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Bankruptcy Law

Bankruptcy Notice: How Critical Is It?

Constitutional implications arise when a creditor fails to receive adequate notice of a bankruptcy proceeding

By Stephen M. Packman and Jerrold S. Kulback

The filing of the bankruptcy petition begins the case but does not itself commonly serve as the vehicle for notification of creditors and other parties in interest of the bankruptcy proceedings. Actually, the creditor matrix filed with the petition is perhaps the most critical first-day document filed.

The matrix is a document that the debtor must file with the petition. It should list all of those parties who have an interest in the proceedings so that they in turn receive notice of the commencement of the case from the bankruptcy court clerk's office. This in turn allows parties in interest to meaningfully participate in the proceedings.

Under §342(a) of the Bankruptcy Code, appropriate notice of the order for relief must be given. Federal Rule of Bankruptcy Procedure 2002(a)(1) requires the clerk, or some other person, to provide notice of the first meeting of creditors to the debtor, the trustee and all creditors. The court clerk issues the notice to creditors listed on the creditor matrix.

Unfortunately, due to the debtor's rush to file the case or an oversight, a creditor is often not included on the matrix and therefore does not receive notice of the filing. If that creditor does not subsequently learn of the filing by other means, its rights may be protected by certain provisions of the code and case law. The impact of these protections on an errant debtor can be substantial.

Right to Notice

Constitutional implications arise when a creditor fails to receive adequate notice of a bankruptcy proceeding. See *In re Hariopoulos*, 118 F.3d 1240 (8th Cir. 1997). As the court noted in *In re Avery*, 134 B.R. 447 (Bankr. N.D.Ga. 1991), a creditor has a right to adequate notice and the opportunity to participate in a meaningful way in the course of a bankruptcy proceeding. Due process requires that a party receive notice, which is reasonably calculated, under all circumstances, to apprise interested parties of the pending action so that they can present their view and protect their rights. See *Mullane v. Central Hanover Bank & Trust Co.*, 339 U.S. 306 (1950).

The courts have crafted case law to protect unaware claimants. Due process dictates that if a potential claimant lacks sufficient notice of a bankruptcy proceeding, his or her claim cannot be discharged by the order confirming a plan of reorganization. See *In re Trans World Airlines, Inc.*, 96 F.3d 687 (3d Cir. 1996). And as the court stated in *In re Barton Indus., Inc.*, 104 F.3d 1241 (10th Cir. 1997), a secured creditor's lien rights cannot be altered by a confirmed plan if the creditor did not receive sufficient notice that the plan would materially affect the security interest held by the creditor.

Similarly, a secured creditor's lien rights cannot be extinguished when it fails to file a claim due to lack of notice of the claim's bar date. As the court put it in *City of New York v. New York, New Haven & Hartford R.R. Co.*, 344 U.S. 293 (1953), "[t]he statutory command for notice embodies a basic principle of justice — that a reasonable opportunity to be heard must precede judicial denial of a party's claimed rights."

Section 542(c) of the code provides that "an entity that has neither actual notice nor actual knowledge of the commencement of the case concerning the debtor may transfer property of the estate, or pay a debt owing to the debtor, in good faith … to an entity other than the trustee, with the same effect as to the entity making such transfer or payment as if the case under this title concerning the debtor had not been commenced."

This section codified the ruling of the Supreme Court under the Bankruptcy Act in *Bank of Marin v. England*, 385 U.S. 99 (1966). Prior to

Packman is a partner and chair of the debtor & creditors' rights department at Archer & Greiner of Haddonfield and Kulback is an associate in the department.

Marin, an entity was absolutely liable to the trustee in bankruptcy for the turnover of personal property of the debtor or its value when the petition was filed.

Other code provisions protect the unknowing creditor. Section 364(e) protects a lender that extends credit in reliance upon an order allowing the credit which is then appealed, whether or not the lender knew of the appeal. Section 549(b) protects a "gap" creditor in an involuntary bankruptcy proceeding.

The debtor's transfer of a security interest to a creditor after the commencement of the case but before the order for relief may be protected by §549(b) to the extent that value is given by an unsuspecting creditor. See *In re Geothermal Resources Intern, Inc*., 93 F.3d 648 (9th Cir. 1996). The court may grant a secured creditor a replacement lien on assets of the debtor's estate where the debtor used the proceeds of the lender's collateral during the case without agreement and court approval. See 11 U.S.C. 363(c)(2), and *In re J.L. Graphics, Inc*., 62 B.R. 750 (Bankr. D.N.H. 1986).

