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Bankruptcy Alternatives in a Post COVID Economy

By: Keith Chulumovich
Managing Director, O'Keefe

The impact of COVID-19 on the U.S. economy is well-documented. If you are like me, you have participated in countless "Zoom" calls and webinars covering a wide array of topics. COVID-19, along with many of the government regulations implemented to control the spread of the virus, forced both public and private enterprises to discontinue operations, or modify the way they reach out to their market. Stay at home orders transformed the way that companies do business; switching from in-store to online, from dine-in to carry-out, and from business lunches to zoom chats. Business may never be the same. For the most part, lenders have been accommodating by modifying loan agreements, extending forbearance, and in some cases re-amortizing loan balances over longer periods. Some businesses have thrived, taking advantage of government loan programs while at the same time streamlining their business. Unfortunately, many companies had to shut down permanently. And just because a business has survived the last nine months does not mean they will not face difficult decisions over the next year or so.

Many businesses, particularly small businesses, are coping with lower revenues, as well as fixed costs that have not decreased in proportion to their revenue base. Many businesses are unable to pay their creditors. As such, these struggling businesses will need to reorganize their business and restructure their debt obligations. Since most of my client base is considered middle market, I wanted to cover some of the reorganization options that are available to small business owners. This article will discuss what the Small Business Reorganization Act (the "SBRA") is and its benefits for small businesses, as well as several alternatives to bankruptcy that could prove to be more affordable and efficient for small businesses.

Small Business Reorganization Act (the "SBRA")

On February 19, 2020, the Small Business Reorganization Act went into effect, shortly preceding the unprecedented blow to the global economy caused by the coronavirus (COVID-19) pandemic. The SBRA was intended "to streamline the process by which small business debtors reorganize and rehabilitate their financial affairs."[1] By allowing for a timely and cost-effective reorganization, the SBRA allows small business debtors to remain in business, thereby benefitting those that rely on that business, including employees, customers, and suppliers. The original debt limit under SBRA was set at $2,725,625. The subsequent Coronavirus Aid, Relief, and Economic Security Act, also known as the CARES Act, increased this debt limit to $7,500,000 for cases filed after March 27, 2020, with the increased eligibility remaining in effect for one year. There has been much discussion about raising the debt limit up to $10 million, so I am hopeful the limit does not revert to the original debt limit.

Prior to the SBRA, the primary "in-court" options for struggling small businesses were limited to either Chapter 7 liquidation or Chapter 11 reorganization, both of which have their drawbacks. A Chapter 7 liquidation is certainly less costly, but it involves the debtor losing control of its operations

[1] H.R. Rep. No. 116-171, at 1 (2019), *available at* https://www.govinfo.gov/content/pkg/CRPT- 116hrpt171/pdf/CRPT-116hrpt171.pdf.

and the assets being liquidated by a trustee to pay creditors, rendering the business unable to survive. Conversely, a Chapter 11 bankruptcy permits the debtor to retain control of its operations and restructure its debts through a court-approved plan, but the extensive court oversight and stringent requirements associated with this option can be too expensive for small businesses.

The SBRA was intended to be a middle ground somewhere between Chapter 7 and Chapter 11 by allowing the small business debtor to retain control of their business, appointing a trustee to ensure the reorganization proceeds efficiently, and eliminating significant costs and time delays associated with Chapter 11. Specifically, the SBRA:

- Modifies confirmation requirements;
- Provides for the participation of a trustee (the "sub V trustee") while the debtor remains in possession of assets and operates the business as a debtor-in-possession;
- Changes several administrative and procedural rules;
- Alters the rules for the debtor's discharge and the definition of property the estate acquires post-petition and with post-petition earnings;
- Absent a court order, a creditors committee is not appointed, which allows the debtor to avoid considerable expenses relating to the committee and the professionals hired by the committee;
- Unlike an ordinary Chapter 11 case, the SBRA does not require the debtor to file a disclosure statement; and
- Only the debtor can submit a reorganization plan, which it must do within 90 days of the commencement of the case.

The SBRA further affords the small business debtor greater latitude for the confirmation of the reorganization plan and permits the debtor to maintain its ownership interest following reorganization, so long as the plan does not discriminate unfairly and is fair and equitable to each class of claims provided for in the plan. Plans will normally be confirmed if they provide that all projected disposable income of the business will be paid to creditors over the following 3 to 5-year period. In summary, the SBRA will be extremely beneficial to small businesses in the current environment by providing small businesses with a quicker, more efficient path for reorganization, by reducing costs and streamlining the bankruptcy process.

