

Virginia State Bar Informational Brochures

THE BANKRUPTCY PROCESS

Prepared by the Bankruptcy Law Section

The Bankruptcy Law Section of the Virginia State Bar has prepared this information as a public service to answer basic questions about the bankruptcy process. This information cannot address every issue that may arise when considering bankruptcy; however, it will introduce basic concepts that can be discussed in detail with an attorney. This information is directed to individuals, but it is also important for businesses and creditors.

I. What Is It—And How Does It Work?

Bankruptcy is a legal process governed by federal law found in the U.S. Bankruptcy Code and Rules and is conducted by the Federal Bankruptcy Court. The primary purpose of bankruptcy is to give a debtor a “fresh start” through which some debts can be paid, restructured, or discharged. Bankruptcy also provides a way for creditors to be treated fairly. The debtor is the person or company who owes money, and the creditor is the person to whom the money or service is owed.

A bankruptcy case begins when you (the debtor) pay a filing fee and file certain papers, called a petition, with the bankruptcy court. You must provide financial information, including a list of all your assets and debts. You must certify this information under penalty of perjury. Additionally, all debtors must now participate in consumer credit counseling with an approved nonprofit agency before filing a Chapter 7 or Chapter 13 bankruptcy petition. The law also requires that you provide the trustee with copies of your federal tax return for the tax year ending prior to the filing of the petition, along with certain copies of pay stubs.

As soon as you file the bankruptcy petition, an “automatic stay” goes into effect, except in unusual circumstances. The “automatic stay” stops most debt-collection efforts against you. However, in some cases, the bankruptcy court can grant the creditor permission to pursue collection activities, and for some matters, the automatic stay expires a few weeks into the case. Creditors, and sometimes a trustee, review the information you have provided, and they may file objections or other motions concerning your affairs. It is important for you to meet all the requirements of the trustee and the bankruptcy procedure on time, or your case might be dismissed. Eventually, if you have met the requirements, the court issues an order discharging the debts and your case is concluded.

2. The Different Kinds of Bankruptcy Cases.

There are several different types of bankruptcy cases:

- Chapter 7—Liquidation of Certain Assets
- Chapter 11—Reorganization (or liquidation) – including small business cases
- Chapter 11, Subchapter V
- Chapter 12—Family Farmer and Fisherman Reorganization
- Chapter 13—Payment of Some Debts from Regular Earnings

In a Chapter 7 liquidation case, sometimes called “straight bankruptcy,” a trustee collects and sells the debtor’s nonexempt assets (as explained below, you keep, or “exempt,” some assets such as basic household goods and some money) and pays the proceeds to creditors in order of priority. Most Chapter 7 cases are “no asset” cases, meaning that the debtor does not have enough nonexempt assets to distribute to creditors. A trustee usually will not sell property on which a creditor has a lien, such as a lien on a car title or mortgage on a house, unless there would be money left over after paying off the lien. However, if the loan is not current, a creditor can often repossess the car or foreclose on the house after a short period of time.

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 remains in control of his property and operates as a “debtor in possession” subject to bankruptcy court supervision. In Chapter 11, the debtor is allowed a certain period of time within which to propose a plan of reorganization, which sets the terms for payment of the debts under bankruptcy procedures. The terms of Chapter 11 plans vary, depending on the nature of the debts or the type of business the debtor operates, and creditors usually get to vote on the plan.

Chapter 11, Subchapter V – Small business debtor reorganization is available to any person or entity engaged in commercial or business activities that has aggregate noncontingent liquidated secured and unsecured debts of \$7,500,000¹ or less (50 percent of which must arise out of commercial or business activities). Excluded from filing under this subchapter, however, are those persons whose main activity is owning single asset real estate. Filing under this subchapter must be elected on the voluntary petition and a subchapter V trustee is appointed to oversee the case and assist in obtaining a confirmable plan. Debtors have

the exclusive right to file the reorganization plan, which must be filed within 90 days after the order for relief, unless the deadline is extended. Generally speaking, the deadlines in subchapter V cases are shorter than in other chapter 11 cases.

Chapter 12 allows family farmers and family fishermen with regular annual income to adjust their debts. Generally, the family farmer must have less than \$10,000,000² 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 \$2,044,225³ (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 creditors under a long-term plan.

