Bankruptcy: The Development of Case Law under the New Code Begins

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On November 6, 1978, the Bankruptcy Reform Act of 1978, usually referred to as the Bankruptcy Code, was signed into law, superseding the Bankruptcy Act of 1898. The new law took effect on October 1, 1979, and governs all bankruptcy cases filed after that date.

The Seventh Circuit decided several cases during its 1981-1982 term which involve issues of substantive bankruptcy law. Appeals arising from bankruptcy cases filed prior to October 1, 1979 presented issues under the Bankruptcy Act, while appeals involving cases filed subsequent to October 1, 1979 were decided by the Seventh Circuit under the Bankruptcy Code. This article will survey four Seventh Circuit opinions, all decided under the Bankruptcy Code, which have significant impact upon the development of bankruptcy law. For the purposes of this article, the Bankruptcy Reform Act of 1978 shall be referred to as the Bankruptcy Code, and the Bankruptcy Act of 1898 as the Bankruptcy Act.

INVOLUNTARY CASES—In Re Covey

One of the significant changes effectuated by the Bankruptcy Code is the treatment of involuntary cases. The Bankruptcy Code has made it easier for creditors to force an individual or corporation into bankruptcy. "Acts of bankruptcy" have been eliminated from the Bankruptcy Code. The debtor's balance sheet insolvency is also no longer a relevant factor in the adjudication of an involuntary petition. Basically, petitioning creditors need only establish that the debtor is gener-

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2. For an excellent discussion of the contrast between involuntary bankruptcy under the Bankruptcy Act and Bankruptcy Code, see H. MILLER AND M. COOK, A PRACTICAL GUIDE TO THE BANKRUPTCY REFORM ACT, 62-89 (1981).
3. Section 3 of the Bankruptcy Act required an act of bankruptcy as a condition to involuntary relief. Petitioning creditors were required to prove that within four months prior to the filing of a petition, the debtor committed one of the six acts of bankruptcy set forth in section 3(a) of the Bankruptcy Act. See 1 COLLIER ON BANKRUPTCY, § 3.03, at 403-44 (14th ed. 1974).
4. Under sections 3(b), (c) and (d) of the Bankruptcy Act, the debtor could assert its solvency as a defense to an involuntary petition.
ally not paying its debts, or that within 120 days before the date of the filing of the petition, a custodian, receiver or agent was appointed or took possession of the debtor's property.\(^5\)

Three or more entities whose claims against the debtor are not contingent as to liability must join in an involuntary bankruptcy petition\(^6\) unless the debtor has fewer than twelve unsecured creditors, in which case the requisite number is reduced to one.\(^7\) The Bankruptcy Code further requires\(^8\) that petitioning creditors must have claims totaling in the aggregate at least $5,000 more than the value of any lien on property of the debtor securing such claims.\(^9\) Additional rules pertain to the commencement of involuntary cases against partnerships.\(^10\)

Since in the context of an involuntary bankruptcy case there is often little debate that the debtor is generally not paying its debts as they become due, the debtor against whom an involuntary bankruptcy petition has been commenced and who wishes to avoid bankruptcy is left to attack the qualifications of the petitioning creditors to initiate the involuntary case. In *In re Covey*,\(^11\) the Seventh Circuit was confronted with several such challenges in considering (1) whether creditors holding claims that are disputed by a bankruptcy debtor may, under section 303(b)(1) of the Bankruptcy Code,\(^12\) use such claims as the basis for an involuntary bankruptcy petition, and (2) whether disputed claims should, under section 303(h)(1),\(^13\) be considered in determining whether the debtor is generally paying its debts as they become due.\(^14\)

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8. Similar requirements under the Bankruptcy Act are set forth in section 59(b).
11. 650 F.2d 877 (7th Cir. 1981).
12. Section 303(b)(1) of the Bankruptcy Code provides:
An involuntary case is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title—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.

13. Section 303(h)(1) of the Bankruptcy Code provides:
If the petition is not timely controverted, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed. Otherwise, after trial, the court shall order relief against the debtor in an involuntary case under the chapter under which the petition was filed, only if—
(1) the debtor is generally not paying such debtor's debts as such debts become due.

14. The court in *Covey* also determined that the decision of a bankruptcy court whether to abstain from a properly filed bankruptcy petition is not reviewable. 650 F.2d at 878. Since the court's holding on this issue is clearly mandated by the literal language of section 305(c) of the
Royal and Norma Covey held a Dodge dealership which they operated as a partnership under the name "Covey Dodge" until November 7, 1979. Two months thereafter, Chrysler Credit Corporation commenced an involuntary bankruptcy petition against the Coveys in the Bankruptcy Court for the Central District of Illinois. Three months after the involuntary case was commenced, the Coveys filed a lawsuit against Chrysler Credit Corporation in the United States District Court alleging breach of contract and antitrust violations. Thereafter Chrysler Motors (as distinguished from Chrysler Credit Corporation), and Anderson Dodge, from whom the Coveys leased the automobile dealership property, intervened as petitioning creditors in the bankruptcy case. All but $500 of the claims of the three petitioning creditors were disputed by the Coveys.

The Coveys argued before the bankruptcy court that the involuntary petition should be dismissed because the claims of the petitioning creditors were disputed. The Coveys further argued that notwithstanding the above, the involuntary petition should be dismissed because they were under no obligation to pay disputed debts. The bankruptcy court found in favor of the petitioning creditors on both issues and entered an order for relief against the Coveys.

The decision of the bankruptcy court was affirmed by the district court in an unpublished opinion. In an opinion written by Judge Sprecher, the Seventh Circuit affirmed the decision of the bankruptcy and district courts. Acknowledging that the claim of Chrysler Credit Corporation was disputed in full, the Seventh Circuit nevertheless held that Chrysler Credit Corporation

Bankruptcy Code, this aspect of the Covey decision will not be discussed in this article. Section 305 of the Bankruptcy Code provides in pertinent part:

**Abstention**

(a) The court, after notice and a hearing, may dismiss a case under this title, or may suspend all proceedings in a case under this title, at any time if—

1. the interests of creditors and the debtor would be better served by such dismissal or suspension;

(c) An order under subsection (a) of this section dismissing a case or suspending all proceedings in a case, or a decision not so to dismiss or suspend, is not reviewable by appeal or otherwise.