Alternatives to Bankruptcy

For small businesses that would like to avoid the overall expense and negative stigma associated with filing bankruptcy, there are other alternatives available to limit the damaging impact of the coronavirus. However, it is important, for businesses to understand the similarities and differences between traditional bankruptcy and its alternatives such, receiverships, assignments for the benefit of creditors, and out-of-court workouts. Below is a brief overview of each.

Receiverships

Receiverships are court-ordered proceedings that are initiated by creditors in which all of a company's property that is subject to a dispute is placed under the control of an independent third-party,

otherwise known as a "Receiver." Receivers are governed by specific orders and are appointed to preserve distressed assets and attempt to maximize the value of the property. Receiverships provide a means in which secured creditors may quickly and efficiently liquidate a distressed business and are favored by secured creditors of smaller businesses that cannot afford the fees associated with a Chapter 11 bankruptcy. Receiverships provide many of the protections afforded by bankruptcy proceedings, while having the added benefit that: (1) a receivership can be commenced by a lender; (2) the costs associated with a receivership can be less than in a bankruptcy proceeding; (3) a lender has more control over who will be operating the business and the timing of decisions related to the disposition of the lender's collateral; and (4) recoveries can be enhanced by instituting improvements in the business operations and the pursuit of claims against third parties. Other advantages to receivership include:

- Receiverships tend to be more flexible for creditors;
- Provides an easy, quick method of liquidating assets;
- Avoids investigation of preference claims by the bankruptcy trustee;
- Requires court oversight of the liquidation;
- Stays creditor actions under certain circumstances; and
- The receiver can still pursue fraudulent conveyance actions.

Just like an assignment for the benefit of creditors, ("ABC"), receiverships do have some advantages when compared to traditional bankruptcy proceedings, but they also have significant disadvantages that include:

- It is still a judicial process;
- It does not stop involuntary bankruptcy;
- Assets, if any, are usually sold for nominal value;
- Lack of a conventional discharge of debts; and
- Inability of the receiver to recover preferential transfers.

Assignment for the Benefit of Creditors ("ABC")

An ABC is another avenue for the orderly liquidation or wind-down of a distressed business. Much like bankruptcy, an ABC can also be used to facilitate a going-concern sale of the debtor's assets. An ABC can provide an expedient and smooth transition if the goal is to transfer the assets of the troubled business to a third-party free of any unsecured debt incurred by the transferor. The ABC is also a way to wind down the business with minimal negative publicity, or potential liability for directors and management.

An ABC begins when an assignor, usually the debtor, irrevocably transfers or assigns substantially all of its property to an assignee for the purpose of conducting the orderly wind down and liquidation of the business for the benefit of the assignor's creditors, which may also include a sale of

assets or going concern sale. The powers and duties of the assignee are comparable to those of the bankruptcy trustee, and include collecting and liquidating assets, providing notices to creditors, operating the assignor's business if necessary, and submitting a final report, among other things. As such, an ABC is similar to bankruptcy in many respects, but there are also significant differences, as well as advantages and disadvantages.

An ABC is cheaper, faster, and more discrete than a traditional Chapter 7 or Chapter 11 filing, which benefits both the debtor and the creditors because there will be more money available for distribution. Unlike the selection of a bankruptcy trustee, the assignor is permitted to choose the assignee to ensure its property is distributed efficiently, and the assignor is more involved in the decision-making process of an ABC. Most of us are familiar with Section 363 of the Bankruptcy Code which offers of the advantage of selling assets "free and clear". However, a buyer seeking to purchase a going concern operation, or the specific assets of a distressed business, can obtain substantially similar relief in an ABC sale without the cost and process associated with bankruptcy if certain precautions are taken. These precautions include running the sale process in a commercially reasonable manner, providing adequate notice similar to the public nature of an Article 9 or bankruptcy sale. The more the sale process deviates toward a private sale format, the more risk there is to the buyer from attacks by creditors.

