

# **Bankruptcy BASICS**

*(Applicable to Cases Filed on or After October 17, 2005)*

James C. Duff, Director

Administrative Office  
of the United States Courts

# **Bankruptcy BASICS**

*(Applicable to Cases Filed on or After October 17, 2005)*

*Bankruptcy Judges Division*

*Administrative Office  
of the United States Courts*

**APRIL 2010**  
*Revised Third Edition*

*While the information presented is accurate as of the date of publication, it should not be cited or relied upon as legal authority. It should not be used as a substitute for reference to the United States Bankruptcy Code (title 11, United States Code) and the Federal Rules of Bankruptcy Procedure, both of which may be reviewed at local law libraries, or to local rules of practice adopted by each bankruptcy court. Finally, this publication should not substitute for the advice of competent legal counsel.*

# Table of CONTENTS

Introduction	5
The Discharge in Bankruptcy	9
Chapter 7. Liquidation Under the Bankruptcy Code	15
Chapter 13. Individual Debt Adjustment	23
Chapter 11. Reorganization Under the Bankruptcy Code	30
Chapter 12. Family Farmer or Family Fisherman Bankruptcy	44
Chapter 9. Municipality Bankruptcy	51
Chapter 15. Ancillary and Other Cross-Border Cases	59
SCRA. Servicemembers' Civil Relief Act	62
SIPA. Securities Investor Protection Act	66
Bankruptcy Terminology	73

# Bankruptcy Basics

## A Publication of the Bankruptcy Judges Division

### Introduction

Bankruptcy Basics is designed to provide basic information to debtors, creditors, court personnel, the media, and the general public on different aspects of the federal bankruptcy laws. It also provides individuals who may be considering bankruptcy with a basic explanation of the different chapters under which a bankruptcy case may be filed and to answer some of the most commonly asked questions about the bankruptcy process.

Bankruptcy Basics provides general information only. While every effort has been made to ensure that the information contained in it is accurate as of the date of publication, it is not a full and authoritative statement of the law on any particular topic. The information presented in this publication should not be cited or relied upon as legal authority and should not be used as a substitute for reference to the United States Bankruptcy Code (title 11, United States Code) and the Federal Rules of Bankruptcy Procedure.

Most importantly, Bankruptcy Basics should not substitute for the advice of competent legal counsel or a financial expert. Neither the Bankruptcy Judges Division nor the Administrative Office of the United States Courts can provide legal or financial advice. Such advice may be obtained from a competent attorney, accountant, or financial adviser.

### The Process

Article I, Section 8, of the United States Constitution authorizes Congress to enact “uniform Laws on the subject of Bankruptcies.” Under this grant of authority, Congress enacted the “Bankruptcy Code” in 1978. The Bankruptcy Code, which is codified as title 11 of the United States Code, has been amended several times since its enactment. It is the uniform federal law that governs all bankruptcy cases.

The procedural aspects of the bankruptcy process are governed by the Federal Rules of Bankruptcy Procedure (often called the “Bankruptcy Rules”) and local rules of each bankruptcy court. The Bankruptcy Rules contain a set of official forms for use in bankruptcy cases. The Bankruptcy Code and Bankruptcy Rules (and local rules) set forth the formal legal procedures for dealing with the debt problems of individuals and businesses.

There is a bankruptcy court for each judicial district in the country. Each state has one or more districts. There are 90 bankruptcy districts across the country. The bankruptcy courts generally have their own clerk’s offices.

The court official with decision-making power over federal bankruptcy cases is the United States bankruptcy judge, a judicial officer of the United States district court. The bankruptcy judge may decide any matter

connected with a bankruptcy case, such as eligibility to file or whether a debtor should receive a discharge of debts. Much of the bankruptcy process is administrative, however, and is conducted away from the courthouse. In cases under chapters 7, 12, or 13, and sometimes in chapter 11 cases, this administrative process is carried out by a trustee who is appointed to oversee the case.

A debtor's involvement with the bankruptcy judge is usually very limited. A typical chapter 7 debtor will not appear in court and will not see the bankruptcy judge unless an objection is raised in the case. A chapter 13 debtor may only have to appear before the bankruptcy judge at a plan confirmation hearing. Usually, the only formal proceeding at which a debtor must appear is the meeting of creditors, which is usually held at the offices of the U.S. trustee. This meeting is informally called a "341 meeting" because section 341 of the Bankruptcy Code requires that the debtor attend this meeting so that creditors can question the debtor about debts and property.

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. This publication describes the bankruptcy discharge in a question and answer format, discussing the timing of the discharge, the scope of the discharge (what debts are discharged and what debts are not discharged), objections to discharge, and revocation of the discharge. It also describes what a debtor can do if a creditor attempts to collect a discharged debt after the bankruptcy case is concluded.

Six basic types of bankruptcy cases are provided for under the Bankruptcy Code, each of which is discussed in this publication. The cases are traditionally given the names of the chapters that describe them.

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 to 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 such a debtor's income is in excess of certain thresholds, the debtor may not be eligible for chapter 7 relief.

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, 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, 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, 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.

The purpose of Chapter 15, entitled Ancillary and Other Cross-Border Cases, is to provide an effective mechanism for dealing with cases of cross-border insolvency. This publication discusses the applicability of Chapter 15 where a debtor or its property is subject to the laws of the United States and one or more foreign countries.

In addition to the basic types of bankruptcy cases, Bankruptcy Basics provides an overview of the Servicemembers' Civil Relief Act, which, among other things, provides protection to members of the military against the entry of default judgments and gives the court the ability to stay proceedings against military debtors.

This publication also contains a description of liquidation proceedings under the Securities Investor Protection Act ("SIPA"). Although the Bankruptcy Code provides for a stockbroker liquidation proceeding, it is far more likely that a failing brokerage firm will find itself involved in a SIPA proceeding. The purpose of SIPA is to return to investors securities and cash left with failed brokerages. Since being established by Congress in 1970, the Securities Investor Protection Corporation has protected investors who deposit stocks and bonds with brokerage firms by ensuring that every customer's property is protected, up to \$500,000 per customer.

The bankruptcy process is complex and relies on legal concepts like the "automatic stay," "discharge," "exemptions," and "assume." Therefore, the final chapter of this publication is a glossary of Bankruptcy Terminology which explains, in layman's terms, most of the

legal concepts that apply in cases filed under the Bankruptcy Code.

## The Discharge in Bankruptcy

The bankruptcy discharge varies depending on the type of case a debtor files: chapter 7, 11, 12, or 13. Bankruptcy Basics attempts to answer some basic questions about the discharge available to *individual debtors* under all four chapters including:

1. What is a discharge in bankruptcy?
2. When does the discharge occur?
3. How does the debtor get a discharge?
4. Are all the debtor's debts discharged or only some?
5. Does the debtor have a right to a discharge or can creditors object to the discharge?
6. Can the debtor receive a second discharge in a later case?
7. Can the discharge be revoked?
8. May the debtor pay a discharged debt after the bankruptcy case has been concluded?
9. What can the debtor do if a creditor attempts to collect a discharged debt after the case is concluded?
10. May an employer terminate a debtor's employment solely because the person was a debtor or failed to repay a discharged debt?

### WHAT IS A DISCHARGE IN BANKRUPTCY?

A bankruptcy discharge releases the debtor from personal liability for certain specified types of debts. In other words, the debtor is no longer legally required to pay any debts that are discharged. The discharge is a permanent order prohibiting the creditors of the debtor from taking any form of collection action on discharged debts, including legal action and communications with the debtor, such as telephone calls, letters, and personal contacts.

Although a debtor is not personally liable for discharged debts, a valid lien (*i.e.*, a charge upon specific property to secure payment of a debt) that has not been avoided (*i.e.*, made unenforceable) in the bankruptcy case will remain after the bankruptcy case. Therefore, a secured creditor may enforce the lien to recover the property secured by the lien.

### WHEN DOES THE DISCHARGE OCCUR?

The timing of the discharge varies, depending on the chapter under which the case is filed. In a chapter 7 (liquidation) case, for example, the court usually grants the discharge promptly on expiration of the time fixed for filing a complaint objecting to discharge and the time fixed for filing a motion to dismiss the case for substantial abuse (60 days following the first date set for the 341 meeting). Typically, this occurs about four months after the date the debtor files the petition with the clerk of the bankruptcy court. In individual chapter 11 cases, and in cases under chapter 12 (adjustment of debts of a family farmer or fisherman) and 13 (adjustment of debts of an individual with regular income), the court generally grants the discharge as soon as

practicable after the debtor completes all payments under the plan. Since a chapter 12 or chapter 13 plan may provide for payments to be made over three to five years, the discharge typically occurs about four years after the date of filing. The court may deny an individual debtor's discharge in a chapter 7 or 13 case if the debtor fails to complete "an instructional course concerning financial management." The Bankruptcy Code provides limited exceptions to the "financial management" requirement if the U.S. trustee or bankruptcy administrator determines there are inadequate educational programs available, or if the debtor is disabled or incapacitated or on active military duty in a combat zone.

### **HOW DOES THE DEBTOR GET A DISCHARGE?**

Unless there is litigation involving objections to the discharge, the debtor will usually automatically receive a discharge. The Federal Rules of Bankruptcy Procedure provide for the clerk of the bankruptcy court to mail a copy of the order of discharge to all creditors, the U.S. trustee, the trustee in the case, and the trustee's attorney, if any. The debtor and the debtor's attorney also receive copies of the discharge order. The notice, which is simply a copy of the final order of discharge, is not specific as to those debts determined by the court to be non-dischargeable, *i.e.*, not covered by the discharge. The notice informs creditors generally that the debts owed to them have been discharged and that they should not attempt any further collection. They are cautioned in the notice that continuing collection efforts could subject them to punishment for contempt. Any inadvertent failure on the part of the clerk to send the debtor or any creditor a copy of the discharge order promptly within the time required by the

rules does not affect the validity of the order granting the discharge.

### **ARE ALL OF THE DEBTOR'S DEBTS DISCHARGED OR ONLY SOME?**

Not all debts are discharged. The debts discharged vary under each chapter of the Bankruptcy Code. Section 523(a) of the Code specifically excepts various categories of debts from the discharge granted to individual debtors. Therefore, the debtor must still repay those debts after bankruptcy. Congress has determined that these types of debts are not dischargeable for public policy reasons (based either on the nature of the debt or the fact that the debts were incurred due to improper behavior of the debtor, such as the debtor's drunken driving).

There are 19 categories of debt excepted from discharge under chapters 7, 11, and 12. A more limited list of exceptions applies to cases under chapter 13.

Generally speaking, the exceptions to discharge apply automatically if the language prescribed by section 523(a) applies. The most common types of nondischargeable debts are certain types of tax claims, debts not set forth by the debtor on the lists and schedules the debtor must file with the court, debts for spousal or child support or alimony, debts for willful and malicious injuries to person or property, debts to governmental units for fines and penalties, debts for most government funded or guaranteed educational loans or benefit overpayments, debts for personal injury caused by the debtor's operation of a motor vehicle while intoxicated, debts owed to certain tax-advantaged retirement plans, and debts for certain condominium or cooperative housing fees.

The types of debts described in sections 523(a)(2), (4) and (6) (obligations affected by fraud or maliciousness) are not automatically excepted from discharge. Creditors must ask the court to determine that these debts are excepted from discharge. In the absence of an affirmative request by the creditor and the granting of the request by the court, the types of debts set out in sections 523(a)(2), (4) and (6) will be discharged.

A slightly broader discharge of debts is available to a debtor in a chapter 13 case than in a chapter 7 case. Debts dischargeable in a chapter 13, but not in chapter 7, include debts for willful and malicious injury to property, debts incurred to pay non-dischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. Although a chapter 13 debtor generally receives a discharge only after completing all payments required by the court-approved (*i.e.*, “confirmed”) repayment plan, there are some limited circumstances under which the debtor may request the court to grant a “hardship discharge” even though the debtor has failed to complete plan payments. Such a discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor’s control. The scope of a chapter 13 “hardship discharge” is similar to that in a chapter 7 case with regard to the types of debts that are excepted from the discharge. A hardship discharge also is available in chapter 12 if the failure to complete plan payments is due to “circumstances for which the debtor should not justly be held accountable.”

### **DOES THE DEBTOR HAVE THE RIGHT TO A DISCHARGE OR CAN CREDITORS OBJECT TO THE DISCHARGE?**

In chapter 7 cases, the debtor does not have an absolute right to a discharge. An objection to the debtor’s discharge may be filed by a creditor, by the trustee in the case, or by the U.S. trustee. Creditors receive a notice shortly after the case is filed that sets forth much important information, including the deadline for objecting to the discharge. To object to the debtor’s discharge, a creditor must file a complaint in the bankruptcy court before the deadline set out in the notice. Filing a complaint starts a lawsuit referred to in bankruptcy as an “adversary proceeding.”

The court may deny a chapter 7 discharge for any of the reasons described in section 727(a) of the Bankruptcy Code, including failure to provide requested tax documents; failure to complete a course on personal financial management; transfer or concealment of property with intent to hinder, delay, or defraud creditors; destruction or concealment of books or records; perjury and other fraudulent acts; failure to account for the loss of assets; violation of a court order or an earlier discharge in an earlier case commenced within certain time frames (discussed below) before the date the petition was filed. If the issue of the debtor’s right to a discharge goes to trial, the objecting party has the burden of proving all the facts essential to the objection.

In chapter 12 and chapter 13 cases, the debtor is usually entitled to a discharge upon completion of all payments under the plan. As in chapter 7, however, discharge may not occur in chapter 13 if the debtor fails to complete a required course on personal

financial management. A debtor is also ineligible for a discharge in chapter 13 if he or she received a prior discharge in another case commenced within time frames discussed the next paragraph. Unlike chapter 7, creditors do not have standing to object to the discharge of a chapter 12 or chapter 13 debtor. Creditors can object to confirmation of the repayment plan, but cannot object to the discharge if the debtor has completed making plan payments.

### **CAN A DEBTOR RECEIVE A SECOND DISCHARGE IN A LATER CHAPTER 7 CASE?**

The court will deny a discharge in a later chapter 7 case if the debtor received a discharge under chapter 7 or chapter 11 in a case filed within eight years before the second petition is filed. The court will also deny a chapter 7 discharge if the debtor previously received a discharge in a chapter 12 or chapter 13 case filed within six years before the date of the filing of the second case unless (1) the debtor paid all “allowed unsecured” claims in the earlier case in full, or (2) the debtor made payments under the plan in the earlier case totaling at least 70 percent of the allowed unsecured claims and the debtor’s plan was proposed in good faith and the payments represented the debtor’s best effort. A debtor is ineligible for discharge under chapter 13 if he or she received a prior discharge in a chapter 7, 11, or 12 case filed four years before the current case or in a chapter 13 case filed two years before the current case.

### **CAN THE DISCHARGE BE REVOKED?**

The court may revoke a discharge under certain circumstances. For example, a trustee, creditor, or the U.S. trustee may request that the court revoke the debtor’s discharge in a

chapter 7 case based on allegations that the debtor: obtained the discharge fraudulently; failed to disclose the fact that he or she acquired or became entitled to acquire property that would constitute property of the bankruptcy estate; committed one of several acts of impropriety described in section 727(a)(6) of the Bankruptcy Code; or failed to explain any misstatements discovered in an audit of the case or fails to provide documents or information requested in an audit of the case. Typically, a request to revoke the debtor’s discharge must be filed within one year of the discharge or, in some cases, before the date that the case is closed. The court will decide whether such allegations are true and, if so, whether to revoke the discharge.

In a chapter 11, 12 and 13 cases, if confirmation of a plan or the discharge is obtained through fraud, the court can revoke the order of confirmation or discharge.

### **MAY THE DEBTOR PAY A DISCHARGED DEBT AFTER THE BANKRUPTCY CASE HAS BEEN CONCLUDED?**

A debtor who has received a discharge may voluntarily repay any discharged debt. A debtor may repay a discharged debt even though it can no longer be legally enforced. Sometimes a debtor agrees to repay a debt because it is owed to a family member or because it represents an obligation to an individual for whom the debtor’s reputation is important, such as a family doctor.

**WHAT CAN THE DEBTOR DO IF A CREDITOR ATTEMPTS TO COLLECT A DISCHARGED DEBT AFTER THE CASE IS CONCLUDED?**

If a creditor attempts collection efforts on a discharged debt, the debtor can file a motion with the court, reporting the action and asking that the case be reopened to address the matter. The bankruptcy court will often do so to ensure that the discharge is not violated. The discharge constitutes a permanent statutory injunction prohibiting creditors from taking any action, including the filing of a lawsuit, designed to collect a discharged debt. A creditor can be sanctioned by the court for violating the discharge injunction. The normal sanction for violating the discharge injunction is civil contempt, which is often punishable by a fine.

**CAN AN EMPLOYER TERMINATE A DEBTOR'S EMPLOYMENT SOLELY BECAUSE THE PERSON WAS A DEBTOR OR FAILED TO PAY A DISCHARGED DEBT?**

The law provides express prohibitions against discriminatory treatment of debtors by both governmental units and private employers. A governmental unit or private employer may not discriminate against a person solely because the person was a debtor, was insolvent before or during the case, or has not paid a debt that was discharged in the case. The law prohibits the following forms of governmental discrimination: terminating an employee; discriminating with respect to hiring; or denying, revoking, suspending, or declining to renew a license, franchise, or similar privilege. A private employer may not discriminate with respect to employment if the

discrimination is based solely upon the bankruptcy filing.

## Chapter 7

### Liquidation Under the Bankruptcy Code

#### ALTERNATIVES TO CHAPTER 7

Debtors should be aware that there are several alternatives to chapter 7 relief. For example, debtors who are engaged in business, including corporations, partnerships, and sole proprietorships, may prefer to remain in business and avoid liquidation. Such debtors should consider filing a petition under chapter 11 of the Bankruptcy Code. Under chapter 11, the debtor may seek an adjustment of debts, either by reducing the debt or by extending the time for repayment, or may seek a more comprehensive reorganization. Sole proprietorships may also be eligible for relief under chapter 13 of the Bankruptcy Code.

In addition, individual debtors who have regular income may seek an adjustment of debts under chapter 13 of the Bankruptcy Code. A particular advantage of chapter 13 is that it provides individual debtors with an opportunity to save their homes from foreclosure by allowing them to “catch up” past due payments through a payment plan. Moreover, the court may dismiss a chapter 7 case filed by an individual whose debts are primarily consumer rather than business debts if the court finds that the granting of relief would be an abuse of chapter 7. 11 U.S.C. § 707(b).

If the debtor’s “current monthly income”<sup>1</sup> is more than the state median, the Bankruptcy Code requires application of a “means test” to determine whether the chapter 7 filing is presumptively abusive. Abuse is presumed if

the debtor’s aggregate current monthly income over 5 years, net of certain statutorily allowed expenses, is more than (i) \$11,725 or (ii) 25% of the debtor’s nonpriority unsecured debt, as long as that amount is at least \$7,025.<sup>2</sup> The debtor may rebut a presumption of abuse only by a showing of special circumstances that justify additional expenses or adjustments of current monthly income. Unless the debtor overcomes the presumption of abuse, the case will generally be converted to chapter 13 (with the debtor’s consent) or will be dismissed. 11 U.S.C. § 707(b)(1).

Debtors should also be aware that out-of-court agreements with creditors or debt counseling services may provide an alternative to a bankruptcy filing.

#### BACKGROUND

A chapter 7 bankruptcy case does not involve the filing of a plan of repayment as in chapter 13. Instead, the bankruptcy trustee gathers and sells the debtor’s nonexempt assets and uses the proceeds of such assets to pay holders of claims (creditors) in accordance with the provisions of the Bankruptcy Code. Part of the debtor’s property may be subject to liens and mortgages that pledge the property to other creditors. In addition, the Bankruptcy Code will allow the debtor to keep certain “exempt” property; but a trustee will liquidate the debtor’s remaining assets. Accordingly, potential debtors should realize that the filing of a petition under chapter 7 may result in the loss of property.

#### CHAPTER 7 ELIGIBILITY

To qualify for relief under chapter 7 of the Bankruptcy Code, the debtor may be an individual, a partnership, or a corporation or

other business entity. 11 U.S.C. §§ 101(41), 109(b). Subject to the means test described above for individual debtors, relief is available under chapter 7 irrespective of the amount of the debtor's debts or whether the debtor is solvent or insolvent. An individual cannot file under chapter 7 or any other chapter, however, if during the preceding 180 days a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court, or the debtor voluntarily dismissed the previous case after creditors sought relief from the bankruptcy court to recover property upon which they hold liens. 11 U.S.C. §§ 109(g), 362(d) and (e). In addition, no individual may be a debtor under chapter 7 or any chapter of the Bankruptcy Code unless he or she has, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group briefing. 11 U.S.C. §§ 109, 111. There are exceptions in emergency situations or where the U.S. trustee (or bankruptcy administrator) has determined that there are insufficient approved agencies to provide the required counseling. If a debt management plan is developed during required credit counseling, it must be filed with the court.

