

# BANKRUPTCY 101



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## Introduction

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The United States Bankruptcy Code was written to offer various levels of protection to consumers, and offer them a well-defined legal process for settling their debts in the event they are no longer able to meet their financial obligations. Unfortunately, many Americans still hang onto a negative view of bankruptcy in large part because of misinformation and stereotyping.

The goal of this e-book is to try and explain the facts and concepts related to bankruptcy in everyday language that people can understand. Our sincere hope is that by providing this information, you will be better able to make an informed decision about your financial future, and not be afraid of considering bankruptcy because of something a friend told you.

But in order to properly explain bankruptcy, we have to consider it from a legal view. By strict definition, bankruptcy refers to a status of a person or company that has been declared insolvent; that is unable to repay the debts owed.

However, insolvency and bankruptcy are not necessarily the same thing.

## What is Insolvency?

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Insolvency is what many people think bankruptcy is—that is to declare a state of complete inability to pay debt.

The two main types of insolvency are:

(A) Balance Sheet Insolvency, meaning the company or person's liabilities are greater than the assets or properties owned.

(B) Cash flow insolvency, meaning you cannot pay your debts as they become due. This is also called equity insolvency.

However, cash flow insolvency can eventually lead to balance sheet insolvency. What often happens is that a company has to cease conducting business because it cannot pay its bills.

In order for there to be legal insolvency, you (or your company) must:

- Be unable to pay your debts with your current balance.
- Be unable to pay your debt because of lack of cash flow.
- Be able to show that your assets are less than the amount of your liabilities.

Now, insolvency is the “state of being” that would cause a person to file for bankruptcy. If a person cannot pay back his/her lenders on time, or if the cash flow falls, or if income is simply too low to cover expenses, then insolvency is the proper term. Of course, the first step of an insolvent person or company would be to take steps towards resolution.

Ideally, the government and your debtors want to help you out of your insolvency status. It doesn't make good business sense to merely declare a loss.

Therefore, companies that claim insolvency usually work together with debtors in an attempt to remodel the financial and organizational structure of the struggling business or individual. This business recovery option is not available in all countries, but in the United States, for example, it is permissible to continue running a company under a “declared protective arrangement”, which identifies other options to keep the business going.

Now on the other side of the spectrum you have bankruptcy.

## *What is Bankruptcy?*

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One does not have to be literally insolvent to voluntarily declare bankruptcy, but as a practical matter, it is the sort of thing you do want to make sure of before proceeding with court action. The term bankruptcy, while in its own right, a legal status, can actually refer to the entire process of declaring bankruptcy status before the government and your debtors, and can apply to the entire insolvency proceedings.

Bankruptcy is the legal declaration of a person or company's inability to pay off debts. The act of bankruptcy is, simply put, a request for the government and local entities to pay off the amount owed. An insolvency and bankruptcy are not the same thing, because a determination of insolvency must be made by the court. On the other hand, some people who are insolvent do not actually declare bankruptcy; instead, they make payments each month.

*Insolvency is not a synonym for bankruptcy, which is a determination of insolvency made by a court of law with resulting legal orders intended to resolve the insolvency.*

You must in essence prove a bankruptcy situation exists; just like a divorce, or like any official filing that involves a government signature, you must make your case to others before legally declaring yourself as such. It is not the right of every person to be “bankrupt”—it is something that must be legally established if you expect any protection or cooperation from others.

Bankruptcy is often an action imposed by court order, not declared by individuals. This forced bankruptcy status usually happens when consumers willfully avoid paying for their charges, and so, debtors have to get the government involved. Even so, forced bankruptcy is not as prevalent a condition as you might think.

Another common misconception is that bankruptcy is the solution to your debt problems. You should know up front that while it will provide relief from creditors, it does not necessarily resolve all of your debt. There are actually different kinds of bankruptcy filings, and depending on which one you choose, you may actually still owe money on your debts—regardless of the fact that you’re now considering bankruptcy.

***Definitions of bankruptcy according to the law:***

Any individual person or company has the right to declare a voluntary bankruptcy. The debtor voluntarily files a “bankruptcy petition” (a series of documents) and formally introduces a bankruptcy proceeding under Chapters 7, 9, 11 or 12 of the US Bankruptcy Code. In addition, creditor(s) may force the debtor into Chapter 7 or 11 bankruptcies if the debtor is generally not paying its debts as they become due. If the debtor has more than 11 creditors, then three creditors with aggregate unsecured claims of \$14,425 must jointly file the involuntary petition. If the debtor has fewer than 12 creditors, one creditor with an aggregate unsecured claim of \$14,425 may file.