One of the key disadvantages of ABC is there is no automatic stay, and creditors are not prohibited from filing an involuntary bankruptcy petition against the business after it has made an assignment. Creditors may also take other actions to stymie the assignee's administration of assets. Other disadvantages include: the assignee does not have the authority to avoid preferential transfers; the assignee, unlike a debtor or bankruptcy trustee, does not have the power to assume and assign executory contracts and leases without the consent of the counterparty to the contract; and most importantly, ABCs do not provide for the discharge of the assignor's debts.

Out of Court Workouts

When circumstances allow, the best option for a struggling business is to avoid the expense and hassle of legal proceedings and instead negotiate a workout agreement with creditors. A workout is often an effective tool in preventing creditors from taking legal action against the business in exchange for a partial or complete repayment of the delinquent debt. If an agreement can be reached with all creditors, it will accomplish many of the same goals and objectives of a Chapter 11 bankruptcy without the associated expenses and burdens. Using the funds that would otherwise be used to pay the costs and expenses of a Chapter 11 bankruptcy to repay the creditors is often a good incentive for creditors to consider accepting the workout plan.

In a Chapter 11 bankruptcy, a dissenting creditor could be compelled to accept a plan. However, a disadvantage of a workout is that the business has no ability to involuntarily bind any unwilling creditor that may refuse to consent to the workout plan. In addition, the invitation to creditors to meet with management will also give the creditors a forum to meet one another. Depending upon the situation, this introduction may serve as a vehicle for creditors to force the business into an involuntary bankruptcy, or to allow creditors to share unwanted information about the business with one another.

If it appears that there is no way to turn the business around within a reasonable period, then the business may need to be liquidated. If the business is insolvent, this liquidation will normally be achieved by either a Chapter 7 bankruptcy or an ABC.

Conclusion

It is undeniable that the COVID-19 has created significant hurdles for businesses, particularly small businesses. Although some businesses have been able to weather the storm and in some cases thrive, more businesses will continue to face financial challenges. As a result, struggling businesses will need to lean heavily on the SBRA to reorganize and maintain operations for the future. In the alternative, these businesses may be able to utilize alternative reorganization options such as ABCs or Receiverships, or they could attempt to negotiate an out of court workout with creditors.

Because no two situations are exactly alike, the foregoing options will have differing impacts on each business. Choosing the right option not only requires the expertise of an experienced bankruptcy attorney, who understands both the law and the effect of each of these options, but also an experienced business turnaround financial advisor. A turnaround professional can often uncover inefficiencies across a broad spectrum of industries and assist senior managers and leaders in the creation and implementation of successful new business strategies that generate cash flows, preserve value, and repair strained relations with the company's stakeholders. A turnaround financial advisor can also assist management in preparing the financial projections of the business, communicating with creditors, and formulating, negotiating, and implementing a workout plan. Managing a workout can be a very time-consuming and stressful job and the turnaround financial advisor and business bankruptcy attorney can alleviate some of the burdens and strains of managing a workout plan and communicating with creditors.

Keith Chulumovich CPA, Managing Director, specializes in strategic and operational planning, business analysis and financial reporting, process improvement, turnaround/profitability improvement initiatives, and management of operating budget and forecast planning cycles.

O'Keefe is a financial and strategic advisory firm specializing in corporate finance, litigation support, strategic advisory services, and turnaround and restructuring. Established in 2001, the company has locations in Detroit and Grand Rapids, Michigan and Phoenix, Arizona. For more information, visit www.okeefellc.com.

To Include or Not Include Non-Debtor Spouse's Income and Expenses: That is the Question!

By: Elizabeth Clark
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Whether to include or not include a non-debtor spouse's income and expenses as part of the projected disposable income test under 11 U.S.C. § 1325(b)(1) and a good faith analysis under 11 U.S.C. § 1325(a)(3) has been an age-old (or at least decades-old) question that has seemed to puzzle many bankruptcy practitioners and courts. Trying to find a discernable rule of law to guide them in this search has been challenging, most likely because the facts surrounding the role of a non-debtor spouse's income in a debtor's household can vary greatly from case to case. For instance, in one case, practitioners and courts could be presented with a situation where a debtor and his or her non-debtor spouse have been married for twenty years but have always maintained separate bank accounts and contributed separately to the household bills and the spouse solely pays for his or her boat, Jaguar, and timeshare. Another case could involve a debtor and his or her non-debtor spouse who have been married for twenty years and who combine all of their income into one bank account out of which they pay all their household expenses and yet the non-debtor spouse refuses to submit any of his or her income information to debtor's counsel because he or she is not part of the Chapter 13 bankruptcy. There could also be a third scenario where the debtor's marriage to his or her non-debtor spouse is his or her second marriage, there was a mutual agreement entered into between the two of them before the marriage that they would keep their income and expenses separate, and all of the debt listed in debtor's bankruptcy schedules is his or her own which she or he accrued before the marriage. While the dizzying and seemingly endless factual possibilities relating to this issue would seem to suggest that finding a majority position adopted by courts would be nearly impossible, courts have in fact in the last approximate forty years set forth and enunciated two distinct views on this issue.

