustee.60

The use of the word “including” means that the grounds for dismissal under § 707(a) are
not limited to those specified. In addition to the enumerated examples of cause listed in §
707(a), “a debtor’s lack of good faith is a valid basis of decision in a ‘for cause’ dismissal by a
bankruptcy court.”61 Dismissal based on lack of good faith should be utilized only in egregious
cases entailing “(1) concealed or misrepresented assets and/or sources of income, (2) excessive

59 Id. at 684.
and continued expenditures, lavish lifestyle, and (3) intention to avoid a large single debt based on conduct akin to fraud, misconduct, or gross negligence.\footnote{62}

Chapter 11 Debtor argued his right to convert was absolute because his conduct did not fall within one of the enumerated exceptions to conversion under § 1112(a). The bankruptcy court explained that the right to convert may be denied under extreme circumstances such as bad faith involving egregious conduct as found in this case.

Prior to filing bankruptcy, Debtor spent money without restraint despite his financial distress, failed to reduce his spending in order to service his debt, and instead continued living a lavish lifestyle. Postpetition, Debtor failed to take the steps necessary to achieve the “principle goal of an individual Chapter 11 reorganization case . . . to provide creditors with a portion of the Debtor’s income rather than the value that can be derived from liquidating property of the bankruptcy estate.”\footnote{63} Debtor failed to obtain a forensic accountant before filing his Motion to Convert which counsel had stated was necessary to file a Chapter 11 Plan; failed to object to claims which would have benefitted creditors’ with legitimate claims; and failed to negotiate with creditors in good faith.

\footnote{62} Id. at *157.

\footnote{63} Id. at *162.

\textbf{(2) Marrama v. Citizens Bank of Ma. (In re Marrama), 127 S. Ct. 1105 (2007):} The Supreme Court held that a Chapter 7 Debtor forfeited his right to convert to Chapter 13 by engaging in bad faith conduct. There is no absolute right to convert from Chapter 7 to Chapter 13. Debtor misrepresented the value of his home and the home’s transfer to a newly created trust without consideration seven months before he filed bankruptcy. Debtor disclosed the trust in his schedules, but represented that the trust had no value. Debtor argued that the right to convert under § 706(a) is absolute. Section 706 reads in part:
(a) The debtor may convert a case under this chapter to a case under chapter 11, 12, or 13 of this title at any time, if the case has not been converted under section 1112, 1208, or 1307 of this title. Any waiver of the right to convert a case under this subsection is unenforceable.

* * * *

(d) Notwithstanding any other provision of this section, a case may not be converted to a case under another chapter of this title unless the debtor may be a debtor under such chapter.

After reviewing the legislative history under the Bankruptcy Code describing the right to convert as absolute, the Supreme Court held that such a determination would fail to give full effect to the express limitation described in § 706(d). Subsection (d) conditions the right to convert on the ability to qualify as a “debtor” under Chapter 13. There are two possible reasons why a debtor may not qualify under subsection (d):

i. § 109(e) imposes a debt limit to qualify for relief under Chapter 13; and

ii. § 1307(c) provides that a Chapter 13 case may be dismissed or converted to Chapter 7 “for cause.”

Bankruptcy courts routinely find that dismissal based on prepetition bad faith conduct constitutes cause for dismissal under § 1307(c). The Supreme Court explained that such conduct must be atypical to qualify as “bad faith” sufficient to support dismissal under Chapter 13 or to deny conversion from Chapter 7.