15. Under section 303(c) of the Bankruptcy Code, a creditor may join an involuntary petition with the same effect as if such creditor were an original petitioning creditor.


17. Under 28 U.S.C. §§ 1334, 1408 (Supp. IV 1980), appeals from bankruptcy court decisions are taken to the district court of the judicial district in which the bankruptcy court is located, unless the circuit council of a circuit orders under 28 U.S.C. § 160 (Supp. IV 1980) that a panel of three bankruptcy judges be designated to hear such appeals. The Seventh Circuit does not utilize the appellate panel of bankruptcy judges. Appeals from orders of the district court reviewing bankruptcy court decisions are taken to the court of appeals.
was not disqualified from initiating a bankruptcy case against the Coveys. The court looked to the language of section 101(4)(A) of the Bankruptcy Code which defines "claim" as any "right to payment" whether "disputed" or "undisputed." Since section 303(b)(1) "gives the right to be a petitioning creditor to any holder of a claim except the holder of a claim contingent as to liability," the dispute regarding Chrysler Credit Corporation's claim was immaterial under section 101(4)(A) to the standing of Chrysler Credit Corporation to be a petitioning creditor. The Seventh Circuit expressly observed that its holding on this issue related only to the ability of creditors holding disputed claims to initiate an involuntary case, and had no bearing upon whether the claims of the petitioning creditors would ultimately be allowed in the ensuing bankruptcy case. The same analysis was applied by the court to the claims of Chrysler Motors and Anderson Dodge.

The Seventh Circuit next considered whether disputed debts must be excluded from the bankruptcy court's calculation of whether the debtors were generally paying their debts as such debts became due. The court considered this issue "a thorny one." On one hand the court noted, debtors should not, to avoid an involuntary petition in bankruptcy, be forced to pay disputed debts. However, the court recognized that "an important goal of the new Bankruptcy Code is to ensure prompt resolution of the question of whether a debtor is generally paying its debts in an initial proceeding, reserving the litigation of specific disputes and defenses for subsequent proceedings." As a method of resolving these conflicting policy considerations, the Seventh Circuit concluded that "there cannot be any absolute rule that disputed debts either should or should not be considered," and formulated instead a structured balancing test to be used in making the determination.

1. First, the bankruptcy courts must examine the nature of the dispute and determine if the dispute concerns the threshold question of whether any claim exists, or merely involves the amount of the claim. If the dispute is only as to the amount, the analysis

18. 650 F.2d at 881.
19. Id.
20. Id.
21. Id.
22. Id. at 882.
23. Id.
24. Id.
25. Id. at 883.
26. Id.
ends here, for the Seventh Circuit notes that there is no reason why claims disputed only as to amount should be excluded in determining whether the debtor is generally paying its debts as they become due.

2. Second, if the debt is disputed in full, the bankruptcy court must consider the complexity of the litigation required to resolve the dispute. If resolution of the dispute will require substantial litigation or if the substantial litigation question itself will require substantial litigation, the litigation should occur later in the case, and the disputed debt should be counted in determining whether the debtor is generally paying its debts as they become due.

3. Third, if resolution of the dispute will not require substantial litigation, bankruptcy courts must balance creditors' interests against those of the debtor. If the balance favors the debtor's interests in avoiding the involuntary bankruptcy, then the court should consider the dispute, and if the debtor prevails, the disputed debt should be excluded. If the interests of the petitioning creditors favor the prompt determination of the involuntary petition, the merits of the dispute should not be considered, and the disputed debts should be considered. Where the scales are equally balanced, the disputed debts should be considered in determining whether the debtor is generally paying its debts as they become due.

Applying the test to the facts before it, the Seventh Circuit determined that the claims of Chrysler Motors and Anderson Dodge would require substantial litigation and, accordingly, should without further analysis be considered in determining whether the Coveys were generally paying their debts as they became due.27 However, as an aside, the court noted that even if balanced, the interests of the petitioning creditors versus the interests of the Coveys did not favor the Coveys. Since the Coveys had closed their automobile dealership, "[t]here was no ongoing business to be harmed by the stigma of an involuntary bankruptcy."28 Further, the fact that the Coveys were disputing 99-1/2% of their debts represented to the court that the Coveys' disputes were merely "strategic gamesmanship."29 Since neither the claim of Chrysler Motors nor Anderson Dodge was being paid, the involuntary petition could stand on this basis alone.30

27. The court also concluded that the claim of Chrysler Credit Corporation would not require substantial litigation. However, since the involuntary petition could be sustained on the basis of the non-payment of the claims of Chrysler Motors and Anderson Dodge, it was not necessary for the court to resort to the "balancing test" as to the claim of Chrysler Credit Corporation. 650 F.2d at 883.

28. Id. at 884.

29. Id.

The Covey decision raises several interesting questions. The Coveys could have argued that the disputed claims of the petitioning creditors were contingent upon a court ultimately declaring their validity, and therefore ineligible under section 303(b)(1) to serve as the basis for an involuntary petition. Under this construction of the word, all disputed claims would be "contingent." The Seventh Circuit touched upon this issue in a footnote in which it quoted from the decision of the bankruptcy court in *In re All Media Properties, Inc.*, where the court observed:

Furthermore, § 303 indicates that there is a difference between a disputed claim, an unmatured claim, an unliquidated claim and a contingent claim. Otherwise, there would be no necessity to include the word contingent. Stated another way, just because a claim is unliquidated, disputed or unmatured apparently does not mean it is contingent. 33

By way of a footnote, the Covey decision suggests that in the Seventh Circuit, disputed claims will not necessarily be considered contingent for the purposes of section 303(b)(1) of the Bankruptcy Code. Since Covey did not directly confront the issue, however, future decisions on this point are a virtual certainty.

