Bankruptcy and debtor-creditor relations

Finance, Banks

Bankruptcy and Debtor-Creditor Relations Bankruptcy often conjures up images of the Great Depression, boarded up store fronts, and social disgrace. Today, however, bankruptcy has evolved into a procedure in which a person or business may preserve their remaining assets, reorganize and continue on or obtain a fresh-start in life. Bankruptcy can be defined simply as " the legal process by which the assets of a debtor are sold to pay off creditors so that the debtors can make a fresh start financially" (Brown, Sukys 2006: 578). Found in Title 11 of the United States Code (USC) the Bankruptcy Code consists of several " chapters", each with its own set of actions and procedures. The four codes most pertinent to business consist of Chapter 7 or ordinary bankruptcy, Chapter 11, also known as reorganization, Chapter 12, a special code dealing exclusively with family farmer debt adjustment, and Chapter 13 or Adjustment of Debts. In all, bankruptcy can be a tool that provides many people with the help and financial safety that they need.

The Debtor and Creditor Although bankruptcy law provides many services to people, its main objectives are to protect creditors and the debtor. It protects creditors that have extended either money or credit to a debtor by making sure that the debtors remaining assets are spread evenly amongst all creditors. Debtors are allowed an " escape from their financial burdens" and given an opportunity to rebuild (Brown, Sukys 2006: 579). This form of bankruptcy law has only existed for roughly thirty years. The Bankruptcy Reform Act of 1978 included the creation of Chapters 11 and 13 which allowed debtors to retain more assets as well as reorganize.

The Reform Act of 1994 further developed these aspects of the law as well as creating the National Bankruptcy Committee. The NBR studies bankruptcy and makes suggestions about how to improve the law. Furthermore, in 2005 bankruptcy law experienced its most dramatic change since the Bankruptcy Reform Act in the Bankruptcy Abuse Prevention and Consumer Protection Act. The bankruptcy process naturally focuses on the debtor. The Bankruptcy Reform Act of 1978 defines a debtor as a " person or municipality concerning which a case under this title has commenced".

This definition uses both the terms " person" and " municipality" because under the law they are mutually exclusive (Frey, McConnico, Frey 1997: 32). Under the United States Code all persons may become debtors with three limitations. First, a person seeking to become a debtor must live, own property, or have a business in the United States. Second, an individual or family farmer may not be a debtor under the USC if they have been a debtor in a case pending at any time in the preceding 180 days if the case was dismissed for willfully neglecting to follow the orders of the court or failing to appear before the court; or if the " debtor requested and obtained the voluntary dismissal of the case following the filing of a request for relief from the automatic stay" (Frey, McConnico, Frey 1997: 33). Finally, a person cannot become a debtor if they have been a debtor and received a discharge, which is essentially the wiping away of a person's debts, within the past six years.

Creditors, along with making sure that the debtor's assets are distributed evenly, want to " assure that the debtor does not receive a discharge unless

one is justified and that the debts are nondischargeable according to law are not discharged through the bankruptcy proceeding (Frey, McConnico, Frey 1997: 7). Within these priorities creditors hold three basic types of claims: priority, secured, and unsecured. Priority claims include those made by employees for employee compensation, claims for alimony, claims made by the IRS, and claims made by the state tax commission, Secured claims are secured by personal property or real estate. Property is also known as collateral and may be taken by the creditor if the debtor did not fulfill their obligation to pay the debt. Unsecured claims are those that are not secured by collateral. Chapter 7: Liquidation or Straight Bankruptcy Chapter 7 is the most common type of bankruptcy available to the average consumer.

Also known as “ straight” or “ liquidation” bankruptcy this form of bankruptcy is generally best suited to people with a modest income, few assets, and comparatively high debts and allows for the discharge of most debts (American Bar Association 2006: 219). It is worth noting that although liquidation of the debtor is the primary function of Chapter 7, liquidation may also occur under other chapters. Chapter 11 may provide for liquidation of some or all of a debtor’s assets (Herbert 1995: 291). Nonetheless, Chapter 7 is the only chapter that deals specifically with liquidation in which “ a trustee gathers up the debtor’s assets, sells them, and generally makes a one-time distribution to creditors” (Frey, McConnico, Frey 1997: 20).

However, Chapter 7 does not require an immediate “ fire sale” of the debtor’s assets; in appropriate circumstances a Chapter 7 trustee may decide upon an extended liquidation or even continue to run a debtor’s

business for a period (Herbert 1995: 291). Chapter 7 cases represent the bulk of original bankruptcy cases filed. Roughly 70 percent of bankruptcy filings nationwide are Chapter 7 cases (American Bar Association 2006: 219). In addition to these original filings, many Chapter 11 and 13 cases will convert to Chapter 7. Given the more stringent codes of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, however, it remains to be seen whether so many people will continue to file for Chapter 7.