The majority of courts have determined that a non-debtor's spouse's income and expenses must be considered when determining whether a debtor has committed all of his or her projected disposable income as required by 11 U.S.C. § 1325(b)(1)(B) and as part of a good faith analysis under 11 U.S.C. § 1325(a)(3). *See, e.g., In re Carter,* 205 B.R. 733 (Bankr. E.D.Pa. 1996); *in re Kern,* 40 B.R. 26 (Bankr. S.D.N.Y. 1984); *Matter of Saunders,* 60 B.R. 187 (Bankr. N.D. Ohio 1986); *in re Rothman,* 204 B.R. 143 (Bankr. E.D. Pa. 1996); *in re Williamson,* 296 B.R. 760 (Bankr. N.D. Ill. 2003); *Matter of Belt,* 106 B.R. 553 (Bankr. N.D. Ind. 1989). *In re Bottelberghe,* 253 B.R. 256 (Bankr. Minn. 2000); *in re McNichols,* 249 B.R. 160 (Bankr. N.D. Ill. 2000); *in re Waechter,* 439 B.R. 253 (Bankr. Mass. 2010); *In re Louviere,* 389 B.R. 502 (Bankr. E.D. Tex. 2008). This majority view is premised upon the assumption that married couples live as one economic unit and inevitably pool their income and expenses. *In re Carter,* 205 B.R. at 736 (Bankr. E.D. Pa. 1996). While there is no statutory authority for a court to consider a non-debtor spouse's income and expenses in computing disposable income, getting an accurate depiction of a debtor's budget is not possible without looking at income from all sources including income from a non-debtor spouse. *Matter of Belt,* 106 B.R. at 561. Courts have reasoned that a non-debtor spouse's income is relevant essentially because if a non-debtor spouse's income is available to defray a debtor's reasonably necessary expenses for the household, a portion of debtor's own income then is freed up for satisfaction of claims under his or her Chapter 13 plan. *In re Bottelberghe,* 253 B.R. at 262. Determining that a non-debtor spouse's income should be considered as part of a debtor's disposable income and as part of a debtor's good faith in proposing his or her Chapter

13 plan is only one part of the equation. That determination still doesn't answer how the non-debtor spouse's income and expenses should be considered. It is this part of the equation where these same courts seemed to diverge into two separate approaches.

Some of these courts in effect have treated the income and expenses of the non-debtor spouse as though the non-debtor spouse had also filed for bankruptcy, and the courts have then inquired into whether the non-debtor spouse's expenses were "reasonable and necessary." *In re Williamson,* 296 B.R. at 765; *see also in re Carter,* 205 B.R. at 736; *in re Bottelberghe,* 253 B.R. at 264. One court adopted this approach even though the debtor had explained to the court that he and his non-debtor spouse maintained separate accounts. *Matter of Belt,* 106 B.R. 553 (Bankr. N.D. Ind. 1989). In their analysis of whether a non-debtor spouse's expenses are "reasonable and necessary," courts have questioned whether their expenses are in fact "frivolous, luxurious, or otherwise unreasonable." *In re Battelberghe,* 253 B.R. at 264. Nevertheless, a non-debtor spouse's own individualized expenses for which he or she is solely liable can still be included in the debtor's household budget. *Matter of Belt,* 106 B.R. at 572. Furthermore, a reasonable reserve or contingency fund can still be incorporated into a debtor's budget in compliance with 11 U.S.C. § 1325(b)(1)(B). *Id.* at 563; *see also, in re Bottelberghe,* 253 B.R. at 263; *in re Nahat,* 278 B.R. 108, 114 (Bankr. N.D. Tex. 2002). Thus, in summary, the courts that have adopted this first approach to the majority view evaluated a non-debtor's expenses on the basis of whether the expenses were "reasonable and necessary" and, while they allowed a non-debtor spouse's individual expenses for which he or she is solely liable in a debtor's household budget, they did not allow non-debtor spouse's luxurious or frivolous individual expenses in a debtor's household budget.

