

June 1984

## Bankruptcy: In the Shadow of Marathon - Case Law Developments under the Bankruptcy Reform Act of 1978

Sue J. Hodges

Halyna M. Traversa

Follow this and additional works at: <https://scholarship.kentlaw.iit.edu/cklawreview>



Part of the [Law Commons](#)

---

### Recommended Citation

Sue J. Hodges & Halyna M. Traversa, *Bankruptcy: In the Shadow of Marathon - Case Law Developments under the Bankruptcy Reform Act of 1978*, 60 Chi.-Kent L. Rev. 429 (1984).

Available at: <https://scholarship.kentlaw.iit.edu/cklawreview/vol60/iss3/3>

This Article is brought to you for free and open access by Scholarly Commons @ IIT Chicago-Kent College of Law. It has been accepted for inclusion in Chicago-Kent Law Review by an authorized editor of Scholarly Commons @ IIT Chicago-Kent College of Law. For more information, please contact [jwenger@kentlaw.iit.edu](mailto:jwenger@kentlaw.iit.edu), [ebarney@kentlaw.iit.edu](mailto:ebarney@kentlaw.iit.edu).

BANKRUPTCY: IN THE SHADOW OF *MARATHON*—CASE  
LAW DEVELOPMENTS UNDER THE BANKRUPTCY  
REFORM ACT OF 1978

SUE J. HODGES\* and HALYNA M. TRAVERSA\*\*

During the 1982-83 term, the United States Court of Appeals for the Seventh Circuit developed new case law under the Bankruptcy Reform Act of 1978.<sup>1</sup> Construing the new Reform Act (the "Code") has not always changed prior law developed under the earlier Bankruptcy Act of 1898 (the "Act").<sup>2</sup> This article will review Seventh Circuit decisions under the Code involving issues of involuntary petitions, standing to appeal from an order, objections and exceptions to discharge, automatic stay litigation, trustee's fees, and administrative expenses.

INVOLUNTARY PETITIONS—*IN RE RASSI*

The Seventh Circuit, in *In re Rassi*,<sup>3</sup> further delineated the law surrounding the involuntary petition. Section 303(b) of the Code<sup>4</sup> provides that three or more entities must join an involuntary petition.<sup>5</sup> However, if there are fewer than twelve creditors, any one creditor who holds at least \$5000 in non-voidable claims may file an involuntary petition.<sup>6</sup> The requirements generally make it much easier for a creditor to file an involuntary petition under the Code than it was under the

\* A.B., U.C.L.A., 1972; J.D., IIT Chicago-Kent College of Law, 1984

\*\* B.S., Loyola University of Chicago, 1966; M.A., University of Illinois, 1968; J.D., IIT Chicago-Kent College of Law, 1984.

1. 11 U.S.C. §§ 101-151326 (Supp. II 1978).

2. Ch. 541, 30 Stat. 544 (1898).

3. 701 F.2d 627 (7th Cir. 1983).

4. Sections 303(b)(1) and (2) provide:

(b) An involuntary case is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title—

(1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or an indenture trustee representing such a holder, if such claims aggregate at least \$5,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;

(2) if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable under section 544, 545, 547, 548, 549, or 724(a) of this title, by one or more of such holders that hold in the aggregate at least \$5,000 of such claims.

11 U.S.C. §§ 303(b)(1)-(2) (1982).

5. 11 U.S.C. § 303(b)(1) (1982).

6. 11 U.S.C. § 303(b)(2) (1982). See also 2 COLLIER ON BANKRUPTCY ¶ 303.08 (15th ed. 1984).

Act.<sup>7</sup>

In the *Rassi* proceedings below, Jefferson Bank, a secured creditor, filed a petition for involuntary bankruptcy against the Rassis. The Rassis moved to dismiss that petition on the grounds that they had more than twelve creditors, thus requiring at least three creditors joining the involuntary petition. Pursuant to Bankruptcy Rule 104(e),<sup>8</sup> the Rassis presented a list containing the names and addresses of all creditors and the nature and amount of each claim. At the hearing on the motion to dismiss, the bank moved for discovery and suggested that small, insignificant creditors should be excluded from the list. The bankruptcy court denied the bank's discovery motion and dismissed its involuntary petition.

On appeal, the first issue addressed by the Seventh Circuit was whether a creditor is entitled to discovery and a hearing to determine the accuracy of the list of creditors provided by the debtor. The Seventh Circuit resolved this issue in favor of the creditor, holding that the bankruptcy court abused its discretion in denying the bank all opportunity to determine which creditors should be excluded from the 303(b) (2) count.<sup>9</sup> The Code provides that fewer than three creditors can bring an involuntary petition only if the debtor has fewer than twelve creditors.<sup>10</sup> Additionally, some creditors are statutorily excluded from this number on the rationale that they would be unlikely to join an involuntary petition.<sup>11</sup> Whenever fewer than three creditors file an involuntary petition, the debtor may answer that there are more than twelve credi-

7. Acts of bankruptcy, a requirement under the former Act, are no longer required under the Code. Additionally, balance sheet insolvency is no longer required in order for creditors to bring an involuntary petition. Rather, the equity insolvency test is now used. That test asks whether a debtor has the ability to pay his obligations as they fall due. H.R. REP. NO. 595, 95th Cong., 1st Sess. 323 (1977).

8. The procedural aspects of bankruptcy practice are governed by the Bankruptcy Rules of Procedure. Rule 104(e) provided:

(e) Creditors other than the original petitioners may join in an involuntary petition at any time before its dismissal. If the answer to an involuntary petition filed by one or 2 creditors avers the existence of 12 or more creditors, the alleged bankrupt shall file with the answer a list of all his creditors with their addresses, a brief statement of the nature of their claims, and the amounts thereof. If it appears that there are 12 or more creditors as counted under section 95(e) of this title [303(b) of the present Code], the court shall thereupon afford a reasonable opportunity for other creditors to join in the petition before a hearing is held thereon.

RULES BANKR. PROC. Rule 104(e).

9. 701 F.2d at 631.

10. See *supra* note 4.

11. The exceptions include employees of the debtor who might have an interest in the continuing operation of the business; "insiders", such as relatives of the debtor; and creditors who have received a voidable transfer. In short, those creditors who might be friendly with the debtor are excluded from the count. 2 COLLIER ON BANKRUPTCY ¶ 303.08[12][a] (15th ed. 1984).

tors and file a supporting list.<sup>12</sup> According to the rules, that list must include all creditors, but need not list those who should be statutorily exempt from the count.<sup>13</sup>

The court's decision on the issue of discovery was carefully circumscribed. The court explicitly stated that it did not reach the question of whether due process mandates an evidentiary hearing in all cases. The court noted that the bankruptcy court did have some discretion in the matter. However, the Seventh Circuit emphasized that the bankruptcy court should not have ruled that the Rule 104 list was sufficient to allow the bank to locate other creditors to join the petition. According to the Seventh Circuit, the bankruptcy court should not have summarily denied the bank all discovery.<sup>14</sup> Thus, the *Rassi* decision does not remove sound discretion to deny discovery if that discovery is unwarranted; it does, however, mandate discovery adequate to permit the petitioning creditor to determine whether another creditor is statutorily exempt.

The second issue the Seventh Circuit addressed in *Rassi* was whether small, recurring creditors should be excluded from the section 303 count.<sup>15</sup> The court declined to fashion a judicially created exception where none was explicitly set forth in the statute.<sup>16</sup> The court noted that an exception might be sensible in order to further the goals of the Code,<sup>17</sup> but opined that since Congress had provided certain statutory exclusions, the court had no authority to fashion others.<sup>18</sup>

That decision is, perhaps, subject to attack on policy grounds. Refusal to judicially create a *de minimis* exception which a minority of courts have in fact created<sup>19</sup> may deny relief to a major creditor simply

12. See *supra* note 8 for the text of the rule setting forth the procedure.

13. *Id.*

14. 701 F.2d at 631. "We hold that the bankruptcy court abused its discretion in denying the bank all opportunity to determine which creditors should be excluded from the 303(b)(2) count."

15. 701 F.2d at 631.

16. *Id.* at 632.

17. Under the old Act, the Fifth Circuit created a judicial exception. *E.g.*, *Denham v. Shellman Grain Elevator, Inc.*, 444 F.2d 1376, 1378-79 (5th Cir. 1971). Contrarily, the Eighth and Ninth Circuits have not recognized the *de minimis* exception. *In re Okamoto*, 491 F.2d 496, 497-98 (9th Cir. 1974); *Theis v. Luther*, 151 F.2d 397, 398 (8th Cir. 1945), *cert. denied*, 327 U.S. 781 (1946). Apparently, the Seventh Circuit noted the correct distinction. That distinction is whether the debtor deliberately accumulated a large number of small debts. 2 COLLIER ON BANKRUPTCY ¶ 303.08[12][d] (15th ed. 1984). Thus, the correct result was reached in the present case without adding to the confusion and split of authority which occurred under the Act.

18. 701 F.2d at 632.