Dismissal of a Chapter 7 Case As with any court case the first priority is to determine if the case can be dismissed. Both Sections 707(a) and 707(b) provide for dismissals of Chapter 7 cases. Section 707(a) provides that a case may be dismissed for a cause (Herbert 1995: 291). 707(a) outlines three non-exclusive and straightforward bases for dismissing a case. The first of these is unreasonable delay by the debtor that is prejudicial to creditors. An example of this is the failure to appear at the meetings of creditors.

Second amongst these bases is the failure to pay required fees. The final is the failure to file the schedules and statement of financial affairs within the required time which is usually 15 days. It must be noted that none of these particular bases is very common (Herbert 1995: 292). Section 707(b) outlines dismissal of a consumer case that is considered a substantial abuse. This Section is a response made by the Bankruptcy Amendments and Federal Judgeship Act of 1984 concerning creditor complaints about the “ supposed laxity of consumer bankruptcy rules” (Herbert 1995: 292).

707(b) applies exclusively to Chapter 7 proceedings, and only then if the debtor is an individual who has largely consumer debts. Under these

conditions the court may dismiss the proceeding if it finds that granting relief to the debtor would be considered a substantial abuse of Chapter 7. Essentially the power of 707(b) lies in the fact that it forces the debtor to either exit bankruptcy altogether or to refile under another chapter. In the already complex field of bankruptcy law Section 707(b) is particularly so. It is marked by many oddities and incoherence largely due to the fact that it is a remnant of a much larger and more ambitious proposal by creditors to regain some of their power in bankruptcy proceedings. While oddities and ambiguities permeate 707(b) the most important one lies in who is able to raise the issue of substantial abuse.

Under 707(b) no one who has any economic interest in the case, including the creditor, can raise the issue of substantial abuse. It may only be " raised sua sponte [voluntarily] by the court or by the United States Trustee, and not at the request or suggestion of a party in interest" (Herbert 1995: 293). This basically constitutes a Catch 22 of sorts; the people most interested in making such a motion are not allowed to. Furthermore, neither the US Trustee nor the judge in such a case is supposed to act on any requests made by creditors concerning substantial abuse. Needless to say, substantial abuse cases are difficult to asses.

The First Steps of Chapter 7 Under new bankruptcy laws debtors are now required to receive credit counseling within 180 days before filing for bankruptcy. Debtors must present the court with a certificate or evidence that they have received such counseling and the counseling must be from an approved not for profit budget and credit counseling agency. This agency

must be approved of or accredited by the US bankruptcy trustee or bankruptcy administrator (American Bar Association 2006: 221-222) However, the commencement of a Chapter 7 case truly begins with the filing of a petition. A petition works by asking that an individual be relieved of their dischargeable debts. This can be a voluntary filing, which an individual files on their own behalf, or an involuntary filing in which a debtor's creditor(s) band together and force them into a bankruptcy proceeding if the debtor " continuously fails to pay bills as they become due" (Brown, Sukys 2006: 580). As soon as a petition for bankruptcy is filed all of the debtor's assets come under the control of the court in the form of a bankruptcy estate.

In addition to this the court issues an automatic stay which immediately prohibits further collection efforts by a creditor against a debtor (American Bar Association 2006: 224). If another individual has co-signed on a loan with the debtor the automatic stay does not, however, stop the creditor from seeking payment from the cosigner. All in all, the entire petition and the forms required for filing for bankruptcy will outline the bankruptcy estate: a list of all creditors and what they are owed, the financial history, incomes, debts, and assets of the debtor. Finally the court will issue an order of relief which is the " courts command that the liquidation begin" (Brown, Sukys 2006: 582). The debtor also has the option at anytime to convert to their case to Chapter 11, 12 or 13 so long as the debtor is eligible for that chapter and the current case has not been previously converted to Chapter 7.

The Selection and Responsibilities of the Trustee Under Chapter 7 a trustee is elected to oversee many aspects of the debtor's assets including the

liquidation of those assets. The trustee may be elected by the creditors. Every creditor who holds an allowable, undisputed, fixed, liquidated, unsecured claim may vote (Herbert 1995: 296). Creditors, however, who have interests that are adverse to the other creditors in general, and creditors that could be considered “ insiders” of the debtor, cannot vote on the trustee. The main concern here is that they may vote for a trustee based on personal interests and this trustee in turn would not properly vindicate the rights of all the creditors.

