

# Bankruptcy - An Overview

## Goals of the Bankruptcy System

A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts. The Supreme Court made this point about the purpose of the bankruptcy law in a 1934 decision:

[I]t gives to the honest but unfortunate debtor...a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt. *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934).

This goal is accomplished through the bankruptcy discharge, which releases debtors from personal liability from specific debts and prohibits creditors from ever taking any action against the debtor to collect those debts.

## Types of Bankruptcy

Six basic types of bankruptcy cases are provided for under the Bankruptcy Code. The cases are traditionally given the names of the chapters that describe them.

### *Chapter 7*

Chapter 7, entitled Liquidation, contemplates an orderly, court-supervised procedure by which a trustee takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors, subject to the debtor's right to retain certain exempt property and the rights of secured creditors. Because there is usually little or no nonexempt property in most chapter 7 cases, there may not be an actual liquidation of the debtor's assets. These cases are called "no-asset cases." A creditor holding an unsecured claim will get a distribution from the bankruptcy estate only if the case is an asset case and the creditor files a proof of claim with the bankruptcy court. In most chapter 7 cases, if the debtor is an individual, he or she receives a discharge that releases him or her from personal liability for certain dischargeable debts. The debtor normally receives a discharge just a few months after the petition is filed. Amendments to the Bankruptcy Code enacted in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 require the application of a "means test" to determine whether individual consumer debtors qualify for relief under chapter 7. If a debtor's income is in excess of certain thresholds, the debtor may not be eligible for chapter 7 relief.

### *Chapter 13*

Chapter 13, entitled Adjustment of Debts of an Individual With Regular Income, is designed for an individual debtor who has a regular source of income. Chapter 13 is often preferable to chapter 7 because it enables the debtor to keep a valuable asset, such as a house, and because it allows the debtor to propose a "plan" to repay creditors over time—usually three to five years. Chapter 13 is also used by consumer debtors who do not qualify for chapter 7 relief under the means test. At a confirmation hearing, the court either approves or disapproves the debtor's repayment plan, depending on whether it meets the Bankruptcy Code's requirements for confirmation. Chapter 13 is very different from chapter 7 since the chapter 13 debtor usually remains in possession of the property of the estate and makes payments to creditors, through the trustee, based on the debtor's anticipated income over the life of the plan. Unlike chapter 7, the debtor does not receive an immediate discharge of debts. The debtor must complete the payments required under the plan before the discharge is received. The debtor is protected from lawsuits, garnishments, and other creditor actions while the plan is in effect. The discharge is also somewhat broader (i.e., more debts are eliminated) under chapter 13 than the discharge under chapter 7.

### *Chapter 11*

Chapter 11, entitled Reorganization, ordinarily is used by commercial enterprises that desire to continue operating a business and repay creditors concurrently through a court-approved plan of reorganization. The chapter 11 debtor usually has the exclusive right to file a plan of reorganization for the first 120 days after it files the case and must provide creditors with a disclosure statement containing information adequate to enable creditors to evaluate the plan. The court ultimately approves (confirms) or disapproves the plan of reorganization. Under the confirmed plan, the debtor can reduce its debts by repaying a portion of its obligations and discharging others. The debtor can also terminate burdensome contracts and leases, recover assets, and rescale its operations in order to return to profitability. Under chapter 11, the debtor normally goes through a period of consolidation and emerges with a reduced debt load and a reorganized business.

### *Chapter 12*

Chapter 12, entitled Adjustment of Debts of a Family Farmer or Fisherman with Regular Annual Income, provides debt relief to family farmers and fishermen with regular income. The process under chapter 12 is very similar to that of chapter 13, under which the debtor proposes a plan to repay debts over a period of time—no more than three years unless the court approves a longer period, not exceeding five years. There is also a trustee in every chapter 12 case whose duties are very similar to those of a chapter 13 trustee. The chapter 12 trustee's disbursement of payments to creditors under a confirmed plan parallels the procedure under chapter 13. Chapter 12 allows a family farmer or fisherman to continue to operate the business while the plan is being carried out.