Other courts have adopted a different approach in determining how a non-debtor spouse's income and expenses should be considered under either the disposable income test of 11 U.S.C. §1325(b)(1)(B) or a good faith analysis under 11 U.S.C. § 1325(a)(3). This second approach requires that a debtor and his or her non-debtor spouse proportionally bear the expenses of the household in the same relative ratio as their respective net incomes. *See, e.g. in re McNichols,* 249 B.R. 160, 172 (Bankr. N.D. Ill. 2000); *in re Waechter,* 439 B.R. 253, 257 (Bankr. Mass. 2010); *in re Louviere,* 389 B.R. 502, 510 (Bankr. E.D. Tex 2008). Under this approach, if a debtor's net income comprises 40% (and in contrast the non-debtor spouse's net income comprises 60%) of the total net household income, the debtor would be expected to shoulder 40% of the household expenses from his or her income in contrast to the 60% of the household expenses that the non-debtor spouse would be expected to shoulder from his or her income. Similar to the courts that adopted the first approach under the majority view, these courts still regarded luxury items of the non-debtor spouse as disallowable under the projected disposable income test of 11 U.S.C § 1325(b)(1)(B) or as evidence of bad faith under 11 U.S.C. § 1325(a)(3) but allowed the non-debtor spouse to still pay down his or her own obligations. *In re McNichols,* 249 B.R. at 172; *in re Waechter,* 439 B.R. at 256. The court in *Waechter* still determined that a debtor's disproportionate contribution to her household expenses evidenced a lack of good faith even though debtor's premarital agreement placed full responsibility of paying household expenses on her. *In re Waechter,* 439 B.R. at 256. In adopting the "proportionate income to expenses" approach, the court in *Louviere* stated that a debtor and her non-debtor spouse's income and expenses had to be fully disclosed on the respective schedules and could not be revealed simply through a unilateral insertion of a household contribution from her non-debtor spouse on Schedule I. *In re Louviere,* 389 B.R. at 510.

Courts that have subscribed to the minority view regarding incorporation of a non-debtor spouse's income and expenses have rejected the assumption that a married couple should be considered

a single economic unit and pool all of their income and expenses. *In re Harmon,* 118 B.R. 68 (Bankr. E.D. Mich. 1990); *in re Welch,* 347 B.R. 247 (Bankr. W.D. Mich. 2006); *in re Ortiz-Feliciano,* 532 B.R. 185 (Bankr. P.R. 2015). Instead, they have determined that a non-filing spouse's income and expenses do not necessarily need to be included in the calculation of a debtor's disposable income under 11 U.S.C. § 1325(b)(1)(B). In *Harmon,* the court determined that a 50/50 split in expenses between the debtor and his non-debtor wife was reasonable even though he earned more than his wife. *In re Harmon,* 118 B.R. at 68. The *Harmon* court noted that the agreement between the debtor and his wife to share their expenses equally was an established part of their marriage prior to the bankruptcy filing. *Id.* Later, the court in *Welch* heavily criticized the "pooling of income and expenses" approach adopted by the majority of courts and instead proffered that each debtor should be given the opportunity to establish that his household is established differently. *In re Welch,* 347 B.R. at 254. Ultimately, the *Welch* court held that a non-debtor spouse's income should only be considered in the disposable income analysis to the extent that a debtor is subsidizing the incremental living costs of either the non-debtor spouse or a dependent of the non-debtor spouse for whom the non-debtor spouse has an obligation and ability to support. *Id.* at 256. Thus, under the ruling of the *Welch* court and assuming debtor's household is just comprised of the debtor and his or her non-debtor spouse, a non-debtor spouse's income can be disregarded with regard to a disposable income analysis as long as the debtor's budget represents solely debtor's expenses in his or her budget and those expenses are reasonable in amount for a household of one in that locality. Nevertheless, a non-debtor spouse's income can still be relevant as part of the "totality of circumstances" standard of good faith. *Id.*

Diverse and modern domestic arrangements with debtors are bound to challenge bankruptcy practitioners and the courts in the future. Only time will tell as to whether these two views of the courts in the past hold up to the test of time or whether a third view will emerge. Regardless, the question of "to include or not include a non-debtor spouse's income and expenses" will most likely remain for bankruptcy courts to decide for decades to come.