One of the primary purposes of bankruptcy is to discharge certain debts to give an honest individual debtor a "fresh start." The debtor has no liability for discharged debts. In a chapter 7 case, however, a discharge is only available to individual debtors, not to partnerships or corporations. 11 U.S.C. § 727(a)(1). Although an individual chapter 7 case usually results in a discharge of debts, the right to a discharge is not absolute, and some types of debts are not discharged. Moreover, a bankruptcy discharge does not extinguish a lien on property.

## HOW CHAPTER 7 WORKS

A chapter 7 case begins with the debtor filing a petition with the bankruptcy 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.<sup>3</sup> In addition to the petition, 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. Fed. R. Bankr. P. 1007(b). 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). 11 U.S.C. § 521. Individual debtors with primarily consumer debts have additional document filing requirements. They must file: a certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling; evidence of payment from employers, if any, received 60 days before filing; a statement of monthly net income and any anticipated increase in income or expenses after filing; and a record of any interest the debtor has in federal or state qualified education or tuition accounts. *Id.* A husband and wife may file a joint petition or individual petitions. 11 U.S.C. § 302(a). 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>. They are not available from the court.)

The courts must charge a \$245 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. 28 U.S.C. § 1930(a); Fed. R. Bankr. P. 1006(b); Bankruptcy Court Miscellaneous Fee Schedule, Item 8. 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. Fed. R. Bankr. P. 1006. 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. 11 U.S.C. § 707(a).

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. 28 U.S.C. § 1930(f).

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.

Among the schedules that an individual debtor will file is a schedule of "exempt" property. The Bankruptcy Code allows an individual debtor<sup>4</sup> to protect some property from the claims of creditors because it is exempt under federal bankruptcy law or under the laws of the debtor's home state. 11 U.S.C. § 522(b). Many states have taken advantage of a provision in the Bankruptcy Code that permits each state to adopt its own exemption law in place of the federal exemptions. In other jurisdictions, the individual debtor has the option of choosing between a federal package of exemptions or the exemptions available under state law. Thus, whether certain property is exempt and may be kept by the debtor is often a question of state law. The debtor should consult an attorney to determine the exemptions available in the state where the debtor lives.

Filing a petition under chapter 7 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. 11 U.S.C. § 362. But filing the petition does not stay certain types of actions listed under 11 U.S.C. § 362(b), 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.

Between 21 and 40 days after the petition is filed, the case trustee (described below) will hold a meeting of creditors. If the U.S. trustee or bankruptcy administrator<sup>5</sup> 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 order for relief. Fed. R. Bankr. P. 2003(a). 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. 11 U.S.C.

§ 343. If a husband and wife have filed a joint petition, they both must attend the creditors' meeting and answer questions. Within 14 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 described in 11 U.S.C. § 704(b).

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. 11 U.S.C. § 341(c).

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<sup>6</sup> 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. 11 U.S.C. § 706(a). Thus, the debtor will not be permitted to convert the case repeatedly from one chapter to another.

## **ROLE OF THE CASE TRUSTEE**

When a chapter 7 petition is filed, the U.S. trustee (or the bankruptcy court in Alabama and North Carolina) appoints an impartial case trustee to administer the case and liquidate the debtor's nonexempt assets. 11 U.S.C. §§ 701, 704. If all the debtor's assets are exempt or subject to valid liens, the trustee will normally file a "no asset" report with the court, and there will be no distribution to unsecured creditors. Most chapter 7 cases involving individual debtors are no asset cases. But if the case appears to be an "asset" case at the outset, unsecured creditors<sup>7</sup> must file their claims with the court within 90 days after the first date set for the meeting of creditors. Fed. R. Bankr. P. 3002(c). A governmental unit, however, has 180 days from the date the case is filed to file a claim. 11 U.S.C. § 502(b)(9). In the typical no asset chapter 7 case, there is no need for creditors to file proofs of claim because there will be no distribution. If the trustee later recovers assets for distribution to

unsecured creditors, the Bankruptcy Court will provide notice to creditors and will allow additional time to file proofs of claim. Although a secured creditor does not need to file a proof of claim in a chapter 7 case to preserve its security interest or lien, there may be other reasons to file a claim. A creditor in a chapter 7 case who has a lien on the debtor's property should consult an attorney for advice.

Commencement of a bankruptcy case creates an "estate." The estate technically becomes the temporary legal owner of all the debtor's property. It consists of all legal or equitable interests of the debtor in property as of the commencement of the case, including property owned or held by another person if the debtor has an interest in the property. Generally speaking, the debtor's creditors are paid from nonexempt property of the estate.

The primary role of a chapter 7 trustee in an asset case is to liquidate the debtor's nonexempt assets in a manner that maximizes the return to the debtor's unsecured creditors. The trustee accomplishes this by selling the debtor's property if it is free and clear of liens (as long as the property is not exempt) or if it is worth more than any security interest or lien attached to the property and any exemption that the debtor holds in the property. The trustee may also attempt to recover money or property under the trustee's "avoiding powers." The trustee's avoiding powers include the power to: set aside preferential transfers made to creditors within 90 days before the petition; undo security interests and other prepetition transfers of property that were not properly perfected under nonbankruptcy law at the time of the petition; and pursue nonbankruptcy claims such as fraudulent conveyance and bulk transfer remedies available under state law. In

addition, if the debtor is a business, the bankruptcy court may authorize the trustee to operate the business for a limited period of time, if such operation will benefit creditors and enhance the liquidation of the estate. 11 U.S.C. § 721.

Section 726 of the Bankruptcy Code governs the distribution of the property of the estate. Under § 726, there are six classes of claims; and each class must be paid in full before the next lower class is paid anything. The debtor is only paid if all other classes of claims have been paid in full. Accordingly, the debtor is not particularly interested in the trustee's disposition of the estate assets, except with respect to the payment of those debts which for some reason are not dischargeable in the bankruptcy case. The individual debtor's primary concerns in a chapter 7 case are to retain exempt property and to receive a discharge that covers as many debts as possible.

## **THE CHAPTER 7 DISCHARGE**

A discharge releases individual debtors from personal liability for most debts and prevents the creditors owed those debts from taking any collection actions against the debtor. Because a chapter 7 discharge is subject to many exceptions, though, debtors should consult competent legal counsel before filing to discuss the scope of the discharge. Generally, excluding cases that are dismissed or converted, individual debtors receive a discharge in more than 99 percent of chapter 7 cases. In most cases, unless a party in interest files a complaint objecting to the discharge or a motion to extend the time to object, the bankruptcy court will issue a discharge order relatively early in the case – generally, 60 to 90 days after the date first set

for the meeting of creditors. Fed. R. Bankr. P. 4004(c).

The grounds for denying an individual debtor a discharge in a chapter 7 case are narrow and are construed against the moving party. Among other reasons, the court may deny the debtor a discharge if it finds that the debtor: failed to keep or produce adequate books or financial records; failed to explain satisfactorily any loss of assets; committed a bankruptcy crime such as perjury; failed to obey a lawful order of the bankruptcy court; fraudulently transferred, concealed, or destroyed property that would have become property of the estate; or failed to complete an approved instructional course concerning financial management. 11 U.S.C. § 727; Fed. R. Bankr. P. 4005.

Secured creditors may retain some rights to seize property securing an underlying debt even after a discharge is granted. Depending on individual circumstances, if a debtor wishes to keep certain secured property (such as an automobile), he or she may decide to “reaffirm” the debt. A reaffirmation is an agreement between the debtor and the creditor that the debtor will remain liable and will pay all or a portion of the money owed, even though the debt would otherwise be discharged in the bankruptcy. In return, the creditor promises that it will not repossess or take back the automobile or other property so long as the debtor continues to pay the debt.

If the debtor decides to reaffirm a debt, he or she must do so before the discharge is entered. The debtor must sign a written reaffirmation agreement and file it with the court. 11 U.S.C. § 524(c). The Bankruptcy Code requires that reaffirmation agreements contain an extensive set of disclosures described in 11 U.S.C.

§ 524(k). Among other things, the disclosures must advise the debtor of the amount of the debt being reaffirmed and how it is calculated and that reaffirmation means that the debtor’s personal liability for that debt will not be discharged in the bankruptcy. The disclosures also require the debtor to sign and file a statement of his or her current income and expenses which shows that the balance of income paying expenses is sufficient to pay the reaffirmed debt. If the balance is not enough to pay the debt to be reaffirmed, there is a presumption of undue hardship, and the court may decide not to approve the reaffirmation agreement. Unless the debtor is represented by an attorney, the bankruptcy judge must approve the reaffirmation agreement.

If the debtor was represented by an attorney in connection with the reaffirmation agreement, the attorney must certify in writing that he or she advised the debtor of the legal effect and consequences of the agreement, including a default under the agreement. The attorney must also certify that the debtor was fully informed and voluntarily made the agreement and that reaffirmation of the debt will not create an undue hardship for the debtor or the debtor’s dependants. 11 U.S.C. § 524(k). The Bankruptcy Code requires a reaffirmation hearing if the debtor has not been represented by an attorney during the negotiating of the agreement, or if the court disapproves the reaffirmation agreement. 11 U.S.C. § 524(d) and (m). The debtor may repay any debt voluntarily, however, whether or not a reaffirmation agreement exists. 11 U.S.C. § 524(f).

An individual receives a discharge for most of his or her debts in a chapter 7 bankruptcy case. A creditor may no longer initiate or continue

any legal or other action against the debtor to collect a discharged debt. But not all of an individual's debts are discharged in chapter 7. Debts not discharged include debts for alimony and child support, certain taxes, debts for certain educational benefit overpayments or loans made or guaranteed by a governmental unit, debts for willful and malicious injury by the debtor to another entity or to the property of another entity, debts for death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated from alcohol or other substances, and debts for certain criminal restitution orders. 11 U.S.C. § 523(a). The debtor will continue to be liable for these types of debts to the extent that they are not paid in the chapter 7 case. Debts for money or property obtained by false pretenses, debts for fraud or defalcation while acting in a fiduciary capacity, and debts for willful and malicious injury by the debtor to another entity or to the property of another entity will be discharged unless a creditor timely files and prevails in an action to have such debts declared nondischargeable. 11 U.S.C. § 523(c); Fed. R. Bankr. P. 4007(c).

The court may revoke a chapter 7 discharge on the request of the trustee, a creditor, or the U.S. trustee if the discharge was obtained through fraud by the debtor, if the debtor acquired property that is property of the estate and knowingly and fraudulently failed to report the acquisition of such property or to surrender the property to the trustee, or if the debtor (without a satisfactory explanation) makes a material misstatement or fails to provide documents or other information in connection with an audit of the debtor's case. 11 U.S.C. § 727(d).

## NOTES

1. The "current monthly income" received by the debtor is a defined term in the Bankruptcy Code and means the average monthly income received over the six calendar months before commencement of the bankruptcy case, including regular contributions to household expenses from nondebtors and including income from the debtor's spouse if the petition is a joint petition, but not including social security income or certain payments made because the debtor is the victim of certain crimes. 11 U.S.C. § 101(10A).
2. To determine whether a presumption of abuse arises, all individual debtors with primarily consumer debts who file a chapter 7 case must complete Official Bankruptcy Form B22A, entitled "Statement of Current Monthly Income and Means Test Calculation - For Use in Chapter 7." (The Official Forms may be purchased at legal stationery stores or downloaded from the internet at: <http://www.uscourts.gov/bkforms/index.html>. They are not available from the court.)
3. An involuntary chapter 7 case may be commenced under certain circumstances by a petition filed by creditors holding claims against the debtor. 11 U.S.C. § 303.
4. Each debtor in a joint case (both husband and wife) can claim exemptions under the federal bankruptcy laws. 11 U.S.C. § 522(m).
5. In North Carolina and Alabama, bankruptcy administrators perform similar functions that U.S. trustees perform in the remaining 48 states. These duties include establishing a panel of private trustees to serve as trustees in chapter 7 cases and supervising the administration of cases and trustees in cases

under chapters 7, 11, 12, and 13 of the Bankruptcy Code. The bankruptcy administrator program is administered by the Administrative Office of the United States Courts, while the U.S. trustee program is administered by the Department of Justice. For purposes of this publication, references to U.S. trustees are also applicable to bankruptcy administrators.

**6.** A fee is charged for converting, on request of the debtor, a case under chapter 7 to a case under chapter 11. The fee charged is the difference between the filing fee for a chapter 7 and the filing fee for a chapter 11. 28 U.S.C. § 1930(a). Currently, the difference is \$755. *Id.* There is no fee for converting from chapter 7 to chapter 13.

**7.** Unsecured debts generally may be defined as those for which the extension of credit was based purely upon an evaluation by the creditor of the debtor's ability to pay, as opposed to secured debts, for which the extension of credit was based upon the creditor's right to seize collateral on default, in addition to the debtor's ability to pay.

## Chapter 13

### Individual Debt Adjustment

#### BACKGROUND

A chapter 13 bankruptcy is also called a wage earner's plan. It enables individuals with regular income to develop a plan to repay all or part of their debts. Under this chapter, debtors propose a repayment plan to make installments to creditors over three to five years. If the debtor's current monthly income is less than the applicable state median, the plan will be for three years unless the court approves a longer period "for cause."<sup>1</sup> If the debtor's current monthly income is greater than the applicable state median, the plan generally must be for five years. In no case may a plan provide for payments over a period longer than five years. 11 U.S.C. §1322(d). During this time the law forbids creditors from starting or continuing collection efforts.

This chapter discusses six aspects of a chapter 13 proceeding: the advantages of choosing chapter 13, the chapter 13 eligibility requirements, how a chapter 13 proceeding works, what may be included in chapter 13 repayment plan and how it is confirmed, making the plan work, and the special chapter 13 discharge.

#### ADVANTAGES OF CHAPTER 13

Chapter 13 offers individuals a number of advantages over liquidation under chapter 7. Perhaps most significantly, chapter 13 offers individuals an opportunity to save their homes from foreclosure. By filing under this chapter, individuals can stop foreclosure proceedings and may cure delinquent mortgage payments

over time. Nevertheless, they must still make all mortgage payments that come due during the chapter 13 plan on time. Another advantage of chapter 13 is that it allows individuals to reschedule secured debts (other than a mortgage for their primary residence) and extend them over the life of the chapter 13 plan. Doing this may lower the payments. Chapter 13 also has a special provision that protects third parties who are liable with the debtor on "consumer debts." This provision may protect co-signers. Finally, chapter 13 acts like a consolidation loan under which the individual makes the plan payments to a chapter 13 trustee who then distributes payments to creditors. Individuals will have no direct contact with creditors while under chapter 13 protection.

#### CHAPTER 13 ELIGIBILITY

Any individual, even if self-employed or operating an unincorporated business, is eligible for chapter 13 relief as long as the individual's unsecured debts are less than \$360,475 and secured debts are less than \$1,081,400. 11 U.S.C. § 109(e). These amounts are adjusted periodically to reflect changes in the consumer price index. A corporation or partnership may not be a chapter 13 debtor. *Id.*

An individual cannot file under chapter 13 or any other chapter if, during the preceding 180 days, a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court or was voluntarily dismissed after creditors sought relief from the bankruptcy court to recover property upon which they hold liens. 11 U.S.C. §§ 109(g), 362(d) and (e). In addition, no individual may be a debtor under chapter 13 or any chapter of the

Bankruptcy Code unless he or she has, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group briefing. 11 U.S.C. §§ 109, 111. There are exceptions in emergency situations or where the U.S. trustee (or bankruptcy administrator) has determined that there are insufficient approved agencies to provide the required counseling. If a debt management plan is developed during required credit counseling, it must be filed with the court.

### HOW CHAPTER 13 WORKS

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) a schedule of current income and expenditures; (3) a schedule of executory contracts and unexpired leases; and (4) a statement of financial affairs. Fed. R. Bankr. P. 1007(b). The debtor must also file a certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling; evidence of payment from employers, if any, received 60 days before filing; a statement of monthly net income and any anticipated increase in income or expenses after filing; and a record of any interest the debtor has in federal or state qualified education or tuition accounts. 11 U.S.C. § 521. The debtor must 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). *Id.* A husband and wife may file a joint petition or individual petitions. 11 U.S.C. § 302(a). (The

Official Forms may be purchased at legal stationery stores or downloaded from the internet at:

<http://www.uscourts.gov/bkforms/index.html>.  
They are not available from the court.)

The courts must charge a \$235 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. 28 U.S.C. § 1930(a); Fed. R. Bankr. P. 1006(b); Bankruptcy Court Miscellaneous Fee Schedule, Item 8. 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. Fed. R. Bankr. P. 1006(b). 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. *Id.* 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. 11 U.S.C. § 1307(c)(2).

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.

When an individual files a chapter 13 petition, an impartial trustee is appointed to administer the case. 11 U.S.C. § 1302. In some districts, the U.S. trustee or bankruptcy administrator<sup>2</sup> appoints a standing trustee to serve in all chapter 13 cases. 28 U.S.C. § 586(b). The chapter 13 trustee both evaluates the case and serves as a disbursing agent, collecting payments from the debtor and making distributions to creditors. 11 U.S.C. § 1302(b).

Filing the petition under chapter 13 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. 11 U.S.C. § 362. Filing the petition does not, however, stay certain types of actions listed under 11 U.S.C. § 362(b), 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. 11 U.S.C. § 1301(a). Consumer debts are those incurred by an individual primarily for a personal, family, or household purpose. 11 U.S.C. § 101(8).

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. 11 U.S.C. § 1322(c). 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.

Between 21 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. Fed. R. Bankr. P. 2003(a). 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. 11 U.S.C. § 343. 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. 11

U.S.C. § 341(c). 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.

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. Fed. R. Bankr. P. 3002(c). A governmental unit, however, has 180 days from the date the case is filed file a proof of claim. 11 U.S.C. § 502(b)(9).

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 chapter 13 repayment plan.

### **THE CHAPTER 13 PLAN AND CONFIRMATION HEARING**

Unless the court grants an extension, the debtor must file a repayment plan with the petition or within 14 days after the petition is filed. Fed. R. Bankr. P. 3015. A plan must be submitted for court approval and must provide for payments of fixed amounts to the trustee on a regular basis, typically biweekly or monthly. The trustee then distributes the funds to creditors according to the terms of the plan, which may offer creditors less than full payment on their claims.

There are three types of claims: priority, secured, and unsecured. Priority claims are those granted special status by the bankruptcy law, such as most taxes and the costs of bankruptcy proceeding.<sup>3</sup> Secured claims are those for which the creditor has the right take

back certain property (*i.e.*, the collateral) if the debtor does not pay the underlying debt. In contrast to secured claims, unsecured claims are generally those for which the creditor has no special rights to collect against particular property owned by the debtor.

The plan must pay priority claims in full unless a particular priority creditor agrees to different treatment of the claim or, in the case of a domestic support obligation, unless the debtor contributes all "disposable income" - discussed below - to a five-year plan.

11 U.S.C. § 1322(a).

If the debtor wants to keep the collateral securing a particular claim, the plan must provide that the holder of the secured claim receive at least the value of the collateral. If the obligation underlying the secured claim was used to buy the collateral (e.g., a car loan), and the debt was incurred within certain time frames before the bankruptcy filing, the plan must provide for full payment of the debt, not just the value of the collateral (which may be less due to depreciation). Payments to certain secured creditors (*i.e.*, the home mortgage lender), may be made over the original loan repayment schedule (which may be longer than the plan) so long as any arrearage is made up during the plan. The debtor should consult an attorney to determine the proper treatment of secured claims in the plan.

The plan need not pay unsecured claims in full as long it provides that the debtor will pay all projected "disposable income" over an "applicable commitment period," and as long as unsecured creditors receive at least as much under the plan as they would receive if the debtor's assets were liquidated under chapter 7. 11 U.S.C. § 1325. In chapter 13,

“disposable income” is income (other than child support payments received by the debtor) less amounts reasonably necessary for the maintenance or support of the debtor or dependents and less charitable contributions up to 15% of the debtor’s gross income. If the debtor operates a business, the definition of disposable income excludes those amounts which are necessary for ordinary operating expenses. 11 U.S.C. § 1325(b)(2)(A) and (B). The “applicable commitment period” depends on the debtor’s current monthly income. The applicable commitment period must be three years if current monthly income is less than the state median for a family of the same size - and five years if the current monthly income is greater than a family of the same size. 11 U.S.C. § 1325(d). The plan may be less than the applicable commitment period (three or five years) only if unsecured debt is paid in full over a shorter period.