Limiting voting eligibility to those creditors with unsecured claims is based on similar concerns; the fundamental role of the Chapter 7 trustee is to protect the interests of unsecured creditors (Herbert 1995: 296). Although the trustee is involved with secured claims, as a practical matter their involvement is usually limited because secured creditors have the right to take collateral to satisfy their debt so that collateral is not sold by the trustee (Brown, Sukys 2006: 585). While the creditors are allowed to elect the trustee, in all but a few cases the trustee is actually appointed by the US Trustee (Herbert 1995: 296). The US Trustee is also obligated to choose a disinterested member of a panel of private trustees to serve as an interim trustee.

The interim trustee will serve until a trustee is elected. However, if no trustee is elected the interim trustee will become the trustee (Frey, McConnico, Frey 1997: 243). The trustee in a Chapter 7 case is then required to: collect the property of the estate, reduce it to cash (unless it is exempt or surrendered), and close the estate expeditiously, be accountable for all

property received, ensure that the debtor performs their intentions, investigate the financial affairs of the debtor, if advisable oppose the debtor's discharge, make periodic reports on the debtor's business (if they have one and it is still in operation), supply information on the estate, and make a final report and file a final account of the administration of the debtor's estate (Herbert 1995: 297-298). As can be seen, the requirements of a trustee in a Chapter 7 case are quite extensive Exempt Assets Some of the debtor's property may be exempt from the reach of the trustee and the creditors. Exempt assets, or assets the law allows the debtor to keep, must be listed but are also " shielded from [the debtor's] unsecured creditors" (American Bar Association 2006: 229). Federal and state laws define the assets that a debtor may exempt.

By and large state laws define what a debtor is allowed to exempt, however, some states allow the debtor to follow the federal laws if they so chose (American Bar Association 2006: 229). Section 522 of the Bankruptcy Code provides a highly detailed list of exemptions available under federal law. A brief highlight of some of the major ones includes: •$18, 450 in a home (also known as a homestead exemption) or burial plot •$2, 950 in one motor vehicle •$475 per item, $9, 850 total, in household furnishings, goods, and appliances •Jewelry with a fair market value of up to $1, 225 •$975 in any property, plus up to $9, 250 of any unused amount of the exemption of the home/burial plot •$1, 850 in any " tools of your trade", including books •Any unmatured life insurance contract other than a credit ife insurance contract •Professionally prescribed health aids •The right to receive a Social Security benefit, unemployment, a veterans' benefit, alimony, a payment under a

stock bonus, pension, or profit sharing plan on account of illness, disability, death, or length of service as is reasonably necessary for the debtor's support or the support of their dependents End of the Case: Discharge and Exemptions Discharge is found under section 727 of the Bankruptcy Code and is essentially the reason for filing for bankruptcy; it is what allows the debtor a " fresh start". Discharge means that " those obligations not satisfied through or in conjunction with the bankruptcy proceeding cease to be binding on the debtor. The creditor may take no action to collect discharged debts from the debtor; the debtor may feel a moral, but has no legal, obligation" (Herbert 1995: 207). However, under some very limited circumstances, a discharge that was previously granted may be revoked.

These revocations always involve a serious act of misconduct by the debtor. In addition, revocation may only be requested within a relatively short time after discharge. A Chapter 7 discharge may be revoked in three circumstances. The first of these is if the discharge was obtained by the debtor's fraud, and the individual requesting revocation of the discharge did not know about the fraud until after the discharge was granted. The second is if the debtor acquires what is supposed to be property of the estate, and both fraudulently and knowingly failed to report this fact and surrender the property to the trustee.

Finally, discharge may be revoked if the debtor engaged in certain types of misconduct during the case. These are unjustified refusal to testify or refusal to obey other lawful orders of the court (Herbert 1995: 226-227). The appointed trustee, any creditor, or the US Trustee all are able to call for

revocation of the discharge on these grounds. Of course, the court may not revoke the discharge without notice and an opportunity for a hearing.

Chapter 11: Reorganization Chapter 11 is the chapter of choice for many businesses filing for relief under the Bankruptcy Code. The order for relief in a Chapter 11 case respite from demands of creditors and affords an opportunity fro the beleaguered business to resolve its difficulties (Frey, Frey, Swinson 2005: 18). Chapter 11 allows anyone who may proceed under Chapter 7 with two exceptions. Stockbrokers and commodity brokers cannot file bankruptcy under Chapter 11 even if they can file under Chapter 7. Chapter 11 also allows for filing by railroads. The filing of Chapter 11 can be either voluntary or involuntary, and like Chapter 7 filing, includes the automatic stay provision (Brown, Sukys 2006: 586).