EVIDENTIARY USE OF TESTIMONY FROM THE MEETING OF CREDITORS

By: Varinder P. Singh
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The Bankruptcy Code provides various opportunities for parties to examine the debtor's assets, liabilities, and financial condition, among other things.[3] One of these opportunities comes early in a bankruptcy case at the meeting of creditors. Section 341 provides, in pertinent part, that "within a reasonable time" after entry of the order for relief, the United States Trustee *shall* convene and preside over the meeting of creditors. 11 U.S.C. § 341(a) (emphasis added). Section 343 places a corresponding duty on the debtor. It provides that a "debtor *shall* appear and submit to examination under oath at the meeting of creditors under section 341(a)…." 11 U.S.C. § 343 (emphasis added). Although the debtor must submit to an examination under oath, the meeting of creditors should not be confused for a court hearing, as no court representative, including the bankruptcy judge, is permitted to participate in or attend the meeting. 11 U.S.C. § 341(c).

Even though the debtor must submit to examination under oath, the meeting of creditors is not a "deposition" in the true sense of the word. Bankruptcy Rule 7030, which incorporates Rule 30 of the Federal Rules of Civil Procedure, provides the process for and scope of a "deposition by oral examination." While similarities exist, several distinctions between the meeting of creditors and a deposition are apparent. Notably, section 341 itself places a duty on the trustee to inform the debtor of certain matters, including the effect of a discharge. *See* 11 U.S.C. § 341(d). In a deposition, however, no such duty exists. Instead, it is wholly adversarial in nature. Perhaps more importantly, a deposition contains certain procedural safeguards arguably not found at the meeting of creditors.

With that said, at least one important similarity exists. The debtor's testimony at the meeting of creditors must be recorded, much like it is during a deposition, and once the testimony is recorded, it may be transcribed just like a deposition. Fed. R. Bankr. P. 2003(c). Under Bankruptcy Rule 2003(c), any party in interest may request a copy of the transcript of the meeting, and the United States Trustee is required to provide it:

> Any examination under oath at the meeting of creditors held pursuant to §341(a) of the Code shall be recorded verbatim by the United States trustee using electronic sound recording equipment or other means of recording, and such record shall be preserved by the United States trustee and available for public access until two years after the conclusion of the meeting of creditors. Upon

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[2] The author is the judicial law clerk to the Hon. John T. Gregg. Neither the author nor the Bankruptcy Court for the Western District of Michigan express any opinion regarding the decisions discussed in this article. The discussion is by no means comprehensive. Practitioners are encouraged to review the actual decisions in order to thoroughly understand the issues and holdings.

[3] The Bankruptcy Code is set forth in 11 U.S.C. §§ 101 *et seq*. Specific sections of the Bankruptcy Code are referred to herein as "section __." Federal Rules of Bankruptcy Procedure set forth in Fed. R. Bankr. P. 1001 *et seq*. and are referred to herein as "Bankruptcy Rule __."

> request of any entity, the United States trustee shall certify and provide a copy or transcript of such recording at the entity's expense.

Fed. R. Bankr. P. 2003(c).

A transcript of the meeting of creditors may prove to be quite useful in contested matters and adversary proceedings, particularly when a debtor is unavailable to testify or the debtor's testimony supports the relief sought. Nonetheless, the testimony will be subject to Federal Rules of Evidence. This article provides a brief overview of certain evidentiary considerations when a party seeks to use testimony from the meeting of creditors.[4]

A. Threshold Considerations

Bankruptcy Rule 9017 makes the Federal Rules of Evidence, among other things, applicable to cases under the Bankruptcy Code. As a result, any party in interest that seeks to admit the testimony from the meeting of creditors must lay the proper foundation. Fed. R. Evid. 901. Moreover, the evidence must be relevant. Fed. R. Evid. 401. While these are obvious points, they are threshold considerations that practitioners and the court should keep in mind.

