

# Overview of the Bankruptcy Process

by Rebecca L. Saitta

In times of economic struggle, consumers and business owners may consider filing a bankruptcy petition with the hope of obtaining a fresh start. Many factors need to be considered prior to seeking bankruptcy protection and the technical rules of the U.S. Bankruptcy Code (Bankruptcy Code) must be followed precisely. This article provides a general overview of the bankruptcy process and some of the paramount considerations that should factor into this important decision. It is critical that competent and experienced counsel be consulted prior to the commencement of a bankruptcy filing.

## The Basics

Bankruptcy is a legal process governed by federal rules and procedures contained in the Bankruptcy Code and the Bankruptcy Rules. The primary purpose of bankruptcy law is to provide a debtor with a fresh start through which some debts can be paid, restructured, or discharged. Bankruptcy can also protect asset values and provide a way for creditors to be treated fairly and equitably. The debtor is the person who files the bankruptcy petition (or in some cases the party against whom an involuntary petition is filed) and who owes money, goods, or services. The creditor is the person to whom the money, goods, or services are owed.

On April 20, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA) was enacted, with most provisions becoming effective on October 17, 2005. This new law provided the most substantial changes to bankruptcy law in many years and the case law is still developing as judges interpret the act's provisions.

A case begins when the debtor pays a filing fee and files a petition with the bankruptcy court in the jurisdiction where he or she resides. Financial information, including a list of assets, debts, and creditors, must be provided. This information must be certified by the debtor under penalty of perjury. One of the changes imposed by BAPCPA requires individual debtors to participate in consumer credit counseling with an approved nonprofit agency within 180 days prior to the filing of a bankruptcy petition. Failure to do so may result in dismissal of the case.

In all Chapter 7 cases (see discussion of the types of bankruptcy cases below), the United States Trustee automatically appoints a trustee to administer the case. The trustee is responsible for collecting and liquidating the debtor's assets for the benefit of the creditors. Debtors must provide the trustee with copies of their federal tax return for the most recent tax year ending prior to the filing of the petition, along with certain copies of pay stubs. The tax return must be provided to the trustee seven days prior to the initial meeting of creditors (discussed below) and the pay stubs must be provided at this meeting. Some Chapter 7 trustees may require additional financial documentation. In Chapter 11 cases, the appointment of a trustee is not automatic and requires a showing of cause such as fraud or mismanagement by the debtor.

As soon as the bankruptcy petition is filed, the debtor's creditors are notified of the filing and the automatic stay goes into effect. The automatic stay generally stops most debt collection efforts against the debtor, unless a creditor obtains permission from the bankruptcy court to pursue collection activities. The bankruptcy court and trustee (if one exists) oversee the debtor's activities, and the debtor, subject to some exceptions, receives a discharge or court-ordered release of liability. In a Chapter 7 case, the debtor will typically receive an order discharging most of his or her debts within three to four months. Chapter 13 usually requires payments over several years before a debtor will receive an order discharging his or her debts.

### Parties Who May File a Bankruptcy Petition

Almost any person who has a residence, business, or property in the United States is eligible to be a debtor under the Bankruptcy Code. Individuals, sole proprietorships, partnerships, corporations, and family farmers are eligible for bankruptcy relief. In rare cases, creditors may force someone into bankruptcy by filing an involuntary petition against a debtor.

Generally, there are no minimum financial or solvency requirements for the filing of a bankruptcy case by the debtor. However, BAPCPA imposed heightened eligibility requirements for filing a petition under Chapter 7. A debtor must pass the means test provided by the new law, which compares his or her family's current monthly income with the statewide median income. As a result, certain individuals may now be required to proceed under Chapter 13 (where they must pay at least some portion of their debts) because they are ineligible for Chapter 7. Note that certain debt restrictions or financial requirements may also apply in other chapters of the Bankruptcy Code.

### Different Types of Bankruptcy Cases

There are several different types of bankruptcy cases:

- Chapter 7 — Liquidation
- Chapter 11 — Reorganization (or Liquidation)
- Chapter 12 — Family Farmer and Fisherman Reorganization
- Chapter 13 — Adjustments of Debts of Individual Regular Income

In a **Chapter 7** liquidation case, sometimes referred to as “straight bankruptcy,” a trustee is appointed to collect and liquidate the debtor's nonexempt assets (see below for an explanation of nonexempt assets) and to pay the proceeds to creditors in the order set forth in the Bankruptcy Code. Most Chapter 7 cases are no-asset cases. This means that the debtor does not have sufficient nonexempt assets or sufficient income to make any distribution to unsecured creditors. Unsecured creditors are those who do not have a valid lien on collateral.

