practice tips

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How the Three Basic Types of Bankruptcy Are Adjudicated

SOONER OR LATER EVERY LAWYER will encounter bankruptcy issues that could impact a client's interests. It is therefore important for the nonbankruptcy practitioner to understand how bankruptcy law works and ways to protect clients from the effects of their own or a third party's insolvency.

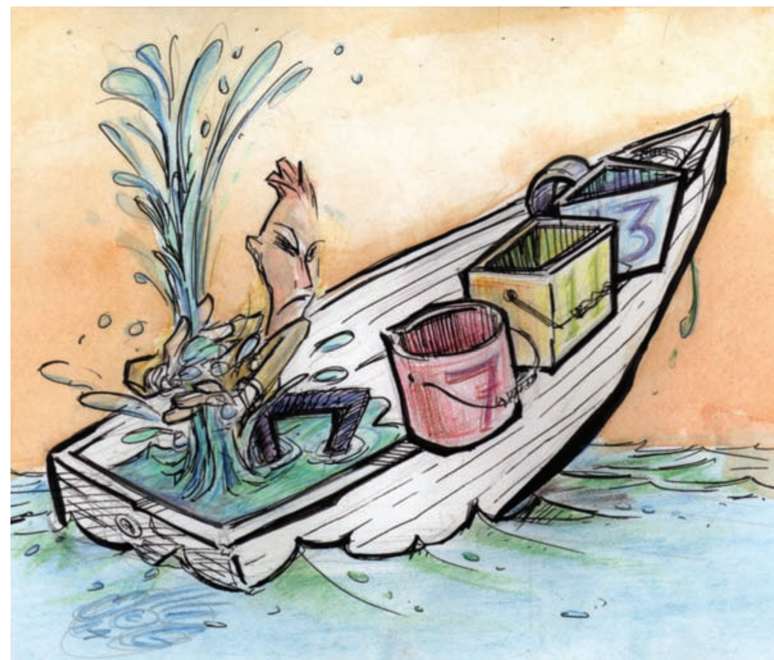
To understand the powers and limits of bankruptcy law, one must understand the impetus for this national set of laws. According to the U.S. Constitution, "Congress shall have Power…To establish…uniform Laws on the subject of Bankruptcies throughout the United States."[1] The first enduring set of federal bankruptcy laws was not enacted until 1898. Prior to that, insolvency issues were resolved by state courts applying state laws, with a few short-lived experiments with federal bankruptcy laws. Since 1898, federal bankruptcy law has gone through a number of revisions, most notably in 1978, when Congress replaced the Bankruptcy Act of 1898 with the current Bankruptcy Code, with subsequent revisions reflecting shifting political winds. Most recently, Congress codified the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA).

Contrary to the apparent vision of the framers of the U.S. Constitution, many aspects of the Bankruptcy Code are governed by the laws of the states in which the respective debtors live, resulting in a less-than-uniform application of this federal law. For example, the laws of each state generally govern the exemptions utilized by debtors, property rights, certain statutes of limitation, and even much of the substantive laws applied by bankruptcy judges. Thus, though the Bankruptcy Code applies in all states, bankruptcy practice differs in certain respects from state to state. Moreover, as federal bankruptcy laws represent limited federal jurisdiction over a discrete area of law, their breadth and application have been the subject of controversy for decades. Consequently, a practitioner must understand that the Bankruptcy Code creates limited jurisdiction in the bankruptcy courts, with the exact demarcation lines sometimes open to interpretation and, perhaps, challenge.

The Bankruptcy Code is divided into various chapters, each designed to address a different set of policy goals or debtors.[2] To understand the advantages and limitations of filing for or pursuing a debtor in bankruptcy, a nonbankruptcy practitioner is well advised to examine the basic concepts underlying chapters 7, 11, and 13, which most individuals or business entities are likely to encounter. Each of these chapters has unique characteristics distinguishing it from the others.

Chapter 7: Liquidation

A chapter 7 liquidation is what most people imagine when they think of bankruptcy.[3] It is available to individuals and most business entities.[4] Filing a petition under chapter 7 (as with chapters 11 and 13) commences a bankruptcy case and creates a bankruptcy estate that is subject to administration under the supervision of the bankruptcy court. The chapter 7 estate comprises essentially all property owned by the debtor when the bankruptcy petition is filed.[5] Assets in which the estate has meaningful equity are sold, and the proceeds are dis-



tributed proportionately to the debtor's creditors.[6] However, certain types of property are exempt from the bankruptcy estate and therefore remain the debtor's property despite the bankruptcy.[7] Subject to certain exceptions,[8] an individual chapter 7 debtor who complies with the requirements of the Code, particularly by acting in good faith and being honest and forthcoming,[9] is entitled to a discharge of debts.[10] The appeal is obvious to debtors and to a U.S. economy that relies heavily on risk-taking entrepreneurs.