Chapter 11 reorganization allows individual debtors as “ debtors in possession” to keep their nonexempt assets that would otherwise be surrendered to the trustee in a Chapter 7 case, and for business debtors to continue to operate after filing. In most Chapter 11 cases no trustee is appointed, and the debtors as debtor in possession have control over the assets of the estate. However, a trustee can be appointed if there is a cause such as fraud, dishonesty, incompetence, or gross mismanagement either before or after the commencement of the case (Frey, Frey, Swinson 2005: 401). Upon filing of a petition and the issuance of an order for relief, a “ primary committee” consisted of the debtor’s unsecured creditors is set up. Secondary committees can also be created to represent other creditors with legitimate claims against the debtor (Brown, Sukys 2006: 588). Both the

primary and secondary committees work with the debtor on the reorganization plan.

The Reorganization Plan The debtor will have the exclusive right to devise a plan for 120 days after the filing of the petition. If the debtor does not file a plan within this time, a plan and a disclosure statement maybe filed by the creditors (Frey, Frey, Swinson 2005: 395). In general, the plan outlines how the debtor intends to reorganize the payment of debts. Also, the plan must group creditors into classes and describe the treatment of each class. By law, all creditors in the same class must be treated equally.

The law also requires that the plan be feasible, meaning that there is a good chance the plan will work. However, the law does not require absolute guarantee of success (Brown, Sukys 2006: 588). Under Chapter 11, a plan does not need to be unanimously approved by all creditors. Only approvals of more than one-half of the creditors in each class are required for the plan to pass.

No approval is required from an “ unimpaired class” – those whose claiming rights have not been changed by the reorganization plan. A confirmation hearing will be held and confirmation will be issued if the plan meets all the requirements. The confirmation of a Chapter 11 plan discharges the debtor and releases it from all the claims and interests of creditors, whether or not the claims and interests are impaired or whether or not their holders have accepted the plan (Frey, Frey, Swinson 2005: 451). Exceptions to discharge include spousal or child support, educational loans, and debts incurred

through fraud. Chapter 12: Family Farmer Debt Adjustment Chapter 12 is an alternative to Chapter 7 bankruptcy only available to family farmers.

The term family farmer is restricted because not all persons involved in farming operations are defined as family farmers. To be considered a family farmer, one must receive more than 50 percent of gross income from farming operation. At least 80 percent of the debt must arise out of farming operation. Also, the aggregate debt must not exceed $1. 5 million. Chapter 12 allows for filing by partnership if a farm family owns at least 50 percent of the farming operation and 80 percent of the value of the partnership consist of assets related to farming operation (Frey, Frey, Swinson 2005: 345).

Many of the features of Chapter 7 filing also pertains in Chapter 12 filing, these features include the automatic stay provision, the ability of creditors to request an exemption from the stay, the role of the debtor as debtor-in-possession, and the possibility of a court appointed trustee. However, Chapter 12 only allows for voluntary filing. Creditors under Chapter 12 Code have no rights to input during the construction of the plan. The Adjustment Plan The debtor filing under Chapter 12 has 90 days after the issuance of order for relief to devise the adjustment plan.

The extension of this period may be allowed. The plan must show how the debtor intends to repay part or all of the creditors' allowed claims from future earnings. If the debtor fails to devise a plan within the time limit, the trustee or creditors may request the dismissal of the case (Frey, Frey, Swinson 2005: 357). There are several mandatory provisions required for a Chapter 12 plan. First, the plan must provide for the trustee's supervision

and control over the portion of the debtor's future income to repay the debt. Second, the plan must provide for full payment of all priority claims.

Third, the plan must provide equal treatment for each creditor in the same classes. Fourth, the plan must be completed within three years unless an extension is approved by the court. The extension may not exceed two years. The hearing of confirmation must be held within 45 days of the filing of the plan. The creditors have no power to help devise the plan under a Chapter 12 case. However, secured creditors have approval power while unsecured creditors have the rights to object the plan.

Despite the objections of unsecured creditors, the court may still confirm the plan (Brown, Sukys 2006: 591). If the plan cannot be confirmed, the case may be converted to Chapter 7 or dismissed. Chapter 13: Adjustment of Debts for Individual with Regular Income Chapter 13 allows for debtors who are individuals with sufficient stable and regular income with unsecured debts of less than $307, 675 and secured debts of less than $922, 975 to file for adjustment. The dollar amounts for a Chapter 13 are adjusted every three years with the next adjustment date of April 1, 2007 (Frey, Frey, Swinson 2005: 299). Corporate and partnership cannot file under Chapter 13.