19. For further cases which exemplify *de minimis* exceptions see *Security Bank and Trust Co. v. Tarlton*, 294 F. 698 (W.D. Tenn. 1923); *In re Branche*, 275 F. 555 (N.D.N.Y. 1921); *In re Burg*, 245 F. 173 (N.D. Tex. 1917); *In re Blount*, 142 F. 263 (E.D. Ark. 1906); *In re Blaine Richards & Co.*, 10 Bankr. 424 (Bankr. E.D.N.Y. 1981). The "counting creditors" controversy is an area which created a problem under the Act, which was not addressed by the draftsmen of the Code.

because many other creditors had very small claims. Courts have also noted that holders of these small recurring claims would be unlikely to join an involuntary petition for reasons which parallel those underlying the statutory exclusions. Perhaps the strongest reason is that the recurring nature of the claims strongly encourages payment.

In a typical situation involving a recurring debt, a debtor needs the goods or services provided. He cannot afford to have the creditor refuse to deal with him further because of non-payment. The *Rassi* decision may have been tempered, however, by the fact that had there been any showing that the debtors purposely incurred large numbers of small claims in order to frustrate the purpose of the Code, the court would have reached a different result. Thus, in *Rassi*, the Seventh Circuit declined to create a judicial exception to the statute while avoiding an undesirable result in the case before it.

#### STANDING TO APPEAL—*IN RE CARBIDE CUTOFF, INC.*

In *In re Carbide Cutoff, Inc.*,<sup>20</sup> the Seventh Circuit addressed the issue of whether a court-appointed special counsel<sup>21</sup> had standing to appeal from an order of the bankruptcy court. The applicable section of the Code is silent on the issue of precisely who has standing to appeal, whereas the Act explicitly limits appeals to a "person aggrieved."<sup>22</sup> In *Carbide Cutoff*, the problem arose because the district

20. 703 F.2d 259 (7th Cir. 1983).

21. Special counsel refers to a law firm or individual attorney appointed by the bankruptcy court to litigate certain claims on behalf of the trustee. One problem in *Carbide Cutoff* was that the *scope* of the special counsel's authority had not been set forth in the order of the bankruptcy court. That order provided in pertinent part:

IT IS ORDERED:

That said Craig McGuire, as trustee of the estate of Carbide Cutoff, Inc., . . . is hereby authorized to employ as counsel LICHTSINN, HAENSEL, BASTIAN, & ERCHUL, s.c. . . . for the purposes of commencing an action to secure the turnover of certain assets transferred by the debtor corporation on or about the 19th day of March, 1980, and for the further purpose of defending an action for declaratory judgment commenced against said Craig McGuire . . .

*Id.* at 262 n. 7.

22. Section 39(c) of the Act provided:

A person aggrieved by an order of a referee may, within ten days after the entry thereof or within such extended time as the court upon petition filed within such ten-day period may for cause shown allow, file with the referee a petition for review of such order by a judge and serve a copy of such petition upon the adverse parties who were represented at the hearing. Such petition shall set forth the order complained of and the alleged errors in respect thereto. Unless the person aggrieved shall petition for review of such order within such ten-day period, or any extension thereof, the order of the referee shall become final. Upon application of any party in interest, the execution or enforcement of the order complained of may be suspended by the court upon such terms as will protect the rights of all parties in interest.

11 U.S.C. § 67(c) (1976); see 1 COLLIER ON BANKRUPTCY ¶ 3.03[6][a][i] (15th ed. 1984).

court simply applied the general rule that the trustee is the appropriate party to appeal on behalf of unsecured creditors.<sup>23</sup> Upon review, the Seventh Circuit found that the facts of *Carbide Cutoff* might present a situation in which that general rule is inapposite. Consequently, the Seventh Circuit reversed the district court decision and remanded the matter to the district court with instructions to further remand it to the bankruptcy court.

Even prior to the beginning of any proceedings in bankruptcy, Carbide Cutoff had experienced severe financial difficulties. It therefore arranged, in early 1980, for its principal creditors to receive additional security for an outstanding loan.<sup>24</sup> Additionally, Carbide Cutoff arranged for the sale of its assets to Alpha Sierra Corporation in exchange for Alpha Sierra's assumption of Carbide's indebtedness to the bank. On February 27, 1980, Carbide sent a bulk sale notice<sup>25</sup> to its

23. That rule is set forth in the Seventh Circuit case of *In re Tyne*, 261 F.2d 249 (7th Cir. 1958), cert. denied, 359 U.S. 974 (1959).

24. After Carbide began experiencing financial difficulties, the bank received a junior mortgage on certain real estate. Subsequently, it received a security interest in Carbide's blade sharpening facilities in Texas and Pennsylvania. 703 F.2d at 261 n. 1.

25. A bulk sales notice is required to protect the rights of subsequent purchasers vis-a-vis a transferor's creditors whenever a bulk sale as defined by the Uniform Commercial Code is effected.

Article 6, section 102 defines bulk transfer, providing:

(1) A "bulk transfer" is any transfer in bulk and not in the ordinary course of the transferor's business of a major part of the materials, supplies, merchandise or other inventory (Section 9—109) of an enterprise subject to this Article.

(2) A transfer of a substantial part of the equipment (Section 9—109) of such an enterprise is a bulk transfer if it is made in connection with a bulk transfer of inventory, but not otherwise.

(3) The enterprises subject to this Article are all those whose principal business is the sale of merchandise from stock, including those who manufacture what they sell.

(4) Except as limited by the following section all bulk transfers of goods located within this State are subject to this Article.

ILL. REV. STAT. ch. 26, § 6-102 (1977).

Moreover, section 6-105 provides for notice to creditors:

In addition to the requirements of the preceding section, any bulk transfer subject to this Article except one made by auction sale (Section 6—107) is ineffective against any creditor of the transferor unless at least 10 days before he takes possession of the goods or pays for them, whichever happens first, the transferee gives notice of the transfer in the manner and to the persons hereafter provided (Section 6—106).

ILL. REV. STAT. ch. 26, § 6-105 (1977).

Section 6-106 sets forth the requirements of the notice:

(1) The notice to creditors shall state:

(a) that a bulk transfer is about to be made; and

(b) the names and business addresses of the transferor and transferee, and all other business names and addresses used by the transferor within 3 years last past so far as known to the transferee; and

(c) whether or not all the debts of the transferor are to be paid in full as they fall due as a result of the transaction, and if so, the address to which creditors should send their bills.

(2) If the debts of the transferor are not to be paid in full as they fall due or if the transferee is in doubt on that point then the notice shall state further:

creditors, announcing the impending sale of assets to Alpha Sierra. On March 7, 1980, before that sale was consummated, an unsecured creditor filed an involuntary petition against Carbide. The creditor initially obtained a temporary restraining order blocking the sale. However, upon expiration of the order, the sale was completed. On April 4, 1980, the bankruptcy court adjudged Carbide Cutoff insolvent. The Chapter VII proceedings continued, although Carbide had been stripped of its principal assets. The trustee appointed by the bankruptcy court made no attempt to pursue the estate's claims against the bank and Alpha Sierra,<sup>26</sup> and took no measures to collect Carbide's assets. Instead, he applied to compromise<sup>27</sup> the estate's claims against the bank and Alpha

(a) the location and general description of the property to be transferred and the estimated total of the transferor's debts;

(b) the address where the schedule of property and list of creditors may be inspected;

(c) whether the transfer is to pay existing debts and if so the amount of such debts and to whom owing;

(d) whether the transfer is for new consideration and if so the amount of such consideration and the time and place of payment.

(3) The notice in any case shall be delivered personally or sent by registered or certified mail to all the persons shown on the list of creditors furnished by the transferor (Section 6—104) and to all other persons who are known to the transferee to hold or assert claims against the transferor.

ILL. REV. STAT. ch. 26, § 6-106 (1977).

26. For example, the trustee, on behalf of the secured creditors, had a colorable claim to set aside the preferential security interest granted to the bank.

27. Section 547(b) of the Code covers preferences and provides:

(b) Except as provided in subsection (c) of this section, the trustee may avoid any transfer of property of the debtor—

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made—

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

(B) between 90 days and one year before the date of the filing of the petition; if such creditor, at the time of such transfer—

(i) was an insider; and

(ii) had reasonable cause to believe the debtor was insolvent at the time of such transfer; and

(5) that enables such creditor to receive more than such creditor would receive if—

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

11 U.S.C. § 547(b) (1982).

Additionally, the trustee was urged to avoid the sale of goods to Alpha-Sierra as an unauthorized post petition transfer, which is governed by section 549 of the Code:

(a) Except as provided in subsection (b) and (c) of this section, the trustee may avoid a transfer of property of the estate—

(1) that occurs after the commencement of the case; and

(2)(A) that is authorized under section 303(f) or 542(c) of this title; or

(B) that is not authorized under this title or by the court.

Sierra. However, that application was later withdrawn. Alpha Sierra filed a declaratory judgment action seeking a ruling that the sale of assets was valid. In response to that complaint, the trustee improperly admitted numerous allegations of that complaint. Subsequently, the trustee sought again to compromise the claims.

