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INTRODUCTION

In adjudicating a bankruptcy, a court must maintain a delicate balance between a creditor's right to a fair and orderly distribution of the assets and a debtor's right to a fresh start. Throughout this process, a court must also consider basic elements of fairness, preservation of the assets, and equality in distribution of the assets. This survey addresses recent decisions of the Tenth Circuit in which the court had the opportunity to consider these fundamental issues in unique situations. Part I of this article provides a background in basic bankruptcy procedures and concepts. Part II discusses the effect of an action taken by a creditor in violation of the automatic stay. Part III explores the viability of prepetition setoffs under 11 U.S.C. § 553(b). Part IV analyzes a creditor's objections to discharges while Part V addresses due process requirements for lien modification in Chapter 11 reorganizations. Part VI examines dischargeability of gap period interest on a tax claim.

I. GENERAL BACKGROUND

The number of individuals and companies filing bankruptcy is increasing at an alarming rate.[1] Congressional sources estimated that one in every one hundred American families would file for bankruptcy during 1997.[2] An increase in bankruptcy filings effects the commercial credit sector.[3] Bankruptcy provides a convenient forum for collecting and equitably distributing the debtor's assets to creditors, and provides debt relief to the financially burdened debtor.[4]

The Bankruptcy Code[5] governs the administration of bankruptcy cases and permits almost any person or entity, including a municipality, to qualify as a debtor.[6] Bankruptcy proceeding may be initiated in several

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1. *See The Increase in Personal Bankruptcy and the Crisis in Consumer Credit: Hearing Before the Subcomm. on Admin. Oversight and the Courts of the Senate Judiciary Comm.*, 105th Cong. 138 (1997) [hereinafter *Hearing on Crisis in Consumer Credit*] (statement of the American Bankruptcy Institute) (reporting that 1,178,555 bankruptcy petitions were filed in 1996).

2. *See Operation of the Bankruptcy System and Status Report from the National Bankruptcy Review Commission: Hearing Before the Subcomm. on Commercial and Admin. Law of the House Judiciary Comm.*, 105th Cong. 6 (1997) [hereinafter *Hearing on Operation of the Bankruptcy System*] (statement of Brady C. Williamson, Chairman, National Bankruptcy Review Commission).

3. *See id.* at 35.

4. Arnold M. Quittner, *Overview: History of the Bankruptcy Code and Prior Bankruptcy Laws*, *in* BANKRUPTCY AND REORGANIZATION 1987: THE SUBSTANTIVE AND PROCEDURAL BASICS 7, 13 (PLI Commercial Law & Practice Course Handbook Series No. A4-4208, 1990).

5. *See* 11 U.S.C. §§ 1-360 (1994 & Supp. II 1996). Congress has the enumerated power "to establish . . . uniform Laws on the subject of Bankruptcies throughout the United States." U.S. CONST. art. I, § 8, cl. 4.

6. *See* 11 U.S.C. § 109. Certain entities, including railroads, insurance companies and banks, do not qualify as debtors. *Id.*

ways. Debtors voluntarily commence bankruptcy by filing a petition under Chapter 7, Chapter 11, or Chapter 13 of the Bankruptcy Code.[7] In addition, three or more creditors with aggregate, unsecured or undersecured claims of "at least $10,000 more than the value of any lien on property of the debtor securing such claims" may commence an involuntary bankruptcy under Chapter 7 or Chapter 11.[8] The bankruptcy court automatically enters an order for relief upon the filing of a voluntary or involuntary bankruptcy petition, which stays all action by a creditor against the debtor or the estate.[9]

Chapter 7 governs liquidation bankruptcy proceedings.[10] In a Chapter 7 proceeding, the court liquidates the nonexempt assets of the debtor and distributes the proceeds to the creditors.[11] Approximately eighty percent of all debtors file bankruptcy under Chapter 7.[12] Under Chapter 7, the bankruptcy court appoints a trustee to supervise the administration of the estate.[13] At the conclusion of a Chapter 7 bankruptcy, an individual debtor usually receives a discharge, essentially releasing a debtor from his existing debts.[14]

Unlike a Chapter 7 liquidation bankruptcy, a Chapter 13 bankruptcy allows a debtor to retain his nonexempt assets and repay creditors through a plan funded by the debtor's postpetition earnings.[15] As in Chapter 7 bankruptcy, a trustee supervises the administration of the estate.[16] In a Chapter 13 bankruptcy, the debtor must submit a plan of re-

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7. *See id.* § 301 ("A voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter."). Debtors who qualify as "family farmers" may also file for bankruptcy under Chapter 12. *See id.* § 101(18); *Hearing on Operation of the Bankruptcy System*, *supra* note 2, at 45 (statement of Charles Tatelbaum, Vice President for Research, American Bankruptcy Institute).

8. *See* 11 U.S.C. § 303.

9. *See* 6 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW AND PRACTICE § 133:7 (2d ed. 1997).

10. *Hearing on Operation of the Bankruptcy System*, *supra* note 2, at 41 (statement of Charles Tatelbaum, Vice President for Research, American Bankruptcy Institute).

11. *Id.*

12. *Hearing on Crisis in Consumer Credit*, *supra* note 1, at 138 (statement of the American Bankruptcy Institute).

13. *See* Michelle J. White, *The Corporate Bankruptcy Decision*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES 207, 208 (Jagdeep S. Bhandari & Lawrence A. Weiss eds., 1996). The duties of a trustee include the responsibility to "collect and reduce to money the property of the estate for which such trustee serves." 11 U.S.C. § 704(1).

14. *See* THOMAS H. JACKSON, THE LOGIC AND LIMITS OF BANKRUPTCY LAW 225 (1986); Lawrence Ponoroff & F. Stephen Knippenberg, *Debtors Who Convert Their Assets on the Eve of Bankruptcy: Villains or Victims of the Fresh Start?*, 70 N.Y.U. L. REV. 235, 237-38 (1995).

15. *See* ARNOLD B. COHEN, BANKRUPTCY, SECURED TRANSACTIONS AND OTHER DEBTOR-CREDITOR MATTERS ¶ 14-401, at 234 (1981).

16. *See* Paul L. Bindler & Shalom Jacob, *Basic Bankruptcy: Chapter 7 and Chapter 13*, *in* BASIC BANKRUPTCY 241, 289 (PLI Commercial Law & Practice Course Handbook Series No. A4-4221, 1988).

payment for confirmation by the bankruptcy court.[17] The debtor must also commence making payments to the trustee within thirty days of the date the plan is filed.[18] Once the court confirms the plan, the provisions of the plan bind the debtor and all creditors.[19] All property of the estate vests in the debtor unless the plan provides otherwise.[20] After the debtor completes the plan payments, the court discharges the debtor of all debts described in the plan.[21] Because relatively few debtors elect to file under Chapter 13 and repay their obligations, some organizations have proposed amendments to the Bankruptcy Code that would provide incentives for more debtors to proceed under Chapter 13.[22]

Chapter 11 bankruptcy gives a business the opportunity to rehabilitate itself so that the business can continue to operate, provide jobs, and pay its creditors.[23] Because a court generally permits the Chapter 11 debtor to continue operating its business throughout this process,[24] unique issues arise with respect to rights of secured creditors, especially concerning the use of cash collateral to continue the operation of the business.[25] The resolution of these various issues involves both bankruptcy law and nonbankruptcy law.[26]

The ultimate goal of a Chapter 11 bankruptcy is to obtain a confirmed plan of reorganization.[27] Bankruptcy procedure requires the debtor or a creditor to propose a plan of reorganization and to solicit acceptance of the plan from creditors through disclosure statements and ballots.[28] The confirmed plan binds the debtor and all creditors, and vests all property of the estate in the debtor.[29] The court deems all property addressed

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17. *See* 11 U.S.C. §§ 1321, 1325; *see also* Bindler & Jacob, *supra* note 16, at 289 (explaining that the plan may provide for repayments over an extended period).

18. *See* Bindler & Jacob, *supra* note 16, at 289.

19. *Id*

20. *Id.*

21. *See Hearing on Operation of the Bankruptcy System*, *supra* note 2, at 47 (statement of Charles Tatelbaum, Vice President for Research, American Bankruptcy Institute).

22. *Hearing on Operation of the Bankruptcy System*, *supra* note 2, at 7 (statement of Brady C. Williamson, Chairman, National Bankruptcy Review Commission).

23. *See* COHEN, *supra* note 15, ¶ 14-501, at 265.

24. *See Hearing on Operation of the Bankruptcy System*, *supra* note 2, at 43 (statement of Charles Tatelbaum, Vice President for Research, American Bankruptcy Institute).

25. *See id.* at 43-44; *see also* Douglas G. Baird, *The Uneasy Case for Corporate Reorganizations*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, *supra* note 13, at 336, 345 (explaining that, in a liquidation creditors' rights are fixed and payments made in cash, but in a reorganization more issues are unresolved, including the value of shares in the reorganized company).

26. *See* Baird, *supra* note 25, at 345.

27. *See id. See also* 11 U.S.C. § 1123(a) (1994) (describing some of the mandatory plan provisions).

28. *See Hearing on Operation of the Bankruptcy System*, *supra* note 2, at 44-45 (statement of Charles Tatelbaum, Vice President for Research, American Bankruptcy Institute).

29. 11 U.S.C. § 1141(a)-(b) (1994).

in the confirmed plan as free and clear of all claims and interest of creditors, unless the plan provides otherwise.[30]

In sum, the bankruptcy system prioritizes the rights of various claimants to particular assets.[31] Despite the complexity of the bankruptcy laws, this system serves to protect the commercial credit economy and allow debtors to become economically productive members of society.[32]

II. VOID/VOIDABLE DISTINCTION FOR VIOLATIONS OF THE AUTOMATIC STAY

A. *Background*

Congress designed the automatic stay[33] to protect debtors from a creditor's efforts to collect property while the debtor attempts to regain financial stability.[34] The automatic stay prohibits creditors from taking any action to enforce debts or liens against the debtor or the bankruptcy estate.[35] By preserving the prepetition state of affairs, the automatic stay protects both debtors and creditors. The stay temporarily relieves the debtor from collection efforts, while simultaneously protecting creditors from diminishment of the estate.[36] The breadth of the automatic stay is expansive, encompassing activities such as sending a demand letter and perfecting a lien against property of the bankruptcy estate.[37]

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30. *Id.* § 1141(d).

31. *See* Thomas H. Jackson, *Translating Assets and Liabilities to the Bankruptcy Forum*, *in* CORPORATE BANKRUPTCY: ECONOMIC AND LEGAL PERSPECTIVES, *supra* note 13, at 58.