B. Statement by Party-Opponent - Fed. R. Evid. 801(d)

Assuming the testimony from the meeting of creditors is relevant and a proper foundation can be laid, a party seeking to admit that testimony should be prepared to address an objection based on hearsay. *See* Fed. R. Evid. 801(d) ("exclusions" from hearsay); Fed. R. Evid. 803 ("exceptions" to hearsay). Simply put, hearsay is an out-of-court statement offered to prove the truth of the matter asserted. Fed. R. Evid. 801(c).

Relatively few published or even unpublished decisions have addressed hearsay in connection with testimony from the meeting of creditors. Courts seem to have uniformly held, however, that if the debtor is the party objecting to the admission of the testimony based on hearsay, the objection will likely be overruled because the testimony constitutes an admission by a party opponent under Fed. R. Evid. 801(d)(2)(A). *See, e.g.*, *In re Scioli*, 2013 WL 318718, at *1 n.3 (Bankr. D. Del. Jan. 28, 2013), *subsequently aff'd*, 586 F. App'x 615 (3d Cir. 2014); *Walton v. Taylor (In re Taylor)*, 2014 WL 1330561, at *8 (Bankr. S.D. Ga. Mar. 31, 2014) (finding that a "[d]ebtor's own statement are not hearsay…and are admissible as a result, unless excluded on a different basis").

A statement is "excluded" from hearsay if it is offered against an opposing party and is the party's own statement. *See* Fed. R. Evid. 801(d)(2)(A). Accordingly, if the debtor is objecting to the admissibility of testimony from the meeting of creditors, a court may be inclined to admit it under Fed. R. Evid. 801(d)(2).

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[4] *See* Michael A. Nardella & Christy Thornton Nash, *341 Transcripts: The Hearsay Rule and Limits on Their Use As Substantive Evidence*, Am. Bankr. Inst. J. 20, 20 (2013).

C. Residual Exception - Fed. R. Evid. 807

When the debtor is not the party opponent, the party seeking to admit the debtor's testimony from the meeting of creditors may need to rely on other evidentiary rules. Such a situation may arise when, for example, a trustee commences an adversary proceeding against a non-debtor defendant. If the trustee is unable to compel the debtor's attendance at trial, he or she may have little alternative other than to rely on the debtor's testimony from the meeting of creditors.

An unpublished decision from the bankruptcy court for the Eastern District of California is instructive. *See Salven v. Mendez* (*In re Mendez)*, 2008 WL 597280, at *1 (Bankr. E.D. Cal. Feb. 29, 2008). In *In re Mendez*, the chapter 7 trustee commenced an adversary proceeding against a non-debtor defendant. When the trustee attempted to introduce the debtor's testimony from the meeting of creditors, the defendant objected based on hearsay. In response, the trustee argued that the transcript was admissible because the debtor was not available to testify under Fed. R. Evid. 804.[5]

The court noted that Fed. R. Evid. 804 did not apply because the party against whom the testimony was being offered must have had an "opportunity and similar motive to develop the testimony by direct, cross, or redirect testimony." *See* Fed. R. Evid. 804(b)(1)(B). Because the meeting of creditors does not provide the debtor with such an opportunity, the court concluded Fed. R. Evid. 804 was inapplicable. With that said, the court turned to the residual exception under Fed. R. Evid. 807, which provides, in pertinent part, that a statement is not hearsay if the statement is "supported by sufficient guarantees of trustworthiness" after considering the totality of the circumstances and "it is more probative on the point for which it is offered than any other evidence that the proponent can submit through reasonable efforts."

The *Mendez* court identified three requirements that must be met for the residual exception to apply. First, the statement must be offered as evidence of a material fact. The court determined this requirement was satisfied because the testimony at the meeting of creditors was under oath. Second, the statement must be more probative on the point for which it is offered than any other evidence that the proponent can submit through reasonable efforts. The court determined that this requirement was also satisfied because the testimony consisted of statements made by the debtor, who was not available to testify at trial. Third and finally, the general purpose of the Federal Rules of Evidence and interests of justice must be best served by the admission of the statement into evidence. The court determined this requirement was also met because the debtor was not available to testify, and there was no suggestion that the testimony was false or unreliable.[6]

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[5] *See In re Katzburg*, 326 B.R. 603, 605 (Bankr. D.S.C. 2004) (discussing unavailability requirement under Fed. R. Evid. 804).