Within 30 days after filing the bankruptcy case, even if the plan has not yet been approved by the court, the debtor must start making plan payments to the trustee. 11 U.S.C. § 1326(a)(1). If any secured loan payments or lease payments come due before the debtor’s plan is confirmed (typically home and automobile payments), the debtor must make adequate protection payments directly to the secured lender or lessor - deducting the amount paid from the amount that would otherwise be paid to the trustee. *Id.*

No later than 45 days after the meeting of creditors, the bankruptcy judge must hold a confirmation hearing and decide whether the plan is feasible and meets the standards for confirmation set forth in the Bankruptcy Code. 11 U.S.C. §§ 1324, 1325. Creditors will receive 28 days’ notice of the hearing and may object to confirmation. Fed. R. Bankr. P.

2002(b). While a variety of objections may be made, the most frequent ones are that payments offered under the plan are less than creditors would receive if the debtor’s assets were liquidated or that the debtor’s plan does not commit all of the debtor’s projected disposable income for the three or five year applicable commitment period.

If the court confirms the plan, the chapter 13 trustee will distribute funds received under the plan “as soon as is practicable.” 11 U.S.C. § 1326(a)(2). If the court declines to confirm the plan, the debtor may file a modified plan. 11 U.S.C. § 1323. The debtor may also convert the case to a liquidation case under chapter 7.<sup>4</sup> 11 U.S.C. § 1307(a). If the court declines to confirm the plan or the modified plan and instead dismisses the case, the court may authorize the trustee to keep some funds for costs, but the trustee must return all remaining funds to the debtor (other than funds already disbursed or due to creditors). 11 U.S.C. § 1326(a)(2).

Occasionally, a change in circumstances may compromise the debtor’s ability to make plan payments. For example, a creditor may object or threaten to object to a plan, or the debtor may inadvertently have failed to list all creditors. In such instances, the plan may be modified either before or after confirmation. 11 U.S.C. §§ 1323, 1329. Modification after confirmation is not limited to an initiative by the debtor, but may be at the request of the trustee or an unsecured creditor. 11 U.S.C. § 1329(a).

## **MAKING THE PLAN WORK**

The provisions of a confirmed plan bind the debtor and each creditor. 11 U.S.C. § 1327. Once the court confirms the plan, the debtor

must make the plan succeed. The debtor must make regular payments to the trustee either directly or through payroll deduction, which will require adjustment to living on a fixed budget for a prolonged period. Furthermore, while confirmation of the plan entitles the debtor to retain property as long as payments are made, the debtor may not incur new debt without consulting the trustee, because additional debt may compromise the debtor's ability to complete the plan. 11 U.S.C. §§ 1305(c), 1322(a)(1), 1327.

A debtor may make plan payments through payroll deductions. This practice increases the likelihood that payments will be made on time and that the debtor will complete the plan. In any event, if the debtor fails to make the payments due under the confirmed plan, the court may dismiss the case or convert it to a liquidation case under chapter 7 of the Bankruptcy Code. 11 U.S.C. § 1307(c). The court may also dismiss or convert the debtor's case if the debtor fails to pay any post-filing domestic support obligations (*i.e.*, child support, alimony), or fails to make required tax filings during the case. 11 U.S.C. §§ 1307(c) and (e), 1308, 521.

## **THE CHAPTER 13 DISCHARGE**

The bankruptcy law regarding the scope of the chapter 13 discharge is complex and has recently undergone major changes. Therefore, debtors should consult competent legal counsel prior to filing regarding the scope of the chapter 13 discharge.

A chapter 13 debtor is entitled to a discharge upon completion of all payments under the chapter 13 plan so long as the debtor: (1) certifies (if applicable) that all domestic support obligations that came due prior to

making such certification have been paid; (2) has not received a discharge in a prior case filed within a certain time frame (two years for prior chapter 13 cases and four years for prior chapter 7, 11 and 12 cases); and (3) has completed an approved course in financial management (if the U.S. trustee or bankruptcy administrator for the debtor's district has determined that such courses are available to the debtor). 11 U.S.C. § 1328. The court will not enter the discharge, however, until it determines, after notice and a hearing, that there is no reason to believe there is any pending proceeding that might give rise to a limitation on the debtor's homestead exemption. 11 U.S.C. § 1328(h).

The discharge releases the debtor from all debts provided for by the plan or disallowed (under section 502), with limited exceptions. Creditors provided for in full or in part under the chapter 13 plan may no longer initiate or continue any legal or other action against the debtor to collect the discharged obligations.

As a general rule, the discharge releases the debtor from all debts provided for by the plan or disallowed, with the exception of certain debts referenced in 11 U.S.C. § 1328. Debts not discharged in chapter 13 include certain long term obligations (such as a home mortgage), debts for alimony or child support, certain taxes, debts for most government funded or guaranteed educational loans or benefit overpayments, debts arising from death or personal injury caused by driving while intoxicated or under the influence of drugs, and debts for restitution or a criminal fine included in a sentence on the debtor's conviction of a crime. To the extent that they are not fully paid under the chapter 13 plan, the debtor will still be responsible for these debts after the bankruptcy case has concluded.

Debts for money or property obtained by false pretenses, debts for fraud or defalcation while acting in a fiduciary capacity, and debts for restitution or damages awarded in a civil case for willful or malicious actions by the debtor that cause personal injury or death to a person will be discharged unless a creditor timely files and prevails in an action to have such debts declared nondischargeable. 11 U.S.C. §§ 1328, 523(c); Fed. R. Bankr. P. 4007(c).

The discharge in a chapter 13 case is somewhat broader than in a chapter 7 case. Debts dischargeable in a chapter 13, but not in chapter 7, include debts for willful and malicious injury to property (as opposed to a person), debts incurred to pay nondischargeable tax obligations, and debts arising from property settlements in divorce or separation proceedings. 11 U.S.C. § 1328(a).

### **THE CHAPTER 13 HARDSHIP DISCHARGE**

After confirmation of a plan, circumstances may arise that prevent the debtor from completing the plan. In such situations, the debtor may ask the court to grant a “hardship discharge.” 11 U.S.C. § 1328(b). Generally, such a discharge is available only if: (1) the debtor’s failure to complete plan payments is due to circumstances beyond the debtor’s control and through no fault of the debtor; (2) creditors have received at least as much as they would have received in a chapter 7 liquidation case; and (3) modification of the plan is not possible. Injury or illness that precludes employment sufficient to fund even a modified plan may serve as the basis for a hardship discharge. The hardship discharge is more limited than the discharge described above and does not apply to any debts that are

nondischargeable in a chapter 7 case. 11 U.S.C. § 523.

### **NOTES**

1. The “current monthly income” received by the debtor is a defined term in the Bankruptcy Code and means the average monthly income received over the six calendar months before commencement of the bankruptcy case, including regular contributions to household expenses from nondebtors and including income from the debtor’s spouse if the petition is a joint petition, but not including social security income or certain payments made because the debtor is the victim of certain crimes. 11 U.S.C. § 101(10A).
2. In North Carolina and Alabama, bankruptcy administrators perform similar functions that U.S. trustees perform in the remaining forty-eight states. The bankruptcy administrator program is administered by the Administrative Office of the United States Courts, while the U.S. trustee program is administered by the Department of Justice. For purposes of this publication, references to U.S. trustees are also applicable to bankruptcy administrators.
3. Section 507 sets forth 10 categories of unsecured claims which Congress has, for public policy reasons, given priority of distribution over other unsecured claims.
4. A fee of \$15 is charged for converting a case under chapter 13 to a case under chapter 7.

## Chapter 11

### Reorganization Under the Bankruptcy Code

#### BACKGROUND

A case filed under chapter 11 of the United States Bankruptcy Code is frequently referred to as a “reorganization” bankruptcy.

An individual cannot file under chapter 11 or any other chapter if, during the preceding 180 days, a prior bankruptcy petition was dismissed due to the debtor’s willful failure to appear before the court or comply with orders of the court, or was voluntarily dismissed after creditors sought relief from the bankruptcy court to recover property upon which they hold liens. 11 U.S.C. §§ 109(g), 362(d)-(e). In addition, no individual may be a debtor under chapter 11 or any chapter of the Bankruptcy Code unless he or she has, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group briefing. 11 U.S.C.

§§ 109, 111. There are exceptions in emergency situations or where the U.S. trustee (or bankruptcy administrator) has determined that there are insufficient approved agencies to provide the required counseling. If a debt management plan is developed during required credit counseling, it must be filed with the court.

#### HOW CHAPTER 11 WORKS

A chapter 11 case begins with the filing of a petition with the bankruptcy court serving the area where the debtor has a domicile or residence. A petition may be a voluntary petition, which is filed by the debtor, or it may

be an involuntary petition, which is filed by creditors that meet certain requirements. 11 U.S.C. §§ 301, 303. A voluntary petition must adhere to the format of Form 1 of the Official Forms prescribed by the Judicial Conference of the United States. Unless the court orders otherwise, the debtor also must file with the court: (1) schedules of assets and liabilities; (2) a schedule of current income and expenditures; (3) a schedule of executory contracts and unexpired leases; and (4) a statement of financial affairs. Fed. R. Bankr. P. 1007(b). If the debtor is an individual (or husband and wife), there are additional document filing requirements. Such debtors must file: a certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling; evidence of payment from employers, if any, received 60 days before filing; a statement of monthly net income and any anticipated increase in income or expenses after filing; and a record of any interest the debtor has in federal or state qualified education or tuition accounts. 11 U.S.C. § 521. A husband and wife may file a joint petition or individual petitions. 11 U.S.C. § 302(a). (The Official Forms are not available from the court, but may be purchased at legal stationery stores or downloaded from the internet at:

<http://www.uscourts.gov/bkforms/index.html>.)

The courts are required to charge an \$1,000 case filing fee and a \$39 miscellaneous administrative fee. The fees must be paid to the clerk of the court upon filing or may, with the court’s permission, be paid by individual debtors in installments. 28 U.S.C. § 1930(a); Fed. R. Bankr. P. 1006(b); Bankruptcy Court Miscellaneous Fee Schedule, Item 8. Fed. R. Bankr. P. 1006(b) limits to four the number of installments for the filing fee. The final installment must be paid not 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 the filing of the petition. Fed. R. Bankr. P. 1006(b). The \$39 administrative fee may be paid in installments in the same manner as the filing fee. 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. 11 U.S.C. § 1112(b)(10).

The voluntary petition will include standard information concerning the debtor's name(s), social security number or tax identification number, residence, location of principal assets (if a business), the debtor's plan or intention to file a plan, and a request for relief under the appropriate chapter of the Bankruptcy Code. Upon filing a voluntary petition for relief under chapter 11 or, in an involuntary case, the entry of an order for relief, the debtor automatically assumes an additional identity as the "debtor in possession." 11 U.S.C.

§ 1101. The term refers to a debtor that keeps possession and control of its assets while undergoing a reorganization under chapter 11, without the appointment of a case trustee. A debtor will remain a debtor in possession until the debtor's plan of reorganization is confirmed, the debtor's case is dismissed or converted to chapter 7, or a chapter 11 trustee is appointed. The appointment or election of a trustee occurs only in a small number of cases. Generally, the debtor, as "debtor in possession," operates the business and performs many of the functions that a trustee performs in cases under other chapters. 11 U.S.C. § 1107(a).

Generally, a written disclosure statement and a plan of reorganization must be filed with the

court. 11 U.S.C. §§ 1121, 1125. The disclosure statement is a document that must contain information concerning the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the debtor's plan of reorganization. 11 U.S.C. § 1125. The information required is governed by judicial discretion and the circumstances of the case. In a "small business case" (discussed below) the debtor may not need to file a separate disclosure statement if the court determines that adequate information is contained in the plan. 11 U.S.C. § 1125(f). The contents of the plan must include a classification of claims and must specify how each class of claims will be treated under the plan. 11 U.S.C.

§ 1123. Creditors whose claims are "impaired," *i.e.*, those whose contractual rights are to be modified or who will be paid less than the full value of their claims under the plan, vote on the plan by ballot. 11 U.S.C. § 1126. After the disclosure statement is approved by the court and the ballots are collected and tallied, the court will conduct a confirmation hearing to determine whether to confirm the plan. 11 U.S.C. § 1128.

In the case of individuals, chapter 11 bears some similarities to chapter 13. For example, property of the estate for an individual debtor includes the debtor's earnings and property acquired by the debtor after filing until the case is closed, dismissed or converted; funding of the plan may be from the debtor's future earnings; and the plan cannot be confirmed over a creditor's objection without committing all of the debtor's disposable income over five years unless the plan pays the claim in full, with interest, over a shorter period of time. 11 U.S.C. §§ 1115, 1123(a)(8), 1129(a)(15).

## **THE CHAPTER 11 DEBTOR IN POSSESSION**

Chapter 11 is typically used to reorganize a business, which may be a corporation, sole proprietorship, or partnership. A corporation exists separate and apart from its owners, the stockholders. The chapter 11 bankruptcy case of a corporation (corporation as debtor) does not put the personal assets of the stockholders at risk other than the value of their investment in the company's stock. A sole proprietorship (owner as debtor), on the other hand, does not have an identity separate and distinct from its owner(s). Accordingly, a bankruptcy case involving a sole proprietorship includes both the business and personal assets of the owners-debtors. Like a corporation, a partnership exists separate and apart from its partners. In a partnership bankruptcy case (partnership as debtor), however, the partners' personal assets may, in some cases, be used to pay creditors in the bankruptcy case or the partners, themselves, may be forced to file for bankruptcy protection.

Section 1107 of the Bankruptcy Code places the debtor in possession in the position of a fiduciary, with the rights and powers of a chapter 11 trustee, and it requires the debtor to perform of all but the investigative functions and duties of a trustee. These duties, set forth in the Bankruptcy Code and Federal Rules of Bankruptcy Procedure, include accounting for property, examining and objecting to claims, and filing informational reports as required by the court and the U.S. trustee or bankruptcy administrator (discussed below), such as monthly operating reports. 11 U.S.C. §§ 1106, 1107; Fed. R. Bankr. P. 2015(a). The debtor in possession also has many of the other powers and duties of a trustee, including the right, with the court's approval, to employ attorneys,

accountants, appraisers, auctioneers, or other professional persons to assist the debtor during its bankruptcy case. Other responsibilities include filing tax returns and reports which are either necessary or ordered by the court after confirmation, such as a final accounting. The U.S. trustee is responsible for monitoring the compliance of the debtor in possession with the reporting requirements.

Railroad reorganizations have specific requirements under subsection IV of chapter 11, which will not be addressed here. In addition, stock and commodity brokers are prohibited from filing under chapter 11 and are restricted to chapter 7. 11 U.S.C. § 109(d).

## **THE U.S. TRUSTEE OR BANKRUPTCY ADMINISTRATOR**

The U.S. trustee plays a major role in monitoring the progress of a chapter 11 case and supervising its administration. The U.S. trustee is responsible for monitoring the debtor in possession's operation of the business and the submission of operating reports and fees. Additionally, the U.S. trustee monitors applications for compensation and reimbursement by professionals, plans and disclosure statements filed with the court, and creditors' committees. The U.S. trustee conducts a meeting of the creditors, often referred to as the "section 341 meeting," in a chapter 11 case. 11 U.S.C. § 341. The U.S. trustee and creditors may question the debtor under oath at the section 341 meeting concerning the debtor's acts, conduct, property, and the administration of the case.

The U.S. trustee also imposes certain requirements on the debtor in possession concerning matters such as reporting its monthly income and operating expenses,

establishing new bank accounts, and paying current employee withholding and other taxes. By law, the debtor in possession must pay a quarterly fee to the U.S. trustee for each quarter of a year until the case is converted or dismissed. 28 U.S.C. § 1930(a)(6). The amount of the fee, which may range from \$250 to \$10,000, depends on the amount of the debtor's disbursements during each quarter. Should a debtor in possession fail to comply with the reporting requirements of the U.S. trustee or orders of the bankruptcy court, or fail to take the appropriate steps to bring the case to confirmation, the U.S. trustee may file a motion with the court to have the debtor's chapter 11 case converted to another chapter of the Bankruptcy Code or to have the case dismissed.

In North Carolina and Alabama, bankruptcy administrators perform similar functions that U.S. trustees perform in the remaining forty-eight states. The bankruptcy administrator program is administered by the Administrative Office of the United States Courts, while the U.S. trustee program is administered by the Department of Justice. For purposes of this publication, references to U.S. trustees are also applicable to bankruptcy administrators.

### **CREDITORS' COMMITTEES**

Creditors' committees can play a major role in chapter 11 cases. The committee is appointed by the U.S. trustee and ordinarily consists of unsecured creditors who hold the seven largest unsecured claims against the debtor. 11 U.S.C. § 1102. Among other things, the committee: consults with the debtor in possession on administration of the case; investigates the debtor's conduct and operation of the business; and participates in formulating a plan. 11 U.S.C. § 1103. A creditors'

committee may, with the court's approval, hire an attorney or other professionals to assist in the performance of the committee's duties. A creditors' committee can be an important safeguard to the proper management of the business by the debtor in possession.

### **THE SMALL BUSINESS CASE AND THE SMALL BUSINESS DEBTOR**

In some smaller cases the U.S. trustee may be unable to find creditors willing to serve on a creditors' committee, or the committee may not be actively involved in the case. The Bankruptcy Code addresses this issue by treating a "small business case" somewhat differently than a regular bankruptcy case. A small business case is defined as a case with a "small business debtor." 11 U.S.C.

§ 101(51C). Determination of whether a debtor is a "small business debtor" requires application of a two-part test. First, the debtor must be engaged in commercial or business activities (other than primarily owning or operating real property) with total non-contingent liquidated secured and unsecured debts of \$2,323,300 or less. Second, the debtor's case must be one in which the U.S. trustee has not appointed a creditors' committee, or the court has determined the creditors' committee is insufficiently active and representative to provide oversight of the debtor. 11 U.S.C. § 101(51D).

In a small business case, the debtor in possession must, among other things, attach the most recently prepared balance sheet, statement of operations, cash-flow statement and most recently filed tax return to the petition or provide a statement under oath explaining the absence of such documents and must attend court and the U.S. trustee meeting through senior management personnel and

counsel. The small business debtor must make ongoing filings with the court concerning its profitability and projected cash receipts and disbursements, and must report whether it is in compliance with the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure and whether it has paid its taxes and filed its tax returns. 11 U.S.C. §§ 308, 1116.

In contrast to other chapter 11 debtors, the small business debtor is subject to additional oversight by the U.S. trustee. Early in the case, the small business debtor must attend an “initial interview” with the U.S. trustee at which time the U.S. trustee will evaluate the debtor’s viability, inquire about the debtor’s business plan, and explain certain debtor obligations including the debtor’s responsibility to file various reports. 28 U.S.C. § 586(a)(7). The U.S. trustee will also monitor the activities of the small business debtor during the case to identify as promptly as possible whether the debtor will be unable to confirm a plan.

Because certain filing deadlines are different and extensions are more difficult to obtain, a case designated as a small business case normally proceeds more quickly than other chapter 11 cases. For example, only the debtor may file a plan during the first 180 days of a small business case. 11 U.S.C. § 1121(e). This “exclusivity period” may be extended by the court, but only to 300 days, and only if the debtor demonstrates by a preponderance of the evidence that the court will confirm a plan within a reasonable period of time. When the case is not a small business case, however, the court may extend the exclusivity period “for cause” up to 18 months.

## **THE SINGLE ASSET REAL ESTATE DEBTOR**

Single asset real estate debtors are subject to special provisions of the Bankruptcy Code. The term “single asset real estate” is defined as “a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental.” 11 U.S.C. § 101(51B). The Bankruptcy Code provides circumstances under which creditors of a single asset real estate debtor may obtain relief from the automatic stay which are not available to creditors in ordinary bankruptcy cases. 11 U.S.C. § 362(d). On request of a creditor with a claim secured by the single asset real estate and after notice and a hearing, the court will grant relief from the automatic stay to the creditor unless the debtor files a feasible plan of reorganization or begins making interest payments to the creditor within 90 days from the date of the filing of the case, or within 30 days of the court’s determination that the case is a single asset real estate case. The interest payments must be equal to the non-default contract interest rate on the value of the creditor’s interest in the real estate. 11 U.S.C. § 362(d)(3).

## **APPOINTMENT OR ELECTION OF A CASE TRUSTEE**

Although the appointment of a case trustee is a rarity in a chapter 11 case, a party in interest or the U.S. trustee can request the appointment of a case trustee or examiner at any time prior to confirmation in a chapter 11 case. The court, on motion by a party in

interest or the U.S. trustee and after notice and hearing, shall order the appointment of a case trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement, or if such an appointment is in the interest of creditors, any equity security holders, and other interests of the estate. 11 U.S.C.