Another interesting aspect of the Covey decision involves the fact that no mention is made of whether the Coveys were, as of the commencement of the involuntary petition, paying their obligations to their other creditors who did not join in the involuntary petition. This is a significant omission because section 303(h) of the Bankruptcy Code imposes no requirement that an involuntary petition be commenced by a creditor whose debt is not being paid, but merely states that the court

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31. A well accepted definition of a contingent claim is one which the debtor will be called upon to pay only upon the occurrence or happening of an extrinsic event which establishes the liability of the debtor to the alleged creditor. *In re All Media Properties, Inc.*, 5 B.R. 126, 133 (Bankr. S.D. Tex. 1980). For example, the liability of a guarantor of a promissory note is contingent upon the default of the primary obligator.

32. *Id.* at 132.

33. *Id.* at 133.

34. A comment recently made in *Bittner v. Borne Chemical Co., Inc.*, 691 F.2d 134 (3rd Cir. 1982), indicates that the Third Circuit has reached the opposite conclusion. There, in the context of a dispute concerning the interpretation of section 502(c)(1) of the Bankruptcy Code, the court noted:

The Rolfite stockholders assert that the claims are not contingent since they are not dependent on some future event which may never occur. Inasmuch as the very existence of the claims in the reorganization proceeding is dependent on a favorable decision by the state court, the Rolfite stockholders are clearly mistaken. 691 F.2d at 137 n.5. The Borne decision suggests that all disputed claims are contingent. Its impact, if any, on the law relating to involuntary bankruptcy petitions remains to be seen.

35. It was acknowledged by the court that the Coveys had more than twelve creditors. 650 F.2d at 880.
shall order relief if “the debtor is generally not paying such debtor’s debts as such debts become due.” Presumably an order for relief could have been entered against the Coveys without regard to whether the debts of the petitioning creditors were being paid. This issue, however, was not considered by the Seventh Circuit.

Third, in analyzing whether disputed debts should be considered in determining if a debtor is generally paying its debts as they become due, the Seventh Circuit eschewed the solution suggested by the literal language of the Bankruptcy Code. The Seventh Circuit commented that “the Code is silent as to the calculation of disputed debts . . .,”\(^{36}\) but failed to note that “debt” is defined in section 101(11) of the Bankruptcy Code as “liability on a claim.” The legislative history indicates that “the terms [debt and claim] are co-extensive; a creditor has a ‘claim’ against debtor; the debtor owes a ‘debt’ to the creditor.”\(^{37}\) As noted by the Seventh Circuit itself, the definition of “claim” includes even disputed claims.\(^{38}\) Likewise then, it would seem to follow that “debts” under the literal language of section 303(h) of the Bankruptcy Code should, technically and definitionally, include disputed debts. On this basis it would seem that without resort to the balancing test, disputed debts should be considered in determining whether a debtor is generally paying its debts as they become due.

Does the Covey decision offer creditors an opportunity to use an involuntary bankruptcy petition as leverage to obtain payment on claims which are the subject of bona fide disputes? Probably not, because section 303 of the Bankruptcy Code provides safeguards against the use of an involuntary bankruptcy petition in that fashion. Furthermore, once initiated, an involuntary petition in bankruptcy is difficult to undo. Section 303(j) of the Bankruptcy Code requires that an involuntary petition can only be dismissed after notice to all creditors of the debtor, and a hearing, and provides non-petitioning creditors an opportunity to examine the circumstances of the proposed dismissal. Preferential payments contemplated in consideration for the agreement of the petitioning creditors to consent to a dismissal may be undone by the court. Further, section 303(i) of the Bankruptcy Code allows the bankruptcy court to impose costs and attorneys’ fees against a petitioning creditor if the bankruptcy court dismisses an involuntary petition other than on consent of all petitioners and the debtor, and even compensa-

\(^{36}\) 650 F.2d at 883.


\(^{38}\) 650 F.2d at 882.
tory and punitive damages if the petition is determined to have been filed in bad faith.

In all, Covey was correctly decided. If adopted by the Seventh Circuit, the Coveys' arguments would have allowed "a debtor to evade an involuntary bankruptcy solely by raising a red flag of dispute."\textsuperscript{39} Covey’s impact, if any, on the practices of creditors relating to involuntary bankruptcy petitions remains, of course, to be seen.

Chapter 13 - \textit{In re Rimgale}

One of the most sweeping changes affected by the Bankruptcy Code is the treatment of cases filed under chapter 13. No longer must debtors solicit and obtain creditor acceptance of their chapter 13 plans by majority vote;\textsuperscript{40} plans are automatically confirmed upon the satisfaction of certain standards which are set forth in section 1325 of the Bankruptcy Code.\textsuperscript{41} Eligibility requirements for chapter 13 relief have been greatly enlarged.\textsuperscript{42} The effect of a discharge obtained under chapter 13, which is set forth in section 1328 of the Bankruptcy Code, has

\textsuperscript{39} Id. at 884.

\textsuperscript{40} Under section 651 of the Bankruptcy Act, a chapter XIII plan could not be confirmed unless it had been accepted by a majority of all unsecured creditors whose claims had been proved and allowed before the conclusion of the first meeting of creditors.

\textsuperscript{41} Section 1325(a) of the Bankruptcy Code provides:

The court shall confirm a plan if—

1. the plan complies with the provisions of this chapter and with other applicable provisions of this title;
2. any fee, charge, or amount required under chapter 123 of title 28, or by the plan, to be paid before confirmation, has been paid;
3. the plan has been proposed in good faith and not by any means forbidden by law;
4. the value, as of the effective date of the plan, of property to be distributed under the plan on account of each allowed unsecured claim is not less than the amount that would be paid on such claim if the estate of the debtor were liquidated under chapter 7 of this title on such date;
5. with respect to each allowed secured claim provided for by the plan—
   \( A \) the holder of such claim has accepted the plan;
   \( B \) (i) the plan provides that the holder of such claim retain the lien securing such claim; and
   \( \text{ii} \) the value, as of the effective date of the plan, of property to be distributed under the plan on account of such claim is not less than the allowed amount of such claim; or
   \( C \) the debtor surrenders the property securing such claim to such holder;
and
6. the debtor will be able to make all payments under the plan and to comply with the plan.