## *Chapter 9*

Chapter 9, entitled Adjustment of Debts of a Municipality, provides essentially for reorganization, much like a reorganization under chapter 11. Only a "municipality" may file under chapter 9, which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts.

## **Chapter 7: How it Works**

Following is an overview of the early course of a typical Chapter 7 bankruptcy case.

### **The Chapter 7 Petition and Filing Requirements**

A chapter 7 case begins with the debtor filing a petition with the bankruptcy court (the court serving the area where the individual lives, or where the business debtor is organized or has its principal place of business or principal assets). In addition to the petition, in a chapter 7 bankruptcy case the debtor must also file with the court:

1. Schedules of assets and liabilities;
2. A schedule of current income and expenditures;
3. A statement of financial affairs; and
4. A schedule of executory contracts and unexpired leases.

Debtors must also provide the assigned case trustee with a copy of the tax return or transcripts for the most recent tax year as well as tax returns filed during the case (including tax returns for prior years that had not been filed when the case began).

1. Individual debtors with primarily consumer debts have additional document filing requirements. They must file:
2. A certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling;
3. Evidence of payment from employers, if any, received 60 days before filing;
4. A statement of monthly net income and any anticipated increase in income or expenses after filing; and
5. A record of any interest the debtor has in federal or state qualified education or tuition accounts.

A husband and wife may file a joint petition or individual petitions. Even if filing jointly, a husband and wife are subject to all the document filing requirements of individual debtors. (The Official Forms may be purchased at legal stationery stores or downloaded from the internet at <http://www.uscourts.gov/bkforms/index.html>.)

## **Fees and Payment Options**

As of October 17, 2005, the courts must charge a \$220 case filing fee, a \$39 miscellaneous administrative fee, and a \$15 trustee surcharge. Normally, the fees must be paid to the clerk of the court upon filing. With the court's permission, however, individual debtors may pay in installments. The number of installments is limited to four, and the debtor must make the final installment no later than 120 days after filing the petition. For cause shown, the court may extend the time of any installment, provided that the last installment is paid not later than 180 days after filing the petition. Id. The debtor may also pay the \$39 administrative fee and the \$15 trustee surcharge in installments. If a joint petition is filed, only one filing fee, one administrative fee, and one trustee surcharge are charged. Debtors should be aware that failure to pay these fees may result in dismissal of the case.

If the debtor's income is less than 150% of the poverty level (as defined in the Bankruptcy Code), and the debtor is unable to pay the chapter 7 fees even in installments, the court may waive the requirement that the fees be paid.

## **Required Information**

In order to complete the Official Bankruptcy Forms that make up the petition, statement of financial affairs, and schedules, the debtor must provide the following information:

1. A list of all creditors and the amount and nature of their claims;
2. The source, amount, and frequency of the debtor's income;
3. A list of all of the debtor's property; and
4. A detailed list of the debtor's monthly living expenses, i.e., food, clothing, shelter, utilities, taxes, transportation, medicine, etc.

Married individuals must gather this information for their spouse regardless of whether they are filing a joint petition, separate individual petitions, or even if only one spouse is filing. In a situation where only one spouse files, the income and expenses of the non-filing spouse is required so that the court, the trustee and creditors can evaluate the household's financial position.

## **The "Automatic Stay"**

Filing a petition under chapter 7 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. But filing the petition does not stay certain types of actions listed under the Bankruptcy Code, and the stay may be effective only for a short time in some situations. The stay arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally may not initiate or continue lawsuits, wage garnishments, or even telephone calls demanding payments. The bankruptcy clerk gives notice of the

bankruptcy case to all creditors whose names and addresses are provided by the debtor.

