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## INTELLECTUAL PROPERTY AND TRANSACTIONAL LAW CLINIC

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# WHAT IS BANKRUPTCY?

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## INTRODUCTORY OVERVIEW

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Bankruptcy is a process that protects debtors seeking relief from unmanageable financial responsibilities and assists creditors attempting to recover obligations from these debtors. Individuals and incorporated entities may invoke the federal bankruptcy protections (11 U.S.C. § 101-1532). A debtor must file a petition to begin a case with the federal bankruptcy courts, at which time he gains temporary protection from his creditors. Dependent upon the type of bankruptcy case, usually Chapter 7, 11, or 13, the bankruptcy court can assist the debtor in restructuring his debts into more manageable obligations, discharge the debtor from personal liability on some obligations, or even order the sale of assets to help creditors recover money owed to them. Debtors typically avail themselves of bankruptcy only when they find themselves in dire financial situations. Accordingly, bankruptcy is a serious situation that no individual should enter into lightly.

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## BANKRUPTCY BASICS

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Debtors often seek bankruptcy to create a “fresh start” from their current financial pressures. To benefit from the process, a debtor must first begin his bankruptcy case by filing a petition with his local federal bankruptcy court. After its commencement, the bankruptcy case immediately provides the debtor with the protections of the “automatic stay,” which prevents creditors from attempting to have the debtor pay on his debts until the case has concluded. This commencement also works to define the assets, obligations, and financial conditions that the bankruptcy case will address, otherwise known as the “property of the estate.” As debtor bankruptcy relief can only affect the obligations and holdings in this property of the estate, the case will not likely address any obligations incurred after the filing of the bankruptcy petition. However, the debtor cannot simply remove assets from his estate before petitioning for bankruptcy in hopes

of keeping property from creditors, as the court can rescind fraudulent transfers and return the property to the bankruptcy estate.

Debtors must provide notice to all creditors who might have a financial interest in the bankruptcy case. Notified creditors must in turn respond to the bankruptcy court by declaring the obligations due to them (a “proof of claim”). Creditors possess “claims,” which are essentially defined as the rights to payments. Claims can be “secured,” meaning the creditor has a right to payment that is supported by a property interest, such as a lien or mortgage. Bankruptcy cannot simply dismiss secured claims, as these property rights are protected by the Constitution and due process. Claims can also be “unsecured,” which means the debtor owes the creditor a financial obligation that is not supported by a security interest. The compensation an unsecured creditor receives through the bankruptcy process is typically proportionate to the debtor's obligations to all of the other creditors. But, these unsecured claims can be prioritized to allow certain obligations to have a greater ability to receive compensation than others. For example, domestic support payments have a high priority and will usually receive payment before other unsecured claims. Typically, unsecured creditors do not receive much compensation at the conclusion of a bankruptcy case, as then the debtor usually has no significant unencumbered assets.

Leases and certain contracts can be important parts of a bankruptcy case. Generally, if the debtor has a lease or a license, he can choose one of three options to determine how his obligations will continue in the bankruptcy case. First, the debtor can choose to “reject” (or breach), and as a result remove his future obligations. However, this also provides the other contracting party with an unsecured claim. The debtor can also choose to “assume” (or keep) the obligation, and therefore continue to be bound by the terms of the contract. The debtor then benefits by being able to maintain a valuable contract or lease, and the other contracting party can get prioritized claims for obligations that arise after the filing of the bankruptcy petition. Finally, the debtor can choose to “assign” (or sell) the lease or executory contract. In this event, the debtor adds to his bankruptcy estate the sale proceeds, and the purchaser benefits by receiving the existing conditions of the debtor's valuable lease or contract. Landlords and lessors do not usually appreciate assignment, as they are disallowed from renegotiating with new, potentially more profitable or stable lessees.

The debtor's objective in a bankruptcy case is the release from personal liability on claims. The case can provide a discharge for some claims, essentially removing the debtor's responsibility to pay back his debts and financial obligations. Third parties, such as guarantors, do not benefit from the bankruptcy process and are likely still liable for obligations to creditors even after the debtor receives a discharge. Creditors do not usually fare as well as debtors, as there is usually very little to share between all having claims against the debtor. Unsecured creditors typically only recover when the debtor liquidates his assets and has enough proceeds to divide amongst the unsecured creditors. However, secured creditors will likely recoup a large amount of their interest through post-bankruptcy actions, like foreclosure, or merely by reacquiring their property.

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## CHAPTER 11

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Chapter 11 bankruptcy attempts to help overburdened entities, usually businesses, reorganize and become more successful. As an entity continues to operate, it incurs debts to service providers, merchants, and financing organizations. Once-successful businesses can become less profitable when market conditions change. Improperly-managed businesses and those which can no longer

compete find themselves with unsustainable debts that continue to accumulate and make their ability to function less and less likely. Chapter 11 is a way for such concerns to pause their debt turmoil and restructure the business to give it a chance at future success.

In a Chapter 11 bankruptcy case, the debtor seeks to create a plan for reorganizing itself and repaying debts. The hope of this plan is to create a new, more streamlined business that can fulfill its obligations and operate more efficiently in the future. Creditors and the court must approve the debtor's Chapter 11 plan. Accordingly, businesses debtors usually confer with their primary creditors before filing to promote cooperation throughout the bankruptcy process. Despite receiving an automatic stay after filing the bankruptcy petition, Chapter 11 debtors must continue to operate their businesses. Accordingly, they must maintain their relationships and obligations so their business partners or vendors do not halt the provision of necessary goods and services to the debtor while it restructures. As soon as the bankruptcy petition is filed, debtor attorneys can file "first day orders" to request accommodations for such partners and other immediate financial concerns, such as employee paychecks. The court will usually allow these payments while the process continues.