32. *See* Quittner, *supra* note 4, at 30.

33. *See* 11 U.S.C. § 362.

34. *See* H.R. REP. NO. 95-595, at 340 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6296-97. The automatic stay is one of the fundamental debtor protections provided by the bankruptcy laws. It 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.

Id.

35. *See* 11 U.S.C. § 362. The statute states:

(a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title, or an application filed under section 5(a)(3) of the Securities Investor Protection Act of 1970, 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 action or 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;

. . .

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

Id. § 362(a)(1), (6).

36. *See* Timothy Arnold Barnes, Note, *The Plain Meaning of the Automatic Stay in Bankruptcy: The Void/Voidable Distinction Revisited*, 57 OHIO ST. L.J. 291, 293 (1996).

37. *See* 11 U.S.C. § 362(a).

Although the automatic stay applies to all entities, including governmental agencies, the protection it offers can be limited.[38] A creditor may request termination, modification or annulment of the stay in certain circumstances.[39] Termination of the automatic stay, the most frequently granted form of relief, prospectively ends the stay.[40] Although less frequent, courts also grant an annulment of the automatic stay, which retroactively validates an act that violated the stay.[41] If a creditor does not seek annulment from the automatic stay, courts will consider an action taken in violation of the automatic stay as void or voidable.[42]

Actions in violation of the automatic stay are classified as either void or voidable, a determination which has important implications. A void act simply has no legal effect, whereas a voidable act requires action by the debtor to undo the effects of the creditor's act.[43] Most courts have considered an action taken in violation of an automatic stay as void.[44] When a court finds that an act taken in violation of the automatic stay is void and, therefore, of no effect, the court furthers the goal of the automatic stay: preservation of the debtor's prepetition financial circumstances.[45] Those courts that find acts taken in violation of the automatic stay voidable view an annulment as a remedy available to a creditor seeking relief from the automatic stay.[46] When a court annuls an act taken in violation of the automatic stay, the court may then retroactively validate the act.[47] Because a court can retroactively validate an act that would have been in violation of the stay, some courts believe that these acts must be voidable because a court would be incapable of retroactively validating a void act, an act defined as being entirely without effect.[48]

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38. 3 WILLIAM MILLER COLLIER, COLLIER ON BANKRUPTCY ¶ 362.03 (Lawrence P. King ed., 15th ed. 1997) (noting that "entity" is broader than the term "person").

39. 11 § 362(d)(1).

> (d) 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—
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> (1) for cause, including the lack of adequate protection of an interest in property of such party in interest; . . . .

Id.

40. *See* GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY LAW 227 (3d ed. 1993).

41. *See id.*

42. *See* Picco v. Global Marine Drilling Co., 900 F.2d 846, 850 (5th Cir. 1990); COLLIER, *supra* note 38, ¶ 362.11[1].

43. *See In re* Schwartz, 954 F.2d 569, 571 (9th Cir. 1992). The distinction between a void or voidable act is similar to the difference between a void or voidable contract. Barnes, *supra* note 36, at 306-08. A court cannot cure a defect in a void contract or enforce a void contract, as in the case of a contract made to further an illegal purpose. *Id.* Unlike a void contract, a court may enforce a voidable contract unless one of the parties to the contract objects, such as when a minor disaffirms a contract. *Id.* at 307.

44. COLLIER, *supra* note 38, ¶ 362.11[1].

45. *See Schwartz*, 954 F.2d at 571.

46. *See* COLLIER, *supra* note 38, ¶ 362.11[1].

47. *See* 11 U.S.C. § 362(d) (1994).

48. *See* Picco v. Global Marine Drilling Co., 900 F.2d 846, 850 (5th Cir. 1990).

The Internal Revenue Service (IRS) has been recognized "as one of the most blatant violators of the automatic stay."[49] Some common actions taken by the IRS in violation of the automatic stay include a setoff of tax refunds against tax liabilities, filing a tax lien against a debtor's property and other collection activities.[50] Courts have also found that the completion of a tax assessment by the IRS violates a stay.[51] An assessment is an initial step in collecting taxes, and usually the assessment occurs automatically upon the filing of a tax return.[52] An assessment determines the amount of taxes due and is not a condition precedent to the accrual of tax liability.[53]

If the IRS assesses taxes without seeking relief from the automatic stay, the validity of the assessment depends upon the void/voidable distinction.[54] A void tax assessment has no effect on the rights of the creditor or debtor, while a voidable tax assessment is valid and affects the parties' rights until and unless the debtor challenges the assessment.[55] If a court considers a tax assessment void, the court must then determine the consequences of the void assessment.[56] Logic dictates that if the assessment is not required to create tax liability, a void tax assessment should not relieve a debtor of the liability, but should only detrimentally affect the collection of the taxes, such as by removing a tax lien.[57]

The Tenth Circuit previously determined that a violation of the automatic stay renders the act void and of no effect.[58] In *Ellis v. Consolidated Diesel Electric Corp.*,[59] the court held that the granting of a motion for summary judgment before obtaining relief from the automatic stay

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49. Barnes, *supra* note 36, at 315.

50. Stephen W. Sather, *Tax Issues in Bankruptcy*, 25 ST. MARY'S L.J. 1363, 1393-94 (1994).

51. *See In re* Schwartz, 954 F.2d 569, 571 (9th Cir. 1991); Alesia Ranney-Marinelli et al., *Recent Developments: Automatic Stay Litigation, in* 18TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION, 1996, at 925, 932 (PLI Commercial Law & Practice Course Handbook No. A4-4498, 1996).

52. *See* Frances R. Hill, *Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach*, 50 TAX LAW. 103, 154-55 (1996) (explaining that the IRS may automatically assess taxes upon the filing of a return or summarily assess taxes if the amount due is understated due to a mathematical or clerical error).

53. *See* United States v. Latham, 754 F.2d 747, 750 (7th Cir. 1985) (stating that an assessment of income taxes is not a prerequisite for income tax liability); Marvel v. United States, 719 F.2d 1507, 1514 (10th Cir. 1983) (explaining that no requirement exists in the Internal Revenue Code that a notice of tax deficiency or assessment must be given before liability accrues for employment taxes since liability arises by the duty to collect such taxes). Recent revisions to the Internal Revenue Code require issuance of a preliminary notice before making an assessment, suggesting that an assessment may be a prerequisite to liability. *See* I.R.C. § 6672 (West Supp. 1997).

54. *See* Barnes, *supra* note 36, at 306; *In re* Schwartz, 954 F.2d 569, 570-71 (9th Cir. 1991).

55. *See Schwartz*, 954 F.2d at 571.

56. *See In re* Goldston, 104 F.3d 1198, 1199-200 (10th Cir. 1997) (considering whether a void tax assessment relieves the debtor of tax liability).

57. *See Schwartz*, 954 F.2d at 574-75 (affirming a bankruptcy court order denying IRS claim).

58. Meyer v. Rowan, 181 F.2d 715, 716 (10th Cir. 1950).

59. 894 F.2d 371 (10th Cir. 1990).

rendered the order on summary judgment void.[60] The Tenth Circuit also determined that liability for taxes is independent of a tax assessment, although *Marvel v. United States*[61] was not decided in the context of the automatic stay.[62] In *Marvel,* the court concluded that deficient tax notices did not relieve a taxpayer of liability because the Internal Revenue Code did not require a notice of assessment before liability accrued.[63] In *In re Goldston,*[64] the court had the opportunity to consider the consequences to the IRS of a tax assessment made in violation of the automatic stay. Although the 1994 amendments to the Bankruptcy Code have largely rendered the void/voidable distinction moot with respect to tax assessments, the amendments were not applicable in *Goldston.*[65]

B. In re Goldston

1. Facts

Goldston, the owner of Sunnylane Electric, withheld approximately $27,000 in FICA and federal employment funds from his employees wages, but failed to remit those funds to the IRS.[66] In October 1989, Goldston filed a voluntary petition under Chapter 11.[67] The IRS assessed a penalty of $27,829.79 against Goldston without obtaining relief from the automatic stay.[68] Goldston subsequently dismissed the bankruptcy, and the IRS filed a notice of federal tax lien with the state register of deeds.[69] In December 1991, Goldston filed a petition under Chapter 13.[70] The IRS, based on the notice of federal tax lien, filed a secured claim.[71] Goldston challenged the claim, arguing that the assessment was void and that therefore, the IRS was not entitled to a secured claim.[72] The bankruptcy court granted summary judgment in favor of the IRS on the basis

60. *Ellis,* 894 F.2d at 372-73.
61. 719 F.2d 1507 (10th Cir. 1983).
62. *Marvel,* 719 F.2d at 1514.
63. *Id.*
64. 104 F.3d 1198 (10th Cir. 1997).
65. *See* 11 U.S.C. § 362(b)(9) (1994); A. Breault et al., *Bankruptcy Act Covers Tax Collection,* 54 TAX'N FOR ACCT. 125, 125 (1995). Although the tax assessment may be valid under the recent amendments, the tax lien that arises from such assessment may not take effect with respect to property of the estate unless the tax is nondischargeable and the property to which the lien may attach is not property of the estate. *See* 6 NORTON, *supra* note 9, § 133:7. The Bankruptcy Code amendments became effective on October 22, 1994, and did not apply to cases commenced prior to the effective date. *See* 11 U.S.C. § 362.
66. *Goldston,* 104 F.3d at 1200.
67. *Id.*
68. *Id.*
69. *Id.*
70. *Id.*
71. *Id.*
72. *Id.*

that Goldston's liability for the taxes existed independent of an assessment.[73] The district court affirmed.[74]

2. Decision

The Tenth Circuit addressed whether a valid tax assessment is a prerequisite to a subsequent secured claim for the taxes.[75] In determining the validity of the tax assessment, the court asserted that the debtor's liability derives from his statutory duty to pay taxes.[76] The court found that the debtor met the definition of a "responsible person" contained in the Internal Revenue Code and that his liability arose at the moment he withheld taxes from his employees' wages.[77] The court held that the tax assessment, though void, did not alter the debtor's liability for the tax.[78] As a penalty against the IRS for violating the automatic stay, the court deprived the IRS of its secured status, rather than invalidating the tax assessment.[79]

C. *Other Circuits*

The Eighth Circuit addressed a similar issue in *In re Riley*.[80] The IRS issued a notice of proposed assessment pursuant to Internal Revenue Code § 6672 without obtaining relief from the automatic stay.[81] After the stay expired, the IRS issued an assessment, of which the debtor paid a portion and sought a refund for the remainder.[82] The Eighth Circuit determined that the provisions of the Internal Revenue Code did not require the IRS to issue a proposed assessment.[83] Although the proposed assessment notice was void, the court concluded that the subsequent tax assessment was not void.[84]

D. *Analysis*

The Bankruptcy Code and the Internal Revenue Code are not systematically coordinated.[85] The goals of bankruptcy and the collection of tax revenue conflict, particularly when the automatic stay prevents the

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73. *Id.*
74. *Id.* at 1199-1200.
75. *Id.*
76. *Id.*
77. *Id.*
78. *Id.*
79. *Id.* at 1201.
80. 118 F.3d 1220 (8th Cir. 1997), *petition for cert. filed*, 66 U.S.L.W. 3434 (U.S. Dec. 15, 1997) (No. 97-990).
81. *Riley*, 118 F.3d at 1221.
82. *Id.*
83. *Id.* at 1222.
84. *Id.* The IRS assessment was not void simply because it was "issued after a 'void' notice that the agency was under no obligation to issue in the first place." *Id.*
85. Hill, *supra* note 52, at 105.