That attempt prompted a group of unsecured creditors to seek removal of the trustee<sup>28</sup> or appointment of a special counsel to pursue in the trustee's name the estate's claims against the bank and Alpha Sierra. The second application to compromise the claims was denied and special counsel was employed by agreement. Upon the bank's and Alpha Sierra's motion for reconsideration, the bankruptcy court granted the application to compromise the claim over the objection of the unsecured creditors. The special counsel then appealed to the district court. The district court declined to reach the merits of the matter and dismissed the appeal on the grounds that the special counsel lacked standing to appeal. The court determined that the special counsel derived his authority solely through the trustee and so, upon entry of the compromise order, the trustee had actually received all relief requested. The special counsel appealed the district court's holding to the Seventh Circuit.

It was evident to the Seventh Circuit that the problem lay in the bankruptcy court's failure to clarify the scope of the special counsel's

(b) In an involuntary case, a transfer that occurs after the commencement of such case but before the order for relief is valid against the trustee to the extent of any value, including services, but not including satisfaction or securing of a debt that arose before the commencement of the case, given after the commencement of the case in exchange for such transfer, notwithstanding any notice or knowledge of the case that the transferee has.

(c) The trustee may not avoid under subsection (a) of this section a transfer, to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value or to a purchaser at a judicial sale, of real property located other than in the county in which the case is commenced, unless a copy of the petition was filed in the office where conveyances of real property in such county are recorded before such transfer was so far perfected that a bona fide purchaser of such property against whom applicable law permits such transfer to be perfected cannot acquire an interest that is superior to the interest of such good faith or judicial sale purchaser. A good faith purchaser, without knowledge of the commencement of the case and for less than present fair equivalent value, of real property located other than in the county in which the case is commenced, under a transfer that the trustee may avoid under this section, has a lien on the property transferred to the extent of any present value given, unless a copy of the petition was so filed before such transfer was so perfected.

(d) An action or proceeding under this section may not be commenced after the earlier of—

- (1) two years after the date of the transfer sought to be avoided; and
- (2) the time the case is closed or dismissed.

11 U.S.C. § 549 (1982).

28. See 11 U.S.C. § 324 (1982) which provides that "[t]he court, after notice and a hearing, may remove a trustee or an examiner, for cause."



authority. Noting that the Seventh Circuit rule generally precluded anyone but the trustee from bringing an appeal,<sup>29</sup> the court determined that the instant case might be one in which the general rule should not apply. Whether or not standing was proper depended upon the scope of the general counsel's authority. If the appointment was merely to assist the trustee, standing would be improper. If, however, the purpose of the appointment was to protect the estate from the trustee's lack of diligence in pursuing certain claims on behalf of the estate, then standing to appeal should lie.

In its discussion regarding possible reasons for declining to apply the general rule, the Seventh Circuit first noted that the Act limited appeals to "persons aggrieved", while the Code is silent on the issue.<sup>30</sup> Noting in the situation before it that considerations under the Act were still appropriate, and that the special counsel actually represented a "person aggrieved", the Seventh Circuit opined that if the bankruptcy court found the authority of the special counsel broad enough to pursue claims on behalf of the general creditors, then his standing to appeal should be upheld.

In reversing the *Carbide Cutoff* district court's mechanical application of the general rule, the court has shown sensitivity to policies underlying the Code. As in *Rassi*, the court recognized the need to balance the equitable principles underlying the Code with the accepted rules of statutory interpretation, and with concerns of orderly administration of the bankrupt estate.

Arguably, the Seventh Circuit should have reached its result by a less circuitous route, interpreting the omission under the Code to be purposeful so that anyone could appeal from an order of the bankruptcy court. This is not, however, the approach recommended by commentators.<sup>31</sup> Additionally, to have adopted such a course would mitigate against the policies of curtailing the flood of litigation and of orderly administration of the bankrupt estate. Therefore, it appears that *Carbide Cutoff* was correctly decided, and that the decision gave proper consideration to relevant policies.

29. The district court simply found that the rule announced in *In re Tyne* governed the case before it. 703 F.2d at 264.

30. See *supra* note 22.

31. See 1 COLLIER ON BANKRUPTCY ¶ 3.03[6][a][i] (15th ed. 1984). The reason for the suggestion is to limit appeals from bankruptcy orders to persons directly affected by those orders. See *Hartman Corp. of America v. United States*, 304 F.2d 429, 431 (8th Cir. 1962).

DISCHARGEABILITY—*IN RE MARTIN* AND *IN RE KREPS*

In *In re Martin*,<sup>32</sup> the Seventh Circuit reviewed a direct appeal<sup>33</sup> arising from bankruptcy proceedings in which objections were filed seeking a denial of discharge because of an alleged concealment of assets. A discharge grants the debtor a legal right not to pay his debts.<sup>34</sup> In a "straight" bankruptcy proceeding under Chapter 7, the matter of a discharge is dealt with in a two-step process. First, the court determines whether the debtor will receive a discharge.<sup>35</sup> Once the court has determined that no objection to discharge exists, it ascertains whether there are claims against the debtor which are excepted from discharge.<sup>36</sup> The concept of the total discharge is the "heart of the fresh start provisions of the bankruptcy law."<sup>37</sup>

Most of the objections which will support a denial of discharge are premised upon the dishonesty or lack of cooperation of the debtor.<sup>38</sup>

32. 698 F.2d 883 (7th Cir. 1983).

33. Direct appeal from an order of the bankruptcy court to the court of appeals is permitted if the parties to the appeal so agree. 28 U.S.C. § 1293(b) (1982).

34. When an objection to discharge is made, a hearing is held to determine the validity of the objection. BANKR. RULE 703. If the court finds that the debtor is not entitled to a discharge, the debtor will owe his debts to the extent that they have not been paid through a distribution of the debtor's assets. During the pendency of his case, a debtor is protected from his creditors through the automatic stay. Upon the disposition of a case, the stay is lifted, 11 U.S.C. § 362 (c)(2)(A) (1982), and the creditors may proceed with their collection efforts.

35. 11 U.S.C. § 727(a) (1982). The court is required to grant the debtor a discharge unless one of the ten conditions listed in subsections (a)(1) through (a)(10) of section 727 is present. Conversely, the debtor is denied a discharge if any of those conditions is present.

36. 11 U.S.C. § 727(b) (1982) provides that, if there are no objections to discharge, then all of the debtor's debts are discharged except for those debts specifically excepted under § 523. Subsection (a)(1) through (a)(9) list the individual types of claims from which a discharge will not be granted. Creditors with non-dischargeable claims can then proceed against the debtor's property after the close of the case, and the termination of the automatic stay. 11 U.S.C. § 362 (c)(2)(A). See *supra* note 34.

37. H.R. REP. NO. 595, 95th Cong., 1st Sess. 384 (1977); S. REP. NO. 989, 95th Cong. 2d Sess. 98 (1978). The practitioner needs to carefully distinguish between such issues as may raise an objection to discharge under § 727 as opposed to those issues which concern exception to discharge under section 523. "A successful objection to a chapter 7 discharge creates a situation in which the debtor's assets are liquidated without significant, corresponding benefits . . . . If an objection is successfully raised, no debts are discharged. Conversely, issues raised under section 523 relate to the dischargeability of individual debts. An exception to dischargeability removes the individual debt from the discharge order, but all other debts are, nevertheless, discharged". Morton, 1 BANKRUPTCY LAW AND PRACTICE § 27.13, at 24 (1981).

38. 11 U.S.C. § 727 (1982) provides:

- (a) The court shall grant the debtor a discharge, unless—
- (1) the debtor is not an individual;
  - (2) the debtor, with intent to hinder, delay, or defraud a creditor or an officer of the estate charged with custody of property under this title, has transferred, removed, destroyed, mutilated, or concealed, or has permitted to be transferred, removed, destroyed, mutilated, or concealed—
    - (A) property of the debtor, within one year before the date of the filing of the petition; or
    - (B) property of the estate, after the date of the filing of the petition;

Since the discharge is to have a constructive rehabilitative function, it cannot be granted to debtors who are unwilling to wipe the slate clean. Thus, while the changes implemented by the Code have not been sweeping,<sup>39</sup> the question of discharge is of prime importance in bank-

(3) the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case;

(4) the debtor knowingly and fraudulently, in or in connection with the case—

(A) made a false oath or account;

(B) presented or used a false claim;

(C) gave, offered, received, or attempted to obtain money, property, or advantage, or a promise of money, property, or advantage, for acting or forbearing to act; or

(D) withheld from an officer of the estate entitled to possession under this title, any recorded information, including books, documents, records, and papers, relating to the debtor's property or financial affairs;

(5) the debtor has failed to explain satisfactorily, before determination of denial of discharge under this paragraph, any loss of assets or deficiency of assets to meet the debtor's liabilities;

(6) the debtor has refused, in the case—

(A) to obey any lawful order of the court, other than an order to respond to a material question or to testify;

(B) on the ground of privilege against self-incrimination, to respond to a material question approved by the court or to testify, after the debtor has been granted immunity with respect to the matter concerning which such privilege was invoked; or

(C) on a ground other than the properly invoked privilege against self-incrimination, to respond to a material question approved by the court or to testify;

(7) the debtor has committed any act specified in paragraph (2), (3), (4), (5), or (6) of this subsection, on or within one year before the date of the filing of the petition, or during the case, in connection with another case concerning an insider;

(8) the debtor has been granted a discharge under this section, under section 1141 of this title, or under section 14,371 or 476 of the Bankruptcy Act, in a case commenced within six years before the date of the filing of the petition;

(9) the debtor has been granted a discharge under section 1328 of this title, or under section 660 or 661 of the Bankruptcy Act, in a case commenced within six years before the date of the filing of the petition, unless payments under the plan in such case totaled at least—

(A) 100 percent of the allowed unsecured claims in such case; or

(B)(i) 70 percent of such claims; and

(ii) the plan was proposed by the debtor in good faith, and was the debtor's best effort.