The purposes in filing for bankruptcy might include:

- To avoid the piecemeal liquidation of a going concern by creditors. Often the value of a whole business exceeds the sum of its many parts.
- To fairly and equitably distribute the debtor's assets among its creditors.
- To reorganize a company's business, debts, leases, etc., thereby continuing to contribute jobs and products or services to the community.
- In the case of individuals, to provide a fresh start free from the stresses and financial burdens of preexisting indebtedness.

## *Special Filings*

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Under Chapter 9, the debtor must be a municipality. This is a specialty filing that will not be applicable to most individuals or companies. Under Chapter 12, the debtor must be a family farmer. This too is a specialty filing that will not be applicable to most individuals or companies.

## *Chapter 7*

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Chapter 7 Bankruptcy requires a filing fee of \$306. This chapter filing involves liquidation of the owner or individual's assets. All of the debtor's property must be liquidated and sold so that the creditors can receive a portion of the money owed. Property, vehicles and other assets may become part of the bankruptcy estate, and a Trustee is appointed to oversee and administer that estate. The Trustee's duties include the collection and recovery of assets and then the distribution of the proceeds of those assets under the distribution rules provided by the Bankruptcy Code.

Chapter 7 allows a corporation to effect through the trustee the orderly liquidation of its assets (and perhaps thereby avoid creditor accusations that it misapplied its assets). Also, the Bankruptcy Code's distribution scheme gives priority to the IRS, so distribution of the corporation's assets through bankruptcy may lessen the personal tax liabilities of the corporation's principals that would not be dischargeable in the principal's Chapter 7 proceeding.

Chapter 7 allows an individual debtor to give up his or her nonexempt assets to the Trustee in exchange for a discharge of all dischargeable debts that are owed as of the date of the bankruptcy filing. Most individuals who file a voluntary Chapter 7 bankruptcy petition do not have any nonexempt assets. Certain debts,

such as most taxes, alimony and other divorce obligations, most student loans, and debts incurred through fraud are not dischargeable.

## *Chapter 13*

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Chapter 13 Bankruptcy requires a filing fee of \$281. This type of bankruptcy, while just as common as the former, is only for individuals with regular income. However, this filing includes sole proprietorship businesses. The individual must have non-contingent, liquidated, unsecured debts of less than \$360,475 and non-contingent, liquidated, secured debts of less than \$1,081,400. The individual retains all of his or her property in exchange for making payments out of disposable earnings to a Chapter 13 Trustee for a period of three to five years.

The Trustee distributes the debtor's payments under the debtor's Chapter 13 plan, which must be approved by the Bankruptcy Court. As an encouragement to debtors to choose Chapter 13 over Chapter 7, the Chapter 13 discharge is broader than the Chapter 7 discharge. For example, debts for equitable distribution and many taxes, which are non-dischargeable in a Chapter 7 proceeding, are discharged in Chapter 13 upon completion of the debtor's payments.

## *Chapter 11*

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Chapter 11 is less common than Chapters 13 and 7, and so comes in third place in our bankruptcy discussion. This filing calls for a filing fee of \$1,046. This option is mostly used by businesses that want to reorganize their financial structures, but can also be used by individuals, especially those whose debts exceed the limits for Chapter 13 or who lack regular income.

Unlike Chapter 7, the debtor remains in possession of its own property and runs its business in the ordinary course, subject to rules of the Bankruptcy Code and the Bankruptcy Court. The Chapter 11 debtor is also sometimes referred to as a Debtor-In-Possession ("DIP"). The DIP has the same rights and duties as a bankruptcy Trustee. For example, the DIP can liquidate assets and pursue voidable transfers (see, for example, Preferences).

A successful Chapter 11 case results in the confirmation of a plan of reorganization pursuant to which the DIP's prepetition creditors are paid pursuant to the plan's terms. One of the requirements for confirmation of a Chapter 11 plan is that the creditors receive at least as much as they would have received under a Chapter 7 liquidation case; but the creditors need not receive 100 cents on the dollar. Additionally, a plan must categorize creditors' claims into classes, and impaired classes must generally vote to accept a plan by returning affirmative ballots representing more than half of the claims in the class and two thirds of the amounts owed in such class.