IRS from taking ordinary steps in collecting taxes.[86] The automatic stay preserves the assets of the estate for equitable distribution among creditors.[87] The effectiveness of the automatic stay depends upon the cooperation of creditors in ceasing their collection efforts and, for this reason, courts use judicial sanctions to ensure cooperation.[88] When a creditor, including the IRS, violates the automatic stay, the bankruptcy court must determine the effect of the creditor's act.[89]

In considering the effect of a violation of the automatic stay, the Tenth Circuit focused on the debtor's underlying liability for the taxes.[90] The Tenth Circuit only had to decide whether a void assessment absolved the taxpayer of liability because the IRS had conceded that the penalty assessment was void.[91] The court determined that the IRS should simply be denied any benefit gained by the assessment and the taxpayer should not be relieved of underlying tax liability.[92] This result is appropriate because an assessment, a prerequisite for collection of the tax, does not affix liability for the taxes.[93]

Although 1994 amendments to the Internal Revenue Code resolved the issue the Tenth Circuit confronted in *Goldston* by excepting assessments from the stay, a similar issue may arise in the future concerning the validity of a preliminary notice of tax assessment. Before the IRS can impose a penalty for failure to remit trust fund taxes (taxes collected and withheld from employees), the IRS must follow certain statutory procedures.[94] To meet one of the procedural requirements, the IRS must issue a preliminary tax notice before assessing a penalty against a responsible person.[95] Although the Bankruptcy Code now excepts tax assessments from the automatic stay, the 1994 amendments did not create an exception to permit the IRS to issue such preliminary notices without seeking relief from the automatic stay.[96] Thus, the issue of the effect of a void act made in violation of the automatic stay may also arise when the IRS is-

86. *Id.* at 156.

87. Barnes, *supra* note 36, at 298 (describing the "feeding frenzy" that might occur on the debtor's assets absent the automatic stay).

88. *Id.* at 292.

89. *Id.* at 306-07.

90. *In re* Goldston, 104 F.3d 1198, 1200 (10th Cir. 1997).

91. *Id.*

92. *Id.*

93. James S. Niblock, Comment, Moran v. United States: *You Pay Your Money and You Take Your Chances*, 22 J. CORP. L. 153, 166 (1996).

94. JACOB MERTENS, JR., MERTENS LAW OF FEDERAL INCOME TAXATION § 55.104 (1942); Matthew J. McGowan, *Enjoining Enforcement of the 100% Tax Penalty in Corporate Chapter 11 Proceedings*, 34 R.I. B. J. 5, 5 (1986).

95. I.R.C. § 6672(b) (Supp. 1997).

96. 11 U.S.C. § 362(d)(9) (1994).

sues a preliminary notice of tax assessment without obtaining relief from the automatic stay.[97]

Goldston indicates that a court may find that the void notice renders a subsequent assessment invalid.[98] Under the Tenth Circuit's *Goldston* analysis, a court could conclude that the debtor's liability existed regardless of the void notice and resulting defective assessment.[99] A court might further reason that the IRS should be placed in the same position it occupied before the debtor filed bankruptcy. In other words, the court could deny the IRS any benefit it obtained from issuing a notice in violation of the stay.[100]

III. VIABILITY OF PREPETITION SETOFFS UNDER 11 U.S.C. § 553(b)

A. *Background*

State law has traditionally governed a creditor's right of setoff.[101] The right of setoff allows a creditor to reduce the amount that the debtor owes the creditor by the amount that the creditor owes the debtor.[102] Setoff often arises in transactions where a bank makes a loan to a debtor who has a depository account at the bank.[103] If the debtor defaults on the loan, the bank may offset the amount owed to the bank by the amount the bank owes to the customer on the depository account.[104]

The Bankruptcy Code preserves the right of a creditor to offset a debt owed to the creditor as the right exists under state law.[105] Nevertheless, the creditor's right to setoff is not unlimited.[106] Prepetition setoffs

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97. *See In re* Riley, 118 F.3d 1220, 1222 (8th Cir. 1997), *petition for cert. filed*, 66 U.S.L.W. 3434 (U.S. Dec. 15, 1997) (No. 97-990) (implying that the assessment might be invalid if proper procedures are not followed).

98. *Id.*

99. *In re* Goldston, 104 F.3d 1198, 1200 (10th Cir. 1997).

100. For example, the court could eliminate the secured claim. *See* Alesia Ranney-Marinelli et al., *supra* note 51, at 933-34 (describing case law interpreting the effect of an action taken in violation of the automatic stay).

101. Russell J. Passamano, *Setoff in Bankruptcy: An Overview of the Mechanics*, 105 BANKING L.J. 349, 351 (1988).

102. *See* Paul Amiel et al., *Take the Money and Run: Setoff and the Bankruptcy Code*, *in* ADVANCED BANKRUPTCY WORKSHOP: CASE STUDIES IN HANDLING CHAPTER 11 PROBLEMS 661, 663 (PLI Commercial Law & Practice Course Handbook Series No. A4-4217, 1988) (stating that the bank's right to offset the indebtedness of the depositor is equitable and does not depend on the existence of a lien).

103. Jack F. Williams, *Application of Cash Collateral Paradigm to the Preservation of the Right to Setoff in Bankruptcy*, 7 BANKR. DEV. J. 27, 31 (1990).

104. *See* Jack B. Justice, *Setoff Against a Depositor Facing Bankruptcy: A Question of Timing*, 110 BANKING L.J. 310, 310 (1993).

105. *See* Williams, *supra* note 103, at 30 (stating that the Bankruptcy Code preserves any nonbankruptcy setoff right).

106. The right of setoff is also subject to certain restrictions. The primary restriction is mutuality. *See id.* at 33. The mutuality requirement prescribes that the debt to be setoff must be owed between the same parties in the same capacity. Mr. Avery, *E Pluribus Unum-Maybe: The Ninth and Tenth Circuits*

are subject to the scrutiny of the trustee and the bankruptcy court,[107] while setoffs made after the debtor files a petition for bankruptcy are precluded by the automatic stay.[108] Under the code, creditors who exercise the right of setoff risk the possibility that the trustee would seek to have the setoff avoided by the court.[109] If the court avoids the setoff, the creditor has an unsecured claim.[110] In contrast, when a creditor refrains from exercising its right to setoff, the creditor retains a secured claim.[111] Moreover, bankruptcy law treats postpetition setoff rights as the equivalent to a lawful preference.[112] Without such preferred status for setoff rights, creditors would precipitously exercise their setoff rights, rather than risk losing that right in subsequent bankruptcy proceedings.[113] The regulation of setoff rights therefore promotes the commercial policy of bankruptcy avoidance because setoffs can prematurely force debtors into bankruptcy.[114]

When a creditor exercises its prepetition setoff rights, the court considers whether the creditor gained an unfair advantage over other creditors by exercising the prepetition setoff.[115] If so, the setoff should be voided.[116] To make this determination, the trustee uses the "point in time" (or improvement in interest) test.[117] Utilizing this test, the court calculates

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Conflict on Bankruptcy Setoff Rights Involving More than One Government Agency, ARMY LAW., Nov. 1995, at 30. The requirement of mutuality is usually strictly construed. *See* Samuel R. Maizel, *Setoff and Recoupment in Bankruptcy*, *in* 19TH ANNUAL CURRENT DEVELOPMENTS IN BANKRUPTCY AND REORGANIZATION 1997, at 733, 742 (PLI Commercial Law & Practice Course Handbook Series No. A4-4519, 1997). Mutuality serves the purpose of defining those kinds of prepetition claims and debts that may be fairly offset in bankruptcy. COLLIER, *supra* note 38, ¶ 553.03[3][a].

107. *See* Samuel R. Maizel, *supra* note 106, at 832 (stating that prepetition setoffs may be avoided or limited by the trustee if the setoff improved the position of the creditor).

108. 11 U.S.C. § 362(a)(7) (1994). The statute states:

> (a) Except as provided in subsection (b) of this section, a petition filed under section 301, 302, or 303 of this title . . . operates as a stay, applicable to all entities, of—
>
> . . .
>
> (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; . . . .
>
> *Id.*

109. *Id.*

110. *Id.*

111. *See* Williams, *supra* note 103, at 35 (explaining that the Bankruptcy Code treats a right to setoff as a secured claim).

112. *See* COLLIER, *supra* note 38, ¶ 553.02 (stating that setoff rights are protected in bankruptcy in the same manner as rights arising from a security agreement); Philip T. Lacy, *Setoff and the Principle of Creditor Equality*, 43 S.C. L. REV. 951, 964-65 (1992) (explaining that the rationale for the trustee's power to avoid preferential transfers is to preserve creditor equality, which means unsecured creditors should share equally in a debtor's estate through pro rata distribution).

113. *See* Justice, *supra* note 104, at 323 (describing the dilemma facing a bank with a setoff right).

114. *See* COLLIER, *supra* note 38, ¶ 553.02[2].

115. Lacy, *supra* note 112, at 975-76.

116. *Id.*

117. *See* 11 U.S.C. § 553(b)(1)(A)-(B).