39. Most exceptions to discharge listed in the Code parallel those allowed under the Act, but the Code narrows the Act's total barriers to discharge, inasmuch as it permits the broadest possible relief in a bankruptcy case. H.R. REP. NO. 595, 95th Cong., 1st Sess. 309 (1977). Specifically, the concept of provability, a central provision of the Act, has been abolished. Section 523 now requires that for an exception to prevail, the reliance of the creditor on a false financial statement must have been reasonable. That provision codifies case law construing section 17(a)(2) of the Act of 1898. S. REP. NO. 989, 95th Cong., 2d Sess. 78 (1978); S. REP. NO. 598, 95th Cong., 2d Sess. 77-79 (1978). See *infra* notes 90 to 123 and accompanying text for review of *In re Krepes* and the meaning of reasonable. Cases related to discharge which are considered in this article all stem from chapter 7 proceedings. Chapter 13 requirements for discharge vary considerably in that a section 1328(a) discharge does not provide for all of the exceptions from discharge that are set out in section 523. Chapter 13 debtors may also be granted a "hardship" discharge under section

ruptcy law, whether in a straight bankruptcy proceeding under Chapter 7, or in a rehabilitation proceeding under Chapter 13.<sup>40</sup>

The largest creditor and the trustee of the estate, appellants in *Martin*, contended that the debtor, Ronald Martin, had an interest in a condominium occupied by the debtor, but asserted by him to be the property of his father, Alex Martin.<sup>41</sup> As testified to during the trial, the condominium was purchased in 1976 for \$67,500, of which \$15,000 was a cash down payment, and the balance from the proceeds of a mortgage loan. The note on the mortgage loan was signed by both the debtor's parents, and title was held by a Chicago bank under a land trust with the debtor's father as beneficial owner. However, it was undisputed that the debtor lived in the condominium, paid all expenses connected with it, including the mortgage, deducted the interest payments on his own federal income tax returns, and generally enjoyed the benefits of ownership.<sup>42</sup>

At the heart of the dispute was the ultimate source of the \$15,000 down payment. While the debtor claimed that the funds used were given to him by his father, a statement corroborated by the testimony of the father, the appellants asserted that the funds were in fact Ronald's. The appellants claimed there was a "secret"<sup>43</sup> agreement between Ronald and his father that the parents would hold the property as nominees for their son.<sup>44</sup> The bankruptcy court found there was no credible proof that the debtor did not provide the \$15,000 for the down payment on the condominium.<sup>45</sup> Neither was there a question of the debtor's insolvency at the time of the purchase, since Ronald's income was found at that time to be over \$100,000 a year, while his father's

1328(b), but that discharge is not as comprehensive as that obtained under section 1328(a). A "hardship" discharge is limited by all of the section 523(a) exceptions to discharge. 11 U.S.C. § 1328(c) (1982). Further discussion of chapter 13 discharge is not within the scope of this article.

40. Chapter 13 provides persons with a regular income an opportunity to reschedule the payment of their debts, rather than liquidating the estate and discharging the debtor as provided for in Chapter 7. Chapter 13 plans are subject to court approval and must be proposed in good faith. The repayment plans range from 10% to 100% of the amounts owed. After repayment according to the plan, the debtor receives a discharge. 11 U.S.C. §§ 1301-1307 (1982).

41. 698 F.2d at 885.

42. *Id.*

43. In fact, no place in their brief do appellants explicitly state that a secret agreement existed. That may only be inferred from the allegations that the debtor and his father "attempte[d] to conceal the true ownership of the condominium." Brief for Appellants, at 19, *In re Martin*, 698 F.2d 883 (7th Cir. 1983).

Appellants state that it was the bankruptcy court which specifically "suggested" "that a . . . possible explanation for [the concealment] was that there was a secret agreement between Alex and Ronald for Alex to hold the property in a land trust as a nominee for Ronald." *Id.* at 885.

44. 698 F.2d at 885.

45. *Id.*

income was only about \$6,000 a year.<sup>46</sup> In spite of these findings, the bankruptcy court granted the debtor a discharge. Moreover, the discharge was granted in spite of the fact that: “[s]eldom has this court observed witnesses whose credibility was lower. It was not so much that they appeared to be lying as it was that they seemed indifferent to the truth.”<sup>47</sup>

The Seventh Circuit reiterated the well-established rule of law that findings of fact made in a bankruptcy proceeding will be set aside only if clearly erroneous.<sup>48</sup> It observed further that due to a lack of documentary evidence, it has been necessary to reconstruct the relevant events and transactions mostly from oral evidence.<sup>49</sup> Consequently, the Seventh Circuit found that the bankruptcy judge’s assessment of the debtor’s credibility, which certainly was critical in this case, was not replicable on appeal. The court agreed with the bankruptcy judge that the source of the funds used to buy the condominium was indeed the debtor’s.<sup>50</sup>

The Seventh Circuit determined, however, that the lower court had erroneously interpreted the burden of proof requirements and that there were “at least two independent grounds upon which a discharge must be denied to the debtor.”<sup>51</sup> The court then reversed and remanded, noting that the case could be reopened for receipt of additional evidence at the discretion of the bankruptcy court.<sup>52</sup>

The two independent grounds for discharge relied upon by the court were section 727(a)(5) of the Code which was cited as the primary ground upon which to deny discharge, and section 727(a)(3). Section 727(a)(5) provides that a discharge shall be denied when “the debtor has failed to explain satisfactorily, . . . any loss of assets or deficiency of assets to meet the debtor’s liabilities.”<sup>53</sup> Noting that this section is basically indistinguishable from section 14(c)(7) of the Act, the court recognized that a discharge will be denied unless the debtor sufficiently persuades the court of the debtor’s good faith. The court cited cases

46. *Id.*

47. *In re Martin*, 13 Bankr. 883, 884 (Bankr. N.D. Ill. 1981).

48. BANK. RULE 810. Cases construing that rule have held that before a judge’s order may be reversed, the court must find that no testimony exists for the support of his order, or that he has acted arbitrarily and capriciously. *In re Knight*, 421 F. Supp. 1387 (M.D. La. 1976), *aff’d*, 551 F.2d 862 (5th Cir. 1977); *Wright v. Lubinko*, 515 F.2d 260 (9th Cir. 1975); *In re Dolnick*, 374 F. Supp. 84 (N.D. Ill. 1974); *Carini v. Matera*, 592 F.2d 378 (7th Cir. 1979).

49. 698 F.2d at 885-86.

50. *Id.* at 886.

51. *Id.*

52. 698 F.2d at 888.

53. 11 U.S.C. § 727(a)(5) (1982).

decided under the Act and under the Code,<sup>54</sup> and noted its broad power to decline discharge when the bankrupt's explanation of loss or disappearance of assets consisted of nothing more than ". . . a vague, indefinite, and uncorroborated hodgepodge of financial transactions."<sup>55</sup>

Expressing its displeasure at the fact that the debtor made virtually no attempt to adequately pinpoint the source of the funds which facilitated his purchase, the court observed that the debtor had mistakenly relied on the notion that the creditors had not made out a prima facie case under their complaint.<sup>56</sup> However, the court concluded that the creditors had indeed presented sufficient evidence to more than satisfy their burden of proof under section 727(a)(5),<sup>57</sup> and held that, given the debtor's failure, in turn, to meet his burden of proof, the discharge should not have been granted.

Such a finding was diametrically opposed to the finding of the bankruptcy court. That court had established that a prima facie showing of a secret agreement between the debtor and his father concerning the ownership of the condominium, which would have satisfied the creditor's burden of first going forward with the evidence, had not been made. Thus, while there was no substantial credible evidence to rebut a prima facie showing of an agreement, it was in any event unnecessary, for "the influence of a secret agreement [between the two was] no stronger than the inference of a gift."<sup>58</sup>

54. *Baum v. Milliken, Inc.*, 359 F.2d 811 (7th Cir. 1966) (in which the court upheld the bankruptcy referee's denial of a discharge on the basis that the debtor had failed to adequately explain the shrinkage in his assets in the 21-month period prior to filing for bankruptcy); *McBee v. Sliman*, 512 F.2d 504 (5th Cir. 1975) (fact that husband asserted lack of legal title to wife's monies, which he allegedly took without her knowledge and lost in gambling spree, did not relieve him of responsibility of accounting for those monies, and wife was therefore, denied discharge); *In re Kapsos*, 16 Bankr. 280 (Bankr. S.D. Fla. 1981) (discharge denied on grounds that debtors had deliberately concealed material items of property within one year before bankruptcy and after filing of petition, had failed to explain satisfactorily loss of their assets); *In re Emmett*, 16 Bankr. 656 (Bankr. S.D. Fla. 1981) (transfer by debtor of all his property into his daughter's name prior to declaration of bankruptcy is sufficient evidence for court to deny discharge based on transfers made without consideration, with requisite intent to hinder, delay or defraud creditors of the estate, with failure to keep or preserve recorded relevant information and failure to reveal existence of certain assets in his schedules).