Creditors form a very vocal and interactive force in a Chapter 11 case. Forming a "creditors committee," the debtor business' creditors have a say in the eventual plan, approving it only when it represents a feasible strategy for improving the business structure well enough to provide for repayment of the debts. In some cases, the debtor business does not have the capital to continue to operate even during the bankruptcy process. In these circumstances, if the business prospects are valuable, new lenders can emerge to give new loans to the business. These new creditors, sometimes referred to as debtor-in-possession ("DIP") financiers, generally take full control of the business and its restructuring as a condition of the provision of the new funds. Part of this new control regime is buying out many of the preexisting creditors, thus simplifying the debt obligations to the business coming out of the bankruptcy case.

If the Chapter 11 plan is approved and confirmed by the bankruptcy court, the debtor receives its discharge. Then, it must commence with the long process of conducting the confirmed plan. Many times, debtors fail after restructuring and must then consider liquidation.

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## CHAPTER 13

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Chapter 13 bankruptcy cases are voluntary options for some individuals. This type of bankruptcy case is prevalent today because it allows eligible debtors to extend their debt payment periods and lower the interest rates on their current debts. However, another large benefit of a Chapter 13 bankruptcy case is that it can allow the debtor to keep his property, such as a house or car. Chapter 13 does this by requiring the debtor to adopt a plan that restructures payments of current debts over a three to five year period. Presumably, if a Chapter 13 debtor properly completes his plan, at the end of the period he will receive a discharge from the affected debts. The Chapter 13 debtor will sometimes be unable to perform the plan, and then must eventually convert the bankruptcy into a Chapter 7 case.

A bankruptcy attorney has a major role in Chapter 13 cases, as he must file various documents with the court, deal with creditors, and help create the debtor's plan. The bankruptcy

court must approve the Chapter 13 debtor plan. A bankruptcy trustee is also important, as he will monitor the debtor's performance of the plan and administer its payments throughout the duration.

The Chapter 13 plan requires the debtor to pay as best he can over the plan period. The debtor's requirements are to pay the administrative expenses of his case, such as attorney and trustee fees, back in full over the plan period. The debtor will likely need to pay secured creditors in full, and cure and defaults that have occurred prior to the commencement. But, the interest rate and original payment schedule may be adjusted for certain secured debts, referred to as "cram down." Personal-use automobile and principle residential home loans are exceptions, and the debtor not will likely be able to significantly adjust the repayment terms of these debts. The debtor must also pay unsecured creditors as much as he is able, and certainly as much as the creditors would receive in a Chapter 7 case.

Only certain parties may file for a Chapter 13 bankruptcy case. Chapter 13 is available to individuals only, and not for corporate entities. Eligibility requirements exist, allowing only those individuals with regular income to file for Chapter 13. Additionally, persons are eligible only if they have unsecured debts less than \$360,475 and secured debts less than \$1,081,400. Without meeting these requirements, a person may not file a petition for Chapter 13 and must seek other bankruptcy categories. If an individual has an excessive amount of disposable income and mostly consumer debt, he may be required to consider Chapter 13 over another filing type, such as Chapter 7.

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## CHAPTER 7

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Chapter 7 bankruptcy is often a last resort option for the debtor thoroughly unable to pay his obligations. For both individual and business debtors, Chapter 7 bankruptcy cases are a drastic method of discerning any assets and distributing them as equally as possible to creditors. For businesses, this bankruptcy case signals the end of the concern, and its property, assets, and inventory are sold to help the creditors recoup. For individuals, Chapter 7 presides over property liquidation as well, however the debtor can have personal relief through discharge.

An individual debtor files for Chapter 7 when he cannot file for Chapter 13. This debtor has inadequate disposable income to participate in a repayment plan, and thus must simply obtain a conclusive end to some of his current debts in the form of personal discharge. After filing his petition, the debtor immediately benefits from the automatic stay and does not suffer from creditor pressures. A bankruptcy trustee evaluates the debtor's property of the estate at the time of filing, collecting and selling what it can. Any such proceeds go to repay secured, priority, and then other unsecured creditors, in that order. Usually, Chapter 7 debtor attorneys are assured full payment for their services to the debtor above other unsecured creditors. Dependent upon state law guidelines, the trustee can exempt certain debtor property from liquidation, such as a principle residence (a "homestead" exemption). After this process, the debtor can receive a discharge and start rebuilding his financial life.

However, the debtor's discharge from personal liability of financial obligations to creditors has limitations. Chapter 7 bankruptcy only applies to the debts accumulated prior to the filing of the petition for the case. Therefore, the debtor is responsible for any loans or obligations he assumes after that date, regardless of any discharge. Additionally, certain types of debts are ineligible for discharge, especially of note being educational loans and domestic support payments.

Finally, if the debtor wants to keep certain encumbered property, the debtor can choose to continue paying on certain obligations through reaffirmation agreements made with the creditor. Regardless of any discharge, security interests are not removed through the bankruptcy process. Therefore, after a Chapter 7 case closes, a creditor with a security interest can use state law actions to reacquire that property, such as a home foreclosure.

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SEE ALSO

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- Epstein, David, Markell, Bruce, Nickles, Steve, and Perris, Elizabeth, *BANKRUPTCY, MATERIALS AND CASES* (3<sup>rd</sup> Ed. 2010).