§ 1104(a). Moreover, the U.S. trustee is required to move for appointment of a trustee if there are reasonable grounds to believe that any of the parties in control of the debtor “participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor’s financial reporting.” 11 U.S.C. § 1104(e). The trustee is appointed by the U.S. trustee, after consultation with parties in interest and subject to the court’s approval. Fed. R. Bankr. P. 2007.1. Alternatively, a trustee in a case may be elected if a party in interest requests the election of a trustee within 30 days after the court orders the appointment of a trustee. In that instance, the U.S. trustee convenes a meeting of creditors for the purpose of electing a person to serve as trustee in the case. 11 U.S.C. § 1104(b).

The case trustee is responsible for management of the property of the estate, operation of the debtor’s business, and, if appropriate, the filing of a plan of reorganization. Section 1106 of the Bankruptcy Code requires the trustee to file a plan “as soon as practicable” or, alternatively, to file a report explaining why a plan will not be filed or to recommend that the case be converted to another chapter or dismissed. 11 U.S.C. § 1106(a)(5).

Upon the request of a party in interest or the U.S. trustee, the court may terminate the trustee’s appointment and restore the debtor in possession to management of bankruptcy

estate at any time before confirmation. 11 U.S.C. § 1105.

## **THE ROLE OF AN EXAMINER**

The appointment of an examiner in a chapter 11 case is rare. The role of an examiner is generally more limited than that of a trustee. The examiner is authorized to perform the investigatory functions of the trustee and is required to file a statement of any investigation conducted. If ordered to do so by the court, however, an examiner may carry out any other duties of a trustee that the court orders the debtor in possession not to perform. 11 U.S.C. § 1106. Each court has the authority to determine the duties of an examiner in each particular case. In some cases, the examiner may file a plan of reorganization, negotiate or help the parties negotiate, or review the debtor’s schedules to determine whether some of the claims are improperly categorized. Sometimes, the examiner may be directed to determine if objections to any proofs of claim should be filed or whether causes of action have sufficient merit so that further legal action should be taken. The examiner may not subsequently serve as a trustee in the case. 11 U.S.C. § 321.

## **THE AUTOMATIC STAY**

The automatic stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the bankruptcy petition. As with cases under other chapters of the Bankruptcy Code, a stay of creditor actions against the chapter 11 debtor automatically goes into effect when the bankruptcy petition is filed. 11 U.S.C. § 362(a). The filing of a

petition, however, does not operate as a stay for certain types of actions listed under 11 U.S.C. § 362(b). The stay provides a breathing spell for the debtor, during which negotiations can take place to try to resolve the difficulties in the debtor's financial situation.

Under specific circumstances, the secured creditor can obtain an order from the court granting relief from the automatic stay. For example, when the debtor has no equity in the property and the property is not necessary for an effective reorganization, the secured creditor can seek an order of the court lifting the stay to permit the creditor to foreclose on the property, sell it, and apply the proceeds to the debt. 11 U.S.C. § 362(d).

The Bankruptcy Code permits applications for fees to be made by certain professionals during the case. Thus, a trustee, a debtor's attorney, or any professional person appointed by the court may apply to the court at intervals of 120 days for interim compensation and reimbursement payments. In very large cases with extensive legal work, the court may permit more frequent applications. Although professional fees may be paid if authorized by the court, the debtor cannot make payments to professional creditors on prepetition obligations, *i.e.*, obligations which arose before the filing of the bankruptcy petition. The ordinary expenses of the ongoing business, however, continue to be paid.

### **WHO CAN FILE A PLAN**

The debtor (unless a "small business debtor") has a 120-day period during which it has an exclusive right to file a plan. 11 U.S.C. § 1121(b). This exclusivity period may be extended or reduced by the court. But, in no event, may the exclusivity period, including

all extensions, be longer than 18 months. 11 U.S.C. § 1121(d). After the exclusivity period has expired, a creditor or the case trustee may file a competing plan. The U.S. trustee may not file a plan. 11 U.S.C. § 307.

A chapter 11 case may continue for many years unless the court, the U.S. trustee, the committee, or another party in interest acts to ensure the case's timely resolution. The creditors' right to file a competing plan provides incentive for the debtor to file a plan within the exclusivity period and acts as a check on excessive delay in the case.

### **AVOIDABLE TRANSFERS**

The debtor in possession or the trustee, as the case may be, has what are called "avoiding" powers. These powers may be used to undo a transfer of money or property made during a certain period of time before the filing of the bankruptcy petition. By avoiding a particular transfer of property, the debtor in possession can cancel the transaction and force the return or "disgorgement" of the payments or property, which then are available to pay all creditors. Generally, and subject to various defenses, the power to avoid transfers is effective against transfers made by the debtor within 90 days before filing the petition. But transfers to "insiders" (*i.e.*, relatives, general partners, and directors or officers of the debtor) made up to a year before filing may be avoided. 11 U.S.C. §§ 101(31), 101(54), 547, 548. In addition, under 11 U.S.C. § 544, the trustee is authorized to avoid transfers under applicable state law, which often provides for longer time periods. Avoiding powers prevent unfair prepetition payments to one creditor at the expense of all other creditors.

## **CASH COLLATERAL, ADEQUATE PROTECTION, AND OPERATING CAPITAL**

Although the preparation, confirmation, and implementation of a plan of reorganization is at the heart of a chapter 11 case, other issues may arise that must be addressed by the debtor in possession. The debtor in possession may use, sell, or lease property of the estate in the ordinary course of its business, without prior approval, unless the court orders otherwise. 11 U.S.C. § 363(c). If the intended sale or use is outside the ordinary course of its business, the debtor must obtain permission from the court.

A debtor in possession may not use “cash collateral” without the consent of the secured party or authorization by the court, which must first examine whether the interest of the secured party is adequately protected. 11 U.S.C. § 363. Section 363 defines “cash collateral” as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents, whenever acquired, in which the estate and an entity other than the estate have an interest. It includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a creditor’s security interest.

When “cash collateral” is used (spent), the secured creditors are entitled to receive additional protection under section 363 of the Bankruptcy Code. The debtor in possession must file a motion requesting an order from the court authorizing the use of the cash collateral. Pending consent of the secured creditor or court authorization for the debtor

in possession’s use of cash collateral, the debtor in possession must segregate and account for all cash collateral in its possession. 11 U.S.C. § 363(c)(4). A party with an interest in property being used by the debtor may request that the court prohibit or condition this use to the extent necessary to provide “adequate protection” to the creditor.

Adequate protection may be required to protect the value of the creditor’s interest in the property being used by the debtor in possession. This is especially important when there is a decrease in value of the property. The debtor may make periodic or lump sum cash payments, or provide an additional or replacement lien that will result in the creditor’s property interest being adequately protected. 11 U.S.C. § 361.

When a chapter 11 debtor needs operating capital, it may be able to obtain it from a lender by giving the lender a court-approved “superpriority” over other unsecured creditors or a lien on property of the estate. 11 U.S.C. § 364.

## **MOTIONS**

Before confirmation of a plan, several activities may take place in a chapter 11 case. Continued operation of the debtor’s business may lead to the filing of a number of contested motions. The most common are those seeking relief from the automatic stay, the use of cash collateral, or to obtain credit. There may also be litigation over executory (*i.e.*, unfulfilled) contracts and unexpired leases and the assumption or rejection of those executory contracts and unexpired leases by the debtor in possession. 11 U.S.C. § 365. Delays in formulating, filing, and obtaining confirmation of a plan often prompt creditors

to file motions for relief from stay, to convert the case to chapter 7, or to dismiss the case altogether.

### **ADVERSARY PROCEEDINGS**

Frequently, the debtor in possession will institute a lawsuit, known as an adversary proceeding, to recover money or property for the estate. Adversary proceedings may take the form of lien avoidance actions, actions to avoid preferences, actions to avoid fraudulent transfers, or actions to avoid post-petition transfers. These proceedings are governed by Part VII of the Federal Rules of Bankruptcy Procedure. At times, a creditors' committee may be authorized by the bankruptcy court to pursue these actions against insiders of the debtor if the plan provides for the committee to do so or if the debtor has refused a demand to do so. Creditors may also initiate adversary proceedings by filing complaints to determine the validity or priority of a lien, revoke an order confirming a plan, determine the dischargeability of a debt, obtain an injunction, or subordinate a claim of another creditor.

### **CLAIMS**

The Bankruptcy Code defines a claim as: (1) a right to payment; (2) or a right to an equitable remedy for a failure of performance if the breach gives rise to a right to payment. 11 U.S.C. § 101(5). Generally, any creditor whose claim is not scheduled (*i.e.*, listed by the debtor on the debtor's schedules) or is scheduled as disputed, contingent, or unliquidated must file a proof of claim (and attach evidence documenting the claim) in order to be treated as a creditor for purposes of voting on the plan and distribution under it. Fed. R. Bankr. P. 3003(c)(2). But filing a

proof of claim is not necessary if the creditor's claim is scheduled (but is not listed as disputed, contingent, or unliquidated by the debtor) because the debtor's schedules are deemed to constitute evidence of the validity and amount of those claims. 11 U.S.C. § 1111. If a scheduled creditor chooses to file a claim, a properly filed proof of claim supersedes any scheduling of that claim. Fed. R. Bankr. P. 3003(c)(4). It is the responsibility of the creditor to determine whether the claim is accurately listed on the debtor's schedules. The debtor must provide notification to those creditors whose names are added and whose claims are listed as a result of an amendment to the schedules. The notification also should advise such creditors of their right to file proofs of claim and that their failure to do so may prevent them from voting upon the debtor's plan of reorganization or participating in any distribution under that plan. When a debtor amends the schedule of liabilities to add a creditor or change the status of any claims to disputed, contingent, or unliquidated, the debtor must provide notice of the amendment to any entity affected. Fed. R. Bankr. P. 1009(a).

### **EQUITY SECURITY HOLDERS**

An equity security holder is a holder of an equity security of the debtor. Examples of an equity security are a share in a corporation, an interest of a limited partner in a limited partnership, or a right to purchase, sell, or subscribe to a share, security, or interest of a share in a corporation or an interest in a limited partnership. 11 U.S.C. § 101(16), (17). An equity security holder may vote on the plan of reorganization and may file a proof of interest, rather than a proof of claim. A proof of interest is deemed filed for any interest that appears in the debtor's schedules, unless it is

scheduled as disputed, contingent, or unliquidated. 11 U.S.C. § 1111. An equity security holder whose interest is not scheduled or scheduled as disputed, contingent, or unliquidated must file a proof of interest in order to be treated as a creditor for purposes of voting on the plan and distribution under it. Fed. R. Bankr. P. 3003(c)(2). A properly filed proof of interest supersedes any scheduling of that interest. Fed. R. Bankr. P. 3003(c)(4). Generally, most of the provisions that apply to proofs of claim, as discussed above, are also applicable to proofs of interest.

### **CONVERSION OR DISMISSAL**

A debtor in a case under chapter 11 has a one-time absolute right to convert the chapter 11 case to a case under chapter 7 unless: (1) the debtor is not a debtor in possession; (2) the case originally was commenced as an involuntary case under chapter 11; or (3) the case was converted to a case under chapter 11 other than at the debtor's request. 11 U.S.C. § 1112(a). A debtor in a chapter 11 case does not have an absolute right to have the case dismissed upon request.

A party in interest may file a motion to dismiss or convert a chapter 11 case to a chapter 7 case "for cause." Generally, if cause is established after notice and hearing, the court must convert or dismiss the case (whichever is in the best interests of creditors and the estate) unless it specifically finds that the requested conversion or dismissal is not in the best interest of creditors and the estate. 11 U.S.C. § 1112(b). Alternatively, the court may decide that appointment of a chapter 11 trustee or an examiner is in the best interests of creditors and the estate. 11 U.S.C. § 1104(a)(3). Section 1112(b)(4) of the Bankruptcy Code sets forth numerous

examples of cause that would support dismissal or conversion. For example, the moving party may establish cause by showing that there is substantial or continuing loss to the estate and the absence of a reasonable likelihood of rehabilitation; gross mismanagement of the estate; failure to maintain insurance that poses a risk to the estate or the public; or unauthorized use of cash collateral that is substantially harmful to a creditor.

Cause for dismissal or conversion also includes an unexcused failure to timely comply with reporting and filing requirements; failure to attend the meeting of creditors or attend a Fed. R. Bankr. P. 2004 examination without good cause; failure to timely provide information to the U.S. trustee; and failure to timely pay post-petition taxes or timely file post-petition returns. Additionally, failure to file a disclosure statement or to file and confirm a plan within the time fixed by the Bankruptcy Code or order of the court; inability to effectuate a plan; denial or revocation of confirmation; inability to consummate a confirmed plan represent "cause" for dismissal under the statute. In an individual case, failure of the debtor to pay post-petition domestic support obligations constitutes "cause" for dismissal or conversion.

Section 1112(c) of the Bankruptcy Code provides an important exception to the conversion process in a chapter 11 case. Under this provision, the court is prohibited from converting a case involving a farmer or charitable institution to a liquidation case under chapter 7 unless the debtor requests the conversion.

## THE DISCLOSURE STATEMENT

Generally, the debtor (or any plan proponent) must file and get court approval of a written disclosure statement before there can be a vote on the plan of reorganization. The disclosure statement must provide “adequate information” concerning the affairs of the debtor to enable the holder of a claim or interest to make an informed judgment about the plan. 11 U.S.C. § 1125. In a small business case, however, the court may determine that the plan itself contains adequate information and that a separate disclosure statement is unnecessary. 11 U.S.C. § 1125(f). After the disclosure statement is filed, the court must hold a hearing to determine whether the disclosure statement should be approved. Acceptance or rejection of a plan usually cannot be solicited until the court has first approved the written disclosure statement. 11 U.S.C. § 1125(b). An exception to this rule exists if the initial solicitation of the party occurred before the bankruptcy filing, as would be the case in so-called “prepackaged” bankruptcy plans (*i.e.*, where the debtor negotiates a plan with significant creditor constituencies before filing for bankruptcy). Continued post-filing solicitation of such parties is not prohibited. After the court approves the disclosure statement, the debtor or proponent of a plan can begin to solicit acceptances of the plan, and creditors may also solicit rejections of the plan.

Upon approval of a disclosure statement, the plan proponent must mail the following to the U.S. trustee and all creditors and equity security holders: (1) the plan, or a court approved summary of the plan; (2) the disclosure statement approved by the court; (3) notice of the time within which acceptances and rejections of the plan may be

filed; and (4) such other information as the court may direct, including any opinion of the court approving the disclosure statement or a court-approved summary of the opinion. Fed. R. Bankr. P. 3017(d). In addition, the debtor must mail to the creditors and equity security holders entitled to vote on the plan or plans: (1) notice of the time fixed for filing objections; (2) notice of the date and time for the hearing on confirmation of the plan; and (3) a ballot for accepting or rejecting the plan and, if appropriate, a designation for the creditors to identify their preference among competing plans. *Id.* But in a small business case, the court may conditionally approve a disclosure statement subject to final approval after notice and a combined disclosure statement/plan confirmation hearing. 11 U.S.C. § 1125(f).

## ACCEPTANCE OF THE PLAN OF REORGANIZATION

As noted earlier, only the debtor may file a plan of reorganization during the first 120-day period after the petition is filed (or after entry of the order for relief, if an involuntary petition was filed). The court may grant extension of this exclusive period up to 18 months after the petition date. In addition, the debtor has 180 days after the petition date or entry of the order for relief to obtain acceptances of its plan. 11 U.S.C. § 1121. The court may extend (up to 20 months) or reduce this acceptance exclusive period for cause. 11 U.S.C. § 1121(d). In practice, debtors typically seek extensions of both the plan filing and plan acceptance deadlines at the same time so that any order sought from the court allows the debtor two months to seek acceptances after filing a plan before any competing plan can be filed.

If the exclusive period expires before the debtor has filed and obtained acceptance of a plan, other parties in interest in a case, such as the creditors' committee or a creditor, may file a plan. Such a plan may compete with a plan filed by another party in interest or by the debtor. If a trustee is appointed, the trustee must file a plan, a report explaining why the trustee will not file a plan, or a recommendation for conversion or dismissal of the case. 11 U.S.C. § 1106(a)(5). A proponent of a plan is subject to the same requirements as the debtor with respect to disclosure and solicitation.

In a chapter 11 case, a liquidating plan is permissible. Such a plan often allows the debtor in possession to liquidate the business under more economically advantageous circumstances than a chapter 7 liquidation. It also permits the creditors to take a more active role in fashioning the liquidation of the assets and the distribution of the proceeds than in a chapter 7 case.

Section 1123(a) of the Bankruptcy Code lists the mandatory provisions of a chapter 11 plan, and section 1123(b) lists the discretionary provisions. Section 1123(a)(1) provides that a chapter 11 plan must designate classes of claims and interests for treatment under the reorganization. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders.

Under section 1126(c) of the Bankruptcy Code, an entire class of claims is deemed to accept a plan if the plan is accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims in the class. Under section 1129(a)(10), if there are impaired classes of

claims, the court cannot confirm a plan unless it has been accepted by at least one class of non-insiders who hold impaired claims (*i.e.*, claims that are not going to be paid completely or in which some legal, equitable, or contractual right is altered). Moreover, under section 1126(f), holders of unimpaired claims are deemed to have accepted the plan.

Under section 1127(a) of the Bankruptcy Code, the plan proponent may modify the plan at any time before confirmation, but the plan as modified must meet all the requirements of chapter 11. When there is a proposed modification after balloting has been conducted, and the court finds after a hearing that the proposed modification does not adversely affect the treatment of any creditor who has not accepted the modification in writing, the modification is deemed to have been accepted by all creditors who previously accepted the plan. Fed. R. Bankr. P. 3019. If it is determined that the proposed modification does have an adverse effect on the claims of non-consenting creditors, then another balloting must take place.

Because more than one plan may be submitted to the creditors for approval, every proposed plan and modification must be dated and identified with the name of the entity or entities submitting the plan or modification. Fed. R. Bankr. P. 3016(b). When competing plans are presented that meet the requirements for confirmation, the court must consider the preferences of the creditors and equity security holders in determining which plan to confirm.

Any party in interest may file an objection to confirmation of a plan. The Bankruptcy Code requires the court, after notice, to hold a hearing on confirmation of a plan. If no objection to confirmation has been timely

filed, the Bankruptcy Code allows the court to determine whether the plan has been proposed in good faith and according to law. Fed. R. Bankr. P. 3020(b)(2). Before confirmation can be granted, the court must be satisfied that there has been compliance with all the other requirements of confirmation set forth in section 1129 of the Bankruptcy Code, even in the absence of any objections. In order to confirm the plan, the court must find, among other things, that: (1) the plan is feasible; (2) it is proposed in good faith; and (3) the plan and the proponent of the plan are in compliance with the Bankruptcy Code. In order to satisfy the feasibility requirement, the court must find that confirmation of the plan is not likely to be followed by liquidation (unless the plan is a liquidating plan) or the need for further financial reorganization.

### **THE DISCHARGE**

Section 1141(d)(1) generally provides that confirmation of a plan discharges a debtor from any debt that arose before the date of confirmation. After the plan is confirmed, the debtor is required to make plan payments and is bound by the provisions of the plan of reorganization. The confirmed plan creates new contractual rights, replacing or superseding pre-bankruptcy contracts.

There are, of course, exceptions to the general rule that an order confirming a plan operates as a discharge. Confirmation of a plan of reorganization discharges any type of debtor – corporation, partnership, or individual – from most types of prepetition debts. It does not, however, discharge an individual debtor from any debt made nondischargeable by section 523 of the Bankruptcy Code.<sup>1</sup> Moreover, except in limited circumstances, a discharge is not available to an individual debtor unless

and until all payments have been made under the plan. 11 U.S.C. § 1141(d)(5). Confirmation does not discharge the debtor if the plan is a liquidation plan, as opposed to one of reorganization, unless the debtor is an individual. When the debtor is an individual, confirmation of a liquidation plan will result in a discharge (after plan payments are made) unless grounds would exist for denying the debtor a discharge if the case were proceeding under chapter 7 instead of chapter 11. 11 U.S.C. §§ 727(a), 1141(d).