Chapter 13 is available to individuals (including married couples) with regular income who owe unsecured debts of less than \$419,275⁴ (unsecured debts are debts owed to creditors who do not have liens on any collateral) and secured debts of less than \$1,257,850⁵ (secured debts are debts subject to valid liens such as mortgages and car loans). By choosing Chapter 13, an individual debtor often may keep his property, stop home mortgage foreclosures, reinstate defaulted home mortgages, and obtain a broader discharge of debts than is available in a Chapter 7 liquidation. The debtor may be able to pay less than what is owed or change the interest rate or number of months to pay. 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-year to five-year period. Ordinarily, the debtor makes monthly payments to the Chapter 13 trustee, who then pays the creditors according to the plan filed by the debtor, accepted by the creditors, and approved by the bankruptcy judge. The debtor pays the trustee a set amount based on his monthly earnings from all sources, less fixed living expenses.

3. Who May File for Bankruptcy?

Almost any person who has a residence, business, or property in the United States can file bankruptcy. 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. If you own a business that is not a separate corporation, you must include both your personal and business debts and property in your case.

Generally, there are no minimum financial requirements for a debtor to file a bankruptcy case. However, the law now has certain financial requirements for filing a petition under Chapter 7. Specifically, a debtor must pass the "means test," which compares your family's current monthly income with the statewide median income and then, if your income is above the median level, it uses IRS standard expense deductions to determine whether a presumption of abuse would exist if you were to file a Chapter 7 petition. In that case, you may be required to use Chapter 13

(where you must pay at least some portion of your debts). Note that certain debt restrictions or financial requirements also apply in Chapter 12 or 13 bankruptcy cases, which then may require you to file Chapter 11.

4. Do I Have to Go to Court?

In the early stage of a bankruptcy case, you must attend a meeting of creditors (also called a Section 341 meeting) at which you must provide information and answer questions under oath from the bankruptcy trustee, the United States Trustee, or your creditors. The bankruptcy judge does not participate in such meetings. Although the meetings are not formal court hearings, testimony is taken under oath and you are subject to criminal penalties for perjury. You must provide your tax return and the pay stubs to the trustee at least seven days before the meeting of creditors (discussed below). Some trustees will require other financial documents as well. If you do not attend your creditors' meeting, your case may be dismissed.

Bankruptcy courts are part of the federal judicial system, and federal bankruptcy judges decide most disputes that arise in bankruptcy cases. If any challenges are raised by creditors in your bankruptcy case, it may be necessary for you to testify in court. Although many of the typical legal issues and procedures can be handled by an attorney without requiring your attendance at a bankruptcy court hearing, it is important that you attend on time if you are required to be there.

5. How Long Will It Take?

In a Chapter 7 case, you will typically receive an order discharging most of your debts within four months, although the case may remain open longer, depending on the situation. Chapter 13 usually requires you to make monthly payments over a three-year to five-year period before you will receive a discharge.

6. How Does Bankruptcy Help?

Bankruptcy can help a debtor in a number of ways. The filing of a bankruptcy case automatically stops most collection actions against you, such as garnishments, foreclosures, and lawsuits, at least temporarily. This allows you to have a "breathing spell" during which you have the opportunity to put your finances in order and chart your financial future. While the bankruptcy case is pending, creditors cannot pursue most actions against debtors without bankruptcy court approval.

The ultimate goal of a bankruptcy filing is to obtain a discharge from certain debts that arose prior to the bankruptcy filing. Once the discharge is obtained, creditors cannot pursue collection efforts against the debtor, and those claims are permanently forgiven, unless a lien remains in place, or you "reaffirm" your obligation to the creditor (see below for a description of reaffirmation of debts). If a lien remains in place, the creditor can pursue the collateral securing the lien even after bankruptcy. If you reaffirm a debt, and do not pay according to its terms, then the creditor can sue and collect from you personally even after bankruptcy.

Bankruptcy also affords a debtor an opportunity to reject ongoing obligations under certain types of contracts and leases, recover property or assets that were transferred or seized prior to the bankruptcy case, and remove certain kinds of liens. If a debtor gives property or pays money to others before filing, other than ordinary expenses, sometimes the trustee can recover that money or property from the person who has it.