C. Preference Claims

**Leidenheimer Baking Co., Ltd. v. Sharp (In re SGSM Acquisition Co., LLC), 439 F.3d 233 (5th Cir. 2009):** Chapter 11 Liquidation agent filed separate adversary proceedings against food suppliers of Chapter 11 grocery store, seeking to avoid Debtor’s alleged preferential
payments during the ninety-day preference period. The Fifth Circuit affirmed the bankruptcy court’s finding that the food suppliers failed to establish the ordinary course of business defense. Further, the bankruptcy court properly applied the subsequent advance defense. The Fifth Circuit explained how preference laws maintain the delicate balance intended under the Code:

The preference provision of the Bankruptcy Code furthers the purpose of equitable distribution among creditors by authorizing the trustee (or debtor-in-possession) to recover most payments made by the debtor on account of antecedent debt within ninety days before bankruptcy. The theory is that when the preferential payments are returned, all creditors that can share ratably in the debtors’ assets, and the race to the courthouse, or the race to receive payment from a dwindling prebankruptcy estate, will be averted. Because some creditors, however, receive payments for shipping supplies that enable the debtor to continue doing business, to that extent they act to forestall an ultimate bankruptcy filing. Congress enacted several affirmative defenses against preference recovery in order to balance the competing interest.64

The two defenses at issue in this case were the ordinary course of business defense, and the payment for subsequent advances. The suppliers failed to satisfy their burden of proof regarding the ordinary course of business defense. Pre-BAPCPA, creditors were required to satisfy both the second and third prongs under 11 U.S.C § 547(c)(2) that payments were made in the ordinary course of business and made according to ordinary business terms. Under BAPCPA, these prongs are now disjunctive. In this pre-BAPCPA case, the supplies were unable to satisfy their burden of proof that the payments were made according to ordinary business terms because the bankruptcy court rejected the suppliers’ expert witness testimony.

The subsequent advance defense “aims to protect creditors who have furnished and been paid for ongoing supplies or revolving credit to a debtor in distress, because such transactions fortify the debtor’s business and may avert bankruptcy. At worst, the extensions of new value do
not harm existing creditors." Here, payments made by the Debtor during the preference period were followed by subsequent product deliveries, and to the extent new value was provided that subsequent new value was properly applied to each of the payments at issue.

D. Exemptions

(1) Schwab v. Reilly (In re Reilly), 130 S. Ct. 2652 (2010): The Supreme Court held that a Trustee does not have to object to an exemption claim when the stated value of the exemption falls within the limits allowed by the Code. Debtor claimed exemptions in the amount of $10,718 for tools of the trade. The Trustee did not object within the 30 day period provided by Bankruptcy Rule 4003(b) because the dollar amounts assigned to the exemption claims fell within the limits under 11 U.S.C. § 522(d)(5) and (6). The Trustee subsequently filed a Motion to Sell the equipment upon discovering its true value was $17,200. Debtor opposed the Motion and argued that the equipment was fully exempt because the Trustee failed to object.

The Bankruptcy Code requires a debtor to file a list of property claimed exempt and if no one objects “the property claimed as exempt on such list is exempt.” Debtor argued that the Trustee was required to object under § 522(l) “to vindicate the Code’s goal of giving debtors a fresh start, and to further its policy of discouraging trustees and creditors from sleeping on their rights.” The Supreme Court agreed that “exemptions in bankruptcy cases are part and parcel of the fundamental bankruptcy concept of a ‘fresh start.’” The Court determined, however, that the fresh start policy does not require the Trustee “to object to a facially valid claim of exemption on pain of forfeiting his ability to preserve for the estate any value in [the] business.

---

65 Id. at 241.
68 Id.
equipment beyond the value of the interest she declared exempt.”⁶⁹ Requiring the Trustee to object under these circumstances would “convert a fresh start into a free pass.”⁷⁰

(2) **Clark v. Rameker (In re Clark), 134 S. Ct. 2242 (2014):** Chapter 7 Trustee objected to the Debtor’s claim of exemption to an inherited IRA. The Supreme Court held that the funds held in the inherited IRA were not retirement funds for purposes of exemption under the Bankruptcy Code. Allowing debtors to exempt retirement funds held in traditional IRAs ensures “that debtors will be able to meet their basic needs during their retirement years . . . The same cannot be said of an inherited IRA.”⁷¹ The Court explained that if a debtor “is allowed to exempt an inherited IRA from her bankruptcy estate, nothing about the inherited IRA’s legal characteristics would prevent (or even discourage) the individual from using the entire balance of the account on a vacation home or sports car immediately after her bankruptcy proceedings are complete. Allowing that kind of exemption would convert the Bankruptcy Code’s purposes of preserving debtors’ ability to meet their basic needs and ensuring they have a “fresh start,” . . . into a ‘free pass.’”⁷²