55. 698 F.2d at 886, citing *Baum v. Milliken, Inc.*, 359 F.2d at 814.

56. 698 F.2d at 886. The debtor had made almost no effort to explain the transaction in question, even to the satisfaction of the bankruptcy court. In fact, he presented no evidence after the creditors had put on their case in chief.

57. *Id.* The Seventh Circuit appeared to take the bankruptcy court to task for its seemingly incongruous holding—on the one hand finding that the money used to purchase the condominium was indeed Ronald Martin's, but speculating on the other hand in spite of Ronald Martin's persistent declarations that he received the money from his father, that the condominium was possibly intended as a gift from the younger Martin to his father.

58. *In re Martin*, 13 Bankr. 883, 886 (Bankr. N.D. Ill. 1981), *rev.*, 698 F.2d 883 (7th Cir. 1983).

The Seventh Circuit also looked to section 727(a)(3) as a second independent ground on which to deny the discharge to the debtor.<sup>59</sup> Under that section, discharge is denied when:

the debtor has concealed, destroyed, mutilated, falsified, or failed to keep or preserve any recorded information, including books, documents, records, and papers, from which the debtor's financial condition or business transactions might be ascertained, unless such act or failure to act was justified under all of the circumstances of the case.<sup>60</sup>

General principles underlying former section 14(c)(2)<sup>61</sup> of the Act also apply to section 727(a)(3) of the Code.<sup>62</sup> Bankruptcy courts have long noted that the granting of a discharge is precluded in any case where complete disclosure is lacking and the court doubts the debtor's good faith.<sup>63</sup> While a court will employ the standard of what is reasonable under the circumstances,<sup>64</sup> it will nevertheless require "that there be available written evidence made and preserved from which the present financial condition of the bankrupt, and his business transactions for a reasonable period in the past may be ascertained."<sup>65</sup> Such records are necessary in order to determine the accuracy of the debtor's status as he portrays it to the court.<sup>66</sup> The Seventh Circuit had already recognized in passing that there was a lack of documentary evidence outside the courtroom with which to support a finding as to the source of the funds used for the down payment on the condominium.<sup>67</sup> It is precisely such a lack of documentation or absence of recordkeeping which amounts to the failure to which section 727(a)(3) applies.<sup>68</sup>

However, under the Act, all cases decided under section 14(c)(2) specifically referred to the conditions of recordkeeping imposed by that section.<sup>69</sup> The Seventh Circuit failed to discuss these requirements, and described the grounds controlling the denial of a discharge under sec-

59. 698 F.2d at 887.

60. 11 U.S.C. § 727(a)(3) (1982).

61. See *Matter of Underhill*, 82 F.2d 258 (2d Cir. 1936).

62. 4 COLLIER ON BANKRUPTCY ¶ 727.03[3] (15th ed. 1984).

63. *In re Underhill*, 82 F.2d 258, 260 (2d Cir. 1936).

64. *Id.* at 260.

65. *Id.*

66. *Id.*

67. 698 F.2d at 886.

68. COHEN, BANKRUPTCY, SECURED TRANSACTIONS AND OTHER DEBTOR-CREDITOR MATTERS at 189 (1981).

69. There have, at the time of writing, been no cases decided by other circuits in which a denial of discharge was considered under section 727(a)(3). For a discussion of cases decided under the Act involving a denial of discharge due to a failure to keep or preserve books or records, see 4 COLLIER ON BANKRUPTCY ¶ 727.03[3] (15th ed. 1984).

tion 727(a)(3) as simply “a continuing concealment of assets.”<sup>70</sup> This appears to be a departure from the grounds for discharge under that section, inasmuch as the legislature clearly intended to retain the requirements related to bookkeeping originally specified under the Act.<sup>71</sup> Indeed, mere continuing concealment of assets as an objection to discharge which the Seventh Circuit here has ascribed to subsection (a)(3), falls within section 727(a)(2)<sup>72</sup> of the Code. Although the principal element under section 727(a)(2) is that the debtor’s fraudulent transfer or concealment of assets occur within one year before the date of the filing of the petition,<sup>73</sup> some courts found the corresponding section under the Act controlling when it was shown that although the Act complained of was done prior to the statutory period, it in effect operated as a continuing concealment.<sup>74</sup>

No justification is given by the Seventh Circuit for its failure to articulate the requirements of section 727(a)(3).<sup>75</sup> Conceivably, the court could have applied the reasoning of *In re Groth*,<sup>76</sup> which in dicta supported the concept that a concealment which would prevent discharge may occur more than one year prior to the declaration of bankruptcy.

Without making any reference to the debtor’s failure to comply with section 727(a)(3)’s recordkeeping requirements, the Seventh Circuit found that section applicable in *Martin* strictly on the basis of a continuing concealment of assets. As with the first ground, the Seventh Circuit found it appropriate to analyze the application of this section in terms of the burden of proof requirements provided for in Bankruptcy

70. 698 F.2d at 887.

71. H.R. REP. NO. 595, 95th Cong., 1st Sess. 384 (1977); S. REP. NO. 989, 95th Cong., 2d Sess. 98 (1978).

72. 11 U.S.C. § 727(a)(2) (1982).

73. *Id.*

74. *In re Groth*, 36 F.2d 41 (7th Cir. 1929). In *Groth*, the court considered whether there had been an intent to conceal assets and defraud creditors. The debtor had sold his personal property and purchasing interest in his home, but continued to occupy it with his family as a homestead for over a year before filing a voluntary petition. The court stated:

much stress was laid upon the fact that the acts complained of occurred more than a year prior to the date of bankruptcy proceedings. But if these acts had as their purpose the concealment of assets of the [debtor], which concealment continued during the period when these proceedings in bankruptcy were contemplated, the lapse of a year would not prevent such concealment from coming within the condemnation of the statute.

*Id.* at 42.

75. The court referred to the fact that appellants themselves sought a denial of discharge under § 727(a)(3), “the claim most strongly pressed by the appellants [in that] the purchase, and subsequent ownership status of the condominium constituted such a continuing concealment of the debtor’s assets.” 698 F.2d at 887.

76. *See supra* note 74.



Rule 407.<sup>77</sup> Repeating its rejection of the lower court's burden of proof analysis, the Seventh Circuit merely served to confuse the issue further by discussing the burden of proof requirements in general terms, without specifically relating them to section 727(a)(3). The court's analysis thus lacked a suitable explanation of why it did not find it necessary to question in particular whether there had been a disappearance or concealment of records or books relating to the debtor's assets. Specifically, the court found that the creditors had satisfied their burden of first going forward with the evidence by proving "a transfer of funds by the debtor, with a continuous subsequent use by the debtor of the property acquired with [those] funds."<sup>78</sup> Consequently, "the burden thereafter of producing additional evidence was shifted to the debtor."<sup>79</sup> Nowhere, however, does the Seventh Circuit mention the section 727(a)(3) requirement that the creditor prove the debtor had "destroyed, mutilated, falsified, or failed to keep or preserve any recorded information. . .from which the debtor's financial condition. . .might be ascertained."<sup>80</sup> The court found instead that since the burden of coming forward with additional evidence had shifted to the debtor, the debtor was obliged to provide "an explanation of his actions."<sup>81</sup> The court found that such an explanation, geared solely towards a transfer of funds and continuous use of the concealed property, would be a sufficient explanation under section 727(a)(3).<sup>82</sup> However, the issues of fund transfers and concealment of assets are more properly objected to under section 727(a)(2).

During the 82-83 term, the Seventh Circuit displayed its sensitivity

77. Rule 407 provides that "[a]t the trial on a complaint objecting to a discharge, the plaintiff has the burden of proving the facts essential to his objection." However, if it appears that the debtor is more likely to have access to evidence tending to prove certain facts, then the court may impose upon the debtor the burden of going forward with evidence relating to those facts. See Notes of Advisory Committee on Rules, Bankr. Rule 407. Initially, however, the plaintiff is required to go beyond a mere showing of "reasonable grounds," as had been previously required prior to the enactment of Rule 407, when the burden of proof as to specific actions of objection had been governed by section 14(c) of the Act. Under Rule 407, the plaintiff must "adduce proof of the facts which will establish that the debtor has committed the act charged before the burden of going forward with the evidence will shift to the debtor. The debtor can meet the burden either by disproving the act charged or, by resort to justification clause in section 727(a)(3), the debtor could satisfy the court that the actions or failure established by the plaintiff were justified under all the circumstances of the case." 4 COLLIER ON BANKRUPTCY ¶ 727.03[4], at 727-45 (15th ed. 1984).

78. 698 F.2d at 887.

79. *Id.*

80. 11 U.S.C. § 727 (a)(3) (1982).

81. 698 F.2d at 888.