\textsuperscript{42} Under section 109(e) of the Bankruptcy Code, individuals with regular income, excluding stockbrokers and commodity brokers, are eligible for chapter 13 relief. This includes "wage earners," the only individuals eligible for relief under section 606(8) of chapter XIII of the Bankruptcy Act, as well as, for example, self-employed individuals, proprietors of unincorporated businesses, and professional persons. For a more detailed discussion of the expanded eligibility requirements under chapter 13 of the Bankruptcy Code, see Lee, \textit{Chapter 13 nee Chapter XIII.}, 53 AM. BANKR. L.J. 303 (1979).
been made extremely broad in scope. Congress has created a chapter 13 which is substantially different in operation from chapter XIII of the Bankruptcy Act.

Section 1328(a) of the Bankruptcy Code\(^43\) excepts only two classes of obligations from the discharge provisions of chapter 13: long term secured or unsecured debts on which the last payment is due after the date on which the final payment under the plan is due, and any debt owed to a spouse, former spouse or child for alimony, maintenance or support. Section 1328(a) allows chapter 13 debtors to discharge debts that would be non-dischargeable in a chapter 7\(^44\) case pursuant to section 523 of the Bankruptcy Code; including, for example, debts for obtaining money, property or services by fraud or false pretense.\(^45\) What is not clear is whether the dischargeability of a debt under chapter 7 plays a role in determining if the standards for confirmation of a chapter 13 plan (set forth in section 1325(a) of the Bankruptcy Code) have been met. Some courts have answered this question unequivocally in the negative.\(^46\) Others, however, have held that the non-dischargeability of certain debts in a hypothetical chapter 7 case, pursuant to section 523 of the Bankruptcy Code, is relevant in determining whether in a chapter 13 case, the "good faith" requirement of section 1325(a)(3) of the Bankruptcy Code has been satisfied.\(^47\) Another court has held that the dischargeability of certain claims under chapter 7 impacts upon whether holders of such claims shall, under the proposed chapter 13 plan, receive on account thereof property equal in value to the amount that would be paid on such claims if the case were administered under chapter 7, as required by section 1325(a)(4) of the Bankruptcy Code.\(^48\)

These issues were considered by the Seventh Circuit in *In re Rim-*

\(^43\) Section 1328(a) of the Bankruptcy Code provides:

(a) As soon as practicable after completion by the debtor of all payments under the plan, unless the court approves a written waiver of discharge executed by the debtor after the order for relief under this chapter, the court shall grant the debtor a discharge of all debts provided for by the plan or disallowed under section 502 of this title, except any debt—

(1) provided for under section 1322(b)(5) of this title; or

(2) of the kind specified in section 523(a)(5) of this title.

\(^44\) The scope of a discharge obtained by an individual debtor under chapter 7 of the Bankruptcy Code is set forth in section 727(b).

\(^45\) See section 523(a) of the Bankruptcy Code for a complete enumeration of those debts exempted from a chapter 7 discharge.


Prior to the commencement of their joint chapter 13 case, the Circuit Court of Cook County, Illinois, entered a judgment against the Rimgales in a lawsuit filed against them by Mary Ravenot. Ms. Ravenot alleged in the lawsuit that Mrs. Rimgale, a psychiatric nurse, had, at a time when Ms. Ravenot was a patient undergoing psychiatric treatment at the hospital in which Mrs. Rimgale was employed, induced her to give the Rimgales the proceeds of her husband's life insurance policies. The Circuit Court of Cook County awarded Ms. Ravenot compensatory damages of $29,743, and $3,988 in prejudgment interest against the Rimgales jointly. The circuit court also awarded Ms. Ravenot punitive damages of $5,000 and attorneys' fees and costs against Donald Rimgale alone, and imposed a constructive trust in Ms. Ravenot's favor on certain real and personal property acquired by the Rimgales with the insurance money, including the Rimgales' personal residence.

The first and first amended chapter 13 plans filed by the Rimgales scheduled Ms. Ravenot's claim as a fully unsecured joint obligation of the Rimgales in the amount of the compensatory damages and attorneys' fees awarded by the Circuit Court of Cook County, making no reference to the punitive damages awarded. Further, even though the circuit court judgment had become final, Ms. Ravenot's claim was scheduled by the Rimgales as "disputed." Neither plan proposed any payments to Ms. Ravenot, although other unsecured creditors were to receive, over a period of thirty-six months, 45% of their claims under the first plan, and 33% thereof under the first amended plan.

The second amended plan filed by the Rimgales, which was ultimately confirmed by the bankruptcy court over Ms. Ravenot's objection, treated the debt owed to Ms. Ravenot as secured to the extent of $25,000, representing an estimate of what Ms. Ravenot would receive through the sale of the Rimgales' house, and an unsecured claim of $24,799.54, of which 11% was to be paid over a period of forty-two months.