7. What Property Can a Debtor Keep?

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” which allows each debtor to claim an exemption of up to \$25,000 of equity in a home or personal property used as a residence, plus an additional \$5000, which can also be used toward the home or other property of the debtor’s choosing (plus \$500 for each dependent). This additional \$5,000 is sometimes referred to as a “wildcard exemption”. Debtors over the age of 65 and some disabled veterans are entitled to claim an extra \$5,000 homestead exemption for a total “wildcard exemption” of up to \$10,000. 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; 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 IRAs) may also be exempt under Virginia law. Generally speaking, cash value of life insurance policies may also be claimed as exempt. The debtor must claim the property as exempt in the bankruptcy schedules. Creditors or the bankruptcy trustee can challenge the type or amount of the exemptions claimed by the debtor.

In a chapter 7 bankruptcy case, a debtor may “reaffirm” his or her 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 the debtor and, sometimes, the debtor’s attorney, and must be filed with the bankruptcy court. A debtor may rescind a reaffirmation agreement within sixty days after signing the agreement.

A debtor may also “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. Property with a lien on it may be surrendered to the creditor, and the remaining balance would be discharged.

8. What Kinds of Claims Survive Bankruptcy?

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 (i.e., repossess the vehicle) but the creditor cannot collect the balance due from the debtor unless the debt has been reaffirmed. Debts that are reaffirmed during the bankruptcy case will survive.

Some debts cannot be discharged in a bankruptcy case. These nondischargeable debts include recent income tax obligations, alimony or child support obligations, criminal fines, student loans, and DUI claims. If a debt is nondischargeable, you are legally obligated to pay the debt even after the bankruptcy. If a creditor objects, a debtor might not be able to discharge debts arising from fraud, false financial statements, intentional injuries, or cash advances and luxury purchases shortly before filing.

Some types of generally nondischargeable debt may be discharged in a Chapter 13 case but not in a Chapter 7 case.

9. What Effect Does Bankruptcy Have on Credit Ratings or Employment?

A bankruptcy filing can be reflected on your credit record for up to ten years, regardless of the type or outcome of the bankruptcy case. A bankruptcy filing may also affect your ability to borrow money, although the effects of such a filing vary significantly depending on the creditor and the nature of the debt. For example, a person’s ability to obtain refinancing on a home mortgage may not be adversely affected by a prior bankruptcy filing as long as payments on similar obligations have remained current. The ability to obtain post-bankruptcy credit or to incur additional debt after a bankruptcy filing may be limited in a Chapter 12 or 13 case because all the debtor’s disposable income must already be committed to repayment of prior creditors’ claims under a plan. Otherwise, there are no legal prohibitions or restrictions against borrowing money, owning property, or transacting business after a bankruptcy filing other than the restrictions set forth in the Bankruptcy Code or by local bankruptcy courts.

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.

10. How Much Does a Bankruptcy Case Cost?

Each bankruptcy case requires a filing fee. Readers are advised to check with counsel or on the court’s website for the current filing fees. Typically, the filing fee is paid in full with the filing, although an individual debtor may apply to pay the filing fee in installments. There are very limited circumstances under which an individual may apply to the court for a waiver of the filing fee. The waiver is not automatic and may not be granted by the court. Please check with counsel, or on the court’s website, for information regarding

such applications. There may be other costs and administrative fees associated with a bankruptcy filing. The legal fees and costs charged by attorneys to handle a bankruptcy case vary significantly depending on the type and complexity of the case. The bankruptcy court has authority to approve or disapprove fees paid to a bankruptcy lawyer. Most attorneys require payment in advance for a Chapter 7, but collect most of their fees over time for Chapter 13 payments.

11. What Are the Alternatives to Bankruptcy?

Bankruptcy is typically thought of as a “last resort.” 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 some financial relief. Some consumer credit counseling companies can help a debtor renegotiate amounts owed or payment terms as an alternative to bankruptcy. However, not all “credit rescue” companies are legitimate. 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, including attorneys, before making such a decision.

If you need assistance in selecting an attorney to assist you with resolving your financial problems, the Virginia State Bar offers a Lawyer Referral Service through which you can obtain the names, addresses and phone numbers of attorneys in your area who practice bankruptcy law.

Public Information Brochures

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