**Chapter 11** is available to individuals and businesses that seek to reorganize their affairs or to liquidate in an orderly manner. In Chapter 11, the debtor typically remains in control of his or her property and operates as a debtor in possession, subject to bankruptcy court supervision. A Chapter 11 debtor is allowed a certain

period of time within which to propose a plan of reorganization which, if approved by the court, will govern payment of the debts. The terms of Chapter 11 plans depend on the nature of the debt or the type of business the debtor operates. A creditors' committee, comprising representatives of the creditor body, assists with the negotiation of the plan.

**Chapter 12** allows family farmers and family fishermen with regular annual income to adjust their debts. Generally, the family farmer must have less than \$3,544,525 in debts (50 percent of which must arise out of the farming operation), and at least 50 percent of the individual's gross income must come from the farming operation. The aggregate debts of a family fisherman must not exceed \$1,642,500 (80 percent of which must arise out of the commercial fishing operation) and at least 50 percent of the individual's gross income must come from the fishing operation. A debtor under Chapter 12 must have regular and stable income that enables him or her to repay his or her creditors under a long term plan.

**Chapter 13** is available to individuals with regular income who owe unsecured debts of less than \$336,900 (unsecured debts are debts owed to creditors who do not have liens on any collateral) and secured debts of less than \$1,010,650 (secured debts are debts subject to valid liens such as mortgages and car loans). By choosing Chapter 13, an individual debtor may avoid a Chapter 7 liquidation, stop home mortgage foreclosure, reinstate a defaulted home mortgage, and obtain a broader discharge of debts than is available in a Chapter 7 liquidation. In exchange, the debtor in a Chapter 13 case must repay unsecured creditors a portion of their claims from the debtor's future income over a three- to five-year period. Ordinarily, payments to unsecured creditors will

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be made by the Chapter 13 trustee according to the plan filed by the debtor and approved by the bankruptcy judge.

**Going to Court**

In the early stage of a bankruptcy case, the debtor must attend a meeting of creditors (also called a Section 341 meeting), during which the debtor must provide information and answer questions under oath (without a bankruptcy judge) from the bankruptcy trustee, the U.S. Trustee, or creditors.

## The ultimate goal for most debtors is to obtain a discharge from certain debts that arose prior to the commencement of the case.

Bankruptcy courts are part of the federal judicial system, and federal bankruptcy judges decide most disputes that arise in bankruptcy cases. Many of the legal issues and procedures that arise in a typical individual case can be handled by an attorney without requiring the debtor's attendance at hearings, though in some instances it may be necessary for the debtor to testify in court.

**Benefits of a Bankruptcy Filing**

Bankruptcy protection can benefit a debtor in a number of ways. As mentioned above, the filing of a bankruptcy petition automatically stops most collection actions, such as garnishments, foreclosures, and lawsuits — at least temporarily. This automatic stay allows the debtor to have a breathing spell during which the debtor has the opportunity to put his finances in order and try to chart a more promising financial future. While the case is pending, creditors cannot pursue most actions against debtors without bankruptcy court approval.

The ultimate goal for most debtors is to obtain a discharge from certain debts that arose prior to the commencement of the case. Debts that are not listed on the bankruptcy schedules will likely not be discharged, so it is important to complete the schedules accurately and completely. Once the discharge of a debt is obtained, creditors cannot pursue collection efforts against the debtor, and those claims are permanently forgiven unless a lien remains in place or the debtor reaffirms his obligation to the creditor. If a lien remains in place, the creditor can pursue the collateral securing the lien even after bankruptcy. If a

debt is reaffirmed, then the creditor can pursue the debtor personally even after bankruptcy.

The bankruptcy process also affords a debtor an opportunity to reject ongoing obligations under certain types of contracts, recover property or assets that were transferred or seized prior to the bankruptcy case, and remove certain kinds of liens.