> Except with respect to a setoff of a kind described in section 362(b)(6), 362(b)(7), 362(b)(14), 365(h), or 365(i)(2) of this title, if a creditor offsets a mutual debt owing to the debtor against a claim against the debtor on or within 90 days before the date of the

the creditor's setoff position, that is, a comparison of the amount the debtor owed to the creditor with the amount the creditor owed the debtor, ninety days before the debtor filed for bankruptcy.[118] The amount by which the creditor's claim exceeds the amount owed to the debtor is the insufficiency.[119] The same measurement is also made on the date of the setoff.[120] Finally, a comparison is made between the creditor's setoff position at the initial reference point and the date on which the setoff was actually taken.[121] The trustee can recover any improvement in the creditor's position.[122] The application of this test does not depend upon the debtor's insolvency at the time of setoff.[123]

During the survey period, the Tenth Circuit addressed a federal administrative agency's challenge to the bankruptcy court's application of the point in time test.[124]

B. In re Turner[125]

1. Facts

Over a period of time, the Turners borrowed approximately $200,000 from the Small Business Association (SBA).[126] The Turners defaulted on the loan and the SBA attempted to accelerate the debt and to require that the Turners immediately pay the entire outstanding balance due on the loan.[127] The Turners subsequently executed four contracts with the Agricultural Stabilization and Conservation Service (ASCS), in which the Turners agreed to withhold certain land from production in exchange for deficiency payments.[128] The SBA notified the Turners that it intended to exercise an administrative offset of any ASCS payments owed to the Turners against the debt they owed to the SBA.[129] From December 30, 1992 to February 8, 1993, SBA offset approximately

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filing of the petition, then the trustee may recover from such creditor the amount so offset to the extent that any insufficiency on the date of such setoff is less than the insufficiency on the later of—

(A) 90 days before the date of the filing of the petition; and

(B) the first date during the 90 days immediately preceding the date of the filing of the petition on which there is an insufficiency.

Id.

118. COLLIER, *supra* note 38, ¶ 553.09[2][a].

119. *Id.*

120. *Id.*

121. *Id.*

122. *Id.*

123. *See* Passamano, *supra* note 101, at 351-52 (explaining the trustee's power to recover a prepetition setoff).

124. *In re* Turner, 96 F.3d 465, 467 (10th Cir. 1996).

125. *Turner*, 84 F.3d at 1296.

126. *In re* Turner, 59 F.3d 1041, 1043 (10th Cir. 1995).

127. *Id.*

128. *Id.*

129. *Id.*

$24,599.35.[130] The bankruptcy court held that setoff was avoidable under 11 U.S.C. § 553(b) because the setoff occurred within the ninety day preference period.[131] The district court affirmed the decision of the bankruptcy court.[132] On the first appeal, the Tenth Circuit determined that 11 U.S.C. § 547 governed the setoff, rather than 11 U.S.C. § 553.[133] After voting to grant rehearing en banc, the Tenth Circuit asserted that 11 U.S.C. § 553 rather than 11 U.S.C. § 547 should be applied.[134] The en banc court remanded the case to the Tenth Circuit panel for consideration of the setoff under 11 U.S.C. § 553.[135]

2. Decision

The panel found that the Turners were not entitled to recover the ASCS payments, and that the setoffs were proper.[136] The court concluded that the amount of the insufficiency did not change between the date ninety days before the petition was filed, and the date of the setoffs because the ASCS payments would have reduced the amount owed to the Turners by the same amount that the debt owed to the SBA would have been reduced.[137]

C. *Other Circuits*

In *Bakersfield Westar Ambulance v. Community First Bank*,[138] the Ninth Circuit analyzed a fully secured creditor's rights under the improvement in position test.[139] The creditor argued that a fully secured creditor cannot improve its position relative to other creditors.[140] Before analyzing the creditor's argument, however, the court found that the creditor did not have a valid security interest, and the improvement in position test of 11 U.S.C. § 553(b) was applicable.[141] The court concluded

130. *Id.*

131. *In re* Turner, 96 F.3d 465, 467 (10th Cir. 1996). Section 553(b) provides for use of the "point in time" test. 11 U.S.C. § 553(b) (1994).

132. *Turner*, 96 F.3d at 465.

133. *Id.*; *see also Turner*, 59 F.3d at 1043 (stating that section 553 applies to setoffs, and section 547 applies to voidable preferences).

134. *In re* Turner, 84 F.3d 1294, 1296 (10th Cir. 1996).

135. *Id.*

136. *Turner*, 96 F.3d at 468.

137. *Id.* at 468. On the date of the petition was filed the amount owed the SBA was $199,551.58 and the amount owed the Turners was $24,599.35, and thus the insufficiency was $174,952.23. *Id.* After the first setoff in the amount of $2,788.00, the Turners would have owed the SBA $196,763.58 and the Turners would be owed $21,811.35 by the ACSC. *Id.* Thus, the insufficiency remained unchanged. *Id.*

138. 123 F.3d 1243 (9th Cir. 1997).

139. *Bakersfield*, 123 F.3d at 1246.

140. *Id.*

141. *Id.* at 1248. In determining the extent of the creditor's security, the court focused on the description of the collateral in the security agreement. *Id.* at 1247.

that the creditor was undersecured and affirmed the bankruptcy court's conclusion that the setoff was voidable.[142]

D. *Analysis*

Because the Bankruptcy Code only preserves a creditor's setoff right as it exists under state law, the court must determine, as a threshold issue, whether the creditor has a valid setoff right under state law.[143] As illustrated by the decision in the Ninth Circuit, a court must first determine the extent of the creditor's setoff rights before deciding the validity of the prepetition setoff.[144]

If the setoff is valid under state law, the trustee may challenge the setoff if it occurred on or within ninety days of the filing of the bankruptcy petition.[145] If the creditor exercised its right to setoff during this prepetition time period, the trustee may recover the amount by which the creditor improved its position.[146] If the creditor did not improve its position, however, the trustee cannot recover.[147]

To determine whether the creditor improved its position due to the setoff, a court compares the difference in value of the creditor's security at two points in time.[148] To illustrate the proper operation of the test, suppose a bank gave a loan to a debtor in the amount of $15,000, and ninety days before filing bankruptcy the debtor had $10,000 in a deposit account.[149] Thus, ninety days before the bankruptcy, the insufficiency was $5,000.[150] Thirty days before filing bankruptcy, the debtor deposited an additional $4,000 in the account, which reduced the insufficiency to $1,000.[151] If the bank exercises its right to setoff, the bank improved its position in the amount of $4,000 ($5,000 insufficiency at ninety days; $1,000 insufficiency at the time of setoff).[152] The trustee may recover the amount of $4,000 from the bank.[153]

When the Tenth Circuit applied the test, the court reduced the amount owed to the SBA by the amount of the setoff in calculating the insufficiency, which appears to be a misapplication of the test.[154] The court stated that the amount of the insufficiency did not change because

142. *Id.* at 1248-49.
143. Williams, *supra* note 103, at 30-31.
144. *Bakersfield*, 123 F.3d at 1247.
145. 11 U.S.C. § 553(b) (1994).
146. *Id.*
147. *Id.*
148. *Id.*
149. 5 COLLIER, *supra* note 38, ¶ 553.09[2][b].
150. *Id.*
151. *Id.*
152. *Id.*
153. *Id.*
154. *See* Justice, *supra* note 104, at 317 (illustrating that the setoff amount does not reduce the loan amount for purposes of calculating the insufficiency).

the setoff decreased the amount owed to the debtor by the same amount as the debt owed to the creditor was decreased.[155] The Tenth Circuit calculated the insufficiency as $174,952.23 by comparing $196,763.58, the amount owed to the creditor, as reduced by the setoff amount, to $21,811.35, the amount owed to the debtor, as reduced by the setoff amount. The Tenth Circuit's calculation appears faulty because it calculated the insufficiency using the setoff amount.[156] According to this analysis, a creditor could never gain an improvement in position because the amount of the setoff always reduces the amount owed to the creditor by the amount of the setoff. Despite the flawed calculation, the Tenth Circuit's result was proper because the SBA did not improve its position by the setoff, and the trustee should not be entitled to recover the amount of the setoff.[157]

IV. DENIAL OF DISCHARGE UNDER 11 U.S.C. § 727

A. *Background*

A discharge relieves a debtor of his or her preexisting obligations and grants the debtor a fresh start, achieving the ultimate goal of a bankruptcy proceeding.[158] Rewarding an honest debtor with a discharge reflects a policy choice to forgive the debtor instead of punishing the debtor for his financial negligence or indolence.[159] A discharge is a privilege, not a right.[160] Only individuals may receive discharges.[161] Further, a discharge only relieves a debtor of those debts that arose prior to the filing of the bankruptcy petition, so a court cannot discharge debts incurred after the bankruptcy commences.[162] If a discharge is denied, the debtor remains liable for repaying his debts.[163]

Because of the strong policy preferences for granting a debtor a fresh start, however, a discharge may be denied only in certain limited statutory exceptions.[164] In a bankruptcy case, the creditor bears the burden

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155. *In re* Turner, 96 F.3d 465, 468 (10th Cir. 1996).

156. *See generally* 5 COLLIER, *supra* note 38, ¶ 553.09[2][a] (illustrating proper application of the improvement in position test).

157. *See* 3 NORTON, *supra* note 9, § 63:18.

158. *See* S. REP. NO. 95-989, at 7 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5793.

159. *See* Craig H. Averch, *Denial of Discharge Litigation*, 16 REV. LITIG. 65, 66 (1997) (describing the history of debtor law and the Roman punishment of cutting up a debtor's body and dividing the pieces among his creditors); Margaret Howard, *A Theory of Discharge in Consumer Bankruptcy*, 48 OHIO ST. L.J. 1047, 1052 (1987).

160. *See* Ponoroff & Knippenberg, *supra* note 14, at 239.

161. COHEN, *supra* note 15, ¶ 13-311.22[1].

162. Averch, *supra* note 159, at 70.

163. *See* Andrea A. Wirum & Jacqueline S. Dailey, *Discharge*, *in* BASICS OF BANKRUPTCY AND REORGANIZATION 1992, at 635, 637 (PLI Commercial Law & Practice Course Handbook Series No. A4-4391, 1992).

164. *See* COLLIER, *supra* note 38, ¶ 727.01[1]; Howard, *supra* note 159, at 1050-51 (describing that the Bankruptcy Commission found little empirical substantiation of the incidences of dishonest conduct by debtors).

of proving by a preponderance of the evidence that the debtor should be denied a discharge.[165] The bases for denial of discharge include the failure to maintain adequate records, the knowing or fraudulent making of a false oath in connection with a bankruptcy, and the transfer of assets within one year of the filing for bankruptcy with the intent to hinder, delay or defraud a creditor.[166] These exceptions focus on the debtor's attempts to conceal or prevent distribution of his assets.