Prior to 2005, chapter 7 was available to individual debtors of all incomes. However, that year Congress enacted BAPCPA, which imposes an income means test that limits the eligibility of individuals with primarily consumer debts to file under chapter 7. A chapter 7 filing by an individual who earns above the median income in his or her respective home state is deemed an abuse of the bankruptcy law unless the income is lower than a specified portion of the debtor's debts. Individuals with incomes below the median for their state are exempt from the means test.[11]

Immediately upon the filing of a chapter 7 case, a trustee is appointed by the Office of the United States Trustee (UST).[12] The chapter 7 trustee is the sole representative of the estate.[13] The chapter 7 trustee's primary duty is to "collect and reduce to money the property of the estate," to distribute funds to unsecure creditors, and then close the estate "expeditiously."[14] The trustee's other duties include

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investigation of the debtor's financial affairs, accountability for the estate's property, and ensuring that the debtor complies with his or her duties.[15] Though generally not authorized to operate the debtor's business, the chapter 7 trustee may obtain such authority for limited periods when to do so is in the best interest of the estate and "consistent with the orderly liquidation of the estate."[16]

Thus, a major feature that distinguishes a chapter 7 case from chapters 11 or 13 is the debtor's loss of control over assets after filing the petition. While this can be detrimental to a debtor who, for example, loses the ability to control ongoing litigation or claims, it can be a boon to a litigation opponent who can now negotiate with a disinterested trustee who is not emotionally invested in the legal dispute. This lack of control is often a reason for the debtor to file under chapter 11 or 13, either of which permits debtors generally to remain in control of their own assets after they file for bankruptcy.

Shortly after a petition is filed, the chapter 7 debtor is required to attend a meeting of creditors, in which the chapter 7 trustee and any present creditors may examine the debtor under oath.[17] The examination is usually short, used to confirm that the debtor read and signed the petition and schedules and the debtor's identification and to ensure that information provided by the debtor is complete and accurate. However, creditors may also utilize this meeting to briefly question debtors about assets and, when conditions are met, to elect a different trustee than the person appointed by the UST.

If the estate has no assets to distribute to creditors, the chapter 7 trustee will file and serve on creditors a report stating that there are no assets (the No Asset Report) and that no distribution to creditors is expected. The case will generally be closed by the court clerk shortly after the filing of the No Asset Report. If there are assets or potential assets in the estate, including legal claims,[18] the trustee will administer the assets, whether by selling readily available property, filing lawsuits, or settling the estate's legal rights. Trustees generally retain legal counsel to perform the legal work required to marshal and sell estate property.[19]

In chapter 7 cases with assets or potential assets, creditors are given notice of a deadline by which they must file their claims, known as the Claims Bar Date.[20] Usually after completing the liquidation of assets, the trustee reviews the proofs of claim filed by debtors in order to determine if there are bases to object. The trustee generally seeks to determine whether a claim contains sufficient evidentiary support and whether the claim is entitled to the level of priority alleged by the claimant.[21] After payment of administration expenses, allowed claims are paid on a pro rata basis and in order of statutory priority, with no lower priority claim being paid prior to payment in full of all higher priority claims.[22]

Likely, the most important goal for an individual chapter 7 debtor is the discharge, which releases the debtor from liability from certain debts and operates as an injunction against collection or any other actions to recover money from the debtor on account of claims incurred prior to the petition filing.[23] At the expiration of 60 days after the first date set for the section 341(a) meeting of creditors, if no actions were filed to deprive the debtor of a discharge or to dismiss the case, and the deadlines to do so have not been extended, the bankruptcy court is required to grant a discharge forthwith.[24]

Chapter 13

Chapter 13 allows certain individuals with regular income to reorganize their debts without the need to surrender or liquidate their assets.[25] Rather, debtors are required to use future earnings to pay their debts over a period of three to five years, or less if creditors are paid in full.[26] Chapter 13 tends to be a fast-paced proceeding, requiring the submission of a payment plan within 14 days after the filing of the bankruptcy petition.[27] To qualify for chapter 13, an individual must have regular income,[28] less than $383,175 in unsecured debts, and less than $1,149,525 in secured debts.[29]

If the debtor's income is under the state median, his or her plan must provide for payments over a period of three years, unless cause is shown to extend the payment period (which cannot exceed five years).[30] Unlike a chapter 11 plan, chapter 13 does not allow creditors to vote on the plan. However, creditors may object and, if they do, the plan may not be confirmed unless creditors are paid in full over the term of the plan or all of the debtor's projected disposable income is committed to the payment of creditors under the plan.[31] The plan must provide for payment to creditors of at least what they would have received had the debtor filed for bankruptcy under chapter 7.[32] As in many other provisions of the Bankruptcy Code, good faith is a requirement to confirmation of a Chapter 13 plan.[33]