On appeal, the district court overturned the order of confirmation, reasoning that the non-dischargeability of Ms. Ravenot's claim under chapter 7 of the Bankruptcy Code meant that Ms. Ravenot was not receiving under the Rimgales' chapter 13 plan at least as much as she

49. 669 F.2d 426 (7th Cir. 1982).
50. Section 302(a) of the Bankruptcy Code permits the commencement of a joint case by the filing of a single petition by an individual and such individual's spouse.
51. Section 1323(a) of the Bankruptcy Code permits the debtor to modify a proposed chapter 13 plan at any time before confirmation.
would have received on her claim in a chapter 7 liquidation, as re-
quired under section 1325(a)(4) of the Bankruptcy Code. This being
dispositive, the district court did not reach Ms. Ravenot's assertions
that the Rimgales' plan had not been filed in "good faith" as required
by section 1325(a)(3) of the Bankruptcy Code, and that "the bank-
ruptcy judge had unduly restricted her arguments against the plan

On appeal, the Seventh Circuit vacated the order of the district
court, hopefully laying to rest permanently the argument that the value
of a claim that would be non-dischargeable in a hypothetical case
under chapter 7 of the Bankruptcy Code is a factor to be taken into
account in determining whether the requirements of section 1325(a)(4)
have been satisfied. The Seventh Circuit correctly observed that
"what is to be compared is the total of the payments to the creditor,
discounted to present value, and the amount the creditor would receive
in a straight liquidation." This does not, noted the Seventh Circuit,
include additional sums that a creditor holding a claim non-discharge-
able under section 523 might receive from a chapter 7 debtor after
liquidation from funds outside of the bankruptcy estate. To have
held otherwise would have effectively rendered meaningless the gener-
ous discharge provisions contained in chapter 13.

However, the Seventh Circuit was not prepared to hold that the
non-dischargeability of a particular debt under section 523 is of no mo-
ment in determining whether a chapter 13 plan was proposed in "good
faith" as required under section 1325(a)(3). The court noted that the
duty of the bankruptcy court to evaluate whether the chapter 13 plan
was filed in "good faith" precludes a "routine" application of the "good
faith" test, and would allow and possibly require the bankruptcy judge
to take into consideration many matters, including possibly the dis-
chargeability in a hypothetical chapter 7 case of a debtor's debts. Ex-
actly what in the final analysis shall constitute "good faith" must,
stated the Seventh Circuit, be defined on a case-by-case basis as courts
encounter varied problems in the administration of chapter 13 cases.
As a guide, the Seventh Circuit offered several factors to be consid-
ered in determining if the "good faith" standard has been satisfied, and

52. 669 F.2d at 430.
53. Id.
54. Id.
55. Id.
56. 669 F.2d at 431-32.
57. Id.
58. Id. at 432.
remanded the case to the bankruptcy court for a consideration of those factors. The factors were:

1. Are the debtor's secured and unsecured debts stated accurately?
2. Does the proposed plan state the debtor's expenses accurately?
3. Is the percentage of repayment of unsecured claims correct?
4. Are inaccuracies in the plan an attempt to mislead the bankruptcy court?
5. Do the proposed payments indicate a fundamental fairness in dealing with one's creditors? Under the facts and circumstances of *Rimgale*, considerations of "fundamental fairness" can include,
   a) The timing of the bankruptcy filings.
   b) The portion of the unsecured debt represented by the Ravenot claim.
   c) The equities of classifying together consumer debts and a judgment debt arising out of intentionally tortious conduct.

At the very least, it appears that *Rimgale* rejects those cases holding that the dischargeability of claims under chapter 7 is immaterial in determining whether the "good faith" requirements of section 1325(a)(3) have been satisfied. By no means, however, does *Rimgale* hold all chapter 13 plans proposing to discharge claims that would be nondischargeable under chapter 7 to be *per se* proposed in "bad faith." In its effort to give structure to the "good faith" analysis, the Seventh Circuit may have created further confusion. There is little doubt that Ms. Ravenot's claim against the Rimgales would have been held to be non-dischargeable under section 523(a)(2) and (6) of the Bankruptcy Code and, accordingly, its consideration as a separate factor in determining "fundamental fairness" would pose little practical difficulty for the bankruptcy court. *Rimgale* offers no indication, however, of the extent to which bankruptcy courts must give consideration to the dischargeability of a claim where the issue of dischargeability is not as clear. Unless it is limited only to its facts, *Rimgale* could be interpreted to require bankruptcy courts to consider in some fashion the dischargeability of a particular claim in a chapter 7 case under section 523 before applying the "fundamental fairness" component of the "good faith" test. Taken to the extreme, *Rimgale* could be deemed to require the adjudication by the bankruptcy court of the dischargeability of a claim under chapter 7 before determining "good faith." This would give creditors control over a chapter 13 case never contemplated by the Bankruptcy Code simply by raising the dischargeability issue at the

59. *Id.* at 433 n.22.
confirmation hearing. Almost certainly this was not the intention of the Seventh Circuit. A possible approach to Rimgale more consistent with the spirit of the Bankruptcy Code would be to require the bankruptcy courts to take into consideration the possible non-dischargeability of a debt under section 523 in determining "fundamental fairness" only where a *prima facie* case of non-dischargeability is apparent. The development of the law on this point will be interesting.

The inclusion by the Seventh Circuit of the timing of the bankruptcy filing as a factor to be considered in determining "fundamental fairness" seems to suggest that a chapter 13 case filed for the obvious purpose of frustrating imminent legal action by a creditor could have a negative effect upon the ability of the debtor to obtain confirmation of his chapter 13 plan. This is troublesome because bankruptcy cases have historically been filed on the eve of creditor action to obtain the immediate benefits of the automatic stay set forth in section 362 of the Bankruptcy Code. Whether the timing of a bankruptcy case becomes for the first time an important factor in determining whether a chapter 13 plan was filed in "good faith" remains to be seen.

Perhaps some insight into the manner in which the Rimgale test will be applied by the bankruptcy courts can be gleaned from *In re Vratanina*. The debtor in Vratanina listed unsecured debts of $10,000, 80% of which were represented by a judgment obtained against him in the circuit court which was assumed by the bankruptcy court to be non-dischargeable under section 523 of the Bankruptcy Code. Vratanina's chapter 13 plan proposed a 10% repayment of all allowed unsecured claims over a period of 36 months. The judgment creditor moved to revoke confirmation of the debtor's chapter 13 plan on the basis that it was not filed in "good faith." In applying the "fundamental fairness" standard required by Rimgale, the bankruptcy court looked only to the portion of the debtor's monthly income to be paid into the chapter 13 plan, and determined it to be satisfactory. Absent from the bankruptcy court's opinion was any mention of the large portion of Vratanina's unsecured debt represented by the non-dischargeable claim. The equities of classifying this claim with Vratanina's other debts was also not discussed.