[6] In 2019, Fed. R. Evid. 807 was amended to, among other things, eliminate the requirement that evidence be material and that the admission of hearsay serve the interests of justice. The hearsay statement no longer needs to be surrounded by "equivalent guarantees of trustworthiness." Now, the statement must simply be supported by sufficient guarantees of trustworthiness when considering the totality of the circumstances. This indicates an easier standard for courts to apply to allow the statements into evidence. After the amendments to Fed. R. Evid. 807, it is unlikely that the decision in *Mendez* would change.

D. Lack of Deposition Safeguards

Even if the testimony from the meeting of creditors does not constitute hearsay, it may still not be admissible due to the lack of procedural safeguards, according to at least one court. *See BancorpSouth Bank v. Avery (In re Avery)*, 594 B.R. 655, 657 (Bankr. S.D. Miss. 2018). In *In re Avery*, a creditor filed a complaint to determine whether the debt owed to the creditor was excepted from discharge. In its motion for summary judgment, the creditor relied, in large part, on the debtor's testimony during the meeting of creditors.

Although the debtor failed to respond to the motion, the court declined to admit the transcript into evidence because it did not constitute a deposition. The court explained that:

> [t]he rules of procedure do not give the debtor a right to discovery from…any interested party for the purpose of preparing a defense for the meeting of creditors because there is nothing to defend. The statutes and rules do not make the meeting of creditors into a mere discovery deposition subject to all the procedural rules governing discovery.

Id. at 660 (quoting *Clippard v. Russell (In re Russell)*, 392 B.R. 315, 359 (Bankr. E.D. Tenn. 2008)). The court, therefore, concluded that the section 341 transcript was inadmissible because it "lacks the safeguards and protections of the discovery rules."

However, the court noted that the testimony from the meeting of creditors could have been admissible upon the consent of all parties. If all parties consent, the court observed that the debtor would have an opportunity to submit counter-affidavits regarding the testimony from the meeting of creditors. Because the debtor did not respond to the motion for summary judgment and absent an agreement between the parties, the court excluded the transcript.

E. Conclusion

The testimony from the meeting of creditors can be quite useful in contested matters and adversary proceedings if, and it's a big "if," it is admitted into evidence. By having a working knowledge of the rules of evidence, including those discussed herein, practitioners will be better equipped to include or exclude from the record testimony from the meeting of creditors.

<u>**EDITOR'S PICKS**</u>

Conversion Post Discharge

In re Pike, Case No. 17-40736 (Bankr. S.D. IL 2020): this is a decision that addresses the split on what effect a Chapter 7 discharge has on pre-petition claims when the case is subsequently converted to Chapter 13. Judge Grandy held that that a "discharge eliminates a debtor's personal liability for a debt, [but] it does not extinguish the liability of the bankruptcy estate." So, when a Chapter 7 is converted post discharge the claims revive for the Chapter 13. This would mean that a so-called Chapter 20 doesn't work when converting after discharge and that a whole new Chapter 13 petition is needed.

Claims Bar – Governmental Units

In re Marquez, Case No. 19-10284 (Bankr. D. NM 2020): Judge Jacobvitz found that a federal credit union is a "governmental unit" for all purposes and are entitled to the additional time allowed to file proofs of claim under Bankruptcy Rule 3002(c)(1) and Section 502(b)(9). Section 101(27) includes in its definition of "governmental unit" a "department, agency or instrumentality of the Unites States." Judge Jacobvitz found that a federal credit is an instrumentality of the United States. To reach this conclusion, the court examined several factors used in determining whether a particular entity is federal instrumentality, including: "whether the particular entity performs an important governmental function; whether the federal government owns the entity or is entitled to its profits and is liable for its losses; whether the federal government supports the entity with financial aid; whether the federal government appoints officers of the entity or controls its operations; whether the entity is a for profit corporation that engages in commercial activities; whether the entity is subject to extensive government regulation; and whether the entity is exempt from federal tax." Judge Jacobvitz found that the most significant factor was whether the entity performs an important government function. Of note, the decision cites Sixth Circuit case law which held that federal credit unions are government instrumentalities and are exempt from state taxation because they perform important government functions. However, the Sixth Circuit did not hold that credit unions are governmental instrumentalities for all purposes. See *United States v. State of Michigan*, 851 F.2d 803 (6th Cir. 1988).