**E. Confirmation Issues**

(1) **In re Wark, 542 B.R. 522 (Bankr. D. Kan. 2015):** The United States Trustee filed Objections to Confirmation in multiple cases and argued that by definition a Plan or Petition filed by a below median income debtor is not filed in good faith under § 1325(a)(3) and (a)(7). The bankruptcy court rejected this argument and explained that Chapter 13 and Chapter 7 both serve the twin goals of balancing a debtor’s fresh start with the fair and equitable treatment of

---

⁶⁹ Id.
⁷⁰ Id.
⁷² Id.
claims. Because the process under each Chapter differs significantly, there may be reasons for a below median income debtor to seek Chapter 13 relief in good faith.

Under Chapter 13, the debtor retains assets pursuant to the terms of a Court approved Plan, and payments are made from the debtor’s future earnings. During the Plan repayment period, the Chapter 13 debtor is encouraged to learn to live within a budget because the debtor is not permitted to incur debt without court authorization. Chapter 13 also provides debtors with relief by staying the collection of nondischargeable unsecured debts during the pendency of the case. In comparison, “Chapter 7 allows a debtor to make a clean break from his financial past, but at a steep price” the prompt liquidation of the debtor’s assets.\(^73\)

Because postpetition wages are property of the estate which may be collected by the Chapter 13 Trustee for distribution to creditors, the Supreme Court has recognized that Chapter 13 proceedings “can benefit debtors and creditors alike. Debtors are allowed to retain their assets, commonly their home or car. And creditors, entitled to a Chapter 13 debtor’s ‘disposable’ postpetition income, usually collect more under a Chapter 13 plan than they would have received under a Chapter 7 liquidation.”\(^74\) Certain debts are also dischargeable in Chapter 13 cases such as non-support debts owed under a divorce or property settlement which are not dischargeable in Chapter 7 cases. Finally, the bankruptcy court recognized that the collection of attorney’s fees are different in Chapter 13 and Chapter 7 cases. In Lamie v. United States Trustee, the Supreme Court determined that the Bankruptcy Code does not permit debtor’s counsel to be compensated from estate funds, thus attorney’s filing Chapter 7 petitions for debtors must collect their fee up front.\(^75\)

\[^{73}\] Id. at 530.

\[^{74}\] In re Wark, 542 B.R. at 531 (quoting Harris v. Viegelahn, 135 S.Ct. 1829, 1835 (2015)).

\[^{75}\] Id. at 531 (citing Lamie v. United States Trustee, 540 U.S. 526 (2004)).
Given the differences between Chapter 13 and Chapter 7, “Circuits to consider challenges to fee only plans unanimously agree that fee only Chapter 13 cases are not per se filed in bad faith.”\textsuperscript{76} Instead, the totality of the circumstances must be examined to determine good faith under § 1325(a)(3) and § 1325(a)(7).

(2) Brown \textit{v.} Gore (\textit{In re Brown}), 742 F.3d 1309 (11th Cir. 2014): The Eleventh Circuit affirmed the bankruptcy court’s order denying confirmation of the Debtor’s Chapter 13 “attorney-fee-centric” Plan, where the Chapter 13 case served “no meaningful or legitimate debt adjustment purpose.”\textsuperscript{77} The Court of Appeals applied the multi-factor totality of the circumstances test for determining good faith set forth in \textit{In re Kitchens}, 702 F.2d 885, 888 (11th Cir. 1983), and upheld the bankruptcy court’s finding that the Debtor had not proposed his Plan in good faith under § 1325(a)(3), nor filed his Petition in good faith under § 1325(a)(7). It was undisputed that the Debtor did not have any non-exempt assets and was, thus, not attempting to preserve any assets by filing a Chapter 13 Plan rather than seeking immediate relief under Chapter 7.