In effect, Rimgale was reduced by the court in Vratanina to a "best efforts" analysis which was not the intention of the Seventh Circuit.

60. For a more thorough discussion of the automatic stay see infra notes 80-90 and accompanying text.
62. Id. at 616.
Future decisions interpreting *Rimgale* will be enlightening, and should be closely monitored by attorneys representing chapter 13 debtors and creditors alike.

**Preferences - *Barash v. Public Finance Corp.***

One of the most important provisions of the Bankruptcy Code is section 547 entitled "Preferences." Section 547(b) defines a preference as a transfer of the debtor's property, made:

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) While the debtor was insolvent.\(^{63}\)
4) On or within ninety days before the date of the filing of the petition.\(^{64}\)
5) Which enables the creditor to receive more than he would have received—
   a) if the case were a liquidation case;
   b) if the transfer had not been made; and
   c) if the claim were allowed or disallowed to the extent permitted by title 11.

Section 547(c) of the Bankruptcy Code sets forth six exceptions to the above. One of the most important, which is contained in section 547(c)(2), provides that a transfer is not preferential:

To the extent that such transfer was —

(A) in payment of a debt incurred in the ordinary course of business or financial affairs of the debtor and the transferee;
(B) made not later than 45 days after such debt was incurred;
(C) made in the ordinary course of business or financial affairs of the debtor and the transferee; and
(D) made according to ordinary business terms.

In *Barash v. Public Finance Corp.*,\(^{65}\) the Seventh Circuit\(^{66}\) considered whether payments to an undersecured creditor during the 90 days prior to bankruptcy should be applied against the secured or unsecured component of such creditor's claim, and "whether installment payments voluntarily made by a debtor to an undersecured creditor in the ordinary course of the debtor's financial affairs within the 90 days pre-

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\(^{63}\) Under section 547(f) of the Bankruptcy Code, a debtor is presumed to have been insolvent on and during the 90 days immediately preceding the date of the filing of the petition.

\(^{64}\) Where the creditor was an insider as defined in section 101(25), and had reasonable cause to believe the debtor was insolvent at the time of such transfer, the relevant period is increased from 90 days to one year. See section 547(f) of the Bankruptcy Code.

\(^{65}\) 658 F.2d 504 (7th Cir. 1981).

\(^{66}\) The case was actually a consolidated appeal involving eight bankruptcy cases in which Barry Barash as chapter 7 trustee sought recovery of alleged preferential transfers. *Id.* at 504.
ceeding bankruptcy, but not more than 45 days after their due date," fall within the section 547(c)(2) exception. Regular installment payments were made by the debtors to certain creditors within 90 days of the commencement of their respective chapter 7 bankruptcy cases. Each creditor receiving payments held security for its claim. In each instance, the value of the creditor's collateral was less than the debt which it secured, but in all but one case, the value of the collateral exceeded the total payments made by the respective debtor during the 90-day period preceding bankruptcy.

Barash, as trustee, commenced actions to recover as preferences the installment payments made to each creditor during the 90 days preceding bankruptcy. The creditors defended on two grounds. Since the value of the collateral held by each as security for its claim was less than the amount each was owed, under section 506(a) of the Bankruptcy Code, all of the creditors held both a secured and unsecured claim in the respective bankruptcy cases. From this the creditors argued that payments which they received should be charged against the secured rather than unsecured portion of their claims. Since in almost every case the value of the collateral held was greater than payments received, the creditors argued that the fifth essential element of a preferential transfer was lacking because such payments did not enable them to receive more than they would have had the transfers not been made and had they received payment on their claims to the extent provided by the Bankruptcy Code. Barash took the contrary position, asserting that payments must be charged against the unsecured portion of the creditors' claims and that, therefore, such payments enabled the creditors to receive a greater proportionate share of their claims than other unsecured creditors.

The Seventh Circuit held in favor of Barash, finding that such payments must be first applied against the unsecured portion of the creditors' claims. While the court's reasoning is somewhat difficult to

67. 658 F.2d at 505.
68. Section 506(a) of the Bankruptcy Code provides:
   An allowed claim of a creditor secured by a lien on property in which the estate has an interest, or that is subject to setoff under section 553 of this title, is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.
69. 658 F.2d at 508.
follow, the result under the facts before it is correct. As set forth in section 506(a), the claim of an undersecured creditor is bifurcated into both a secured and unsecured claim, with the claim being “secured to the extent of the value of such creditor’s interest” in the debtor’s property. Accordingly, payments received by an undersecured creditor during the 90 days preceding bankruptcy would not result in a reduction in the secured component of its claim because, absent other circumstances, the value of the collateral is unchanged.\textsuperscript{70} Such payments result merely in a reduction of the difference between the total amount owed to the creditor and the value of the collateral held, which difference equals the unsecured portion of the claim. Since payments received by necessity have the effect of reducing the unsecured portion of the claim, the court’s conclusion on this issue was correct.

The Seventh Circuit did not mention that it will not in all instances be proper to apply payments against the unsecured portion of a debt owed to an undersecured creditor. Consider the situation where payments are made by a debtor out of the proceeds of a creditor’s collateral. Here, unlike above, the value of the collateral, at least theoretically, declines as payments are made to the creditor, and the secured portion of the creditor’s claim is, under section 506(a), reduced by a like amount. It is therefore incorrect to apply payments which represent the proceeds of a creditor’s collateral to the unsecured portion of the creditor’s claim and, as a result, such payments, even if made within 90 days of bankruptcy, would not be preferential. \textit{Barash} should not be interpreted as holding that payments made to an undersecured creditor are to be applied against the unsecured portion of a creditor’s claim under all circumstances.