A debtor may at any time voluntarily convert a chapter 13 to chapter 7 or may request that the chapter 13 case be dismissed.[34] The UST, or a party in interest, may seek conversion to chapter 7 "for cause," including, among others, for unreasonable delay, failure to timely file a plan, a material default in the terms of a confirmed plan, and failure to pay domestic support obligations such as child or spousal support.[35] The debtor receives a discharge after completing all payments under the chapter 13 plan.[36]

Chapter 13 trustees have a different role from their chapter 7 counterparts. That is because chapter 13 creditors are typically paid from the debtor's postpetition income, rather than from the liquidation of assets, though chapter 13 plan payments may also come from liquidation of assets.[37] Unlike in a chapter 7 case, the chapter 13 trustee does not take possession of the debtor's assets unless the plan so provides.[38] Part of the chapter 13 trustee's role is to make sure that the debtor commences timely payments and to advise and assist the debtor in executing the plan.[39] The trustee collects the plan payments from the debtor and distributes funds to creditors according to the terms of the confirmed plan.[40]

Chapter 11

Chapter 11 cases may be filed by either business entities or individual debtors. Although a debtor may liquidate through chapter 11,[41] the central goal of chapter 11 is to reorganize the debtor's obligations through a payment plan that allows the debtor to continue its prebankruptcy business activities. Unlike chapters 7 and 13, in a chapter 11 case a trustee is not appointed automatically. Rather, the debtor becomes a debtor-in-possession and manages the bankruptcy estate for the benefit of creditors.[42] The court must appoint a chapter 11 trustee for cause upon a request from the UST or a party in interest,[43] or because appointment of a trustee would be in the best interest of creditors.[44] Appointment of a chapter 11 trustee is generally considered a major blow to a company's prospects as a going concern since the debtor's ability to stay in control of the bankruptcy estate is an important reason to choose this chapter over chapter 7. However, while chapter 11 allows the debtor more control and flexibility, these advantages come with a price. The costs of filing and administering a chapter 11 case are significantly higher than those under chapters 7 and 13.

The hallmark of a chapter 11 case is the plan of reorganization. Generally speaking, only the debtor may file a plan during the first 120 days of the chapter 11 case.[45] However, any party in interest may file a plan if the debtor has not done so within that period or has not obtained acceptance of the plan by all impaired classes of claims and interest holders within 180 days of filing.[46] The court may extend or reduce that exclusivity period for cause, but not beyond 18 months for the debtor to file a plan and 20 months for the debtor to gain its acceptance.[47]

A plan of reorganization must follow the requirements in Section 1123 of the code, including a designation of classes of claims (held by creditors) and interests (equity interests).[48] Among other requirements, the plan must specify whether any classes are impaired,[49] which means that the creditor will receive less than the amount of the claim or interest, and how claims or interests will be treated.[50] The plan must provide for identical treatment of all claims and interests within each class unless a claimant consents to different treatment.[51]

Voting on the Plan

Creditors and interest holders must be allowed to vote on a plan of reorganization before it is confirmed by the bankruptcy court. Before the vote, the debtor must file, obtain approval, and serve creditors and interest holders with a disclosure statement.[52] The statement must contain adequate information regarding the debtor's business and financial condition as to enable anyone voting on the plan to make an informed judgment about the plan.[53]

After creditors vote, the court determines whether to confirm the plan. To be confirmed, a plan must meet numerous requirements, including that it was proposed in good faith and not by any means forbidden by law.[54]

Once confirmed, the debtor emerges from bankruptcy with all its property, unless the plan provides otherwise. For example, the plan may provide for sales of certain assets.[55] The property of the reorganized debtor is owned by the debtor free and clear of debt or equity, unless the plan provides otherwise.[56] The confirmation of the plan generally serves to discharge the debtor (if an individual) of all claims, with certain exceptions.[57] An order confirming a chapter 11 plan may only be revoked on the basis of a fraud brought to the court's attention within 180 days of entry of the order.[58] The finality of the confirmation order provides the debtor with a fresh start. ■

[1] U.S. Const. art. I, §8, cl. 4.

[2] Chapters 1, 3 and 5 generally apply to all bankruptcy cases. Chapters 7, 9 (municipalities), 11, 12 (family farmers or fishermen), 13, and 15 (cross-border cases) refer to specific types of bankruptcy cases.

[3] 11 U.S.C. §§701-784. *See* http://www.uscourts.gov/uscourts/Statistics/BankruptcyStatistics/BankruptcyFilings/2013/0313_f2.pdf.