82. Despite their failure to keep records, the appellants were able to reconstruct, with apparent accuracy, the transfer of all those funds in order to prove to the Seventh Circuit's satisfaction the debtor's interest in the condominium. Brief for Appellant, *In re Martin*, at 8-12.

to the policy issues underlying the Code in *Rassi* and *Carbide Cutoff*.<sup>83</sup> Conversely, this sensitivity is lacking in *Martin*. Perhaps the court's seeming indifference to the finer points of distinction within section 727 is explained by the court's statement that "[i]t is clearly unsatisfactory to grant the debtor a discharge in a case such as this, where the debtor 'stonewalls' the creditor and refuses to credibly explain to the court his puzzling or suspect transactions."<sup>84</sup>

The court equated the failure of the debtor to come forward with an explanation of his actions, once the burden of going forward with the evidence had shifted upon his shoulders, with the requirement of recordkeeping enumerated under section 727(a)(3). Unfortunately, the court did not expressly note that it was making that connection, or for that matter, define where the connection was between section 727(a)(3) and a mere continuing concealment of assets.

The Seventh Circuit's analysis is thus not specifically articulated in the concrete terms of section 727(a)(3); it would appear that the court expects the section to be read between the lines in order to support a denial of discharge.

The Seventh Circuit also considered cases arising under section 523(a)(2),<sup>85</sup> which enumerates debts not included in section 727(a)'s general grant of discharge.

In *In re Kreps*,<sup>86</sup> the court resolved whether reasonable reliance is to be interpreted under section 523(a)(2)(B)<sup>87</sup> of the Code in the same way the courts interpreted reasonable reliance under section 17(a)(2) of the Act.<sup>88</sup> Section 523(a)(2)(B) precludes the discharge of any debt incurred through the use of a materially false written statement about the debtor's financial condition, on which the creditor has *reasonably relied*, and which was made by the debtor with an intent to deceive.<sup>89</sup> The element of reasonableness as a factor in establishing reliance by the debtor constitutes the principal difference between the corresponding sections under the Act and the Code. Section 17(a)(2) required only a showing of reliance in fact and precluded discharge of debts incurred through "a renewal of credit in reliance upon a materially false statement in writing respecting [a debtor's] financial condition

83. See *supra* notes 3-31 and accompanying text.

84. 698 F.2d at 888.

85. 11 U.S.C. § 523(a)(2) (1982).

86. 700 F.2d 372 (7th Cir. 1983).

87. 11 U.S.C. § 523(a)(2)(B) (1982).

88. 11 U.S.C. § 35(a)(2) (1976).

89. 11 U.S.C. § 523(a)(2)(B) (1982).

made with. . . intent to deceive. . ."<sup>90</sup> Later development of case law, however, ostensibly established a requirement of reasonable reliance.<sup>91</sup> Thus, the inclusion of reasonableness as a criterion for reliance under section 523(a)(2)(B)(iii) explicitly reflected congressional intent to codify "case law construing [section 17(a)(2)]."<sup>92</sup>

*In re Kreps* was heard on appeal from a judgment of the district court, which had affirmed a bankruptcy court order granting a discharge to the debtors, Orrin and Margaret Kreps. It was the Seventh Circuit's first opportunity to interpret section 523(a)(2)(B)(iii) of the Code.<sup>93</sup> The creditor, First National Bank of Lansing, had objected to the discharge. Kreps and the bank had had a lending relationship for fifteen years.<sup>94</sup> At all times, Kreps had dealt directly with the bank's president, Gilbert J. Rynberk.<sup>95</sup> While earlier loans were made for Kreps' home construction business, the loan at issue involved a 90-day \$32,000 unsecured personal loan to Kreps.<sup>96</sup> When the note for this loan came due, Kreps sought and received a renewal of the loan. On a second 90-day renewal, Rynberk prepared, and Kreps signed, a list of Kreps' assets. It was undisputed at trial that this statement contained materially false information.<sup>97</sup> Shortly after the bank had renewed the loan a second time, Kreps filed a petition for bankruptcy.<sup>98</sup>

The bankruptcy court found that, while the written statement concerning Kreps' financial condition signed by Kreps for the purpose of obtaining the second renewal was materially false and was made with an intent to deceive, the First National Bank had not relied upon the statement in renewing the loan.<sup>99</sup> Rather, the court found that the re-

90. *In re Garman*, 625 F.2d 755, 761 (7th Cir. 1980), *republished at* 693 F.2d 1252 (7th Cir. 1980), to accurately reflect the representation of counsel.

91. *Id.* at 759. *See also In re Matera*, 592 F.2d 378 (7th Cir. 1979) (for a debt to be nondischargeable in bankruptcy on the ground that it was induced by false representations, it must be found that the creditor actually relied upon the representation and that such reliance was reasonable); *In re Knight*, 421 F. Supp. 1387 (M.D. La. 1976) *aff'd*, 551 F.2d 861 (5th Cir. 1977) (creditor had relied as much, if not more on the debtor's good "track record" and not on the fraudulent financial statement, and therefore reliance was not reasonable); *In re Smith*, 424 F. Supp. 858 (M.D. La. 1976) (creditor's reliance unreasonable). The court rejected the contention that "mere reliance upon the misrepresentations is the test to apply in determining the dischargeability of the bankrupt's debt." *Id.* at 861. *In re Adams*, 368 F. Supp. 80 (D.S.D. 1973) (lack of reasonableness in creditor's reliance implicit in court's finding that reliance was unjustified).

92. H.R. REP. NO. 595, 95th Cong., 1st Sess. 364 (1977); S. REP. NO. 984, 95th Cong., 2d Sess. 77-79 (1978).

93. 700 F.2d 372, 373 (7th Cir. 1983).

94. *Id.* at 373.

95. *Id.*

96. *Id.* at 373-74.

97. *Id.* at 374.

98. *Id.*

99. *Id.*

newal was induced by the bank's excellent 15-year loan experience with the debtor.<sup>100</sup> The bankruptcy court subsequently ruled that its finding of no reliance was a finding of fact and not of law because the execution of a financial statement is not an indication that the creditor relied on the statement when granting the loan. In alleging reliance, the creditor as plaintiff must make an affirmative showing of such reliance. The court found that ". . .the plaintiff had the burden of proof in regard to the reliance issue" and that it failed to meet this burden.<sup>101</sup>

The Seventh Circuit then considered two separate issues on appeal: first, whether the bankruptcy court applied the correct legal standard,<sup>102</sup> and second, whether the bankruptcy court's fact findings were clearly erroneous.<sup>103</sup>

The Seventh Circuit first recongnized that a two-part standard developed under the Act, and codified into law under the Code, was applicable in interpreting section 523(a)(2).<sup>104</sup> Not only might actual reliance be proven by circumstantial evidence of reliance,<sup>105</sup> but the actual reliance must also be reasonable.<sup>106</sup> Mindful of its decision in *In re Garman*,<sup>107</sup> the court reiterated that "this second aspect of the section 17(a)(2) reliance test is not meant as an invitation to second guess a creditor's decision to make a loan or to set loan policy for the creditor."<sup>108</sup> The court also noted that section 17(a)(2) did not permit the court to "undertake a subjective evaluation and judgment of a creditor's lending policies and practices."<sup>109</sup> *Garman* had made clear that a creditor need only establish its reliance in fact for the reviewing court to find that the reliance was reasonable.<sup>110</sup>

In the *Kreps* appeal, the appellant bank asserted that the bankruptcy court had applied an erroneous legal standard when it construed this circuit's interpretation of reasonable reliance in *Garman*.<sup>111</sup> The Seventh Circuit rejected this argument, for it found that the bankruptcy court had never even considered whether the creditor's reliance had

100. *Id.*

101. *Id.* at 375.

102. 700 F.2d at 373.

103. *Id.*

104. *Id.* at 375.

105. *In re Garman*, 625 F.2d 755, 759 (7th Cir. 1980), *republished* at 643 F.2d 1252 (7th Cir. 1980).

106. *In re Matera*, 592 F.2d 378, 381 (7th Cir. 1981).

107. *See supra* note 105.

108. 700 F.2d at 375 (quoting *In re Garman*, 625 F.2d at 761).

109. 700 F.2d at 376 (citing *In re Garman*, 625 F.2d at 759).

110. 625 F.2d at 759.

111. 700 F.2d at 376.

been reasonable. The lower court had held that a determination of reasonableness had been unnecessary, because it had found that there was no reliance at all.<sup>112</sup> Ignoring the *Garman* court's agreement with prior case law that reasonableness is simply "circumstantial evidence of actual reliance,"<sup>113</sup> the bankruptcy court had instead established as a finding of fact that the creditor had not actually relied upon the false statement when receiving the loan.