The refusal to discharge for failure to maintain adequate records stems from the belief that a creditor has a right to ascertain the debtor's financial status and verify the information he has provided under oath.[167] The standard for adequacy of records is determined on a case-by-case basis.[168] The records do not have to be in a specific format, but the form must be appropriate to a debtor's business.[169] The debtor must make documents and computer-generated records that reflect a debtor's financial condition available to the creditors.[170] If the court determines that the debtor breached this duty to maintain these records, and the debtor fails to adequately justify this breach, a denial of discharge is appropriate.[171]

A court may also deny discharge if the debtor knowingly and fraudulently made a false oath in connection with the case.[172] This exception ensures that the debtor provides reliable information throughout the bankruptcy proceedings.[173] A court may find that a debtor has misrepresented his financial state if the bankruptcy petition and schedules contain false information because the debtor must sign these documents under oath.[174] The knowing or fraudulent making of a false oath in connection with a bankruptcy, by definition, excludes inadvertent errors by the debtor.[175] The false statement must, however, relate to a material matter in the case, which generally includes statements that relate to the discovery of assets or the business dealings of the debtor.[176]

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165. Averch, *supra* note 159, at 128-29.

166. *See* 11 U.S.C. § 727 (1994).

167. 6 NORTON, *supra* note 9, § 74:9 (stating that complete disclosure is a "quid pro quo for discharge").

168. *See* Meridian Bank v. Alten, 958 F.2d 1226, 1230 (3rd Cir. 1992).

169. *See* Johnson v. Bockman, 282 F.2d 544, 547 (10th Cir. 1960) (noting that impeccable bookkeeping is not required).

170. *See* COLLIER, *supra* note 38, ¶ 727.03[1].

171. *Id.*

172. 11 U.S.C. § 727(a)(4)(A) (1994).

173. Averch, *supra* note 159, at 104.

174. COLLIER, *supra* note 38, ¶ 727.04[1][a]; *see also* Averch, *supra* note 159, at 106-07 (suggesting that understatement of income of value of assets may be considered a false oath under 11 U.S.C. § 727(a)(4)(A) (1994)).

175. *See In re* Espino, 806 F.2d 1001, 1002 (11th Cir. 1986) (upholding a bankruptcy court finding that debtor's failure to list a contingent claim was not an act intended to defraud creditors).

176. *See In re* Chalik, 748 F.2d 616, 618 (11th Cir. 1984); Averch, *supra* note 159, at 102-03.

Denial of discharge is also appropriate if the debtor transferred assets with the intent to hinder, delay, or defraud creditors.[177] Courts broadly construe what constitutes a transfer.[178] Courts examine evidence of the debtor's intent as the determinative factor in distinguishing between lawful and unlawful transfers.[179] The intent of the debtor to defraud creditors must be an actual, rather than constructive intent.[180] The creditor may use circumstantial evidence or suggest inferences from a course of conduct to establish fraudulent intent.[181] The debtor's intent to favor one creditor over another, without additional evidence, however, is not sufficient to warrant denial of a discharge.[182] Similarly, the conversion of nonexempt assets into exempt assets on the eve of bankruptcy, without additional evidence, does not establish the debtor's intent to defraud creditors.[183]

In order to grant a denial of discharge, courts must make fact-specific evaluations. For this reason, appellate courts review the trial court's findings using the deferential "clearly erroneous" standard.[184] The Tenth Circuit used this standard to resolve an appeal in which the creditor claimed that the debtor should have been denied discharge on all three statutory grounds.

B. In re Brown[185]

1. Facts

Four days before filing bankruptcy, Brown transferred a security interest in an antique car collection.[186] Through the transfer, Brown sought to infuse cash into his business to pay attorneys and suppliers.[187] Brown continued to possess and use the collection.[188] Some discrepancies existed between the value of the debtor's assets as disclosed on prepetition financial statements and the submitted bankruptcy schedules, and the

177. 11 U.S.C. § 727(a)(2) (1994).

178. *Id.* § 101(54). Transfer is defined as "every mode, direct or indirect, absolute or conditional, voluntary or involuntary, of disposing of or parting with property or with an interest in property, including retention of title as a security interest and foreclosure of the debtor's equity of redemption." *Id.*

179. *See* Ponoroff & Knippenberg, *supra* note 14, at 243-44 (explaining that the outcome of cases on objection to discharge appear to be based on the court's subjective assessment of the debtor's honesty instead of the debtor's intent in effectuating the transfer).

180. COLLIER, *supra* note 38, ¶ 727.02[3][a].

181. *See In re* Miller, 39 F.3d 301, 304-05 (11th Cir. 1994).

182. *In re* Parnell Lumber Co., 107 F. Supp. 794, 800 (N.D. Ohio 1951).

183. Averch, *supra* note 159, at 87.

184. *See In re* Schneider, 864 F.2d 683, 685 (10th Cir. 1988).

185. 108 F.3d 1290 (10th Cir. 1997).

186. *Brown*, 108 F.3d at 1293.

187. *Id.*

188. *Id.*

debtor omitted an automobile from his schedules.[189] The debtor also failed to keep adequate records involving the antique car collection.[190]

2. Decision

The court held that a denial of discharge was not warranted in this case,[191] rejecting all three of the creditor's bases for denial of Brown's discharge. The creditor objected to discharge because the debtor transferred a security interest in the antique car.[192] The court found that although the granting of a security interest is a transfer, the circumstances did not indicate that the debtor acted with the intent to hinder or defraud the creditor.[193] The mere fact that the transfer occurred soon before the filing and that the debtor retained control of the assets did not alter the fact that the transaction was made at arm's length.[194]

The debtor's errors on his bankruptcy schedules created the second potential basis for the denial of discharge.[195] The court found that because the debtor voluntarily disclosed what he claimed had been inadvertent omissions, he lacked fraudulent intent.[196]

The creditor also argued that the court should deny the discharge because the debtor maintained inadequate records.[197] To make a prima facie case on this claim, the creditor must demonstrate that the failure to preserve adequate records made it impossible to ascertain the debtor's financial condition and material business transactions.[198] In addition, the court considered the debtor's cash transactions not unusual because they were in furtherance of his hobby.[199]

C. *Other Circuits*

The Fourth Circuit reviewed two cases in which the trial court denied a discharge for failure to disclose assets in the bankruptcy schedules. Utilizing the "clearly erroneous" standard of review, the Fourth Circuit,[200] affirmed the denial of a debtor's discharge based upon the debtor's false oath in failing to disclose material information on his schedules pertaining to his ownership interest in a business the debtor

189. *Id.* at 1294.
190. *Id.* at 1295.
191. *Id.* at 1294.
192. *Id.* at 1293.
193. *Id.*
194. *Id.*
195. *Id.* at 1294.
196. *Id.* at 1295.
197. *Id.*
198. *Id.*
199. *Id.*
200. *In re* Jaray, 114 F.3d 1176 (4th Cir. 1997).

owned and operated.[201] The court found the debtor's attempt to amend his schedules inadequate to cure the false oath.[202]

In *In re Kestell*,[203] the debtor filed for bankruptcy thirteen days after a divorce judgment was awarded to his ex-wife, and reaffirmed almost all debts, except those owed to his ex-wife.[204] The debtor's ex-wife filed an objection to discharge based upon the debtor's failure to disclose and turn over to the trustee his income tax refund in the approximate amount of $13,000 and accrued sick leave benefits in the amount of $33,511.09.[205] The Fourth Circuit affirmed the bankruptcy court's denial of discharge, but based its decision on 11 U.S.C. § 707(b), which permits a court to dismiss a bankruptcy case for substantial abuse of the Chapter 7 provisions.[206] The court found that the debtor was using the bankruptcy simply to antagonize his ex-wife.[207] The Fourth Circuit stated that only honest and forthright debtors were entitled to receive a fresh start.[208]

D. *Analysis*

The goal of bankruptcy is to reward an honest debtor with a fresh start.[209] For this reason, courts tend to construe the statutory provisions describing the bases for denial of discharge in favor of the debtor.[210]

The Tenth Circuit's analysis and conclusions in *Brown*[211] reflect this tendency by establishing an extremely high standard for denial of discharge for failure to maintain adequate records.[212] A creditor must show that the inadequate records made it impossible to ascertain the debtor's financial status and business matters.[213] The adequacy of the records depends on the type of business and the sophistication of the debtor, but such a high standard makes it difficult for a creditor to establish a basis for denial of discharge.[214] The Ninth Circuit and the Third Circuit similarly require a creditor to prove that it is impossible to ascertain the debtor's financial conditions.[215] While a standard of impossibility comports with the underlying policy that a debtor is entitled to a discharge,

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201. *Id.* at 1176.
202. *Id.*
203. 99 F.3d 146 (4th Cir. 1996).
204. *Kestell*, 99 F.3d at 147.
205. *Id.* (stating that the debtor deposited the funds in his bank account in Jamaica).
206. *Id.* at 149.
207. *Id.* at 150.
208. *See id.* at 149.
209. Howard, *supra* note 159, at 1047.
210. *In re* Brown, 108 F.3d 1290, 1292 (10th Cir. 1997).
211. *Brown*, 108 F.3d at 1290.
212. *Id.* at 1295.
213. *Id.*
214. *Id.* (noting that cash sales for the debtor's hobby was not uncommon in concluding that the debtor's minimal records were adequate under the circumstances).
215. *See* Cox v. Cox, 41 F.3d 1294, 1296 (9th Cir. 1994); Meridian Bank v. Alten, 958 F.2d 1226, 1232 (3rd Cir. 1992).

this standard nevertheless conflicts with the policy requiring a debtor to provide full disclosure of information.[216] Congress intended to encourage disclosure of information, but the Tenth Circuit's decision subverts this intent to the extent that a debtor does not have to explain his failure to maintain records until after the creditor shows it is impossible to ascertain the debtor's financial condition.[217]

Courts do not always determine that the policy of rewarding honest debtors with discharge should trump other policy considerations. Although a creditor's objection to a debtor's discharge must establish that the debtor acted with the intent to hinder, delay or defraud creditors, in *Kestell,* the Fourth Circuit denied the discharge because of the debtor's failure to file for bankruptcy in good faith, rather than focusing on the intent of the debtor.[218] The Fourth Circuit's analysis supports the theory that courts resolve objections to discharge through subjective assessment of debtor's honesty rather than on the debtor's fraudulent intent.[219]

Reviewing courts tend to defer to the findings of the trial court because discharge determinations are dependent on the facts of each case. The differing outcomes of the Fourth and Tenth Circuits in *Jaray* and *Brown* reflect this deference. In *In re Jaray,*[220] the Fourth Circuit affirmed the trial court's finding that the debtor's attempt to amend his bankruptcy schedules was inadequate to cure his false oath.[221] In considering whether a subsequent disclosure can cure a false oath, the Tenth Circuit reached the opposite conclusion and found that a delayed attempt by a debtor to disclose omitted information was strong evidence the debtor lacked fraudulent intent.[222] These decisions indicate that the debtor's actions in correcting an omission, as well as the nature of the omitted asset, can influence the court's determination of whether the debtor willfully made a false oath.[223]

V. DUE PROCESS REQUIREMENTS WITH LIEN MODIFICATION

A. *Background*

The Constitution gave Congress the power to regulate bankruptcy,[224] but this enumerated power is limited by the Fifth Amendment's due pro-

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216. *See* Averch, *supra* note 159, at 99 (stating that maintenance of records is a prerequisite to granting a discharge in bankruptcy and absent justification for a failure to maintain records, a discharge should not be granted).