### **POSTCONFIRMATION MODIFICATION OF THE PLAN**

At any time after confirmation and before “substantial consummation” of a plan, the proponent of a plan may modify the plan if the modified plan would meet certain Bankruptcy Code requirements. 11 U.S.C. § 1127(b). This should be distinguished from preconfirmation modification of the plan. A modified postconfirmation plan does not automatically become the plan. A modified postconfirmation plan in a chapter 11 case becomes the plan only “if circumstances warrant such modification” and the court, after notice and hearing, confirms the plan as modified. If the debtor is an individual, the plan may be modified postconfirmation upon the request of the debtor, the trustee, the U.S. trustee, or the holder of an allowed unsecured claim to make adjustments to payments due under the plan. 11 U.S.C. § 1127(e).

### **POSTCONFIRMATION ADMINISTRATION**

Notwithstanding the entry of the confirmation order, the court has the authority to issue any other order necessary to administer the estate. Fed. R. Bankr. P. 3020(d). This authority

would include the postconfirmation determination of objections to claims or adversary proceedings, which must be resolved before a plan can be fully consummated. Sections 1106(a)(7) and 1107(a) of the Bankruptcy Code require a debtor in possession or a trustee to report on the progress made in implementing a plan after confirmation. A chapter 11 trustee or debtor in possession has a number of responsibilities to perform after confirmation, including consummating the plan, reporting on the status of consummation, and applying for a final decree.

### **REVOCATION OF THE CONFIRMATION ORDER**

Revocation of the confirmation order is an undoing or cancellation of the confirmation of a plan. A request for revocation of confirmation, if made at all, must be made by a party in interest within 180 days of confirmation. The court, after notice and hearing, may revoke a confirmation order “if and only if the [confirmation] order was procured by fraud.” 11 U.S.C. § 1144.

### **THE FINAL DECREE**

A final decree closing the case must be entered after the estate has been “fully administered.” Fed. R. Bankr. P. 3022. Local bankruptcy court policies generally determine when the final decree is entered and the case closed.

### **NOTES**

1. Debts not discharged include debts for alimony and child support, certain taxes, debts for certain educational benefit overpayments or loans made or guaranteed by a

governmental unit, debts for willful and malicious injury by the debtor to another entity or to the property of another entity, debts for death or personal injury caused by the debtor’s operation of a motor vehicle while the debtor was intoxicated from alcohol or other substances, and debts for certain criminal restitution orders. 11 U.S.C. § 523(a). The debtor will continue to be liable for these types of debts to the extent that they are not paid in the chapter 11 case. Debts for money or property obtained by false pretenses, debts for fraud or defalcation while acting in a fiduciary capacity, and debts for willful and malicious injury by the debtor to another entity or to the property of another entity will be discharged unless a creditor timely files and prevails in an action to have such debts declared nondischargeable. 11 U.S.C. § 523(c); Fed. R. Bankr. P. 4007(c).

## Chapter 12

### Family Farmer or Family Fisherman Bankruptcy

#### BACKGROUND

Chapter 12 is designed for “family farmers” or “family fishermen” with “regular annual income.” It enables financially distressed family farmers and fishermen to propose and carry out a plan to repay all or part of their debts. Under chapter 12, debtors propose a repayment plan to make installments to creditors over three to five years. Generally, the plan must provide for payments over three years unless the court approves a longer period “for cause.” But unless the plan proposes to pay 100% of domestic support claims (*i.e.*, child support and alimony) if any exist, it must be for five years and must include all of the debtor’s disposable income. In no case may a plan provide for payments over a period longer than five years. 11 U.S.C. § 1222(b)-(c).

In tailoring bankruptcy law to meet the economic realities of family farming and the family fisherman, chapter 12 eliminates many of the barriers such debtors would face if seeking to reorganize under either chapter 11 or 13 of the Bankruptcy Code. For example, chapter 12 is more streamlined, less complicated, and less expensive than chapter 11, which is better suited to large corporate reorganizations. In addition, few family farmers or fishermen find chapter 13 to be advantageous because it is designed for wage earners who have smaller debts than those facing family farmers. In chapter 12, Congress sought to combine the features of the Bankruptcy Code which can provide a

framework for successful family farmer and fisherman reorganizations.

The Bankruptcy Code provides that only a family farmer or family fisherman with “regular annual income” may file a petition for relief under chapter 12. 11 U.S.C. §§ 101(18), 101(19A), 109(f). The purpose of this requirement is to ensure that the debtor’s annual income is sufficiently stable and regular to permit the debtor to make payments under a chapter 12 plan. But chapter 12 makes allowance for situations in which family farmers or fishermen have income that is seasonal in nature. Relief under chapter 12 is voluntary, and only the debtor may file a petition under the chapter.

Under the Bankruptcy Code, “family farmers” and “family fishermen” fall into two categories: (1) an individual or individual and spouse and (2) a corporation or partnership. Farmers or fishermen falling into the first category must meet each of the following four criteria as of the date the petition is filed in order to qualify for relief under chapter 12:

1. The individual or husband and wife must be engaged in a farming operation or a commercial fishing operation.
2. The total debts (secured and unsecured) of the operation must not exceed \$3,792,650 (if a farming operation) or \$1,757,475 (if a commercial fishing operation).
3. If a family farmer, at least 50%, and if family fisherman at least 80%, of the total debts that are fixed in amount (exclusive of debt for the debtor’s home) must be related to the farming or commercial fishing operation.

4. More than 50% of the gross income of the individual or the husband and wife for the preceding tax year (or, for family farmers only, for each of the 2<sup>nd</sup> and 3<sup>rd</sup> prior tax years) must have come from the farming or commercial fishing operation.

In order for a corporation or partnership to fall within the second category of debtors eligible to file as family farmers or family fishermen, the corporation or partnership must meet each of the following criteria as of the date of the filing of the petition:

1. More than one-half the outstanding stock or equity in the corporation or partnership must be owned by one family or by one family and its relatives.

2. The family or the family and its relatives must conduct the farming or commercial fishing operation.

3. More than 80% of the value of the corporate or partnership assets must be related to the farming or fishing operation.

4. The total indebtedness of the corporation or partnership must not exceed \$3,792,650 (if a farming operation) or \$1,757,475 (if a commercial fishing operation).

5. At least 50% for a farming operation or 80% for a fishing operation of the corporation's or partnership's total debts which are fixed in amount (exclusive of debt for one home occupied by a shareholder) must be related to the farming or fishing operation.

6. If the corporation issues stock, the stock cannot be publicly traded.

A debtor cannot file under chapter 12 (or any other chapter) if during the preceding 180 days a prior bankruptcy petition was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court or was voluntarily dismissed after creditors sought relief from the bankruptcy court to recover property upon which they hold liens. 11 U.S.C. §§ 109(g), 362(d) and (e). In addition, no individual may be a debtor under chapter 12 or any chapter of the Bankruptcy Code unless he or she has, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group briefing. 11 U.S.C. §§ 109, 111. There are exceptions in emergency situations or where the U.S. trustee (or bankruptcy administrator)<sup>1</sup> has determined that there are insufficient approved agencies to provide the required counseling. If a debt management plan is developed during required credit counseling, it must be filed with the court.

## HOW CHAPTER 12 WORKS

A chapter 12 case begins by filing a petition with the bankruptcy court serving the area where the individual lives or where the corporation or partnership debtor has its principal place of business or principal assets. Unless the court orders otherwise, the debtor also shall file with the court (1) schedules of assets and liabilities, (2) a schedule of current income and expenditures, (3) a schedule of executory contracts and unexpired leases, and (4) a statement of financial affairs. Fed. R. Bankr. P. 1007(b). A husband and wife may file a joint petition or individual petitions. 11 U.S.C. § 302(a). (The Official Forms may be purchased at legal stationery stores or downloaded from the internet at:

<http://www.uscourts.gov/bkforms/index.html>.  
They are not available from the court.)

The courts must charge a \$200 case filing fee and a \$39 miscellaneous administrative fee. Normally the fees should be paid to the clerk of the court upon filing. With the court's permission, however, they may be paid in installments. 28 U.S.C. § 1930(a); Fed. R. Bankr. P. 1006(b); Bankruptcy Court Miscellaneous Fee Schedule, Item 8. The number of such installments is limited to four and the debtor must make the final installment no later than 120 days after filing the petition. Fed. R. Bankr. P. 1006(b). 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 the filing of the petition. *Id.* 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. 11 U.S.C. § 1208(c)(2).

In order to complete the Official Bankruptcy Forms which make up the petition, statement of financial affairs, and schedules, the debtor will need to 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 farming and living expenses, *i.e.*, food,

shelter, utilities, taxes, transportation, medicine, feed, fertilizer, etc.

Married individuals must gather this information for each 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 the creditors can evaluate the household's financial position.

When a chapter 12 petition is filed, an impartial trustee is appointed to administer the case. 11 U.S.C. § 1202. In some districts, the U.S. trustee appoints a standing trustee to serve in all chapter 12 cases. 28 U.S.C.

§ 586(b). As in chapter 13, the trustee both evaluates the case and serves as a disbursing agent, collecting payments from the debtor and making distributions to creditors. 11 U.S.C. § 1202.

Filing the petition under chapter 12 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. 11 U.S.C. § 362. Filing the petition does not, however, stay certain types of actions listed under 11 U.S.C. § 362(b). The stay arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally cannot initiate or continue any 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.

Chapter 12 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 with the debtor. 11 U.S.C. § 1201(a). Consumer debts are those incurred by an individual primarily for a personal, family, or household purpose. 11 U.S.C. § 101(8).

Between 21 to 35 days after the petition is filed, the chapter 12 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 the 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 the proposed terms of the debtor’s repayment plan. 11 U.S.C. § 343; Fed. R. Bankr. P. 4002. If a husband and wife have filed a joint petition, they both must attend the creditors’ meeting. In order to preserve their independent judgment, bankruptcy judges are prohibited from attending. 11 U.S.C. § 341(c). 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.

In a chapter 12 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. Fed. R. Bankr. P. 3002(c). A governmental unit, however, has 180 days from the date the case is filed file a proof of claim. 11 U.S.C. § 502(b)(9).

After the meeting of creditors, the debtor, the chapter 12 trustee, and interested creditors will attend a hearing on confirmation of the debtor’s chapter 12 repayment plan.

### **THE CHAPTER 12 PLAN AND CONFIRMATION HEARING**

Unless the court grants an extension, the debtor must file a plan of repayment with the petition or within 90 days after filing the petition. 11 U.S.C. § 1221. The plan, which must be submitted to the court for approval, provides for payments of fixed amounts to the trustee on a regular basis. The trustee then distributes the funds to creditors according to the terms of the plan, which typically offers creditors less than full payment on their claims.

There are three types of claims: priority, secured, and unsecured. Priority claims are those granted special status by the bankruptcy law, such as most taxes and the costs of bankruptcy proceeding.<sup>2</sup> Secured claims are those for which the creditor has the right to liquidate certain property if the debtor does not pay the underlying debt. In contrast to secured claims, unsecured claims are generally those for which the creditor has no special rights to collect against particular property owned by the debtor.

A chapter 12 plan usually lasts three to five years. It must provide for full payment of all priority claims, unless a priority creditor agrees to different treatment of the claim or, in the case of a domestic support obligation, unless the debtor contributes all “disposable income” - discussed below - to a five-year plan. 11 U.S.C. § 1222(a)(2), (4).

Secured creditors must be paid at least as much as the value of the collateral pledged for the debt. One of the features of Chapter 12 is that payments to secured creditors can sometimes continue longer than the three-to-five-year period of the plan. For example, if the debtor's underlying debt obligation was scheduled to be paid over more than five years (*i.e.*, an equipment loan or a mortgage), the debtor may be able to pay the loan off over the original loan repayment schedule as long as any arrearage is made up during the plan.

The plan does not have to pay unsecured claims in full, as long as it commits all of the debtor's projected "disposable income" (or property of equivalent value) to plan payments over a 3 to 5 year period, and as long as the unsecured creditors are to receive at least as much as they would receive if the debtor's nonexempt assets were liquidated under chapter 7. 11 U.S.C. § 1225. "Disposable income" is defined as income not reasonably necessary for the maintenance or support of the debtor or dependents or for making payments needed to continue, preserve, and operate the debtor's business. 11 U.S.C. § 1225(b)(2).

Within 45 days after filing the plan, the presiding bankruptcy judge decides at a "confirmation hearing" whether the plan is feasible and meets the standards for confirmation under the Bankruptcy Code. 11 U.S.C. §§ 1224, 1225. Creditors, who receive 20 days' notice, may appear at the hearing and object to confirmation. Fed. R. Bankr. P. 2002(a)(8). While a variety of objections may be made, the typical arguments are that payments offered under the plan are less than creditors would receive if the debtor's assets were liquidated, or that the plan does not

commit all of the debtor's disposable income for the three-to-five-year period of the plan.

If the court confirms the plan, the chapter 12 trustee will distribute funds received in accordance with the terms of the plan. 11 U.S.C. § 1226(a). If the court does not confirm the plan, the debtor may file a modified plan. 11 U.S.C. § 1223. The debtor may also convert the case to a liquidation under chapter 7.<sup>3</sup> 11 U.S.C. § 1208(a). If the debtor fails to confirm a plan and the case is dismissed, the court may authorize the trustee to keep some of the funds for costs, but the trustee must return all remaining funds to the debtor (other than funds already disbursed to creditors). 11 U.S.C. § 1226(a).

On occasion, changed circumstances will affect the debtor's ability to make plan payments. A creditor may object or threaten to object to a plan, or the debtor may inadvertently have failed to list all creditors. In such instances, the plan may be modified either before or after confirmation. 11 U.S.C. §§ 1223, 1229. Modification after confirmation is not limited to an initiative by the debtor, but may also be made at the request of the trustee or an unsecured creditor. 11 U.S.C. § 1229(a).

## **MAKING THE PLAN WORK**

The provisions of a confirmed plan bind the debtor and each creditor. 11 U.S.C. § 1227. Once the court confirms the plan, the debtor must make the plan succeed. The debtor must make regular payments to the trustee, which will require adjustment to living on a fixed budget for a prolonged period. Furthermore, while confirmation of the plan entitles the debtor to retain property as long as payments are made, the debtor may not incur any

significant new debt without consulting the trustee, because additional debt may compromise the debtor's ability to complete the plan. 11 U.S.C. §§ 1222(a)(1), 1227. In any event, failure to make the plan payments may result in dismissal of the case. 11 U.S.C.

§ 1208(c). In addition, the court may dismiss the case or convert the case to a liquidation case under chapter 7 of the Bankruptcy Code upon a showing that the debtor has committed fraud in connection with the case. 11 U.S.C. § 1208(d).

### **THE CHAPTER 12 DISCHARGE**

The debtor will receive a discharge after completing all payments under the chapter 12 plan as long as the debtor certifies (if applicable) that all domestic support obligations that came due before making such certification have been paid. The discharge has the effect of releasing the debtor from all debts provided for by the plan allowed under section 503 or disallowed under section 502, with limited exceptions. Those creditors who were provided for in full or in part under the plan may no longer initiate or continue any legal or other action against the debtor to collect the discharged obligations.

Certain categories of debts are not discharged in chapter 12 proceedings. 11 U.S.C.

§ 1228(a). Those categories include debts for alimony and child support; money obtained through filing false financial statements; debts for willful and malicious injury to person or property; debts for death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated; and debts from fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny. The bankruptcy law regarding the scope of a chapter 12 discharge is complex, however,

and debtors should consult competent legal counsel in this regard prior to filing. Those debts which will not be discharged should be paid in full under a plan. With respect to secured obligations, those debts may be paid beyond the end of the plan payment period and, accordingly, are not discharged.

### **CHAPTER 12 HARDSHIP DISCHARGE**

The court may grant a "hardship discharge" to a chapter 12 debtor even though the debtor has failed to complete plan payments. 11 U.S.C. § 1228(b). Generally, a hardship discharge is available only to a debtor whose failure to complete plan payments is due to circumstances beyond the debtor's control and through no fault of the debtor. Creditors must have received at least as much as they would have received in a chapter 7 liquidation case, and the debtor must be unable to modify the plan. For example, injury or illness that precludes employment sufficient to fund even a modified plan may serve as the basis for a hardship discharge. The hardship discharge does not apply to any debts that are nondischargeable in a chapter 7 case. 11 U.S.C. § 523.

### **NOTES**

**1.** In North Carolina and Alabama, bankruptcy administrators perform similar functions that U.S. trustees perform in the remaining forty-eight states. The bankruptcy administrator program is administered by the Administrative Office of the United States Courts, while the U.S. trustee program is administered by the Department of Justice. For purposes of this publication, references to U.S. trustees are also applicable to bankruptcy administrators.

2. Section 507 sets forth 10 categories of unsecured claims which Congress has, for public policy reasons, given priority of distribution over other unsecured claims.
3. A fee of \$15 is charged for converting a case under chapter 12 to a case under chapter 7.

## Chapter 9

### Municipality Bankruptcy

The first municipal bankruptcy legislation was enacted in 1934 during the Great Depression. Pub. L. No. 251, 48 Stat. 798 (1934). Although Congress took care to draft the legislation so as not to interfere with the sovereign powers of the states guaranteed by the Tenth Amendment to the Constitution, the Supreme Court held the 1934 Act unconstitutional as an improper interference with the sovereignty of the states. *Ashton v. Cameron County Water Improvement Dist. No. 1*, 298 U.S. 513, 532 (1936). Congress enacted a revised Municipal Bankruptcy Act in 1937, Pub. L. No. 302, 50 Stat. 653 (1937), which was upheld by the Supreme Court. *United States v. Bekins*, 304 U.S. 27, 54 (1938). The law has been amended several times since 1937. In the more than 60 years since Congress established a federal mechanism for the resolution of municipal debts, there have been fewer than 500 municipal bankruptcy petitions filed. Although chapter 9 cases are rare, a filing by a large municipality can—like the 1994 filing by Orange County, California—involve many millions of dollars in municipal debt.

#### PURPOSE OF MUNICIPAL BANKRUPTCY

The purpose of chapter 9 is to provide a financially-distressed municipality protection from its creditors while it develops and negotiates a plan for adjusting its debts. Reorganization of the debts of a municipality is typically accomplished either by extending debt maturities, reducing the amount of principal or interest, or refinancing the debt by obtaining a new loan.

Although similar to other chapters in some respects, chapter 9 is significantly different in that there is no provision in the law for liquidation of the assets of the municipality and distribution of the proceeds to creditors. Such a liquidation or dissolution would undoubtedly violate the Tenth Amendment to the Constitution and the reservation to the states of sovereignty over their internal affairs. Indeed, due to the severe limitations placed upon the power of the bankruptcy court in chapter 9 cases (required by the Tenth Amendment and the Supreme Court's decisions in cases upholding municipal bankruptcy legislation), the bankruptcy court generally is not as active in managing a municipal bankruptcy case as it is in corporate reorganizations under chapter 11.

The functions of the bankruptcy court in chapter 9 cases are generally limited to approving the petition (if the debtor is eligible), confirming a plan of debt adjustment, and ensuring implementation of the plan. As a practical matter, however, the municipality may consent to have the court exercise jurisdiction in many of the traditional areas of court oversight in bankruptcy, in order to obtain the protection of court orders and eliminate the need for multiple forums to decide issues.

#### ELIGIBILITY

Only a “municipality” may file for relief under chapter 9. 11 U.S.C. § 109(c). The term “municipality” is defined in the Bankruptcy Code as a “political subdivision or public agency or instrumentality of a State.” 11 U.S.C. § 101(40). The definition is broad enough to include cities, counties, townships, school districts, and public improvement districts. It also includes

revenue-producing bodies that provide services which are paid for by users rather than by general taxes, such as bridge authorities, highway authorities, and gas authorities.

Section 109(c) of the Bankruptcy Codes sets forth four additional eligibility requirements for chapter 9:

1. The municipality must be *specifically* authorized to be a debtor by State law or by a governmental officer or organization empowered by State law to authorize the municipality to be a debtor;
2. The municipality must be insolvent, as defined in 11 U.S.C. § 101(32)(C);
3. The municipality must desire to effect a plan to adjust its debts; and
4. The municipality must either:
  - obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan in a case under chapter 9;
  - negotiate in good faith with creditors and fail to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that the debtor intends to impair under a plan;
  - be unable to negotiate with creditors because such negotiation is impracticable; or
  - reasonably believe that a creditor may attempt to obtain a preference.

## COMMENCEMENT OF THE CASE

Municipalities must voluntarily seek protection under the Bankruptcy Code. 11 U.S.C. §§ 303, 901(a). They may file a petition only under chapter 9. A case under chapter 9 concerning an unincorporated tax or special assessment district that does not have its own officials is commenced by the filing of a voluntary “petition under this chapter by such district’s governing authority or the board or body having authority to levy taxes or assessments to meet the obligations of such district.” 11 U.S.C. § 921(a).