[4] *See* 11 U.S.C. §109(b) ("Persons" may be chapter 7 debtors if they are not railroads, insurance companies, banks, or other specified institutions.); 11 U.S.C. §101(41) (The term "person" under the Bankruptcy Code includes individuals, partnerships, and corporations but generally not governmental units.).

[5] *See* 11 U.S.C. §541(a) (defining "property of the estate").

[6] Assets with de minimis value (the threshold for which may vary by district), or which are subject to liens leaving little equity, will generally be abandoned back to the debtor or left for the secured creditor to foreclose upon.

[7] 11 U.S.C. §522. California has opted out of the Bankruptcy Code's exemptions, which means that California debtors must use California's exemption schemes. *See* 11 U.S.C. §522(b)(2); Code Civ. Proc. §703.130.

[8] *See* 11 U.S.C. §523(a).

[9] *See* 11 U.S.C. §727(a).
[10] 11 U.S.C. §524.
[11] *See* 11 U.S.C. §707(b)(2).
[12] 11 U.S.C. §701.
[13] *See, e.g.*, 11 U.S.C. §§323, 542(a), 704(a).
[14] 11 U.S.C. §704(a)(1).
[15] 11 U.S.C. §704(a).
[16] 11 U.S.C. §721.
[17] 11 U.S.C. §§341(a), 343.
[18] The estate's legal claims may include the right to avoid contract or tort claims the debtor may have possessed prior to the chapter 7 filing, as well as certain prepetition transfers. *See* 11 U.S.C. §§541, 544-550.
[19] The chapter 7 trustee and the trustee's retained professionals are paid from the estate's funds, subject to bankruptcy court approval, after proper notice and a hearing. 11 U.S.C. §330. The trustee and retained professionals must file fee applications that comply with the requirements of the code, the Federal Rules of Bankruptcy Procedure, local bankruptcy rules, and guidelines published by the UST. In many chapter 7 cases, the bankruptcy estates are administratively insolvent.
[20] *See* Fed. R. Bankr. P. 3002.
[21] Fed. R. Bankr. P. 3007.
[22] 11 U.S.C. §726.
[23] Only individual debtors are entitled to a discharge. 11 U.S.C. §727(a)(1).
[24] Fed. R. Bankr. P. 4004; 11 U.S.C. §727(a). Under certain circumstances, generally involving fraud or abuse of the bankruptcy process, a court may revoke a previously granted discharge. 11 U.S.C. §727(d).
[25] 11 U.S.C. §§1301-30.
[26] 11 U.S.C. §1325(b)(4).
[27] Fed. R. Bankr. P. 3015(b).
[28] *See* 11 U.S.C. §101(30) (The debtor must be an "individual whose income is sufficiently stable and regular to enable such individual to make payments under a plan under chapter 13.").
[29] 11 U.S.C. §§104,109(e).
[30] 11 U.S.C. §1322(d)(2).
[31] 11 U.S.C. §1325(b)(1).
[32] 11 U.S.C. §1325(a)(4).
[33] 11 U.S.C. §§1325(a)(3) and (7). The petition and plan must be filed and proposed in good faith. *See* Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934).
[34] 11 U.S.C. §§1307(a)-(b).
[35] 11 U.S.C. §§1307(c)(1)-(11).
[36] 11 U.S.C. §1328.
[37] 11 U.S.C. §1322(b)(8).
[38] 11 U.S.C. §1306(b).
[39] 11 U.S.C. §§1302(b)(4)-(5).
[40] 11 U.S.C. §1326.
[41] 11 U.S.C. §1129(a)(11).
[42] *See* 11 U.S.C. §1107.
[43] 11 U.S.C. §1104(a)(1) ("Cause" includes "fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management.").
[44] 11 U.S.C. §1104(a)(2).
[45] 11 U.S.C. §1121(b).
[46] 11 U.S.C. §1121(c).
[47] 11 U.S.C. §1121(d).
[48] 11 U.S.C. §1123(a)(1).
[49] 11 U.S.C. §§1123(a)(2)-(3).
[50] 11 U.S.C. §1123(a)(3).
[51] 11 U.S.C. §1123(a)(4). Besides the mandatory provisions, plans may also include any number and combinations of provisions, so long as they are legal and feasible. 11 U.S.C. §1123(b)(6).
[52] 11 U.S.C. §1125.
[53] 11 U.S.C. §1125(a)(1).
[54] 11 U.S.C. §1129(a).
[55] 11 U.S.C. §1141(b).
[56] 11 U.S.C. §1141(c).
[57] 11 U.S.C. §1141(d).
[58] 11 U.S.C. §1144.