### **Meeting of Creditors**

Usually between 20 and 40 days after the petition is filed, the case trustee will hold a meeting of creditors. During this meeting, the trustee puts the debtor under oath, and both the trustee and creditors may ask questions. The debtor must attend the meeting and answer questions regarding the debtor's financial affairs and property. If a husband and wife have filed a joint petition, they both must attend the creditors' meeting and answer questions. Within 10 days of the creditors' meeting, the U.S. trustee will report to the court whether the case should be presumed to be an abuse under the "means test" (which determines eligibility for filing bankruptcy under chapter 7)

It is important for the debtor to cooperate with the trustee and to provide any financial records or documents that the trustee requests. The Bankruptcy Code requires the trustee to ask the debtor questions at the meeting of creditors to ensure that the debtor is aware of the potential consequences of seeking a discharge in bankruptcy such as the effect on credit history, the ability to file a petition under a different chapter, the effect of receiving a discharge, and the effect of reaffirming a debt. Some trustees provide written information on these topics at or before the meeting to ensure that the debtor is aware of this information.

In order to preserve their independent judgment, bankruptcy judges are prohibited from attending the meeting of creditors.

### **Conversion from Chapter 7**

In order to accord the debtor complete relief, the Bankruptcy Code allows the debtor to convert a chapter 7 case to case under chapter 11, 12 or 13 as long as the debtor is eligible to be a debtor under the new chapter. However, a condition of the debtor's voluntary conversion is that the case has not previously been converted to chapter 7 from another chapter. Thus, the debtor will not be permitted to convert the case repeatedly from one chapter to another.

## **Chapter 13: How it Works**

Following is an overview of the early course of a typical Chapter 13 bankruptcy case.

### **The Petition and Other Filings**

A chapter 13 case begins by filing a petition with the bankruptcy court serving the area where the debtor has a domicile or residence. Unless the court orders otherwise, the debtor must also file with the court:

1. Schedules of assets and liabilities;
2. Schedule of current income and expenditures;
3. Schedule of executory contracts and unexpired leases; and
4. Statement of financial affairs.
5. Certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling;
6. Evidence of payment from employers, if any, received 60 days before filing;
7. Statement of monthly net income and any anticipated increase in income or expenses after filing; and
8. Record of any interest the debtor has in federal or state qualified education or tuition accounts.

The debtor must also provide the chapter 13 case trustee with a copy of the tax return or transcripts for the most recent tax year as well as tax returns filed during the case (including tax returns for prior years that had not been filed when the case began). A husband and wife may file a joint petition or individual petitions. (The Official Forms may be purchased at legal stationery stores or downloaded from the internet at <http://www.uscourts.gov/bkforms/index.html>.)

### **Filing and Administrative Fees**

As of October 17, 2005, the courts must charge a \$150 case filing fee and a \$39 miscellaneous administrative fee. Normally the fees must be paid to the clerk of the court upon filing. With the court's permission, however, they may be paid in installments. The number of installments is limited to four, and the debtor must make the final installment no later than 120 days after filing the petition. For cause shown, the court may extend the time of any installment, as long as the last installment is paid no later than 180 days after filing the petition. The debtor may also pay the \$39 administrative fee in installments. If a joint petition is filed, only one filing fee and one administrative fee are charged. Debtors should be aware that failure to pay these fees may result in dismissal of the case.

### **More Required Information**

In order to complete the Official Bankruptcy Forms that make up the petition, statement of financial affairs, and schedules, the debtor must compile the following information:

1. A list of all creditors and the amounts and nature of their claims;

2. The source, amount, and frequency of the debtor's income;
3. A list of all of the debtor's property; and
4. A detailed list of the debtor's monthly living expenses, i.e., food, clothing, shelter, utilities, taxes, transportation, medicine, etc. Married individuals must gather this information for their spouse regardless of whether they are filing a joint petition, separate individual petitions, or even if only one spouse is filing. In a situation where only one spouse files, the income and expenses of the non-filing spouse is required so that the court, the trustee and creditors can evaluate the household's financial position.

### **Appointment of Trustee**

When an individual files a chapter 13 petition, an impartial trustee is appointed to administer the case. In some districts, the U.S. trustee or bankruptcy administrator appoints a standing trustee to serve in all chapter 13 cases. The chapter 13 trustee both evaluates the case and serves as a disbursing agent, collecting payments from the debtor and making distributions to creditors.