A municipal debtor must file a list of creditors. 11 U.S.C. § 924. Normally, the debtor files the list of creditors with the petition. However, the bankruptcy court has discretion to fix a different time if the debtor is unable to prepare the list of creditors in the form and with the detail required by the Bankruptcy Rules at the time of filing. Fed. R. Bankr. P. 1007.

## ASSIGNMENT OF CASE TO A BANKRUPTCY JUDGE

One significant difference between chapter 9 cases and cases filed under other chapters is that the clerk of court does not automatically assign the case to a particular judge. “The chief judge of the court of appeals for the circuit embracing the district in which the case is commenced [designates] the bankruptcy judge to conduct the case.” 11 U.S.C. § 921(b). This provision was designed to remove politics from the issue of which judge will preside over the chapter 9 case of a major municipality and to ensure that a municipal

case will be handled by a judge who has the time and capability of doing so.

### **NOTICE OF CASE/OBJECTIONS/ ORDER FOR RELIEF**

The Bankruptcy Code requires that notice be given of the commencement of the case and the order for relief. 11 U.S.C. § 923. The Bankruptcy Rules provide that the clerk, or such other person as the court may direct, is to give notice. Fed. R. Bankr. P. 2002(f). The notice must also be published “at least once a week for three successive weeks in at least one newspaper of general circulation published within the district in which the case is commenced, and in such other newspaper having a general circulation among bond dealers and bondholders as the court designates.” 11 U.S.C. § 923. The court typically enters an order designating who is to give and receive notice by mail and identifying the newspapers in which the additional notice is to be published. Fed. R. Bankr. P. 9007, 9008.

The Bankruptcy Code permits objections to the petition. 11 U.S.C. § 921(c). Typically, objections concern issues like whether negotiations have been conducted in good faith, whether the state has authorized the municipality to file, and whether the petition was filed in good faith. If an objection to the petition is filed, the court must hold a hearing on the objection. *Id.* The court may dismiss a petition if it determines that the debtor did not file the petition in good faith or that the petition does not meet the requirements of title 11. *Id.*

If the petition is not dismissed upon an objection, the Bankruptcy Code requires the court to order relief, allowing the case to proceed under chapter 9. 11 U.S.C. § 921(d).

### **AUTOMATIC STAY**

The automatic stay of section 362 of the Bankruptcy Code is applicable in chapter 9 cases. 11 U.S.C. §§ 362(a), 901(a). The stay operates to stop all collection actions against the debtor and its property upon the filing of the petition. Additional automatic stay provisions are applicable in chapter 9 that prohibit actions against officers and inhabitants of the debtor if the action seeks to enforce a claim against the debtor. 11 U.S.C. § 922(a). Thus, the stay prohibits a creditor from bringing a mandamus action against an officer of a municipality on account of a prepetition debt. It also prohibits a creditor from bringing an action against an inhabitant of the debtor to enforce a lien on or arising out of taxes or assessments owed to the debtor.

Section 922(d) of title 11 limits the applicability of the stay. Under that section, a chapter 9 petition does not operate to stay application of pledged special revenues to payment of indebtedness secured by such revenues. Thus, an indenture trustee or other paying agent may apply pledged funds to payments coming due or distribute the pledged funds to bondholders without violating the automatic stay.

### **PROOFS OF CLAIM**

In a chapter 9 case, the court fixes the time within which proofs of claim or interest may be filed. Fed. R. Bankr. P. 3003(c)(3). Many creditors may not be required to file a proof of claim in a chapter 9 case. For example, a proof of claim is deemed filed if it appears on the list of creditors filed by the debtor, unless the debt is listed as disputed, contingent, or unliquidated. 11 U.S.C.

§ 925. Thus, a creditor must file a proof of claim if the creditor's claim appears on the list of creditors as disputed, contingent, or unliquidated.

### **COURT'S LIMITED POWER**

Sections 903 and 904 of the Bankruptcy Code are designed to recognize the court's limited power over operations of the debtor.

Section 904 limits the power of the bankruptcy court to "interfere with – (1) any of the political or governmental powers of the debtor; (2) any of the property or revenues of the debtor; or (3) the debtor's use or enjoyment of any income-producing property" unless the debtor consents or the plan so provides. The provision makes it clear that the debtor's day-to-day activities are not subject to court approval and that the debtor may borrow money without court authority. In addition, the court cannot appoint a trustee (except for limited purposes specified in 11 U.S.C. § 926(a)) and cannot convert the case to a liquidation proceeding.

The court also cannot interfere with the operations of the debtor or with the debtor's use of its property and revenues. This is due, at least in part, to the fact that in a chapter 9 case, there is no property of the estate and thus no estate to administer. 11 U.S.C. § 902(1). Moreover, a chapter 9 debtor may employ professionals without court approval, and the only court review of fees is in the context of plan confirmation, when the court determines the reasonableness of the fees.

The restrictions imposed by 11 U.S.C. § 904 are necessary to ensure the constitutionality of chapter 9 and to avoid the possibility that the court might substitute its control over the political or governmental affairs or property of

the debtor for that of the state and the elected officials of the municipality.

Similarly, 11 U.S.C. § 903 states that "chapter [9] does not limit or impair the power of a State to control, by legislation or otherwise, a municipality of or in such State in the exercise of the political or governmental powers of the municipality, including expenditures for such exercise," with two exceptions – a state law prescribing a method of composition of municipal debt does not bind any non-consenting creditor, nor does any judgment entered under such state law bind a nonconsenting creditor.

### **ROLE OF THE U.S. TRUSTEE/BANKRUPTCY ADMINISTRATOR**

In a chapter 9 case, the role of the U.S. trustee (or the bankruptcy administrator in North Carolina or Alabama)<sup>1</sup> is typically more limited than in chapter 11 cases. Although the U.S. trustee appoints a creditors' committee, the U.S. trustee does not examine the debtor at a meeting of creditors (there is no meeting of creditors), does not have the authority to move for appointment of a trustee or examiner or for conversion of the case, and does not supervise the administration of the case. Further, the U.S. trustee does not monitor the financial operations of the debtor or review the fees of professionals retained in the case.

## **ROLE OF CREDITORS**

The role of creditors is more limited in chapter 9 than in other cases. There is no first meeting of creditors, and creditors may not propose competing plans. If certain requirements are met, the debtor's plan is binding on dissenting creditors. The chapter 9 debtor has more freedom to operate without court-imposed restrictions.

In each chapter 9 case, however, there is a creditors' committee that has powers and duties that are very similar to those of a committee in a chapter 11 case. These powers and duties include selecting and authorizing the employment of one or more attorneys, accountants, or other agents to represent the committee; consulting with the debtor concerning administration of the case; investigating the acts, conduct, assets, liabilities, and financial condition of the debtor; participating in the formulation of a plan; and performing such other services as are in the interest of those represented. 11 U.S.C. §§ 901(a), 1103.

## **INTERVENTION/RIGHT OF OTHERS TO BE HEARD**

When cities or counties file for relief under chapter 9, there may be a great deal of interest in the case from entities wanting to appear and be heard. The Bankruptcy Rules provide that "[t]he Secretary of the Treasury of the United States may, or if requested by the court shall, intervene in a chapter 9 case." Fed. R. Bankr. P. 2018(c). Further, "[r]epresentatives of the state in which the debtor is located may intervene in a chapter 9 case." *Id.* In addition, the Bankruptcy Code permits the Securities and Exchange Commission to appear and be heard on any issue and gives parties in interest the right to

appear and be heard on any issue in a case. 11 U.S.C. §§ 901(a), 1109. Parties in interest include municipal employees, local residents, non-resident owners of real property, special tax payers, securities firms, and local banks.

## **POWERS OF THE DEBTOR**

Due to statutory limitations placed upon the power of the court in a municipal debt adjustment proceeding, the court is far less involved in the conduct of a municipal bankruptcy case (and in the operation of the municipal entity) while the debtor's financial affairs are undergoing reorganization. The municipal debtor has broad powers to use its property, raise taxes, and make expenditures as it sees fit. It is also permitted to adjust burdensome non-debt contractual relationships under the power to reject executory contracts and unexpired leases, subject to court approval, and it has the same avoiding powers as other debtors. Municipalities may also reject collective bargaining agreements and retiree benefit plans without going through the usual procedures required in chapter 11 cases.

A municipality has authority to borrow money during a chapter 9 case as an administrative expense. 11 U.S.C. §§ 364, 901(a). This ability is important to the survival of a municipality that has exhausted all other resources. A chapter 9 municipality has the same power to obtain credit as it does outside of bankruptcy. The court does not have supervisory authority over the amount of debt the municipality incurs in its operation. The municipality may employ professionals without court approval, and

the professional fees incurred are reviewed only within the context of plan confirmation.

## **DISMISSAL**

As previously noted, the court may dismiss a chapter 9 petition, after notice and a hearing, if it concludes the debtor did not file the petition in good faith or if the petition does not meet the requirements of chapter 9. 11 U.S.C. § 921(c). The court may also dismiss the petition for cause, such as for lack of prosecution, unreasonable delay by the debtor that is prejudicial to creditors, failure to propose or confirm a plan within the time fixed by the court, material default by the debtor under a confirmed plan, or termination of a confirmed plan by reason of the occurrence of a condition specified in the plan. 11 U.S.C. § 930.

## **TREATMENT OF BONDHOLDERS AND OTHER LENDERS**

Different types of bonds receive different treatment in municipal bankruptcy cases. General obligation bonds are treated as general debt in the chapter 9 case. The municipality is not required to make payments of either principal or interest on account of such bonds during the case. The obligations created by general obligation bonds are subject to negotiation and possible restructuring under the plan of adjustment.

Special revenue bonds, by contrast, will continue to be secured and serviced during the pendency of the chapter 9 case through continuing application and payment of ongoing special revenues. 11 U.S.C. § 928. Holders of special revenue bonds can expect to receive payment on such bonds during the chapter 9 case if special revenues are available. The application of pledged special revenues to

indebtedness secured by such revenues is not stayed as long as the pledge is consistent with 11 U.S.C. § 928 [§ 922(d) erroneously refers to § 927 rather than § 928], which insures that a lien of special revenues is subordinate to the operating expenses of the project or system from which the revenues are derived. 11 U.S.C. § 922(d).

Bondholders generally do not have to worry about the threat of preference liability with respect to any prepetition payments on account of bonds or notes, whether special revenue or general obligations. Any transfer of the municipal debtor's property to a noteholder or bondholder on account of a note or bond cannot be avoided as a preference, *i.e.*, as an unauthorized payment to a creditor made while the debtor was insolvent. 11 U.S.C. § 926(b).

## **PLAN FOR ADJUSTMENT OF DEBTS**

The Bankruptcy Code provides that the debtor must file a plan. 11 U.S.C. § 941. The plan must be filed with the petition or at such later time as the court fixes. There is no provision in chapter 9 allowing creditors or other parties in interest to file a plan. This limitation is required by the Supreme Court's pronouncements in *Ashton*, 298 U.S. at 528, and *Bekins*, 304 U.S. at 51, which interpreted the Tenth Amendment as requiring that a municipality be left in control of its governmental affairs during a chapter 9 case. Neither creditors nor the court may control the affairs of a municipality indirectly through the mechanism of proposing a plan of adjustment of the municipality's debts that would in effect determine the municipality's future tax and spending decisions.

## CONFIRMATION STANDARDS

The standards for plan confirmation in chapter 9 cases are a combination of the statutory requirements of 11 U.S.C. § 943(b) and those portions of 11 U.S.C. § 1129 (the chapter 11 confirmation standards) made applicable by 11 U.S.C. § 901(a). Section 943(b) lists seven general conditions required for confirmation of a plan. The court must confirm a plan if the following conditions are met:

1. the plan complies with the provisions of title 11 made applicable by sections 103(e) and 901;
2. the plan complies with the provisions of chapter 9;
3. all amounts to be paid by the debtor or by any person for services or expenses in the case or incident to the plan have been fully disclosed and are reasonable;
4. the debtor is not prohibited by law from taking any action necessary to carry out the plan;
5. except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that on the effective date of the plan, each holder of a claim of a kind specified in section 507(a)(1) will receive on account of such claim cash equal to the allowed amount of such claim;
6. any regulatory or electoral approval necessary under applicable nonbankruptcy law in order to carry out any provision of the plan has been obtained, or such provision is expressly conditioned on such approval; and
7. the plan is in the best interests of creditors and is feasible.

11 U.S.C. § 943(b).

Section 943(b)(1) requires as a condition for confirmation that the plan comply with the provisions of the Bankruptcy Code made applicable by sections 103(e) and 901(a) of the Bankruptcy Code. The most important of these for purposes of confirming a plan are those provisions of 11 U.S.C. § 1129 (*i.e.*, § 1129(a)(2), (a)(3), (a)(6), (a)(8), (a)(10)) that are made applicable by 11 U.S.C. § 901(a). Section 1129(a)(8) requires, as a condition to confirmation, that the plan has been accepted by each class of claims or interests impaired under the plan. Therefore, if the plan proposes treatment for a class of creditors such that the class is impaired (*i.e.*, the creditor's legal, equitable, or contractual rights are altered), then that class's acceptance is required. If the class is not impaired, then acceptance by that class is not required as a condition to confirmation. Under 11 U.S.C. § 1129(a)(10), the court may confirm the plan only if, should any class of claims be impaired under the plan, at least one impaired class has accepted the plan. If only one impaired class of creditors consents to the plan, plan confirmation is still possible under the "cram down" provisions of 11 U.S.C. § 1129(b). Under "cram down," if all other requirements are met except the § 1129(a)(8) requirement that all classes either be unimpaired or have accepted the plan, then the plan is confirmable if it does not discriminate unfairly and is fair and equitable.

The requirement that the plan be in the "best interests of creditors" means something different under chapter 9 than under chapter 11. Under chapter 11, a plan is said to be in the "best interest of creditors" if creditors would receive as much under the plan as

they would if the debtor were liquidated. 11 U.S.C. § 1129(a)(7)(A)(ii). Obviously, a different interpretation is needed in chapter 9 cases because a municipality's assets cannot be liquidated to pay creditors. In the chapter 9 context, the "best interests of creditors" test has generally been interpreted to mean that the plan must be better than other alternatives available to the creditors. *See* 6 COLLIER ON BANKRUPTCY § 943.03[7] (15<sup>th</sup> ed. rev. 2005). Generally speaking, the alternative to chapter 9 is dismissal of the case, permitting every creditor to fend for itself. An interpretation of the "best interests of creditors" test to require that the municipality devote all resources available to the repayment of creditors would appear to exceed the standard. The courts generally apply the test to require a reasonable effort by the municipal debtor that is a better alternative for its creditors than dismissal of the case. *Id.*

Parties in interest may object to confirmation, including creditors whose claims are affected by the plan, an organization of employees of the debtor, and other tax payers, as well as the Securities and Exchange Commission. 11 U.S.C. §§ 901(a), 943, 1109, 1128(b).

## DISCHARGE

A municipal debtor receives a discharge in a chapter 9 case after: (1) confirmation of the plan; (2) deposit by the debtor of any consideration to be distributed under the plan with the disbursing agent appointed by the court; and (3) a determination by the court that securities deposited with the disbursing agent will constitute valid legal obligations of the debtor and that any provision made to pay or secure payment of such obligations is valid. 11 U.S.C. § 944(b). Thus, the discharge is conditioned not only upon confirmation, but also upon deposit of the consideration to be

distributed under the plan and a court determination of the validity of securities to be issued.

There are two exceptions to the discharge in chapter 9 cases. The first is for any debt excepted from discharge by the plan or order confirming the plan. The second is for a debt owed to an entity that, before confirmation of the plan, had neither notice nor actual knowledge of the case. 11 U.S.C. § 944(c).

At any time within 180 days after entry of the confirmation order, the court may, after notice and a hearing, revoke the order of confirmation if the order was procured by fraud. 11 U.S.C. §§ 901(a), 1144.

## NOTES

1. In North Carolina and Alabama, bankruptcy administrators perform similar functions that United States trustees perform in the remaining forty-eight states. The bankruptcy administrator program is administered by the Administrative Office of the United States Courts, while the United States trustee program is administered by the Department of Justice. For purposes of this publication, references to United States trustees are also applicable to bankruptcy administrators.

## Chapter 15

### Ancillary and Other Cross-Border Cases

Chapter 15 is a new chapter added to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. It is the U.S. domestic adoption of the Model Law on Cross-Border Insolvency promulgated by the United Nations Commission on International Trade Law (“UNCITRAL”) in 1997, and it replaces section 304 of the Bankruptcy Code. Because of the UNCITRAL source for chapter 15, the U.S. interpretation must be coordinated with the interpretation given by other countries that have adopted it as internal law to promote a uniform and coordinated legal regime for cross-border insolvency cases.

The purpose of Chapter 15, and the Model Law on which it is based, is to provide effective mechanisms for dealing with insolvency cases involving debtors, assets, claimants and other parties in interest involving more than one country. This general purpose is realized through five objectives specified in the statute: (1) to promote cooperation between the United States courts and parties in interest and the courts and other competent authorities of foreign countries involved in cross-border insolvency cases; (2) to establish greater legal certainty for trade and investment; (3) to provide for the fair and efficient administration of cross-border insolvencies that protects the interests of all creditors and other interested entities, including the debtor; (4) to afford protection and maximization of the value of the debtor’s assets; and (5) to facilitate the rescue of financially troubled businesses, thereby

protecting investment and preserving employment. 11 U.S.C. § 1501.

Generally, a chapter 15 case is ancillary to a primary proceeding brought in another country, typically the debtor’s home country. As an alternative, the debtor or a creditor may commence a full chapter 7 or chapter 11 case in the United States if the assets in the United States are sufficiently complex to merit a full-blown domestic bankruptcy case. 11 U.S.C. § 1520(c). In addition, under chapter 15 a U.S. court may authorize a trustee or other entity (including an examiner) to act in a foreign country on behalf of a U.S. bankruptcy estate. 11 U.S.C. § 1505.

An ancillary case is commenced under chapter 15 by a “foreign representative” filing a petition for recognition of a “foreign proceeding.”<sup>1</sup> 11 U.S.C. § 1504. Chapter 15 gives the foreign representative the right of direct access to U.S. courts for this purpose. 11 U.S.C. § 1509. The petition must be accompanied by documents showing the existence of the foreign proceeding and the appointment and authority of the foreign representative. 11 U.S.C. § 1515. After notice and a hearing, the court is authorized to issue an order recognizing the foreign proceeding as either a “foreign main proceeding” (a proceeding pending in a country where the debtor’s center of main interests are located) or a “foreign non-main proceeding” (a proceeding pending in a country where the debtor has an establishment,<sup>2</sup> but not its center of main interests). 11 U.S.C. § 1517. Immediately upon the recognition of a foreign main proceeding, the automatic stay and selected other provisions of the Bankruptcy Code take effect within the United States. 11

U.S.C. § 1520. The foreign representative is also authorized to operate the debtor's business in the ordinary course. *Id.* The U.S. court is authorized to issue preliminary relief as soon as the petition for recognition is filed. 11 U.S.C. § 1519.

Through the recognition process, chapter 15 operates as the principal door of a foreign representative to the federal and state courts of the United States. 11 U.S.C. § 1509. Once recognized, a foreign representative may seek additional relief from the bankruptcy court or from other state and federal courts and is authorized to bring a full (as opposed to ancillary) bankruptcy case. 11 U.S.C. §§ 1509, 1511. In addition, the representative is authorized to participate as a party in interest in a pending U.S. insolvency case and to intervene in any other U.S. case where the debtor is a party. 11 U.S.C. §§ 1512, 1524.

Chapter 15 also gives foreign creditors the right to participate in U.S. bankruptcy cases and it prohibits discrimination against foreign creditors (except certain foreign government and tax claims, which may be governed by treaty). 11 U.S.C. § 1513. It also requires notice to foreign creditors concerning a U.S. bankruptcy case, including notice of the right to file claims. 11 U.S.C. § 1514.

One of the most important goals of chapter 15 is to promote cooperation and communication between U.S. courts and parties in interest with foreign courts and parties in interest in cross-border cases. This goal is accomplished by, among other things, explicitly charging the court and estate representatives to "cooperate to the maximum extent possible" with foreign courts and foreign representatives and authorizing direct communication between the court and authorized estate representatives and the foreign

courts and foreign representatives. 11 U.S.C. §§ 1525 - 1527.

If a full bankruptcy case is initiated by a foreign representative (when there is a foreign main proceeding pending in another country), bankruptcy court jurisdiction is generally limited to the debtor's assets that are located in the United States. 11 U.S.C. § 1528. The limitation promotes cooperation with the foreign main proceeding by limiting the assets subject to U.S. jurisdiction, so as not to interfere with the foreign main proceeding. Chapter 15 also provides rules to further cooperation where a case was filed under the Bankruptcy Code prior to recognition of the foreign representative and for coordination of more than one foreign proceeding. 11 U.S.C. §§ 1529 - 1530.