217. 3 NORTON, *supra* note 9, §74:9.

218. *In re* Kestell, 99 F.3d 146, 149 (4th Cir. 1996).

219. *See* Ponoroff & Knippenberg, *supra* note 14, at 123-24.

220. 114 F.3d 1176 (4th Cir. 1997).

221. *Jaray,* 114 F.3d at 1176.

222. *In re* Brown, 108 F.3d 1290, 1295 (10th Cir. 1997).

223. *See* Averch, *supra* note 159, at 103-04 (explaining that the requisite intent may be inferred if the debtor fails to clean up inconsistencies by filing amendments to the bankruptcy schedules).

224. U.S. CONST. art. I, § 8, cl. 4.

cess requirement.[225] To invoke the constitutional due process protection, some governmental action must affect a constitutionally protected property right.[226] In the bankruptcy context, enforcement of the Bankruptcy Code by a federal court is a type of governmental action that affects constitutionally protected property rights of secured creditors.[227] A creditor must have notice of the proposed action that would affect its property rights and an opportunity to be heard to satisfy the due process requirement.[228]

Congress has recognized that compliance with due process is essential. Specifically, Congress provided that in the bankruptcy context, certain actions may only occur after a notice and opportunity for a hearing.[229] Although Congress has stated that the notice must be "appropriate in the particular circumstances,"[230] Congress has not elaborated on the circumstances in which notice is appropriate, nor described the type of notice necessary.[231] The Supreme Court has determined that the Constitution requires that creditors be notified, even if the creditor knows of the pending bankruptcy proceeding.[232] The Supreme Court rejected, however, the notion that creditors have a general duty of inquiry.[233]

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225. U.S. CONST. amend V.

226. *Id.* ("No person shall . . . be deprived of life, liberty, or property, without due process of law; . . . .").

227. *See* Eric S. Richards, *Due Process Limitations on the Modification of Liens Through Bankruptcy Reorganization*, 71 AM. BANKR. L.J. 43, 45 (1997); Russell A. Eisenberg & Frances Gecker, *Due Process and Bankruptcy: A Contradiction in Terms?*, 10 BANKR. DEV. J. 47, 71-72 (1994) (stating that secured creditors have property rights subject to protection and suggesting that unsecured creditors also have rights subject to protection).

228. Mullane v. Hanover, 339 U.S. 306, 314 (1950) ("An elementary and fundamental requirement of due process in any proceeding . . . is notice reasonably calculated, under all the circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections.").

229. *See* 11 U.S.C. § 102 (1994) (defining "after notice and a hearing"); *id.* § 362(d) (allowing relief from stay after notice and a hearing); *id.* § 502 (providing for objections to claims after notice and hearing); *id.* § 727(d) (stating that a discharge may only be revoked after notice and a hearing); *id.* § 1128 (requiring a notice and hearing to confirm a plan of reorganization).

230. *Id.* § 102(1)(A).

231. *See* Robert M. Lawless, *Realigning the Theory and Practice of Notice in Bankruptcy Cases*, 29 WAKE FOREST L. REV. 1215, 1218-19 (1994). Because of the many issues that may arise in a bankruptcy case, the appropriate notice varies. For example, certain emergency matters, such as a debtor's use of cash collateral, may require notice and hearing within hours of the filing of a motion, whereas a motion for relief from the automatic stay, which is usually not an emergency matter, permits a longer period for notifying interested parties of the proposed action. *See* Eisenberg & Gecker, *supra* note 227, at 86-88 (explaining that certain peculiar bankruptcy situations exist that may require taking action before notice and an opportunity to be heard can be given).

232. City of New York v. New York, New Haven & Hartford R.R. Co., 344 U.S. 293, 297 (1953).

233. *City of New York*, 344 U.S. at 297 ("[C]reditors who have knowledge of a reorganization have a right to assume that the statutory 'reasonable notice' will be given them before their claims are forever barred."). *But see* Nicholas A. Franke, *The Code and the Constitution: Fifth Amendment Limits on the Debtor's Discharge in Bankruptcy*, 17 PEPP. L. REV. 853, 862 (1990) (arguing that the Bankruptcy Code's requirement of notice is significantly less substantial than the notice found unconstitutional in *City of New York*).

Due process is particularly important in the context of modification of a creditor's lien in a reorganization under either Chapter 11, Chapter 12 or Chapter 13.[234] In a bankruptcy filed under one of these chapters, a secured creditor files a proof of claim to protect its secured interest.[235] The statutory provisions pertaining to plan modification allow for the amendment of a creditor's lien through a plan of reorganization.[236] A confirmed plan binds all the creditors, regardless of whether they approved of the plan,[237] and all property vests in the debtor free and clear of the claims and interests of a creditor, unless the plan provides otherwise.[238] If a creditor does not know that the plan modifies its lien and the court confirms the plan, the creditor's lien could be extinguished without offering the creditor an effective opportunity to object.[239] Even if a secured creditor receives a copy of a plan of reorganization, the creditor may not review the plan provisions because it erroneously believes the legal maxim that liens survive bankruptcy.[240]

The federal courts have concluded that due process may be satisfied at different phases of the reorganization. Specifically, decisions of the courts indicate that due process may be satisfied during either the claims procedure or confirmation of the plan.[241] One commentator has suggested that the federal courts fall into one of three categories in their approach to satisfying due process requirements in a lien modification.[242] Some courts give priority to confirmation of the plan, precluding creditors from collaterally attacking the plan, while other courts gives priority to claims allowances precluding modification of liens in the absence of an objection to the claim. Finally, a third category of courts recognize lien modification by confirmed plans, provided that secured creditors receive adequate preconfirmation notice of the proposed lien modification.[243]

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234. *See* Richards, *supra* note 227, at 44.

235. William J. Wahoff, Comment, *The Adequate Protection of Secured Creditors in Termination of Stay Litigation Under the Bankruptcy Code*, 43 OHIO ST. L.J. 715, 720 (1982).

236. *See* Richards, *supra* note 227, at 52.

237. 11 U.S.C. § 1141(a) (1994) ("[T]he provisions of a confirmed plan bind the debtor . . . and any creditor, equity security holder, or general partner in the debtor, whether or not the claim of interest of such creditor . . . is impaired under the plan and whether or not such creditor . . . has accepted the plan.").

238. *Id.* § 1141(b) ("Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all property of the estate in the debtor.").

239. *See* Franke, *supra* note 233, at 867 (stating that creditors with allowed claims must be given notice of confirmation of a plan and an opportunity to be heard).

240. *See* Richards, *supra* note 227, at 51-52 (explaining that the reorganization provisions of the Bankruptcy Code allow modification of a creditor's security interest).

241. *See In re* Be-Mac Transp. Co., 83 F.3d 1020, 1027 (8th Cir. 1996) (noting that when a plan does not expressly preserve a lien, the lien may be extinguished if the lienholder participated in the reorganization); Cen-Pen Corp. v. Hanson, 58 F.3d 89, 93 (4th Cir. 1995) (stating that liens can only be modified through an adversary proceeding, not during confirmation of a Chapter 13 plan).

242. *See* Richards, *supra* note 227, at 65.

243. *Id.*

Before this survey period, the Tenth Circuit rejected a creditor's claim that it was denied due process when the creditor specifically received notice of the treatment of its claim in the reorganization plan.[244] *In re Barton Industries, Inc.*,[245] the Tenth Circuit had the opportunity to establish which of the three categories the court recognized as providing due process for the secured creditor.[246]

B. In re Barton Industries, Inc.

1. Facts

In *Barton*, the debtor contracted with Transamerica Insurance Finance Corporation (TIFC) to borrow money for the purpose of purchasing casualty insurance.[247] The loan required the debtor to assign to TIFC all unearned return premiums as security for the repayment of the loan.[248] The debtor borrowed the down payment for the loan from its primary creditor, American Bank and Trust Company (ABT).[249] Under a preexisting credit arrangement with ABT, the debtor had granted ABT a security interest in all intangible assets of the debtor, which arguably included any return premiums.[250]

Shortly after the loan was made, the debtor filed a voluntary Chapter 11 bankruptcy petition.[251] The debtor canceled the insurance policy, and the insurance company refunded the return premiums to the insurance agent, who then remitted the return premiums to TIFC.[252] ABT commenced an adversary proceeding against TIFC alleging that the plan of reorganization conveyed to ABT all of the return premiums or a security interest in the premiums superior to TIFC.[253] In response, TIFC argued that it did not receive meaningful notice of the plan, and therefore, was not bound by the plan.[254]

2. Decision

The court noted that a creditor's claim is not subject to a confirmed plan if inadequate notice denied the creditor due process.[255] The court also concluded that due process required that TIFC receive notice describing

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244. Turney v. FDIC, 18 F.3d 865, 868-69 (10th Cir. 1994).

245. 104 F.3d 1241 (10th Cir. 1997).

246. *See* Richards, *supra* note 227, at 52.

247. *Barton Indus.*, 104 F.3d at 1244.