The Seventh Circuit then turned its attention to the applicability of the exception contained in section 547(c)(2), which is commonly known as the “45 day rule.” Each payment in \textit{Barash} was on an installment contract made within 45 days of the date each particular installment became due. The creditors argued that section 547(c)(2) immunizes such payments from the trustee’s attack. Barash disagreed, claiming that the payments were not made within “45 days after such debt was incurred,” because the debt was incurred at the time the underlying purchase was made, and not when each installment became due.

Called upon to decide when a debt is incurred in an installment

\textsuperscript{70} This is true only until the amount owed to the creditor is reduced below the value of the collateral held, in which case the creditor is no longer unsecured.
transaction for the purposes of section 547(c)(2), the Seventh Circuit adopted the position advanced by the trustee and held that the debt is incurred when the legal obligation to pay arises.\textsuperscript{71} The Seventh Circuit commented that section 547(c)(2) "is aimed at transactions which, although they are technically credit transactions, are not intended to remain unpaid for a long time."\textsuperscript{72} The court did not consider the legislative history pertaining to section 547(c)(2) indicating that the purpose of section 547(c)(2) is to "leave undisturbed normal financial relations" which was the context in which the subject payments were made.\textsuperscript{73} Rather, the court concluded that the installment debts involved did not fall within the statutory design, and held that the payments made by the debtors in \textit{Barash} could be avoided as preferential transfers to the extent that such payments are credited against the unsecured component of a particular creditor's claim.\textsuperscript{74}

The Seventh Circuit in \textit{Barash} did not consider an interesting issue raised by the Eighth Circuit Court of Appeals in \textit{In re Iowa Premium Service Co., Inc.}\textsuperscript{75} which is directly pertinent. There the court observed that in many instances, a portion of a typical installment payment represents accrued interest rather than principal. While an obligation to repay principal arises at the inception of the credit transaction, an interest debt, the court notes, is not incurred until the interest accrues\textsuperscript{76} since "the use of money for another day is new consideration each day."\textsuperscript{77} This being the case, the court concluded that for the purposes of section 547(c)(2) of the Bankruptcy Code, the portion of an installment payment representing repayment of principal must be analyzed separately from that constituting interest, for frequently interest will not have accrued more than 45 days before the date of the payment. \textit{Barash} did not address the question of accrued interest, treating the entire amount of each installment payment as a transfer on account of a debt incurred at the inception of the credit transaction.

Unless it is said that a contingent obligation to pay interest, which itself constitutes a "debt" under section 547(c)(2), arises at the time the installment credit transaction is entered into, the well-reasoned analysis of the Eighth Circuit has merit. If the distinction between the compo-

\begin{itemize}
\item \textsuperscript{71} 658 F.2d at 509.
\item \textsuperscript{72} \textit{Id.} at 511.
\item \textsuperscript{73} H.R. REP. No. 595, 95th Cong., 1st Sess. 373-74 (1977).
\item \textsuperscript{74} 658 F.2d at 511.
\item \textsuperscript{75} 695 F.2d 1109 (8th Cir. 1982).
\item \textsuperscript{76} \textit{Id.} at 1111.
\item \textsuperscript{77} \textit{Id.} at 1112.
\end{itemize}
nents of an installment payment representing principal and interest is given general recognition by the courts, the analysis required to determine if a particular payment falls within the section 547(c)(2) exception will be painstaking. Since interest accrues on a per diem basis, it will be necessary to relate the date on which each payment is made to the daily interest accrual to determine what portion of the interest paid accrued more than 45 days before the payment date. Future case law on this point will be interesting to monitor.

Automatic Stay—*In re Holtkamp*

Fundamental to bankruptcy law is the concept of the automatic stay. The provisions of the automatic stay, which are set forth in section 362(a) of the Bankruptcy Code, are designed to prevent the depletion of the debtor's estate through the random action of creditors in favor of an orderly liquidation and distribution under chapter 7 or a court supervised reorganization under chapters 11 and 13. Under section 362(a), all lawsuits and actions to enforce liens and collect upon or recover claims against a bankruptcy debtor, with certain limited exceptions enumerated in section 362(b) of the Bankruptcy Code, are stayed immediately upon the commencement of a bankruptcy case.

Section 362(d)(1) of the Bankruptcy Code provides for the modification or termination of the automatic stay, "for cause, including the

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78. In pertinent part, section 362(a) of the Bankruptcy Code provides:

Except as provided in subsection (b) of this section, a petition filed under section 301, 302, and 303 of this title operates as a stay, applicable to all entities, of—

(1) the commencement or continuation, including the issuance or employment of process, of a judicial, administrative, or other proceeding against the debtor that was or could have been commenced before the commencement of the case under this title, or to recover a claim against the debtor that arose before the commencement of the case under this title;

(2) the enforcement, against the debtor or against property of the estate, of a judgment obtained before the commencement of the case under this title;

(3) any act to obtain possession of property of the estate or of property from the estate;

(4) any act to create, perfect, or enforce any lien against property of the estate;

(5) any act to create, perfect, or enforce against the debtor any lien to the extent that such lien secures a claim that arose before the commencement of the case under this title;

(6) any act to collect, assess, or recover a claim against the debtor that arose before the commencement of the case under this title;

(7) the setoff of any debt owing to the debtor that arose before the commencement of the case under this title against any claim against the debtor; and

(8) the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor.

79. The automatic stay "gives the debtor a breathing spell from his creditors. It stops all collection efforts, all harassment, and all foreclosure actions. It permits the debtor to attempt a repayment or reorganization plan, or simply to be relieved of the financial pressures that drove him into bankruptcy." H.R. REP. NO. 595, 95th Cong., 1st Sess. 340 (1977).
lack of adequate protection of an interest in property of such party in interest."80 In In re Holtkamp,81 the Seventh Circuit considered an appeal from an order of the bankruptcy court modifying an automatic stay to permit a personal injury lawsuit to proceed against Holtkamp,82 the debtor. Five days before a personal injury suit initiated by Littlefield was set for trial, Holtkamp filed a chapter 11 case which automatically stayed the personal injury suit pursuant to the provisions of section 362(a) of the Bankruptcy Code. Littlefield immediately filed a complaint to modify the automatic stay,83 which the bankruptcy court agreed to hear on an emergency basis with only three hours notice to Holtkamp. After the hearing, the bankruptcy court modified the automatic stay, permitting the personal injury lawsuit to proceed against Holtkamp in the court in which it was pending, but expressly prohibited Littlefield from collecting upon any judgment entered against Holtkamp. After a jury trial, a $5,025,000 judgment was entered in Littlefield’s favor.