Upon confirmation of the Chapter 11 plan (or, in an individual case, upon completion of the plan), the debtor receives a discharge from its prepetition obligations. Chapter 11 can be a powerful tool to debtors that allows them to reject leases for unprofitable locations while allowing it to assume and maintain leases for its profitable locations.

Chapter 11 also provides specialized rules for "small business debtors," and for debtors that own "single asset real estate."

## *The Automatic Stay Filing*

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Regardless of what bankruptcy petition you file for, the automatic stay of 11 U.S.C. § 362 takes effect. The stay is an injunction against lawsuits, foreclosures, or any other collection actions against the debtor. The stay is

automatic in that the debtor need only file the bankruptcy petition to obtain its benefits. By automatically enjoining any creditor lawsuits or collection actions, the Bankruptcy Code provides the debtor with breathing room during the pendency of the bankruptcy case.

Thus, a prepetition creditor would violate the automatic stay by repossessing the debtor's vehicle or garnishing the debtor's bank account prior to the stay having been lifted by the Court or terminated by operation of law. A creditor who violates the automatic stay may be held in contempt of the Bankruptcy Court and subject to damages, including punitive damages in appropriate circumstances.

This is perhaps the best advantage that bankruptcy filing brings you—it gives you a “do not harass” card until the legalities can be squared away.

## *Avoidance Actions By The Trustee Or DIP*

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The representative of the bankruptcy estate may pursue avoidance actions to generate money or property to distribute to creditors. Some of these actions include:

**Fraudulent Conveyances:** Sometimes, debtors will have transferred assets that hinder the Trustee from distributing such assets to the debtors' creditors. For example, if a debtor does not want the Trustee to have his money, he will “give” his money to his grandmother by depositing it in her bank account. Or another example might be a debtor transferring his house to himself and his wife as tenants by the entirety, thereby exempting the house from the reach of his own non-joint creditors. In this event, the Trustee would be entitled to recover the debtor's property from the grandmother if made within the statute of limitations period. Transfers of property are subject to attack, when the debtor conveys property without receiving a reasonably equivalent value in return, or with an actual intent to hinder, delay, or defraud creditors.

**Preferences:** This action is not too popular among creditors since it carries the risk of them giving back money they were already paid. Because of the bankruptcy policy that the debtor's property should be fairly and evenly distributed among the debtor's creditors, the Bankruptcy Code allows the estate's representative to undo transfers that the debtor made on the eve of his bankruptcy filing. The idea is that if a creditor received money or property either arbitrarily or intentionally before bankruptcy, such money/property should be given back so that it can be divided evenly among all of the debtor's creditors. Payments made within 90 days of the bankruptcy filing are subject to attack, except that payments to "insiders" (relatives, controlling persons, or related entities of the debtor) are subject to attack for a full year prepetition.

**Failure to Perfect:** Creditors who take a security interest in an item of property owned by the debtor (and therefore have collateral to secure their claim) may have their security interest avoided (undone), unless they "perfected" the security interest prepetition, such as by filing a financing statement to put other creditors and the world on notice that they claim dibs on a particular asset. The Uniform Commercial Code (UCC) controls issues of perfection with respect to most items of personal property. Even if a creditor properly perfected his security interest prepetition, the perfection may be avoidable as a preference if obtained within the preference period.

**Statute of Limitations:** The Trustee has a statute of limitations with respect to avoiding transfers: the earlier of two years from the date of the bankruptcy filing or one year after the Trustee's appointment, whichever is later; or the date the case is closed or dismissed.

## *What A Creditor May/Should Do To Protect Itself In Bankruptcy*

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What can you do if you are trying to protect yourself from creditor harassment?