248. *Id.* Return premiums are premiums paid in advance by the insured, but unearned at the time the insurance coverage is reduced or canceled so that a refund of those premiums is made to the insured. *Id.*

249. *Id.*

250. *Id.*

251. *Id.*

252. *Id.*

253. *Id.*

254. *Id.*

255. *Id.* at 1245.

the treatment of TIFC's claim sufficient for TIFC to make an informed judgment about the plan in this case.[256]

The court found that TIFC had not received sufficient notice because the plan and disclosure statement sent to TIFC did not specifically refer to the return premiums or TIFC's interest in the premiums.[257] The court determined that "[w]hile creditors have a responsibility to take an active role in protecting their claims," TIFC could not sufficiently evaluate the notice because it inadequately explained the modification of TIFC's lien.[258] The court concluded that TIFC's claim was not modified by the plan.[259]

C. *Other Circuits*

The Fourth Circuit and the Eighth Circuit also addressed the issue of due process in the bankruptcy context during the survey period. The Fourth Circuit considered the adequacy of the notice received by creditors when their interests were affected by plans of reorganization. In *Spartan Mills v. Bank of America*,[260] the Fourth Circuit found that the modification of the creditor's lien did not violate due process because the creditor received notice of its lien modification, but chose to wait to litigate its claim in a different forum.[261] An order authorizing the sale of the debtor's assets free and clear of liens was sent to the creditor, who held a textile processor's lien on some of the debtor's equipment.[262] The creditor negotiated with another creditor to permit the sale of the assets, but it reserved the right to litigate the priority of its claim on the proceeds.[263] The creditor argued that it did not receive due notice; however, the court asserted that the creditor cannot sit silently while an order extinguishes its lien and hope to attack the order collaterally.[264]

A different notice issue arose in *Maryland v. Antonelli Creditors' Liquidating Trust*,[265] in which the Fourth Circuit determined that when a creditor received a copy of a plan of reorganization, the creditor was bound by the terms of the plan even though the creditor's claim would arise in the future.[266] The plan of reorganization stated that the sale and transfer of the debtor's assets would be exempt from state transfer taxes.[267] As an existing creditor, Maryland received a copy of the plan of

256. *Id.*
257. *Id.* at 1245-46.
258. *Id.* at 1246.
259. *Id.*
260. 112 F.3d 1251 (4th Cir.), *cert. denied*, 118 S. Ct. 417 (1997).
261. *Spartan Mills*, 112 F.3d at 1257-58.
262. *Id.* at 1252-53.
263. *Id.* at 1254.
264. *Id.* at 1256.
265. 123 F.3d 777 (4th Cir. 1997).
266. *Antonelli*, 123 F.3d at 781.
267. *Id.* at 780.

reorganization.[268] Maryland did not object to the tax exempt provision until approximately one year after the bankruptcy court confirmed the plan.[269] The court concluded that the adequacy of the notice did not depend on the status of the creditor, but merely on whether the creditor received adequate notice of the plan provisions.[270]

In *In re Hairopoulos*,[271] the Eighth Circuit analyzed whether the terms of a confirmed plan could bind a creditor who had received some notice of the bankruptcy proceedings, but did not file a proof of claim.[272] The debtor commenced a bankruptcy proceeding under Chapter 7, and the bankruptcy court clerk issued a notice stating that no dividends were expected and that creditors should not file proofs of claim.[273] Subsequently, the debtor converted his case to a Chapter 13 bankruptcy, but the IRS apparently did not receive notice of the conversion.[274] The debtor's confirmed plan did not mention the debt to the IRS.[275] After the debtor received a discharge, the IRS began collection efforts.[276] The bankruptcy court found that the IRS was on inquiry notice when it learned the debtor filed bankruptcy and discharged the tax debt.[277] The Eighth Circuit concluded that the IRS did not have a duty to inquire about the status of the bankruptcy proceedings and reinstated the debt due to the inadequacy of the notices.[278]

D. *Analysis*

Large bankruptcy cases can affect thousands of claimants and providing notice to each claimant may not be fiscally feasible.[279] In order for the reorganization to be successful, however, each claimant must be bound by the plan of reorganization.[280] The National Bankruptcy Conference recognized this dilemma and recommended that Congress modify the Bankruptcy Code to substantially reduce the information required in the disclosure statement in small business Chapter 11 reorganizations, where providing notice can become particularly financially burdensome.[281] Unless such changes go into effect, however, a court may

268. *Id.*
269. *Id.* at 781.
270. *Id.* at 782.
271. 118 F.3d 1240 (8th Cir. 1997).
272. *Hairopoulos*, 118 F.3d at 1242-43.
273. *Id.* at 1242.
274. *Id.*
275. *Id.*
276. *Id.* at 1243.
277. *Id.*
278. *Id.* at 1246.
279. Lawless, *supra* note 231, at 1218.
280. *Id.*
281. 1 BANKR. REVIEW COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS 637 (1997).

resolve the dilemma by employing a balancing test that weighs the cost of providing notice against the property interest at stake.[282]

Once a court determines who should receive notice, the court must then focus on the adequacy of the notice.[283] This issue is particularly important when a plan of reorganization modifies a creditor's lien.[284] No set rules exist to assist the courts in determining whether the contents of a notice are sufficient.[285] Some forms of notice, however, are clearly inadequate. Constructive notice to a creditor known to the debtor cannot satisfy due process requirements for the discharge or modification of that creditor's claim.[286] In addition, as illustrated by the Eighth Circuit's decision in *Hairopoulos*, notice that does not inform a creditor that its rights could be affected clearly fails to satisfy due process.[287]

At a minimum, due process requires that the creditor receive some form of notice that the plan of reorganization will adversely affect its lien.[288] The Fourth Circuit found that simply giving the creditor a copy of the plan of reorganization, even though a creditor may not review the plan because of the complexity of the provisions, satisfies due process.[289] While this approach may satisfy due process, it is questionable whether the notice realistically apprises the creditor of the adverse treatment of its claim.[290]

The Tenth Circuit rejected the approach utilized by the Fourth Circuit and determined that adequate notice must inform the creditor of how the plan of reorganization treats its claim so that the creditor could make an informed decision on the plan.[291] While the Tenth Circuit now appears to require more than a generic description of the claim in the plan of reorganization, the Tenth Circuit did not specify the extent of detail necessary to satisfy due process.[292] One alternative would be to require a sufficient level of detail such that the notice would alert even an unsophisticated creditor that its lien rights are in jeopardy.[293] The information in the notice would not need to be voluminous, but would have to go beyond

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282. Lawless, *supra* note 231, at 1231.

283. Eisenberg & Gecker, *supra* note 227, at 54.

284. Richards, *supra* note 227, at 43.

285. Eisenberg & Gecker, *supra* note 227, at 59.

286. Franke, *supra* note 233, at 868.

287. *In re* Hairopoulos, 118 F.3d 1240, 1245 (8th Cir. 1997) (stating that the debtor's argument undermines the very purpose for giving parties the right and opportunity to participate in bankruptcy proceedings).

288. Richards, *supra* note 227, at 104.

289. Maryland v. Antonelli Creditors' Liquidating Trust, 123 F.3d 777, 783 (4th Cir. 1997).

290. *See* Richards, *supra* note 227, at 104-05 (suggesting that the adequacy of the notice must apprise the creditor of the specific property interests at stake).

291. *In re* Barton Indus., Inc., 104 F.3d 1241, 1245 (10th Cir. 1997) (stating that it was a "close case" in determining the adequacy of the notice to the creditor).

292. *Barton Indus.*, 104 F.3d at 1245-46.

293. Richards, *supra* note 227, at 105.

boilerplate to satisfy due process.[294] Another alternative would be to determine the necessary amount of detail by utilizing a test that weighs all the interests at stake and the nature of the proposed action.[295]

Regardless of how a court would determine the necessary level of detail, the Tenth Circuit's decision is pragmatic because it assures creditors that they will receive fair notice, while allowing debtors the flexibility to determine the type of notice that is appropriate under the circumstances. Because the sufficiency of notice necessarily varies on a case by case basis in bankruptcy,[296] such an approach reflects the reality that requirements of due process depend on the type and nature of the hearing, as well as the interests at stake.[297]

VI. DISCHARGEABILITY OF "GAP PERIOD INTEREST" IN CHAPTER 11 REORGANIZATIONS

A. *Background*

Congress debated the appropriate balance between the collection of revenue and the rehabilitation of debtors in drafting the 1978 amendments to the Bankruptcy Code.[298] The need to collect revenue proved a stronger policy motivation than the need to ensure liberal discharge privileges, and today certain types of tax debts receive special protection through priority claims and nondischargeable status.[299] Protection of tax claims is not unlimited, however, and certain taxes may be dischargeable.[300]

The IRS may file a proof of claim for either assessed or unassessed taxes.[301] A proof of claim is a written statement describing the creditor's claim.[302] If the claim is filed in accordance with the bankruptcy rules, it constitutes "prima facie evidence of the validity and amount" of the creditor's claim.[303]

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294. *Id.*

295. *Id.* at 93.

296. Eisenberg & Gecker, *supra* note 227, at 93.

297. *Id.* at 116.

298. S. REP. NO. 95-989, at 77-78 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5862-64; *see also* Paul D. Bancroft, *Post Petition Interest on Tax Liens in Bankruptcy Proceedings*, 62 AM. BANKR. L.J. 327, 327-28 (1988) (stating that a conflict exists between the equitable bankruptcy goals and the need to maintain revenue collection).

299. *See* Hill, *supra* note 52, at 148 (describing how the automatic stay, claims procedure, and priority scheme modify the tax collection process); *see, e.g.*, 11 U.S.C. § 507(a)(8) (1994) (establishing priority status for tax claims); *id.* § 523(a)(1) (making certain tax debts nondischargeable).

300. *See* Hill, *supra* note 52, at 166.

301. *Id.* at 158.

302. FED. R. BANKR. P. 3001(a). Claim is broadly defined as, a "right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, disputed, undisputed, legal, equitable, secured, or undersecured." 11 U.S.C. § 101(5)(A).

303. FED. R. BANKR. P. 3001(f).

A creditor's claim may be secured or unsecured, and these categories also apply to claims of the IRS.[304] A secured claim means a creditor has a right to have the debtor's assets applied to its claim before such assets are used to satisfy the claims of other creditors.[305] To the extent that the value of the collateral is insufficient to pay the claim, it is undersecured and will be divided into a secured and an unsecured claim component.[306] Secured claims are usually paid before unsecured claims may receive proceeds from the liquidation of a debtor's assets.[307] Among unsecured creditors, the Bankruptcy Code creates a system of prioritizing claims placing unsecured creditors in competition with other unsecured creditors.[308] For example, an unsecured tax claim has priority over a general unsecured claim in certain circumstances, but an unsecured, priority tax claim is subordinate to administrative expenses of the bankruptcy estate.[309]

Generally, unsecured creditors cannot collect unmatured or postpetition interest.[310] Secured creditors, however, may collect interest that has accrued on the claim after the filing of the petition but before confirmation of the plan if the value of the collateral exceeds the value of the claim.[311] This type of interest is referred to as postpetition or gap period interest.[312] The policy which permits secured creditors, but not unsecured creditors, to collect gap period interest is based upon concern for expedient administration of bankruptcy estates.[313] The delays inherent in liquidating the debtor's assets financially harm creditors by prolonging the

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304. Jack E. Karns, *Can the Internal Review Service Levy and Collect Against ERISA Qualified Pension Plan Benefits in Bankruptcy Proceedings?*, 27 WAKE FOREST L. REV. 657, 668 (1992).