The UNCITRAL Model Law has also been adopted (with certain variations) in Canada, Mexico, Japan and several other countries. Adoption is pending in the United Kingdom and Australia, as well as other countries with significant international economic interests.

## NOTES

1. A "foreign proceeding" is a "judicial or administrative proceeding in a foreign country ... under a law relating to insolvency or adjustment of debt in which proceeding the [debtor's assets and affairs] are subject to control or supervision by a foreign court for the purpose of reorganization or liquidation." 11 U.S.C. § 101(23). A "foreign representative" is the person or entity authorized in the foreign proceeding "to administer the reorganization or liquidation of the debtor's assets or affairs

or to act as a representative of such foreign proceeding.”

**2.** An establishment is a place of operations where the debtor carries out a long term economic activity. 11 U.S.C. § 1502(2).

## **Servicemembers' Civil Relief Act**

### **BACKGROUND**

The Servicemembers' Civil Relief Act ("SCRA") is found at 50 U.S.C. app. §§ 501 et seq. The purpose of the SCRA is strengthen and expedite national defense by giving servicemembers certain protections in civil actions. By providing for the temporary suspension of judicial and administrative proceedings and transactions that may adversely affect servicemembers during their military service, the SCRA enables servicemembers to focus their energy on the defense of the United States. Among other things, the SCRA allows for forbearance and reduced interest on certain obligations incurred prior to military service, and it restricts default judgments against servicemembers and rental evictions of servicemembers and all their dependents. The SCRA applies to all members of the United States military on active duty, and to U.S. citizens serving in the military of United States allies in the prosecution of a war or military action. The provisions of the SCRA generally end when a servicemember is discharged from active duty or within 90 days of discharge, or when the servicemember dies. Portions of the SCRA also apply to reservists and inductees who have received orders but not yet reported to active duty or induction into the military service.

### **GENERAL PROVISIONS**

There are three primary areas of coverage under the SCRA: (1) protection against the entry of default judgments; (2) stay of proceedings where the servicemember has notice of the proceeding; and (3) stay or vacation of execution of judgments, attachments and

garnishments. 50 U.S.C. app. §§ 521, 522 and 524.

### *Protection Against Default Judgements*

Section 521 of the SCRA establishes certain procedures that must be followed in all civil proceedings in order to protect servicemember defendants against the entry of default judgements. These procedures are outlined below:

- If a defendant is in default for failure to appear in the action filed by the plaintiff, the plaintiff must file an affidavit<sup>1</sup> with the court before a default judgment may be entered. The affidavit must state whether the defendant is in the military, or that the plaintiff was unable to determine whether the defendant is in the military.
- If, based on the filed affidavits, the court cannot determine whether the defendant is in the military, it may condition entry of judgment against the defendant upon the plaintiff's filing of a bond. The bond would indemnify the defendant against any loss or damage incurred because of the judgment if the judgment is later set aside in whole or in part.
- The court may not order entry of judgment against the defendant if the defendant is in the military until after the court appoints an attorney to represent the defendant.
- If requested by counsel for a servicemember defendant, or upon the court's own motion, the court will grant a stay of proceedings for no less than 90 days if it determines that (1) there may

be a defense and the defense cannot be presented without the defendant's presence; or (2) after due diligence the defendant's attorney has not been able to contact the defendant or otherwise determine if a meritorious defense exists.

- The court may, in its discretion, make further orders or enter further judgments to protect the rights of the defendant under the SCRA.
- If a judgment is entered against the defendant while he or she is in military service or within 60 days of discharge from military service, and the defendant was prejudiced in making his or her defense because of his or her military service, the judgment may, upon application by the defendant, be opened by the court and the defendant may then provide a defense. Before the judgment may be opened, however, the defendant must show that he or she has a meritorious or legal defense to some or all of the action.

#### *Stay of Proceedings Where Servicemember Has Notice*

Outside the default context, and at any time before final judgement in a civil action, a person covered by the SCRA who has received notice of a proceeding may ask the court to stay the proceeding. 50 U.S.C. app. § 522. The court may also order a stay on its own motion. *Id.* The court will grant the servicemember's stay application and will stay the proceeding for at least 90 days if the application includes: (1) a letter or other communication setting forth facts demonstrating that the individual's current military duty requirements materially affect the servicemember's ability to appear along with a date when the servicemember will be able to

appear; and (2) a letter or other communication from the servicemember's commanding officer stating that the servicemember's current military duty prevents his or her appearance and that military leave is not authorized for the servicemember at the time of the letter. The court has discretion to grant additional stays upon further application.

#### *Stay or Vacation of Execution of Judgements, Attachments and Garnishments*

In addition to the court's ability to regulate default judgments and stay proceedings, the court may on its own motion and must upon application: (1) stay the execution of any judgment or order entered against a servicemember; and (2) vacate or stay any attachment or garnishment of the servicemember's property or assets, whether before or after judgment if it finds that the servicemember's ability to comply with the judgment or garnishment is materially affected by military service. 50 U.S.C. app. § 524. The stay of execution may be ordered for any part of the servicemember's military service plus 90 days after discharge from the service. The court may also order the servicemember to make installment payments during any stay ordered.

#### *Additional Protections*

Several additional rights are available under the SCRA. For example, when an action for compliance with a contract is stayed under the SCRA, contractual penalties do not accrue during the period of the stay. 50 U.S.C. app. § 523. The SCRA also provides in most instances that a landlord cannot evict a servicemember or dependants from a primary residence without a court order. In

an eviction proceeding, the court may also adjust the lease obligations to protect the interests of the parties. 50 U.S.C. app. § 531. If the court stay the eviction proceeding, it may provide equitable relief to the landlord by ordering garnishment of a portion of the servicemember's pay. *Id.* Under the SCRA a servicemember may terminate residential and automotive leases if he or she is transferred after the lease is made. 50 U.S.C. app. § 535. A court may also extend some of the protections afforded a servicemember under the SCRA to persons co-liable or secondarily liable on the servicemember's obligation. 50 U.S.C. app. § 513.

#### **APPLICABILITY TO BANKRUPTCY PROCEEDINGS**

The language of the SCRA states that it is generally applicable in any action or proceeding commenced in any court. 50 U.S.C. app. §§ 521, 522 and 524. Therefore, absent contravening language with respect to bankruptcy proceedings, the SCRA applies to all actions or proceedings before a bankruptcy court.

The applicability of the SCRA in bankruptcy proceedings is also evident in the Federal Rules of Civil Procedure and the Federal Rules of Bankruptcy Procedure. For example, the advisory committee note to Federal Rule for default judgments, Fed. R. Civ. P. 55(b), states that it is directly affected by the SCRA.<sup>2</sup> Under Fed. R. Bankr. P. 7055 and 9014 of the Federal Rules of Bankruptcy Procedure, Fed. R. Civ. P. 55 is applicable in bankruptcy adversary proceedings and contested matters. Thus, the default judgment protections of the SCRA clearly apply in bankruptcy cases.

The bankruptcy court clerk's office is aware of the requirement that the plaintiff must provide

an affidavit stating whether the defendant is in the military before default may be entered against the defendant. Bankruptcy Procedural Forms B260, B261A, and B261B, and their accompanying instructions, provide additional guidance concerning the applicability of the SCRA to default judgments and related procedural requirements.

#### **NOTES**

1. The requirement for an affidavit may be satisfied by a statement, declaration, verification, or certificate in writing subscribed and certified or declared to be true under penalty of perjury. 50 U.S.C. app. § 521(4).

2. The advisory committee note to Fed. R. Civ. P. 55 comments on the applicability of the Servicemembers' Civil Relief Act (formally known as the Soldiers' and Sailors' Civil Relief Act of 1940) to default judgements as follows:

The operation of Rule 55(b) (Judgment) is directly affected by the Soldiers' and Sailors' Civil Relief Act of 1940, 50 U.S.C. Appendix, § 501 et seq. Section 200 of the Act [50 U.S.C. Appendix, § 520] imposes specific requirements which must be fulfilled before a default judgment can be entered, e.g., *Ledwith v. Storkan*, D.Neb.1942, 6 Fed. Rules Serv. 60b.24, Case 2, 2 F.R.D. 539, and also provides for the vacation of a judgment in certain circumstances. See discussion in Commentary, Effect of Conscription Legislation on the Federal Rules, 1940, 3 Fed. Rules Serv. 725; 3 *Moore's Federal Practice*, 1938, Cum. Supplement § 55.02.

# Securities Investor Protection Act

## OVERVIEW

Typically, when a brokerage firm fails, the Securities Investor Protection Corporation (“SIPC”) arranges the transfer of the failed brokerage’s accounts to a different securities brokerage firm. If the SIPC is unable to arrange the accounts’ transfer, the failed firm is liquidated. In that case, the SIPC sends investors either certificates for the stock that was lost or a check for the market value of the shares.

Although the Bankruptcy Code provides for a stockbroker liquidation proceeding, 11 U.S.C. § 741 *et seq.*, it is far more likely that a failing brokerage will find itself involved in a proceeding under the Securities Investor Protection Act of 1970 (“SIPA”) (15 U.S.C. §§ 78aaa *et seq.*), rather than a Bankruptcy Code liquidation case. Brokerage firms may be liquidated under the Bankruptcy Code, however, if the SIPC does not file an application for a protective decree with the district court or if the district court finds that customers of the brokerage firm are not in need of protection under the SIPA. 15 U.S.C. §§ 78eee.

## HISTORY

Before 1938, little protection existed for customers of a bankrupt stockbroker unless they could trace cash and securities held by failed stockbrokers. In 1938 Congress enacted section 60(e) of the Bankruptcy Act creating a single and separate fund concept to minimize losses to customers by giving them priority over claims of general creditors. *1898 Bankruptcy Act § 60(e)(2) (repealed)*. Because the fund was

normally inadequate, however, customer losses continued.

Following a period of great expansion in the securities industry during the 1960's, a serious business contraction hit the industry in 1969-1970. This situation led to voluntary liquidations, mergers, receiverships, and bankruptcies of a substantial number of brokerage houses. *Annotation, Validity, Construction, and Application of Securities Investor Protection Act of 1970*, 23 A.L.R. Fed. 157, 179 (1975). The cash and securities customers that had deposited with these failed firms were dissipated or tied up in lengthy bankruptcy proceedings. In addition to mounting customer losses and the subsequent erosion of investor confidence, the Congress was concerned with a possible “domino effect” involving otherwise solvent brokers that had substantial open transactions with firms that failed.

Congress enacted the SIPA in reaction to this growing concern. The goal was to prevent the failure of more brokerage houses, restore investor confidence in the capital markets, and upgrade the financial responsibility requirements for registered brokers and dealers. *Securities Investor Protection Corp. v. Barbour*, 421 U.S. 412, 414 (1975). Congress designed the SIPA to apportion responsibility for carrying out the various goals of the legislation to several groups. Among them are the Securities and Exchange Commission (hereinafter referred to as SEC), various securities industry self-regulatory organizations, and the SIPC. The SIPA was designed to create a new form of liquidation proceeding. It is applicable only to member firms and was designed to accomplish the completion of open

transactions and the speedy return of most customer property. *Id.*

## **SIPA**

The SIPA is codified in Title 15 of the United States Code at Sections 78aaa - 111. The SIPA created the SIPC, a nonprofit, private membership corporation to which most registered brokers and dealers are required to belong. 15 U.S.C. § 78ccc. The SIPC fund, which constitutes an insurance program, is authorized under 15 U.S.C. § 78ddd(a), and assessments against members are authorized by 15 U.S.C. §§ 78ddd(c) and (d). The fund is designed to protect the customers of brokers or dealers subject to the SIPA from loss in case of financial failure of the member. The fund is supported by assessments upon its members. If the fund should become inadequate, the SIPA authorizes borrowing against the U.S. Treasury. An analogy could be made to the role of the Federal Deposit Insurance Corporation in the banking industry.

## **BANKRUPTCY LIQUIDATION VERSUS THE SIPA LIQUIDATION IN BANKRUPTCY COURT**

The essential difference between a liquidation under the Bankruptcy Code and one under the SIPA is that under the Bankruptcy Code the trustee is charged with converting securities to cash as quickly as possible and, with the exception of the delivery of customer name securities, making cash distributions to customers of the debtor in satisfaction of their claims. A SIPC trustee, on the other hand, is required to distribute securities to customers to the greatest extent practicable in satisfaction of their claims against the debtor.

There is a fundamental difference in orientation between the two proceedings. There is a statutory grant of authority to a SIPC trustee to purchase securities to satisfy customer net equity claims to specified securities. 15 U.S.C. § 78fff-2(d). The trustee is required to return customer name securities to customers of the debtor (15 U.S.C. § 78fff-2(c)(2)), distribute the fund of “customer property” ratably to customers (15 U.S.C. § 78fff-2(b)), and pay, with money from the SIPC fund, remaining customer net equity claims, to the extent provided by the Act (15 U.S.C. §§ 78fff-2(b) and 3(a)). A trustee operating under the Bankruptcy Code lacks similar resources. The Code seeks to protect the filing date value of a customer’s securities account by liquidating all non-customer name securities. SIPA seeks to preserve an investor’s portfolio as it stood on the filing date. Under SIPA, the customer will receive securities whenever possible.

## **ROLE OF THE DISTRICT COURT**

15 U.S.C. § 78eee(a)(3)(A) provides that the SIPC may file an application for a protective decree with the U.S. district court if the SIPC determines that any member has failed or is in danger of failing to meet obligations to customers and meets one of the four conditions specified in 15 U.S.C. § 78eee(b)(1). This application is filed as a civil case in which the SIPC or the SEC or both are named as plaintiff, and the member securities firm is named as the debtor-defendant. In the event that the SIPC refuses to act under the SIPA, the SEC may apply to the U.S. District Court for the District of Columbia to require the SIPC to discharge its obligations under the SIPA. 15 U.S.C. § 78ggg(b). By contrast, customers of failing broker-dealers do not have an implied right

of action under the SIPA to compel the SIPC to exercise its statutory authority for their benefit. *Barbour*, 421 U.S. at 425. Upon the filing of an application, the district court has exclusive jurisdiction of the debtor-defendant and its property.

The institution of a case under the SIPA brings a pending bankruptcy liquidation to a halt. Irrespective of the automatic stay, the SIPC may file an application for a protective decree under SIPA. 11 U.S.C. § 742; 15 U.S.C. § 78aaa *et seq.* The filing stays all proceedings in the bankruptcy case until the SIPC action is completed. *Id.* Pending issuance of a protective decree, the district court:

[i.] *shall* stay any pending *bankruptcy*, mortgage foreclosure, equity receivership, or other proceeding to reorganize, conserve, or liquidate the debtor or its property and any other suit against any receiver, conservator, or trustee of the debtor or its property, and shall continue such stay upon appointment of a trustee ...

[ii.] *may* stay any proceeding to enforce a lien against property of the debtor or any other suit against the debtor, including a suit by stockholders of the debtor which interferes with prosecution by the trustee of claims against former directors, officers, or employees of the debtor, and may continue such stay upon appointment of a trustee ...

[iii.] *may* stay enforcement of, and upon appointment of a trustee ... [if a protective decree is issued] ... may continue the stay for such period of time as may be appropriate, but shall not abrogate any right of setoff, except to the

extent such right may be affected under section 553 of Title 11, ... and shall not abrogate the right to enforce a valid, nonpreferential lien or pledge against the property of the debtor; and

[iv.] *may* appoint a temporary receiver.

15 U.S.C. § 78eee(b)(2)(B)(I - iv) (emphasis added).

In addition, upon the filing of a SIPC application, 11 U.S.C. § 362 comes into effect.

The SIPA provides that the district court will issue a protective decree if the debtor consents, the debtor fails to contest the application for a protective decree, or the district court finds that one of the conditions specified in 15 U.S.C. § 78eee(b)(1) exist. If the court issues a protective decree, then the court will appoint a trustee and an attorney for the trustee whom the SIPC, in its sole discretion, specifies. 15 U.S.C. § 78eee(b)(3). Upon the issuance of a protective decree and appointment of a trustee, or a trustee and counsel, the district court will order the removal of the entire liquidation proceeding to the bankruptcy court in the same judicial district. 15 U.S.C. § 78eee(b)(4).

## **REMOVAL TO BANKRUPTCY COURT**

The case is removed to the bankruptcy court as an adversary proceeding for liquidation. No filing or removal fee is charged. The reason for using an adversary proceeding number is historical. Although the SIPA

proceedings are not bankruptcy cases, by law certain procedures prescribed in chapters 1, 3, and 5, and subchapters I and II of chapter 7 of Title 11 of the U.S. Code are applicable in SIPA proceedings. In addition, there is no related bankruptcy case number. Statistical reports to the Administrative Office should repeat the adversary number so that the Statistics Division will know it is a SIPA matter. Forms B111A (Adversary Proceeding Opening Report) and B111B (Adversary Proceeding Closing Report) should be used since this is an adversary proceeding. For adversary proceedings within the adversary SIPA proceeding, the clerk's office should use the original adversary proceeding number for the related case number.

The SIPA requires that the bankruptcy court hold a hearing with 10 days notice to customers, creditors, and stockholders on the disinterestedness of the trustee or attorney for the trustee. 15 U.S.C. § 78eee(b)(6)(B). At the hearing, the court will entertain grounds for objection to the retention of the trustee or attorney for the trustee including, among other things, insider considerations. 15 U.S.C. § 78eee(b)(6)(A). If SIPC appoints itself as trustee, it should be deemed disinterested, and where a SIPC employee has been specified, the employee can not be disqualified solely because of his employment. *Id.* Neither the Bankruptcy Code, Bankruptcy Rules, nor SIPA provide for U.S. trustee or bankruptcy administrator involvement.

The SIPA provides for noticing of both customers and creditors. The noticing requirements provided for in 15 U.S.C. § 78fff-2(a)(1) are performed by the trustee, not the clerk of the bankruptcy court. While the SIPA does not require a formal proof of claim for customers (other than certain insiders and their relatives), it does require a written statement of

claim. The trustee will normally provide customers with claim forms and instructions. The claim form must be filed with the trustee rather than the clerk of the bankruptcy court. 15 U.S.C. § 78fff-2(a)(2). With limited, specified exceptions, no claim of a customer or other creditor can be allowed unless it is received by the trustee within six months after the initial publication of notice. 15 U.S.C. § 78fff-2(a)(3).

## **LIQUIDATION PROCEEDINGS**

The purposes of a SIPA liquidation are: (1) to deliver customer name securities to or on behalf of customers; (2) to distribute customer property and otherwise satisfy net equity claims of customers; (3) to sell or transfer offices and other productive units of the debtor's business; (4) to enforce the rights of subrogation; and (5) to liquidate the business as promptly as possible. 15 U.S.C. § 78fff(a). To the extent possible, consistent with SIPA, the liquidation is conducted in accordance with chapters 1, 3, 5 and subchapters I and II of chapter 7 of Title 11. 15 U.S.C. § 78fff(b). A section 341 meeting of creditors is conducted by the trustee. Noncustomer claims are handled as in an asset case. Costs and expenses, and priorities of distribution from the estate, are allowed as provided in section 726 of Title 11. Funds advanced by SIPC to the trustee for costs and expenses are recouped from the estate, to the extent there is any estate. 11 U.S.C. § 507.

## **POWERS OF THE TRUSTEE**

The powers of the trustee in a SIPC case are essentially the same as those vested in a chapter 7 trustee appointed under Title 11.

“In addition, a trustee may, with the approval of SIPC but without any need for court approval:

- (1) hire and fix the compensation of all personnel (including officers and employees of the debtor and of its examining authority) and other persons (including accountants) that are deemed by the trustee necessary for all or any purposes of the liquidation proceeding;
- (2) utilize SIPC employees for all or any purposes of a liquidation proceeding; and
- (3) margin and maintain customer accounts of the debtor . . .”

15 U.S.C. § 78fff-1(a).

A SIPC trustee may reduce to money customer securities constituting customer property or in the general estate of the debtor. 15 U.S.C. § 78fff-1(b). The trustee must, however, deliver securities to customers to the maximum extent practicable. 15 U.S.C. § 78fff-1(b)(1). Subject to prior approval of SIPC, but again without any need for court approval, the trustee may also pay or guarantee any part of the debtor’s indebtedness to a bank, person, or other lender when certain conditions exist. 15 U.S.C. § 78fff-1(b)(2).

The trustee is responsible for investigating the acts, conduct, and condition of the debtor and reporting thereon to the court. 15 U.S.C. § 78fff-1(d)(1). The trustee must also provide a statement on the investigation to SIPC and to other persons as the court might direct. 15 U.S.C. § 78fff-1(d)(4). Moreover, the trustee must make periodic reports to the court and to SIPC on the progress of distribution of cash and securities to customers. 15 U.S.C. § 78fff-1(c).