You can take any of these angles:

1. You can attend the creditors' meeting and ask questions of the debtor.
2. You can take the debtor's deposition under F.R. Bankr. P. 2004.
3. You can file a timely proof of claim. (11 U.S.C. § 502) Under all chapters of the Bankruptcy Code, a creditor must file a proof of claim in order to assure that he will receive distributions made to creditors in the case. When the case is filed, the debtor probably will have listed the creditor on the bankruptcy schedules. Theoretically, a creditor need not file a proof of claim in a Chapter 11 case unless the debtor listed the debt as disputed, contingent, or un-liquidated.
4. You can enter an appearance in the case by filing a Notice Of Appearance. This ensures that the creditor will receive notices of what the debtor is doing.
5. You can review a Chapter 11 DIP's monthly reports that are filed with the Bankruptcy Court and sent to the U.S. Trustee.
6. Seek relief from the Automatic Stay. (11 U.S.C. § 362). If you have a security interest in items of the debtor's property or lease equipment to the debtor, you may want to seek relief from the automatic stay to foreclose on the property or to recover your leased property. The creditor is entitled to relief from the automatic stay if the debtor has no equity in the property and the property is not necessary to an effective reorganization that is in prospect, or if there is cause for lifting the

stay, such as the debtor is not adequately protecting the creditor's interest in the property. If the property is being leased, the Bankruptcy Code enables debtors to "assume or reject" leases and executory (partially unperformed on both sides) contracts. However, a creditor can move the Bankruptcy Court to compel the Trustee or DIP to make a decision whether to assume or reject leases and executory contracts.

7. Investigate Payment of Administrative Claim: a creditor providing an actual, necessary benefit to the bankruptcy estate post-petition, has an administrative claim with priority over most other creditors. (11 U.S.C. § 503) While the automatic stay prevents collection actions with respect to prepetition debts owed the creditor, the creditor should be kept current with respect to products/services it provides post-petition.

8. Seek appointment of a Trustee in a Chapter 11 case. If the DIP appears to be mismanaging its business or assets, or taking actions detrimental to creditors, then a creditor can ask the Bankruptcy Court to appoint a Trustee.

9. Seek the dismissal of a case, for cause, such as bad faith, thereby removing the automatic stay and relegating the parties to their pre-bankruptcy and non-bankruptcy law rights.

10. Ensure that the debtor has properly valued your collateral in a Chapter 13 or Chapter 11 case. If the creditor is owed more than the collateral is worth, then the creditor can be treated by the debtor as having a secured claim and an unsecured claim for the deficiency amount not secured. However, creditors whose claims are secured solely by an interest in a debtor's principal residence are not subject to having their secured claims modified, except that the prepetition arrearages can be cured over time under a Chapter 13 or Chapter 11 repayment plan, and a deed of trust (mortgage) lien that is wholly unsecured may be stripped off the residence under Chapter 13 or Chapter 11.

11. Make sure that the Chapter 13 or Chapter 11 plan treats your claim properly; otherwise, object to confirmation of the plan. For example, if the creditor has collateral that the debtor intends to keep, then the creditor must get paid the value of the collateral with interest, unless the creditor agrees otherwise.

12. You can declare your intention to surrender or retain a secured creditor's collateral to the secured creditor in a Chapter 7 case. A debtor may retain the collateral by reaffirming (maintaining his liability, despite the bankruptcy discharge) the obligation or redeeming the property by paying the fair market value of the collateral.

13. Object to the debtor's discharge, or the dischargeability of the debt you are owed. Debts for fraud, false financial statements, or for willful/malicious injuries, among others, are non-dischargeable under Chapter 7 or Chapter 11, but the creditor must object within 60 days of the creditors' meeting.

## *Conclusion*

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Of course, it's one thing to generalize bankruptcy information for general consumption, and quite another thing to find a personalized solution to your debt problems. All of what you have read in this book consists of general principles. However, if you are seriously thinking about declaring bankruptcy then the best decision would be to consult an attorney for amplification of and qualifications concerning how these principles apply in a particular case—your case. Generalized information just doesn't work for a particular situation that involves taking into account your actions with your local county laws.

We are an experienced law firm that provides assistance with all sorts of bankruptcy filings and tricky situations, from Chapter 7 and 11 bankruptcies or

even more complex Chapter 13 cases. We have been serving the Northern Virginia community since 1986, offering help to creditors and trustees alike.

We are based in Northern Virginia (around “Old Town Alexandria” to be specific) and serve Prince William, Loudoun, Fairfax, Fauquier, Alexandria, Arlington, Manassas, Tyson's, Vienna, McLean, Great Falls, Falls Church, Reston, Herndon, Ashburn, Woodbridge and Springfield. If you have questions about bankruptcy, then by all means, give us a call and we can offer you a FREE CONSULTATION regardless of your situation. You can contact us at (703) 549-5000. Or visit our website at [www.TBRCLaw.com](http://www.TBRCLaw.com) to learn more about bankruptcy law.