(3) In \textit{re Mason}, 456 B.R. 245 (Bankr. N.D. W. Va. 2011): Chapter 13 Debtor proposed a Plan classifying student loans separately. No creditor objected, and the Chapter 13 Trustee recommended confirmation. Debtor’s proposed Plan provided for a 72% distribution to student loan claims, while only proposing an 8% distribution to other general unsecured creditors.

\textsuperscript{76} \textit{Id.} at 533.
\textsuperscript{77} \textit{Brown v. Gore (In re Brown),} 742 F.3d 1309, 1315 (11th Cir. 2014).
Student loan debts are excepted from discharge under § 523(a)(8) unless repayment will “impose an undue hardship on the debtor and the debtor’s dependents.” Congress did not define the term undue hardship for purposes of § 523(a)(8), leaving this instead for bankruptcy courts to decide. “[I]n excepting student loans from discharge, Congress made a policy choice to protect the viability of the student-loan program.”

Section 1322(b)(1) provides that a Plan may “designate a class or classes of unsecured claims, as provided in section 1122 of this title, but may not discriminate unfairly against any class so designated . . .” In the Chapter 11 context, a debtor is free to separately classify similar claims so long as the reason for the separate classification is “independent of the debtor’s motivation to secure the vote of an impaired assenting class of claims.”

Voting is not an issue in the Chapter 13 context, so the only question is whether claims are substantially similar. Student loan claims are similar to other unsecured claims such as credit card claims in that they are both unsecured debts. However, the nature of the debts differ in that student loan claims are generally excepted from discharge. Based on the differing nature of such claims, the bankruptcy court found no prohibition against separately classifying student loan debts from other unsecured debts.

Although Section 1322(b)(1) prohibits unfair discrimination between designated classes, it does not prohibit all discrimination, only unfair discrimination. The bankruptcy court recognized a split of decisions regarding the separate classification of student loans with some courts finding debtors will not be afforded a fresh start in bankruptcy if they are defaulting on student loan payments over the term of a five year Plan, while others note Congress clearly made the policy decision to subordinate debtors’ rights to a fresh start to the repayment of student

---

80 Id. at 249.
loans. The bankruptcy court concluded that some discrimination between classes is allowed. ""[B]y allowing for separate classes of unsecured claims, Congress anticipated some discrimination, otherwise separate classes would have no significance."" 81

To determine whether separate classification is unfairly discriminatory, ""a court must be mindful of the twin aims of the Bankruptcy Code: that of providing the debtor with a fresh start and to provide a mechanism for the collection of debts."" 82 The bankruptcy court sought to balance these goals. The court found that permitting separate classification supported the debtor’s fresh start by ensuring the debtor is no worse off for having filed bankruptcy. Although Congress chose to favor student loan debts over other unsecured debts by excepting them from discharge, the exception to discharge is not based on the debtor’s bad conduct. Accordingly, the bankruptcy court found that a basis for treating student loan debt more favorably exists.

To balance the debtor’s fresh start while ensuring the fair and equitable treatments of claims, a debtor must, however “be able to articulate a reason why the discriminatory treatment is being proposed, and be able to demonstrate that a lesser discriminatory means of treatment is not advisable.” 83

**CONCLUSION**

Bankruptcy courts must resolve the issues resulting from the inherent tensions created by Congress in the Bankruptcy Code by keeping in mind the twin policies undergirding the Code. At the same time, bankruptcy courts should remain mindful of the separation between administrative and judicial functions originally intended under the Bankruptcy Code. When the line between these functions becomes blurred, the entire bankruptcy system suffers, leading to diminished relief for both debtors and creditors.

---

82 Id.
83 Id. at 252.