305. COHEN, *supra* note 15, ¶ 21-100.

306. *See* Mary Josephine Newborn, *Undersecured Creditors in Bankruptcy: Dewsnup, Nobelman, and the Decline of Priority*, 25 ARIZ. ST. L.J. 547, 549-50 (1993) (describing two methods of analyzing an undersecured claim); COHEN, *supra* note 15, ¶ 21-201 (defining undersecured as when the collateral is less than the amount of the claim).

307. Veryl Victoria Miles, *Bankruptcy Relief from Secured Tax Liens*, PRAC. LAW., Apr. 1996, at 35, 38.

308. *See* Hill, *supra* note 52, at 163.

309. *See* 11 U.S.C. § 507(a) (1994).

310. *See id.* § 502(b)(2) (stating that claims will be disallowed to the extent the claim amount is for unmatured interest); Seth D. Gould, *Unsecured Creditors' Entitlement to Postpetition Interest in Solvent Debtor Bankruptcy: The Code's Silent Abrogation of a Pre-Code Doctrine*, 37 WAYNE L. REV. 1849, 1849-50 (1991) (explaining that the Bankruptcy Code diminishes an unsecured creditor's right to postpetition interest).

311. *See* 11 U.S.C. § 506(b) (providing for postpetition interest when the value of the collateral exceeds the secured claim); Bancroft, *supra* note 298, at 328 (explaining that one of the incidents of a secured claim is postpetition interest).

312. *See* United States v. Victor, 121 F.3d 1383, 1384 (10th Cir. 1997) (describing gap period interest in the context of a Chapter 11 reorganization); David Gray Carlson, *Postpetition Interest Under the Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 579 (1989) (defining postpetition interest as interest that accrues after the petition is filed but before the proceeding is terminated by liquidation or confirmation of a Chapter 11 plan of reorganization).

313. *See In re* Hanna, 872 F.2d 829, 830 (8th Cir. 1989).

distribution of assets.[314] With secured claims, the collateral serves as security for the interest, lessening the concern with administrative expediency.[315]

Ordinarily, a debtor receives a discharge from any debt which arose prior to confirmation unless it is the type of debt which has been statutorily excepted from discharge.[316] If a tax debt is nondischargeable, the interest that accrues on the debt is likewise nondischargeable.[317] During the survey period, the Tenth Circuit analyzed the circumstances under which the IRS may collect gap period interest.

B. United States v. Victor[318]

1. Facts

This case presented consolidated appeals of decisions pertaining to the dischargeability of gap period interest.[319] Brumback filed a Chapter 11 bankruptcy proceeding, in which the IRS filed a proof of claim for employment taxes in the amount of $93,175.22.[320] Of that amount, $60,208.80, including interest and penalties, was secured.[321] The claim stated that to the extent that postpetition interest was unpaid, it was nondischargeable.[322] The confirmed plan of reorganization provided for payment in full of the secured and priority claim of the IRS, but it did not provide for payment of gap period interest.[323] After Brumback satisfied the tax claims, he brought an action seeking a declaratory judgment for an order to discharge the gap period interest under 11 U.S.C. § 1141(d).[324]

In the second case, Victor filed a Chapter 11 bankruptcy proceeding, in which the IRS filed a proof of claim for employment taxes in the amount of $74,002.[325] Of that amount, $70,891 was secured, including interest and penalties.[326] The proof of claim form similarly noted that to the extent postpetition interest was due, it was nondischargeable.[327] Victor's confirmed plan of reorganization provided for payment in full of the

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314. *See* Gould, *supra* note 310, at 1869 (explaining the policy concern that debtor's could abuse the bankruptcy process through delay tactics that are detrimental to creditors).

315. *See* Bancroft, *supra* note 298, at 330 (justifying postpetition interest on the basis that a creditor relies on its secured position in extending credit).

316. *See* 11 U.S.C. § 1141(d)(2).

317. *In re* Hanna, 872 F.2d 289, 830 (8th Cir. 1989) (citing Bruning v. United States, 376 U.S. 358, 363 (1964)).

318. 121 F.3d 1383 (10th Cir. 1997).

319. *Victor*, 121 F.3d at 1384.

320. *Id.*

321. *Id.*

322. *Id.*

323. *Id.* at 1384-85.

324. *See id.*

325. *Id.* at 1385.

326. *Id.*

327. *Id.*

secured and priority tax claims.[328] Victor sold his business, and the proceeds were distributed in accordance with the bankruptcy plan.[329] The IRS sought to recover gap period interest.[330]

2. Decision

The court found that the terms of a confirmed plan of reorganization bind all interested parties and that a creditor must object at the time of the confirmation of the plan if the creditor opposes the treatment of its claim by the plan.[331] The court rejected the IRS' claim that it could not object to the treatment of its claim because unmatured interest is generally disallowed under 11 U.S.C. § 502(b).[332] The court stated that secured creditors are entitled to postpetition interest and thus the IRS could have objected to the plan provisions which did not provide for postpetition interest on the secured tax claims.[333]

The IRS alternately claimed that it was entitled to interest as part of the nondischargeable tax debt owed by the debtor.[334] The court found that the Bankruptcy Code created two types of tax claims, secured and unsecured.[335] The special provisions pertaining to nondischargeability do not apply to secured claims because the source of repayment for secured claims is the collateral.[336] In contrast, unsecured priority claims rely on special treatment by the Bankruptcy Code to obtain repayment.[337] The court held that the exception to tax debts applies only when the IRS held an unsecured priority claim.[338] Because the IRS held a secured claim, and the plan did not provide for the gap period interest, the court discharged any gap period interest due.[339]

C. *Other Circuits*

In *In re T-H New Orleans Limited Partnership*,[340] the Fifth Circuit considered the extent to which a secured creditor may recover postpetition interest when the creditor becomes oversecured during the interim between the commencement of the bankruptcy case and the confirmation of the plan of reorganization.[341] The creditor held a security interest in

328. *Id.*
329. *Id.* at 1386.
330. *Id.*
331. *See id.*
332. *Id.* at 1386-87.
333. *Id.* at 1387.
334. *Id.* at 1386.
335. *See id.* at 1388-89.
336. *Id.* at 1389.
337. *See id.* at 1389.
338. *Id.* at 1390.
339. *See id.*
340. 116 F.3d 790 (5th Cir. 1997).
341. *T-H New Orleans*, 116 F.3d at 796.

various hotels owned by the debtor.[342] The creditor was undersecured at the filing of the bankruptcy, but because of payments made by the debtor the creditor was oversecured when the bankruptcy court confirmed the plan of reorganization.[343] The Fifth Circuit found that valuation of the collateral and the creditor's claim should be flexible and not fixed on a set date, such as the date the plan was commenced or the confirmation date.[344] Using this test, the court concluded that the creditor could recover postpetition interest if it established by a preponderance of the evidence that it was oversecured.[345]

D. *Analysis*

Determining whether a creditor has the right to gap period interest is one of the most difficult aspects of a bankruptcy case.[346] While it is clear that a secured creditor is entitled to gap period interest, it is less certain whether a nondischargeable unsecured tax lien is similarly entitled to such interest.[347] This conflict arises in the context of tax claims because tax claims may be secured by a lien on a debtor's property or it may be given priority, nondischargeable status.[348] A lien may survive bankruptcy, and thus a secured tax claim does not require special statutory protection.[349] Unsecured claims are generally discharged, and in order to protect repayment of unsecured tax claims, a statutory exception to discharge was created.[350]

In *Victor*, the IRS filed a secured claim, and sought gap period interest arguing that it was entitled to such interest because the tax debt was nondischargeable, notwithstanding its secured status.[351] As the Tenth Circuit acknowledged, the categories of secured and priority claims are mutually exclusive because a tax claim cannot be both a secured and an unsecured priority claim.[352] By upholding the distinction between a secured claim and a priority tax claim, the Tenth Circuit's decision follows the statutory order of priority of claims.[353] Such a scheme attempts to balance the divergent interests of debtors, creditors, and the IRS.[354] Strict adherence to the distinctions between the different types of claims is important to maintain balance and fairness among these divergent inter-

342. *Id.* at 794.
343. *Id.* at 796.
344. *Id.* at 798.
345. *Id.*
346. Carlson, *supra* note 312, at 579.
347. Bancroft, *supra* note 298, at 328.
348. Sather, *supra* note 50, at 1366.
349. Miles, *supra* note 307, at 37.
350. 11 U.S.C. § 523 (1994).
351. United States v. Victor, 121 F.3d 1383, 1387 (10th Cir. 1997).
352. Sather, *supra* note 50, at 1366.
353. *See* Miles, *supra* note 307, at 38.
354. Hill, *supra* note 52, at 178.

ests. For these reasons, the Tenth Circuit properly denied the IRS' claim for gap period interest on the unsecured claim.

The Tenth Circuit did not, however, discuss the propriety of awarding gap period interest on secured tax claims. If the main purpose of a secured tax claim is to secure repayment of taxes, it is difficult to explain why such claims should include gap period interest.[355] Consensual secured creditors may recover gap period interest in order to preserve the benefit of the secured creditor's bargain.[356] A similar reason does not exist for the nonconsensual tax lien.[357] Awarding gap period interest on tax claims compromises the principal of equality of distribution among creditors.[358] When the IRS receives gap period interest on its secured tax claim, the amount available for distribution to other creditors is reduced.[359]

CONCLUSION

During the survey period, the Tenth Circuit decided cases involving fundamental issues in bankruptcy: discharge, the automatic stay, and exceptions to discharge. Many of these issues were resolved through analysis of the legislative history, as well as the applicable statutory language. Overall, the Tenth Circuit did not prefer the debtor or the creditor in its decisions. The decisions reflect the court's willingness to consider the facts and the applicable law, without undue regard to the decisions of the other circuits.

Sherri L. Rotert

355. Bancroft, *supra* note 298, at 339.
356. *Id.* at 330.
357. *Id.*
358. *Id.*
359. *Id.* at 328.