## CLAIMS

Upon receipt of a written statement of claim, the trustee promptly discharges obligations of the debtor relating to cash and securities by delivering securities or making payments to or on behalf of the customer insofar as such obligations are ascertainable from books and records of the debtor, or are otherwise established to the satisfaction of the trustee. The value of securities delivered in this regard are calculated as of the close of business on the filing date. 15 U.S.C. § 78fff-2(b).

The court must authorize the trustee to satisfy claims out of monies advanced by SIPC for this purpose, notwithstanding that the estate may not have sufficient funds for such payment. 15 U.S.C. § 78fff-2(b)(1). The court is generally not involved in the process except to the extent that a dispute arises between the trustee and customers regarding specific claims. Simple objections stay with the initial adversary proceeding. Occasionally, however, significant litigation arises in this area which generates related actions in the form of additional adversary proceedings.

## DISTRIBUTION

Customer related property of the debtor is allocated in the following order:

1. To SIPC in repayment of advances made to the extent they were used to recover securities apportioned to customer property;
2. To customers of the debtor on the basis of their net equities;

3. To SIPC as subrogee for the claims of customers; and
4. To SIPC in repayment of advances made by SIPC to transfer or sell customer accounts to another SIPC member firm.

15 U.S.C. § 78fff-2(c)(1).

The trustee must deliver customer name securities to the customer if the customer is not indebted to the debtor. If indebted, the customer may, with the approval of the trustee, reclaim securities in his or her name upon payment to the trustee of all such indebtedness. 15 U.S.C. § 78fff-2(c)(2).

The trustee may, with the approval of the SIPC, sell or otherwise transfer to another member of the SIPC, without consent of any customer, all or any part of the account of a customer. 15 U.S.C. § 78fff-2(f). The trustee may also enter into any agreement, and the SIPC will advance funds as necessary, to indemnify the member firm against shortages of cash or securities in customer accounts sold or transferred. 15 U.S.C. § 78fff-2(f)(2). In addition, the trustee may purchase securities in a fair and orderly market in order to deliver securities to customers in satisfaction of their claims. 15 U.S.C. § 78fff-2(d).

To the extent customer property and the SIPC advances are not sufficient to pay or satisfy in full the net equity claims of customers, then customers are entitled to participate in the estate as unsecured creditors. 15 U.S.C. § 78fff-2(c)(1).

### **ADVANCES**

The law requires that SIPC make advances to the trustee in order to satisfy claims and

otherwise liquidate the business. These advances are made to satisfy customer claims in cash, to purchase securities to satisfy net equity claims in lieu of cash, and to pay all necessary costs and expenses of administration and liquidation of the estate to the extent the estate of the debtor is insufficient to pay said costs and expenses. Any amount advanced in satisfaction of customer claims may not exceed \$500,000 per customer. 15 U.S.C. § 78fff-3(a). If part of the claim is for cash, the total amount advanced for cash payment must not exceed \$100,000. 15 U.S.C. § 78fff-3(a)(1). The difference between cash payments and the maximum amount allowed can be satisfied by the delivery of securities, or cash in lieu of securities.

### **DIRECT PAYMENT UNDER SIPA OUTSIDE THE BANKRUPTCY COURT**

In certain situations, the SIPC may elect to utilize a direct payment procedure to the customers of a debtor, thereby avoiding a trustee and the courts. Certain preconditions must exist. The claims of all customers must aggregate less than \$250,000, the debtor must be financially distressed as defined in the law, and the cost to the SIPC for direct payment process must be less than for liquidation through the courts. 15 U.S.C. § 78fff-4(a).

If direct payment is utilized, the entire proceeding remains outside the court. The process remains essentially a transaction between the SIPC and the debtor's customers.

Although the SIPA provides for a direct payment procedure in lieu of instituting a

liquidation proceeding, the bankruptcy court may still become involved in disputes regarding the direct payment procedure. A person aggrieved by a SIPC determination with respect to a claim in a direct payment procedure may, within six months following mailing of a SIPC determination, seek a final adjudication of such claim by the court. 15 U.S.C. § 78fff-4(e). The courts having jurisdiction over cases under Title 11 have original and exclusive jurisdiction of any civil action for the adjudication of such claims. The action is to be brought in the judicial district where the head office of the debtor is located. It would be brought as an adversary proceeding in the bankruptcy court even though there is no main case.

#### **ROLE OF SECURITIES AND EXCHANGE COMMISSION**

The SEC is responsible for regulating and supervising the activities of the SIPC. The SEC promulgates operating rules that establish the role of self-regulatory organizations and examining authorities, and their reporting responsibilities to the SIPC of inspections and reviews of its member firms. The SIPC's member firms are also required to provide information and documentation as necessary to assist in accomplishing these inspections. The penalties for fraud, deceit, or withholding of information throughout the processes covered by this law are severe. 15 U.S.C. § 78jjj(c).

#### **COMPENSATION IN A SIPA ACTION**

The SIPA specifies that the bankruptcy court must grant reasonable compensation for the services and expenses of the trustee and the attorney for the trustee. Interim allowances are also permitted. 15 U.S.C. § 78eee(b)(5)(A). Any person seeking allowances must file an application complying in form and content with

provisions in Title 11, and must also serve a copy on the debtor, SIPC, creditors and other persons the court may designate. The court is required to fix a time for a hearing on the application. Notice need not be given to customers whose claims have been or will be paid in full or creditors who cannot reasonably be expected to receive any distribution. 15 U.S.C. § 78eee(b)(5)(B).

The SIPC will review the application and file its recommendation with respect to such allowances prior to the hearing on the application. In any case where the allowances are to be paid by SIPC without reasonable expectation of recoupment and there is no difference between the amount applied for and the amount recommended by SIPC, the bankruptcy court must award that amount. 15 U.S.C. § 78eee(b)(5)(C). If there is a difference, the court must, among other considerations, place considerable reliance on the recommendation of SIPC. If the estate is insufficient to cover these awards as costs of administration, 15 U.S.C. § 78eee(b)(5)(E) provides that SIPC will advance the necessary funds to cover the costs.

## Bankruptcy Terminology

Most debtors who file a bankruptcy petition, and many of their creditors, know very little about the bankruptcy process. Bankruptcy Basics is designed to provide debtors, creditors, judiciary employees, and the general public with a basic explanation of bankruptcy and how it works. This glossary of bankruptcy terminology explains, in layman's terms, many of the legal terms that are used in cases filed under the Bankruptcy Code.

**adversary proceeding** A lawsuit arising in or related to a bankruptcy case that is commenced by filing a complaint with the court. A nonexclusive list of adversary proceedings is set forth in Fed. R. Bankr. P. 7001.

**assume** An agreement to continue performing duties under a contract or lease.

**automatic stay** An injunction that automatically stops lawsuits, foreclosures, garnishments, and all collection activity against the debtor the moment a bankruptcy petition is filed.

**bankruptcy** A legal procedure for dealing with debt problems of individuals and businesses; specifically, a case filed under one of the chapters of title 11 of the United States Code (the Bankruptcy Code).

**bankruptcy administrator** An officer of the judiciary serving in the judicial districts of Alabama and North Carolina who, like the U.S. trustee, is responsible for supervising the administration of bankruptcy cases, estates, and trustees; monitoring plans and disclosure statements; monitoring creditors' committees; monitoring fee applications; and performing other statutory duties. *Compare* **U.S. trustee**.

**Bankruptcy Code** The informal name for title 11 of the United States Code (11 U.S.C. §§ 101-1330), the federal bankruptcy law.

**bankruptcy court** The bankruptcy judges in regular active service in each federal judicial district; a unit of the district court.

**bankruptcy estate** All legal or equitable interests of the debtor in property at the time of the bankruptcy filing. (The estate includes all property in which the debtor has an interest, even if it is owned or held by another person.)

**bankruptcy judge** A judicial officer of the United States district court who is the court official with decision-making power over federal bankruptcy cases.

**bankruptcy petition** The document filed by the debtor (in a voluntary case) or by creditors (in an involuntary case) by which opens the bankruptcy case. (There are official forms for bankruptcy petitions.)

**chapter 7** The chapter of the Bankruptcy Code providing for "liquidation" (*i.e.*, the sale of a debtor's nonexempt property and the distribution of the proceeds to creditors).

**chapter 9** The chapter of the Bankruptcy Code providing for reorganization of municipalities (which includes cities and towns, as well as villages, counties, taxing districts, municipal utilities, and school districts).

**chapter 11** The chapter of the Bankruptcy Code providing (generally) for reorganization, usually involving a corporation or partnership. (A chapter 11 debtor usually proposes a plan of

reorganization to keep its business alive and pay creditors over time. People in business or individuals can also seek relief in chapter 11.)

**chapter 12** The chapter of the Bankruptcy Code providing for adjustment of debts of a “family farmer,” or a “family fisherman” as those terms are defined in the Bankruptcy Code.

**chapter 13** The chapter of the Bankruptcy Code providing for adjustment of debts of an individual with regular income. (Chapter 13 allows a debtor to keep property and pay debts over time, usually three to five years.)

**chapter 15** The chapter of the Bankruptcy Code dealing with cases of cross-border insolvency.

**claim** A creditor’s assertion of a right to payment from the debtor or the debtor’s property.

**confirmation** Bankruptcy judges’s approval of a plan of reorganization or liquidation in chapter 11, or payment plan in chapter 12 or 13.

**consumer debtor** A debtor whose debts are primarily consumer debts.

**consumer debts** Debts incurred for personal, as opposed to business, needs.

**contested matter** Those matters, other than objections to claims, that are disputed but are not within the definition of adversary proceeding contained in Rule 7001.

**contingent claim** A claim that may be owed by the debtor under certain circumstances, *e.g.*, where the debtor is a cosigner on another person’s loan and that person fails to pay.

**creditor** One to whom the debtor owes money or who claims to be owed money by the debtor.

**credit counseling** Generally refers to two events in individual bankruptcy cases: (1) the “individual or group briefing” from a nonprofit budget and credit counseling agency that individual debtors must attend prior to filing under any chapter of the Bankruptcy Code; and (2) the “instructional course in personal financial management” in chapters 7 and 13 that an individual debtor must complete before a discharge is entered. There are exceptions to both requirements for certain categories of debtors, exigent circumstances, or if the U.S. trustee or bankruptcy administrator have determined that there are insufficient approved credit counseling agencies available to provide the necessary counseling.

**creditors’ meeting** *see* **341 meeting**

**current monthly income** The average monthly income received by the debtor over the six calendar months before commencement of the bankruptcy case, including regular contributions to household expenses from nondebtors and income from the debtor’s spouse if the petition is a joint petition, but not including social security income and certain other payments made because the debtor is the victim of certain crimes. 11 U.S.C. § 101(10A).

**debtor** A person who has filed a petition for relief under the Bankruptcy Code.

**debtor education** *see* **credit counseling**

**defendant** An individual (or business) against whom a lawsuit is filed.

**discharge** A release of a debtor from personal liability for certain dischargeable debts set forth in the Bankruptcy Code. (A discharge releases a debtor from personal liability for certain debts known as dischargeable debts and prevents the creditors owed those debts from taking any action against the debtor to collect the debts. The discharge also prohibits creditors from communicating with the debtor regarding the debt, including telephone calls, letters, and personal contact.)

**dischargeable debt** A debt for which the Bankruptcy Code allows the debtor's personal liability to be eliminated.

**disclosure statement** A written document prepared by a chapter 11 debtor or other plan proponent designed to provide "adequate information" to creditors to enable them to evaluate the chapter 11 plan of reorganization.

**equity** The value of a debtor's interest in property that remains after liens and other creditors' interests are considered. (Example: If a house valued at \$100,000 is subject to a \$80,000 mortgage, there is \$20,000 of equity.)

**executory contract or lease** Generally includes contracts or leases under which both parties to the agreement have duties remaining to be performed. (If a contract or lease is executory, a debtor may assume it or reject it.)

**exemptions, exempt property** Certain property owned by an individual debtor that the Bankruptcy Code or applicable state law permits the debtor to keep from unsecured creditors. For example, in some states the debtor may be able to exempt all or a portion of the equity in the debtor's primary residence (homestead exemption), or some or all "tools of the trade" used by the debtor to make a living (*i.e.*, auto

tools for an auto mechanic or dental tools for a dentist). The availability and amount of property the debtor may exempt depends on the state the debtor lives in.

**family farmer or family fisherman** An individual, individual and spouse, corporation, or partnership engaged in a farming or fishing operation that meets certain debt limits and other statutory criteria for filing a petition under chapter 12.

**fraudulent transfer** A transfer of a debtor's property made with intent to defraud or for which the debtor receives less than the transferred property's value.

**fresh start** The characterization of a debtor's status after bankruptcy, *i.e.*, free of most debts. (Giving debtors a fresh start is one purpose of the Bankruptcy Code.)

**insider (of an individual debtor)** Any relative of the debtor or of a general partner of the debtor; partnership in which the debtor is a general partner; general partner of the debtor; or a corporation of which the debtor is a director, officer, or person in control.

**insider (of a corporate debtor)** A director, officer, or person in control of the debtor; a partnership in which the debtor is a general partner; a general partner of the debtor; or a relative of a general partner, director, officer, or person in control of the debtor.

**joint administration** A court-approved mechanism under which two or more cases can be administered together. (Assuming no conflicts of interest, these separate businesses or individuals can pool their resources, hire the same professionals, etc.)

**joint petition** One bankruptcy petition filed by a husband and wife together.

**lien** The right to take and hold or sell the property of a debtor as security or payment for a debt or duty.

**liquidation** A sale of a debtor's property with the proceeds to be used for the benefit of creditors.

**liquidated claim** A creditor's claim for a fixed amount of money.

**means test** Section 707(b)(2) of the Bankruptcy Code applies a "means test" to determine whether an individual debtor's chapter 7 filing is presumed to be an abuse of the Bankruptcy Code requiring dismissal or conversion of the case (generally to chapter 13). Abuse is presumed if the debtor's aggregate current monthly income (see definition above) over 5 years, net of certain statutorily allowed expenses is more than (i) \$10,950, or (ii) 25% of the debtor's nonpriority unsecured debt, as long as that amount is at least \$6,575. The debtor may rebut a presumption of abuse only by a showing of special circumstances that justify additional expenses or adjustments of current monthly income.

**motion to lift the automatic stay** A request by a creditor to allow the creditor to take action against the debtor or the debtor's property that would otherwise be prohibited by the automatic stay.

**no-asset case** A chapter 7 case where there are no assets available to satisfy any portion of the creditors' unsecured claims.

**nondischargeable debt** A debt that cannot be eliminated in bankruptcy. Examples include a

home mortgage, debts for alimony or child support, certain taxes, debts for most government funded or guaranteed educational loans or benefit overpayments, debts arising from death or personal injury caused by driving while intoxicated or under the influence of drugs, and debts for restitution or a criminal fine included in a sentence on the debtor's conviction of a crime. Some debts, such as debts for money or property obtained by false pretenses and debts for fraud or defalcation while acting in a fiduciary capacity may be declared nondischargeable only if a creditor timely files and prevails in a nondischargeability action.

**objection to dischargeability** A trustee's or creditor's objection to the debtor being released from personal liability for certain dischargeable debts. Common reasons include allegations that the debt to be discharged was incurred by false pretenses or that debt arose because of the debtor's fraud while acting as a fiduciary.

**objection to exemptions** A trustee's or creditor's objection to the debtor's attempt to claim certain property as exempt from liquidation by the trustee to creditors.

**party in interest** A party who has standing to be heard by the court in a matter to be decided in the bankruptcy case. The debtor, the U.S. trustee or bankruptcy administrator, the case trustee and creditors are parties in interest for most matters.

**petition preparer** A business not authorized to practice law that prepares bankruptcy petitions.

**plan** A debtor's detailed description of how the debtor proposes to pay creditors' claims over a fixed period of time.

**plaintiff** A person or business that files a formal complaint with the court.

**postpetition transfer** A transfer of the debtor's property made after the commencement of the case.

**prebankruptcy planning** The arrangement (or rearrangement) of a debtor's property to allow the debtor to take maximum advantage of exemptions. (Prebankruptcy planning typically includes converting nonexempt assets into exempt assets.)

**preference or preferential debt payment** A debt payment made to a creditor in the 90-day period before a debtor files bankruptcy (or within one year if the creditor was an insider) that gives the creditor more than the creditor would receive in the debtor's chapter 7 case.

**presumption of abuse** *see means test*

**priority** The Bankruptcy Code's statutory ranking of unsecured claims that determines the order in which unsecured claims will be paid if there is not enough money to pay all unsecured claims in full. For example, under the Bankruptcy Code's priority scheme, money owed to the case trustee or for prepetition alimony and/or child support must be paid in full before any general unsecured debt (*i.e.* trade debt or credit card debt) is paid.

**priority claim** An unsecured claim that is entitled to be paid ahead of other unsecured claims that are not entitled to priority status. Priority refers to the order in which these unsecured claims are to be paid.

**proof of claim** A written statement and verifying documentation filed by a creditor that describes the reason the debtor owes the creditor money. (There is an official form for this purpose.)

**property of the estate** All legal or equitable interests of the debtor in property as of the commencement of the case.

**reaffirmation agreement** An agreement by a chapter 7 debtor to continue paying a dischargeable debt (such as an auto loan) after the bankruptcy, usually for the purpose of keeping collateral (*i.e.* the car) that would otherwise be subject to repossession.

**secured creditor** A creditor holding a claim against the debtor who has the right to take and hold or sell certain property of the debtor in satisfaction of some or all of the claim.

**secured debt** Debt backed by a mortgage, pledge of collateral, or other lien; debt for which the creditor has the right to pursue specific pledged property upon default. Examples include home mortgages, auto loans and tax liens.

**schedules** Detailed lists filed by the debtor along with (or shortly after filing) the petition showing the debtor's assets, liabilities, and other financial information. (There are official forms a debtor must use.)

**small business case** A special type of chapter 11 case in which there is no creditors' committee (or the creditors' committee is deemed inactive by the court) and in which the debtor is subject to more oversight by the U.S. trustee than other chapter 11 debtors. The Bankruptcy Code

contains certain provisions designed to reduce the time a small business debtor is in bankruptcy.

**statement of financial affairs** A series of questions the debtor must answer in writing concerning sources of income, transfers of property, lawsuits by creditors, etc. (There is an official form a debtor must use.)

**statement of intention** A declaration made by a chapter 7 debtor concerning plans for dealing with consumer debts that are secured by property of the estate.

**substantive consolidation** Putting the assets and liabilities of two or more related debtors into a single pool to pay creditors. (Courts are reluctant to allow substantive consolidation since the action must not only justify the benefit that one set of creditors receives, but also the harm that other creditors suffer as a result.)

**341 meeting** The meeting of creditors required by section 341 of the Bankruptcy Code at which the debtor is questioned under oath by creditors, a trustee, examiner, or the U.S. trustee about his/her financial affairs. Also called **creditors' meeting**

**transfer** Any mode or means by which a debtor disposes of or parts with the debtor's property.

**trustee** The representative of the bankruptcy estate who exercises statutory powers, principally for the benefit of the unsecured creditors, under the general supervision of the court and the direct supervision of the U.S. trustee or bankruptcy administrator. The trustee is a private individual or corporation appointed in all chapter 7, chapter 12, and chapter 13 cases and some chapter 11 cases. The trustee's responsibilities include reviewing the debtor's

petition and schedules and bringing actions against creditors or the debtor to recover property of the bankruptcy estate. In chapter 7, the trustee liquidates property of the estate, and makes distributions to creditors. Trustees in chapter 12 and 13 have similar duties to a chapter 7 trustee and the additional responsibilities of overseeing the debtor's plan, receiving payments from debtors, and disbursing plan payments to creditors.

**U.S. trustee** An officer of the Justice Department responsible for supervising the administration of bankruptcy cases, estates, and trustees; monitoring plans and disclosure statements; monitoring creditors' committees; monitoring fee applications; and performing other statutory duties. *Compare, bankruptcy administrator.*

**undersecured claim** A debt secured by property that is worth less than the full amount of the debt.

**unliquidated claim** A claim for which a specific value has not been determined.

**unscheduled debt** A debt that should have been listed by the debtor in the schedules filed with the court but was not. (Depending on the circumstances, an unscheduled debt may or may not be discharged.)

**unsecured claim** A claim or debt for which a creditor holds no special assurance of payment, such as a mortgage or lien; a debt for which credit was extended based solely upon the creditor's assessment of the debtor's future ability to pay.

**voluntary transfer** A transfer of a debtor's property with the debtor's consent.