**The Effect of a Bankruptcy Filing on Credit Ratings and Employment**

A bankruptcy filing can be reflected on a debtor's credit report for up to ten years, regardless of the type or outcome of the bankruptcy case. A bankruptcy filing may also affect the debtor's ability to borrow money, although the effects of such a filing vary significantly depending on the creditor and the nature of the debt. A debtor should consult an attorney to learn more about the likely effects of a bankruptcy filing.

Private employers are prohibited from terminating or otherwise discriminating against an individual solely because of a bankruptcy filing. A governmental employer may not terminate or refuse to hire a person solely as a result of a bankruptcy filing. Similarly, a governmental unit may not deny, suspend, or refuse to renew a license, permit, or similar grant to a debtor as the result of a bankruptcy filing. The filing of a bankruptcy petition may affect a debtor's security clearance or the ability to obtain a clearance in the future, though the impact of a bankruptcy filing on one's security clearance will depend on the specific facts and circumstances of the case.

**Exempt Property**

The Bankruptcy Code allows the individual debtor to retain certain property as exempt. Exempt property is free of the claims of creditors and cannot be taken by the trustee to be liquidated. Virginia law determines the types and amount of exempt property. The debtor is entitled to a homestead exemption that allows each debtor to claim a one-time exemption for any property of up to \$5,000 (or up to \$10,000 if the debtor is 65 years of age or older) plus \$500 for each dependent. The debtor is also entitled to a specific exemption, sometimes referred to as the "poor debtor's" exemption, in different types of property (for example, clothes up to \$1,000; household furnishings up to \$5,000; or tools of a person's trade or business up to \$10,000). Other types of property (such as proceeds from a personal injury settlement or award and certain contributions to qualified

pension plans or individual retirement accounts) may also be exempt under Virginia law. A debtor must claim the property as exempt in his bankruptcy schedules in order to claim the homestead exemption. His or her lawyer must also properly prepare and file a homestead deed within a certain time limit. Creditors or the bankruptcy trustee can challenge the type or amount of the exemptions claimed by the debtor, and in some cases a hearing may be necessary to resolve the validity of a particular exemption.

A debtor may reaffirm his obligations to a secured creditor who holds a lien on a house, car, or other significant item. A reaffirmation agreement must be in writing, signed by both the debtor and the debtor's attorney, and must be filed with the bankruptcy court. A debtor may rescind a reaffirmation agreement within sixty days after the agreement is filed with the court. A debtor may also free or redeem property from a lien by paying the secured creditor the fair market value of the property in a lump sum. The bankruptcy judge can set the value if the parties do not agree.

#### Surviving Claims

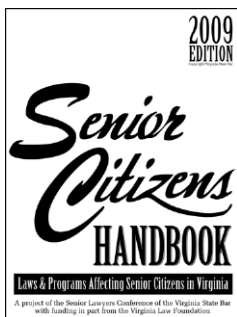
The liens of secured creditors survive bankruptcy unless the underlying debt is paid off or the lien is removed during the bankruptcy case. This means the creditor can pursue the collateral (for example, repossess the vehicle) but the creditor cannot collect against the debtor personally unless the debt has been reaffirmed. Debts that are reaffirmed during the bankruptcy case will survive.

Certain types of debts generally cannot be discharged in a bankruptcy case. These include recent taxes, alimony or child support obligations, student loans, and driving-under-the-influence claims. Debts incurred as the result of a debtor's fraud are likewise nondischargeable. If a debt is nondischargeable, the debtor is legally obligated to pay the debt even after the bankruptcy. Certain types of generally nondischargeable debt may be discharged in a Chapter 13 case but not in a Chapter 7 case.

#### Alternatives to Bankruptcy

Bankruptcy is typically thought of as a last resort for individuals and entities that have serious financial problems. Prior to a bankruptcy filing, it is common for financially troubled individuals or entities to consider alternatives such as consumer credit counseling or an out-of-court workout or debt restructuring in which obligations to some or all creditors are modified to provide the individual or entity with financial relief. Virginia law also provides for an assignment for the benefit of creditors, under which another individual handles the disposition of assets and proceeds for the benefit of creditors.

The nature and extent of a debtor's financial problems will dictate the course of action or the legal procedure that should be followed in a particular case. Individuals or entities who are experiencing such problems should consult with knowledgeable and competent professionals before deciding whether to seek bankruptcy protection.



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