However, sole proprietorships can file under Chapter 13 if they meet other requirements. Chapter 13 only allows for voluntary filing. The automatic stay provision is the same in Chapter 13 as with Chapter 7. A trustee must be appointed in a Chapter 13 case. The main advantage of Chapter 13 over Chapter 7 is that it allows the debtor to keep nonexempt assets that would be surrendered to the trustee in a Chapter 7 case without liquidation. The

Chapter 13 Plan The plan must be filed no later than 15 days after the petition under Chapter 13 has been filed.

Chapter 13 plan must include several mandatory provisions, which are virtually identical to those of Chapter 12 plan. Creditors in a chapter 13 case, as in the case with Chapter 12, have no input during the construction of the plan. Secured creditors have approval power. Unsecured creditors do not have approval power but are allowed to object the plan.

If the debtor plans to turnover 100 percent of his or her disposable future income to the trustee, the objection will not be allowed (Brown, Sukys 2006: 591). The debtor must start making payments within 30 days after the filing of the plan. The debtor can start paying before the hearing of the plan by giving the payment to the trustee. The trustee retains the payment until confirmation or rejection of the plan. In cases that the debtor cannot even make the first payment within the time limit, the case would likely be converted to Chapter 7 or dismissed (Frey, Frey, Swinson 2005: 318). The debtor is discharged after the amounts agreed under the plan are paid.

The exceptions to discharge under Chapter 13 include priority claims, alimony and child support, educational loans to governmental unit, debt incurred under DUI, and restitution resulted from a conviction of crime. The discharge under Chapter 13 allows debtor to be discharged from debts that would be nondischargeable under Chapter 7, and is the broadest discharge available to a debtor under the Bankruptcy Code (Frey, Frey, Swinson 2005: 341). Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 On April 20, 2005, the Bankruptcy Abuse Prevention Act and Consumer

Protection Act of 2005 was signed into law by President Bush after it was passed by the Senate and approved by the House of Representatives by a vote of 302-126. The Act represents the most comprehensive reform of the Bankruptcy Code since its enactment in 1978. The Act was intended to improve bankruptcy law and practice with a dominant theme of restoring personal responsibility and integrity in the bankruptcy system (CCH Incorporated 2005: 1).

Most of the provisions of the Act went into effect on October 17, 2005. Although the Act largely affects consumer bankruptcy, there are provisions that affect corporations, farmers, and businesses. Due to the amount and complexity of changes in the Act, it is impractical to address all the provisions in this paper. Instead, major highlights of the Act are presented.

A significant change in consumer bankruptcy is the “ Means Testing” system. The system evaluates if the debtor is eligible to file under Chapter 7. The Act mandates a presumption of bankruptcy abuse if the debtor’s current monthly income will allow the debtor to repay creditors at least $100 per month (calculated through a formula) in a 5 year Chapter 13 plan (Edwards & Taylor 2007). If the debtor fails this test, the case will be dismissed, or converted to a Chapter 13 case where the debtor will repay parts of the debts. In response to the problems of serial filing, the Act limits the discharge allowed in subsequent case.

The Act “ provides that a discharge will not be granted in a Chapter 13 case if the debtor obtained a discharge under a Chapter 7, 11, or 12 case within 4 years prior to the date of the filing of the pending case, or in a Chapter 13

within 2 years prior to the date of the filing of the pending case” (Edwards & Taylor 2007). The debtor can still file a Chapter 13 case and take advantage of the automatic stay provision and the ability to make payments for the debts. Under the Act, the time period between discharges under Chapter 7 case has also increase from 6 to 8 years. Under previous law, if the debtor fails to perform (surrender, redeem, or reaffirm) the intention filed under the Statement of Intent within 45 days after the filing, the creditor is required to actively request for a relief from the automatic stay to protect its collateral.

The Act now provides that the debtor is required to perform according to the Statement of Intent within 30 days; otherwise the automatic stay terminates automatically. Changes to Chapter 12 include making it a permanent part of the Bankruptcy Code, raising the debt limit from $1. million to $3, 237, 000, reducing the liability percentage requirement from 80 percent to 50 percent (Edwards & Taylor 2007). Source Material CCH Incorporated. “ CCH Bankruptcy Reform Act Briefing: Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

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