The Seventh Circuit found that the bankruptcy court's ruling of non-reliance was clearly erroneous. The court rejected the bankruptcy court's reasoning that the creditor, as plaintiff, had failed to sustain its burden of proving the element of actual reliance. Unquestionably, the burden of proving each element, including reasonable reliance, lies with the creditor.<sup>114</sup> However, the Seventh Circuit found that the creditor's increased vigilance in demanding the statement, as well as its subsequent assertion that it would not have granted the renewal request without the debtor's statement, was sufficient "important circumstantial evidence of actual reliance."<sup>115</sup> The Seventh Circuit found, therefore, that the lower court's findings of fact were erroneous. The court reversed and remanded, but concluded that it was unnecessary to litigate any further on the reasonableness of the bank's reliance.<sup>116</sup> The court followed its reasoning in *Garman*,<sup>117</sup> i.e., that it was not the responsibility of the court to determine whether the creditor was reasonable in relying on the false statement. Rather, the court's responsibility was to decide whether the creditor had reasonably relied on the statement itself. Thus, once the creditor has met his burden of proof in showing actual reliance, unless there is a showing that it was so unreasonable for the creditor to rely, a finding of reasonable reliance is almost guaranteed. In *Kreps*, the Seventh Circuit was satisfied that the creditor's burden of proof had been met.

Results of future litigation relating to section 523(a)(2)(B)(iii), at least within this circuit, are therefore clearly dependent upon the *Gar-*

112. *Id.*

113. 625 F.2d at 759.

114. 700 F.2d at 376; *See also In re Taylor*, 514 F.2d 1370, 1373 (9th Cir. 1975).

115. 700 F.2d at 376.

116. *Id.*

117. 625 F.2d at 759. The *Garman* court reviewed cases which either stated directly that dischargeability shall not be denied when a creditor's claimed reliance on a financial statement would be so unreasonable as not to be actual reliance at all, or when the lack of actual reliance was implicit in the record. *See In re Smith*, 424 F. Supp. 858 (M.D. La. 1976); *In re Adams*, 368 F. Supp. 80 (D.S.D. 1973); *Sweet v. Ritter Finance Co.*, 263 F. Supp. 540 (W.D. Va. 1967); *In re Arden*, 2 Bankr. Ct. Dec. 204 (D.R.I. 1975); *Cash Finance Service, Inc. v. Haisch*, 173 So. 2d 851 (La. App. 1965); *In re Ducote*, 4 Bankr. Ct. Dec. 943 (W.D. La. 1978).

*man* test: reliance will be deemed reasonable when the creditor has established actual reliance in fact.<sup>118</sup> A finding of reasonable reliance will be disallowed only when the evidence is blatantly inapposite to a showing of any reliance at all.<sup>119</sup>

The Seventh Circuit's decision to construe section 523(a)(2)(B) in the light of *Garman* is certain to be criticized. While Congress arguably did not intend to add to the creditor's burden in proving nondischargeability of individual debts, at the same time had it intended that the creditor's reliance be only reliance in fact, such an intent would reduce the element of reasonableness to a meaningless appendage of that section. This could hardly have been the desired result. The better view would be for the courts, in ascertaining congressional purposes underlying section 523(a)(2)(B)(iii), to "attempt to strike a balance between the legitimate competing interests of creditors seeking to establish exceptions and debtors seeking discharge within the statutory framework."<sup>120</sup> In doing so, courts should judge each case upon its particular set of facts to determine whether the creditor's reliance was indeed reasonable.

#### AUTOMATIC STAY—*PITTS V. UNARCO INDUSTRIES*

The concept of automatic stay, which provides that once a debtor has filed a petition in bankruptcy, all proceedings in other courts are "stayed" has traditionally been a concept central to bankruptcy law. Although stays were granted judicially under earlier law, they were not statutorily provided for.<sup>121</sup> Conversely, the Code has codified the automatic stay concept.<sup>122</sup> The substance of the stay provisions is to stay pending proceedings, or the filing of new proceedings, during a bankruptcy action.

118. 625 F.2d at 761.

119. *Id.* at 763.

120. *In re Patch*, 24 Bankr. 563, 567 (D. Md. 1982). The *Patch* court distinguished *Garman* and provided a standard against which the reasonableness of a creditor's reliance on a financial statement should be judged: The creditor's actual conduct is compared with

(1) the creditor's own normal business practices, and (2) the standard and custom of the industry, (3) in light of the surrounding circumstances existing at the time the application was made and credit extended.

*Id.* at 566-67.

121. Under the Act, there was no comprehensive stay provision. However, there were provisions scattered throughout the act which stayed certain actions against the debtor once a bankruptcy proceeding had been filed. Those provisions were frequently created by the Supreme Court pursuant to its rulemaking power. *See, e.g.*, BANKR. RULES 401, 601, BANKR. RULE APP. §§ 8-501, 9-4, 10-601, 11-44, 12-43 and 13-401.

122. 11 U.S.C. § 362(a) (1982).

The Seventh Circuit, in *Pitts v. Unarco Industries*,<sup>123</sup> addressed the question of whether filing a petition for reorganization under Chapter 11 of the Code stays pending proceedings as to all parties involved, or only as to the debtor.

Prior to Unarco's filing for reorganization, asbestos litigation was pending in other courts. Defendants in that litigation were many manufacturers of asbestos, including Unarco.<sup>124</sup> Subsequent to judgment against the defendants, and during the pendency of appeal in that case, Unarco filed its Chapter 11 petition. That the asbestos litigation was stayed as to Unarco was undisputed. However, Armstrong World Industries argued that as a co-defendant, the asbestos litigation was stayed also as to Armstrong during the term of Unarco's reorganization.<sup>125</sup> The Seventh Circuit, however, held that section 362(a)(1) of the Code extended the automatic stay provisions only to the debtor and to no co-defendants.<sup>126</sup> Noting the contrast between the statutory language of 362(a)(1) and the automatic stay provisions applicable to Chapter 13 proceedings,<sup>127</sup> the court found crucial the fact that co-debtors were not mentioned in the stay provisions germane to Chapter 11 proceedings.<sup>128</sup> It virtually adopted the district court's opinion in *Royal Truck & Trailer v. Amadora Martina Salvadorean*.<sup>129</sup>

123. 698 F.2d 313 (7th Cir. 1983).

124. The entire problem of chapter 11 reorganizations by asbestos manufacturers is beyond the scope of this article. However, at the time the John-Manville reorganization was filed, 17,000 suits were pending. In fact, lobbyists for Manville Corporation and 12 other asbestos manufacturers have drafted legislation to establish a fund for dispensing awards to asbestos victims. Efron, *Asbestos Firms Draft Bill to End Litigation*, Chicago Daily Law Bulletin, Feb. 2, 1984, at 1, col 3.

125. The automatic stay terminates in 30 days unless the debtor attempts to extend it, or upon the entry of a discharge. In the event of a liquidation, the stay terminates quite quickly. On the other hand, chapter 11 reorganization plans frequently span several years and a discharge is not entered until the completion of the plan. Therefore, the litigation against the asbestos manufacturers would remain "in limbo" for some time.

126. "[W]e agree with the *Royal Truck* court's conclusion that the automatic stay provisions of section 362(a) operate only in favor of the bankrupt debtor . . ." 698 F.2d at 315.

127. Section 1301 governs stay in chapter 13 proceedings. Subparagraph (a) provides:

(a) Except as provided in subsections (b) and (c) of this section, after the order for relief under this chapter, a creditor may not act, or commence or continue any civil action, to collect all or any part of a consumer debt of the debtor from any individual that is liable on such debt with the debtor, or that secured such debt, unless—

(1) such individual became liable on or secured such debt in the ordinary course of such individual's business; or

(2) the case is closed, dismissed, or converted to a case under chapter 7 or 11 of this title.

11 U.S.C. § 1301(a) (1982).

The purpose of including co-debtors in the stay under chapter 13 was to insulate the debtor from "indirect pressure" from his creditors exerted through friends or relatives that may have cosigned an obligation of the debtor. Notes of Committee on the Judiciary, H.R. REP. NO. 595, 95th Cong., 1st Sess. 121 (1977).

128. 698 F.2d at 314.

129. 10 Bankr. 488 (N.D. Ill. 1981).

In *Royal Truck*, the district court relied upon legislative history and the clear language of the section to summarily determine that the automatic stay operated only as to the debtor in a Chapter 11 proceeding. Although the reasoning withstands scrutiny, the Seventh Circuit failed to note that *Pitts v. Unarco* presented a very different problem from *Royal Truck*. Whereas *Royal Truck* involved breach of lease claims,<sup>130</sup> *Unarco* involved products liability actions against many defendants.<sup>131</sup> Were the litigation allowed simply to proceed to judgment against the remaining defendants, the burden of any judgment would be shared by those remaining defendants as joint tortfeasors.<sup>132</sup> Although such a result may be perfectly defensible, it seems that the problem should at least have been noted. Although *Royal Truck* may have been a relatively easy case, *Pitts v. Unarco*, was not. The facts presented the Seventh Circuit with an opportunity to effectuate the policies underlying the Code, and define the relationship between bankruptcy law and all matters which effect a business during reorganization proceedings. While the *Pitts* result was correct, the Seventh Circuit apparently, in contrast to their reasoning in other decisions this term, opted for a mechanical operation of the clearcut rule, rather than even mentioning the difficulties inherent in the case before it. Although a contrary result would potentially have opened the door for abusive use of Chapter 11 reorganization, this was entirely ignored by the *Pitts* court. Once any defendant had filed a Chapter 11 proceeding, all other defendants to other litigation could claim the benefits of the stay provisions, effectively denying or delaying an avenue for relief to a plaintiff.<sup>133</sup>

130. In *Royal Truck*, the plaintiff leased trucks to one of the defendants, Armasal, who subsequently filed a petition for reorganization under chapter 11. Uiterwyk, guarantor of the lease and a general agent of Armasal, sought relief under the automatic stay. The court found that the stay operated only as to the debtor. *Id.*

131. The court cited *In re Related Asbestos Cases*, 23 Bankr. 523 (N.D. Cal. 1982) in which the district court wrestled with the problem presented by asbestos manufacturers filing for reorganization under chapter 11. The conclusions of the California court were similar to those reached by the Seventh Circuit. Since the Seventh Circuit decided *Pitts v. Unarco*, the Sixth Circuit has reached a similar result in *Lynch v. Johns-Manville Sales Corp.*, 710 F.2d 1194 (6th Cir. 1983). That case relied upon the same grounds for decision but explicitly discussed the problems involved in litigation against many defendants. Cases cited by the Sixth Circuit in *Lynch* illustrate that the same result has been reached by a majority of courts.