### **The "Automatic Stay"**

Filing the petition under chapter 13 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. Filing the petition does not, however, stay certain types of actions, and the stay may be effective only for a short time in some situations. The stay arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally may not initiate or continue lawsuits, wage garnishments, or even make telephone calls demanding payments. The bankruptcy clerk gives notice of the bankruptcy case to all creditors whose names and addresses are provided by the debtor.

Chapter 13 also contains a special automatic stay provision that protects co-debtors. Unless the bankruptcy court authorizes otherwise, a creditor may not seek to collect a "consumer debt" from any individual who is liable along with the debtor. Consumer debts are those incurred by an individual primarily for a personal, family, or household purpose.

Individuals may use a chapter 13 proceeding to save their home from foreclosure. The automatic stay stops the foreclosure proceeding as soon as the individual files the chapter 13 petition. The individual may then bring the past-due payments current over a reasonable period of time. Nevertheless, the debtor may still lose the home if the mortgage company completes the foreclosure sale under state law before the debtor files the petition. The debtor may also lose the home if he or she fails to make the regular mortgage payments that come due after the chapter 13 filing.

### **Meeting of Creditors**

Between 20 and 50 days after the debtor files the chapter 13 petition, the chapter 13 trustee will hold a meeting of creditors. If the U.S. trustee or bankruptcy administrator schedules the meeting at a place that does not have regular U.S. trustee or bankruptcy administrator staffing, the meeting may be held no more than 60 days after the debtor files. During this meeting, the trustee places the debtor under oath, and both the trustee and creditors may ask questions. The debtor must attend the meeting and answer questions regarding his or her financial affairs and the proposed terms of the plan. If a husband and wife file a joint petition, they both must attend the creditors' meeting and answer questions. In order to preserve their independent judgment, bankruptcy judges are prohibited from attending the creditors' meeting. The parties typically resolve problems with the plan either during or shortly after the creditors' meeting. Generally, the debtor can avoid problems by making sure that the petition and plan are complete and accurate, and by consulting with the trustee prior to the meeting.

### **Claim Filing**

In a chapter 13 case, to participate in distributions from the bankruptcy estate, unsecured creditors must file their claims with the court within 90 days after the first date set for the meeting of creditors. A governmental unit, however, has 180 days from the date the case is filed file a proof of claim.

### **Repayment Plan Hearing**

After the meeting of creditors, the debtor, the chapter 13 trustee, and those creditors who wish to attend will come to court for a hearing on the debtor's chapter13 repayment plan.

## **When Chapter 7 Bankruptcy Is Better than Chapter 13**

Most people choose Chapter 7, if they have a choice. Here are some reasons why.

Most people who file for bankruptcy choose Chapter 7 because it's fast, effective, easy to file, and doesn't require payments over time.

### **Advantages of Chapter 7 Bankruptcy**

A typical Chapter 7 case is opened and closed within three to six months, and the person filing emerges debt-free except for a mortgage, car payments, and certain types of debts that survive bankruptcy, such as student loans, recent taxes, and back child support

Although you can lose property in Chapter 7, most filers don't. Bankruptcy lets you keep most necessities -- if you have little to begin with, chances are good you'll be able to keep most items (unless you pledged the item as collateral when you bought it).

However, not everyone is eligible to use Chapter 7. If your income is sufficient, after subtracting what you'll spend on certain allowed expenses and monthly payments for child support, tax debts, secured debts (such as a mortgage or car loan), and a few other types of debts, to fund a Chapter 13 repayment plan, you won't be allowed to file for Chapter 7

### **Drawbacks of Chapter 13 Bankruptcy**

Probably the main reason most people prefer Chapter 7 is that it doesn't require you to repay any portion of your debts, as Chapter 13 does. And if you use Chapter 13, you must complete the entire three- to five-year repayment plan in order to have your remaining debts discharged (unless the court lets you off the hook early, for hardship reasons). The majority of those who file for Chapter 13 are unable to complete their plans.

If you choose to convert from Chapter 13 to Chapter 7 (and you are eligible to file under Chapter 7), all of the money you paid into your plan for dischargeable debts will have been for naught. If you handle your debts outside of bankruptcy, your debts will be reduced by the amount you repaid during your plan.