Innocent Creditor

However, an innocent creditor is not uniformly protected. In a recent decision, *In re Cybridge Corp*., 304 B.R. 681 (Bankr. D.N.J. 2004), the court held that a prepetition secured lender who is without notice of the bankruptcy proceedings during the entirety of the Chapter 11 case is not protected from the Chapter 7 Trustee's demand for avoidance of post-petition transfers to that creditor under 11 U.S.C. 549(a).

After learning of the bankruptcy from the trustee, the lender requested approval of its post-petition loans to the debtor, out of time, under 11 U.S.C. 364(c). The lender relied upon its lack of any knowledge of the filing in requesting nunc pro tunc approval of its loan pursuant to the seminal case, *In re American Cooler*, 125 B.R. 496 (2d Cir. 1942). The court denied relief to the lender holding that it had no standing under §364(c) to seek approval of the loan. That section provides that the trustee may obtain approval for secured credit, not the creditor extending the loan.

The trustee in *Cybridge* then filed a complaint against the lender under §549(a) and §550(a) seeking to avoid and recover for creditors in excess of $160,000 in accounts receivable of the debtor which the lender had collected during the Chapter 11 without court approval. The lender advanced several arguments in defense of the avoidance action.

Since it had no notice of the Chapter 11 proceeding, the lender primarily advanced a constitutional argument that it could not be bound by the code avoidance provisions. The lender argued that the post-petition loans (and proceeds of the accounts collected) were made in the ordinary course of the debtor's business and constituted the proceeds of the lender's prepetition collateral.

The lender additionally argued that it was entitled to set off the amounts it loaned the debtor post-petition against any avoidance recovery awarded to the trustee.

The court ruled that the lender did not have a recognized defense to the avoidance action, since the transfers of the accounts to the lender were not authorized by the court or under the code and the lender had no discernable defense under section 549(b). The court previously noted during the case that unsuspecting creditors are not uniformly protected by the code. The preference avoidance provisions of 11 U.S.C. 547(b) permit the trustee to recover transfers made by an insolvent debtor within 90 days of the bankruptcy to an unsuspecting general creditor because of antecedent debts.

The court, however, did not directly address the lender's constitutional arguments in its decision. Rather, it focused on the exceptions to the avoidance rule set forth in §549.

The court rejected the lender's ordinary course argument holding that "secured borrowing is not the essence of Cybridge's [Debtor's] business." The court also dispensed with the lender's good faith argument reasoning that if Congress had intended a good faith defense for the unknowing post-petition transferee of personal property, it could have enacted such a provision. 11 U.S.C. 549(c) protects only the innocent good faith purchaser who has given fair value for real property transferred in violation of §549(a). The court noted that several other provisions of the code — for instance, §§549(b), 550(b) and 542(c) — protect good faith parties without knowledge.

The court did not provide the lender with protection under §542(c), reasoning that under the section, the debtor's customers who sent their checks to the lender were protected, not the lender which negotiated those checks. Section 549(a)(2)(A) additionally permits avoidance of post-petition transfers that are otherwise authorized by §542(c). In other words, §549(a)(2)(A) would seemingly override a defense to the transfer under §542(c).

The court finally rejected the lender's argument for protection under §552(b). The lender in *Cybridge* argued that the proceeds of the debtor's accounts were actually prepetition contract proceeds and therefore attached to its prepetition lien, which was not disputed by the trustee. The court held that §552(b) did not apply since the lender's pre-petition loan balance was already satisfied by the time it collected any of the debtor's prepetition receivables.

The court upheld the trustee's avoidance claim but did not award her any monetary damages. The court gave the lender a credit against the collections for those post-petition sums that the lender advanced to the debtor acting as a fiduciary, debtor-in-possession under 11 U.S.C. 1107(a). The court noted that the debtor used the funds to operate its business as it was entitled to do under §1108 of the code. The assets removed were in fact replenished by the lender's loans.

In the end, the court held that the transfers of cash had been restored and, since cash is fungible, and the lender's post-petition advances exceeded its post-petition collections, the lender was equitably entitled to a credit greater than the value of the avoided transfers. The court entered a judgment entitling the trustee to no recovery. The matter is now on appeal. ■