132. Joint tortfeasors are jointly and severally liable. All may be joined in the same action although each is liable for a plaintiff's entire damages. *See, e.g., Hess v. Gray*, 85 F.R.D. 15 (N.D. Ill. 1979); *Tcherepnin v. Franz*, 424 F. Supp. 778 (N.D. Ill. 1976), *aff'd*, 570 F.2d 187 (7th Cir.), *cert. denied sub. nom.* *Alton v. Berke*, 439 U.S. 876 (1978).

133. That problem was noted by the Sixth Circuit in *Lynch* in which the plaintiff's rights and avenues of redress weighed in the decision.



## FEES

Any fee or administrative expense award in a bankruptcy proceeding must be approved by the bankruptcy court.<sup>134</sup> Section 506(c)<sup>135</sup> of the Code provides for the recovery of fees. The Seventh Circuit reviewed two fee awards during the 82-83 term, one of which was pursuant to Truth in Lending Laws involved in a bankruptcy proceeding,<sup>136</sup> and hence beyond the scope of this article. The award involves recovery of fees by a trustee from a secured creditor and cannot be properly resolved by the clear language approach which the Seventh Circuit took.<sup>137</sup>

*In re Trim-X*<sup>138</sup> involved a Chapter 11 trustee's appeal of a fee award and recovery of expenses from a secured creditor upon the trustee's abandonment of property of the estate. Abandonment is governed by section 554 of the Code<sup>139</sup> which provides that after notice and hearing, a trustee may abandon any property which is burdensome or of inconsequential value to the estate. In *Trim-X*, the debtor owned assets in which a creditor had perfected security interest.<sup>140</sup> The trustee employed a security company to protect the assets which were located in a warehouse, and had those assets appraised. The appraisal indicated that their value was, in fact, less than the amount of the security interest. On December 20, 1979, the trustee sought, pursuant to section 554, to abandon the assets. On January 21, 1980, the creditor filed a

134. 11 U.S.C. § 503 (1982).

135. Section 506(c) provides:

The 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 U.S.C. § 506(c) (1982).

136. *In re Pine*, 705 F.2d 936 (7th Cir. 1983).

137. *In re Trim-X*, 695 F.2d 296 (7th Cir. 1983).

138. 695 F.2d 296 (7th Cir. 1983).

139. Section 554 of the Code provides:

(a) After notice and a hearing, the trustee may abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate.

(b) On request of a party in interest and after notice and a hearing, the court may order the trustee to abandon any property of the estate that is burdensome to the estate or that is of inconsequential value to the estate.

(c) Unless the court orders otherwise, any property that is scheduled under section 521(1) of this title and that is not administered before a case is closed under section 350 of this title is deemed abandoned.

(d) Unless the court orders otherwise, property of the estate that is not abandoned under subsection (a) or (b) of this section and that is not administered in the case remains property of the estate.

11 U.S.C. § 554 (1982).

140. The perfection of security interests are matters of state law and are governed by the provisions of Article 9 of the Uniform Commercial Code. *See, e.g.*, ILL. REV. STAT. ch. 26, §§ 9-101-9-507 (1981).

counter-claim. On February 1, 1980, the bankruptcy court ordered the trustee to abandon the assets. Thereafter, the secured creditor sold those assets for less than the amount of the secured claim. When the bankruptcy court held evidentiary hearings on the fee issue, the trustee claimed that he was entitled to recover the reasonable expenses incurred in preserving the assets from the date of his appointment until the date of the court's order of abandonment. The creditor objected and the bankruptcy court sharply limited the fees allowed. The district court affirmed the award as not clearly erroneous,<sup>141</sup> emphasizing the fact that the creditor's security interest exceeded the value of the collateral. In such a case, it suggested a bankruptcy court's fee award could never be set aside as too small.<sup>142</sup>

The Seventh Circuit held that the relative value of the assets and the secured claim are not determinative factors in the section 506(c) analysis however, and emphasized the express terms of the statute.<sup>143</sup> The court noted, but gave no credence to a clearly contrary Senate Report,<sup>144</sup> which stated that fees are recoverable only where the value of the property exceeds the amount of the security interest. Instead the court relied upon statements made when amendments to the section were introduced.<sup>145</sup> Those statements indicated that *anytime* a trustee or debtor in possession expended funds to preserve the secured creditor's collateral, all reasonable expenses are recoverable. The court's sympathies were clearly with the trustee, since the secured creditor had 'caused' the added expenditures. Although the language of the statute and its legislative history are not entirely clear, the court appears to have emphasized the "express terms of the statute".<sup>146</sup> The court later discussed factors<sup>147</sup> which demonstrate that it was properly concerned with balancing the principle that administrative expenses should be

141. 695 F.2d at 298 (7th Cir. 1982).

142. *Id.*

143. *Id.*

144. S. REP. NO. 989, 95th Cong., 1st Sess. 68 (1978).

145. Those statements provided that

[a]ny time the trustee or debtor in possession expends money to provide for the reasonable and necessary cost and expenses of preserving . . . a secured creditor's collateral, the trustee or debtor in possession is entitled to recover such expenses from the secured party or from the property securing an allowed secured claim held by such party.

124 CONG. REC. H11089 (Sept. 20, 1978), reprinted in U.S. CODE CONG. & AD. NEWS 6505, 6520 (statement of Sen. DeConcini).

146. The express terms have been considered by other courts as well. See *In re Hotel Associates, Inc.*, 6 Bankr. Rep. 108 (Bankr. E.D. Pa. 1980); *Equitable Loan & Sec. Co. v. Moss & Co.*, 125 F. 609 (5th Cir. 1903).

147. "[W]e conclude that the relative values of the assets and the secured claim are not determinative factors in the section 506(c) analysis in this case. Rather, the focus must be on the express terms of the statute." *In re Trim-X*, 695 F.2d at 299.

borne by the general creditors to entitle the secured creditor to the full value of his security if possible, unimpaired by the bankruptcy liquidations<sup>148</sup> with the policy that even a secured creditor should bear expenses which he caused. The court was properly concerned with expenses "caused" by the secured creditor for which the trustee requested reimbursement.<sup>149</sup> Thus, the *Trim-X* opinion properly discusses the factors which must be considered, but the actual holding relied upon the "clear language" of the statute. Clearly, policy considerations concerning trustee reimbursement should have been the articulated rationale for the holding.

### CONCLUSION

Development of substantive case law under the Code continues, even in the shadow of *Marathon*.<sup>150</sup> During the 82-83 term, the Seventh Circuit carefully avoided carelessly engrafting exceptions to the Code. Except for its decision in *Kreps*, the overall emphasis appears to have focused on construing the clear language of the statute, and, indeed the court made those references even in instances where the language was, in fact, less than clear. However, the court's decisions on dischargeability, the very heart of the Code, are clearly open to question. Additionally, the court declined to address the difficult policy questions involved in staying litigation as to co-defendants in asbestos litigation. Thus, during this past term, the Seventh Circuit rendered decisions which ranged from dubiously acceptable to solidly defensible.

148. The court first noted that the three elements of proof necessary for recovery under section 506(c) were that the expenses were necessary, benefited the secured creditor, and were reasonable. *Id.* The court further noted that, although administrative expenses were not usually charged against secured creditors, there had traditionally been an exception where expenses were incurred primarily for the benefit of the secured creditor or where those expenses had been caused by or consented to by the secured creditor. See 4B COLLIER ON BANKRUPTCY ¶ 70.99[6] (14th ed. 1978). The court seemed particularly persuaded by the fact that the secured creditor had, in failing to respond promptly to the motion to abandon, caused those expenses. The court relies heavily upon *In re Hotel Assoc.*, 6 Bankr. 108 (Bankr. E.D. Pa. 1980), in which the court entered an order stating prospectively that the chapter 11 trustee would be able to recover expenses under 506 (c) regardless of the worth of the property as related to the amount of the secured claim. *Id.*

149. See the discussion of "Allocation of Expenses". 4B COLLIER ON BANKRUPTCY ¶ 70.99[6] (14th ed. 1978).

150. *Northern Pipeline Construction Company v. Marathon Pipeline Co.*, 458 U.S. 50, *judgment stayed sub. nom. U.S. v. Marathon Pipeline Co.*, 459 U.S. 813 (1982).