The Seventh Circuit quickly dismissed Holtkamp’s first argument that section 362(d) of the Bankruptcy Code applies only to secured creditors, noting that section 362(d) is available to any “party in interest.”84 The court observed that the “stay should be lifted in appropriate circumstances,”85 drawing for support the following excerpt from the legislative history of section 362:

“It will often be more appropriate to permit proceedings to continue in their place of origin, when no great prejudice to the bankruptcy estate would result, in order to leave the parties to their chosen forum and to relieve the bankruptcy court from many duties that may be handled elsewhere. S. Rep. No. 989, 95th Cong., 2d Sess. 50 (1978).”

80. Section 362(d) of the Bankruptcy Code provides:
On request of a party in interest and after notice and a hearing, the court shall grant relief from the stay provided under subsection (a) of this section, such as by terminating, annulling, modifying, or conditioning such stay—
(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; or
(2) with respect to a stay of an act against property, if—
(A) the debtor does not have an equity in such property; and
(B) such property is not necessary to an effective reorganization.

81. 669 F.2d 505 (7th Cir. 1982).
82. Holtkamp involved joint appeals taken by both Charles Holtkamp individually and Holtkamp Farms, Inc., as related chapter 11 debtors. For ease of reference, Holtkamp individually and Holtkamp Farms, Inc. shall be collectively referred to in this discussion as “Holtkamp.”
84. 669 F.2d at 508.
85. Id.
The Seventh Circuit concluded that the decision of the bankruptcy court to modify the automatic stay was not an abuse of its discretion.\textsuperscript{86} The court rejected Holtkamp's assertion that the modification of the automatic stay was improper because it "enabled Littlefield to gain a superior position over other creditors . . . ."\textsuperscript{87} By expressly prohibiting Littlefield from enforcing his judgment, the bankruptcy court's order effectively allowed Littlefield only to determine the amount of his claim outside the bankruptcy court. Allowing the personal injury lawsuit to go forward on this basis alone did not, noted the Seventh Circuit, "jeopardize Holtkamp's bankrupt estate because his insurance company assumed full financial responsibility for defending that litigation."\textsuperscript{88}

Finally, the Seventh Circuit rejected Holtkamp's claims that proper notice of the emergency hearing had not been given, that the bankruptcy court erred in allowing Littlefield to present evidence and take testimony at the hearing, and that the emergency hearing was defective because the bankruptcy judge failed to state specific findings of fact and conclusions of law.\textsuperscript{89} The Seventh Circuit noted that the emergency hearing was a necessity since the chapter 11 case had been filed on the eve of the trial of the personal injury lawsuit, and was entirely consistent with rules 712(a) and 906(c) of the Bankruptcy Rules, which authorize the bankruptcy judge to shorten any specified time period, and Rule 4001(b) of the Interim Bankruptcy Rules, which permits the bankruptcy court to grant relief from the automatic stay on an \textit{ex parte} basis.\textsuperscript{90} The court further determined that the manner in which the emergency hearing was conducted by the bankruptcy court and the absence of specific findings and conclusions were not improper under the circumstances.\textsuperscript{91}

It is rare that a bankruptcy court will modify the automatic stay only days after the commencement of a chapter 11 case. Critical to the court's decision in \textit{Holtkamp} was the existence of insurance coverage and the responsibility of the insurance carrier to represent Holtkamp in the personal injury lawsuit. As the Seventh Circuit observed, there was little justification from the standpoint of the bankruptcy estate for con-

\textsuperscript{86} \textit{Id.} at 509.
\textsuperscript{87} \textit{Id.} at 508.
\textsuperscript{88} \textit{Id.} at 508-09.
\textsuperscript{89} \textit{Id.} at 509.
\textsuperscript{90} \textit{Id.}
\textsuperscript{91} \textit{Id.} at 508-09.
continuing the automatic stay in effect under such circumstances, especially where preparations for trial had been completed.

Where insurance coverage does not include the obligation of the carrier to defend a bankruptcy debtor, the analysis becomes more difficult, especially in a chapter 11 case. Under these circumstances the court is required to balance the interests of the creditor in obtaining a prompt adjudication of its claim and payment from such insurance proceeds as may exist, against the additional costs and expenses to the chapter 11 estate of retaining counsel to represent the debtor outside of the bankruptcy court at a time when all of the debtor's resources are required to sustain the operation of the debtor's business for the benefit of all creditors. Less troublesome is the situation where no insurance coverage is present. There, absent unusual facts, little justification exists for terminating the automatic stay at the outset of a chapter 11 case to permit a personal injury lawsuit to proceed outside of the bankruptcy court. Modifying the automatic stay under these circumstances would be contrary to philosophical underpinnings of the automatic stay which are intended to give the debtor a "breathing spell from his creditors while the debtor" attempts a repayment or reorganization plan. All things considered, Holtkamp, at least as it pertains to the modification of the automatic stay on an emergency basis, will probably have limited application outside of cases involving facts virtually identical to those before the court.

**Conclusion**

With few exceptions, the decisions of the Seventh Circuit during the recent term add little to the advancement of bankruptcy law. As yet, the court has not had an opportunity to confront many of the significant issues which remain unresolved under the new Bankruptcy Code.

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92. An example of facts which might justify the modification of the automatic stay shortly after the commencement of a bankruptcy case by an uninsured debtor is where the plaintiff in the pending lawsuit is the major or only creditor of the debtor and the bankruptcy case is filed for the sole purpose of frustrating the collection efforts of that creditor.

93. See supra note 78.