

## **PURPOSES, BENEFITS AND COSTS OF BANKRUPTCY**

Disclosure pursuant to Code § 527(a)(1) & § 342(b)(1)

The United States Constitution provides a method whereby individuals, burdened by excessive debt, can obtain a fresh financial start and pursue newly productive lives unimpaired by past financial problems. It is an important alternative for persons mired deep in financial difficulty. The federal bankruptcy laws were enacted to provide debtors with a fresh start and to establish a ranking and equity among all the creditors who are clamoring for the debtor's limited resources.

Bankruptcy helps people avoid the kind of permanent discouragement that can prevent them from ever reestablishing themselves as hard-working members of society. Also, creditors are ranked so that the debtor's nonexempt property can be fairly distributed according to established rules guaranteeing identical treatment to all creditors of the same rank.

This discussion is intended only as a brief overview of the types of bankruptcy filings and of what a bankruptcy filing can and cannot do. Anyone considering this course of action is encouraged to seek the advice and assistance of an attorney specializing in bankruptcy law.

### **Types of Bankruptcy**

The Bankruptcy Code is divided into chapters. The chapters which usually apply to consumer debtors are chapter 7, known as a Liquidation, and chapter 13, known as an Adjustment of the Debts of an Individual with Regular Income.

An important feature applicable to all types of bankruptcy filings is the automatic stay. The automatic stay means that the mere request for bankruptcy protection automatically "stays" or forces an abrupt halt to repossessions, foreclosures, evictions, garnishments, attachments, utility shut-offs, and debt collection harassment. It offers debtors a breathing spell by giving the debtor and the trustee assigned to the case time to review the situation and develop an appropriate plan. Creditors cannot take any further action against the debtor or the property without permission from the bankruptcy court.

### **Chapter 7**

In a chapter 7, or liquidation case, the bankruptcy court appoints a trustee to examine the debtor's assets and divide them into exempt and nonexempt property. Exempt property is limited to a certain amount of equity in the debtor's residence, motor vehicle, household goods, life insurance, health aids, specified future earnings such as social security benefits and alimony, and certain other personal property. The trustee may then sell the nonexempt property and distribute the proceeds among the unsecured creditors. Although a liquidation case can rarely help with secured debt (the secured creditor still has the right to repossess the collateral), the debtor will be discharged from the legal obligation to pay unsecured debts such as credit card debts, medical bills and utility arrearages. However, certain types of unsecured debt are allowed special treatment and cannot be discharged. These include some student loans, alimony, child support, criminal fines, and some taxes.

### **Chapter 13**

In a chapter 13 case, the debtor puts forward a plan, following the rules set forth in the bankruptcy laws, to repay all creditors over a period of time, usually from future income. A chapter 13 case may be advantageous in that the debtor is allowed to get caught up on mortgages

or car loans without the threat of foreclosure or repossession and is allowed to keep both exempt and nonexempt property. The debtor's plan is a simple document outlining to the bankruptcy court how the debtor proposes to pay current expenses while paying off all the old debt balances. The debtor's property is protected from seizure from creditors, including mortgage and other lien holders, as long as the proposed payments are made. The plan generally requires monthly payments to the bankruptcy trustee over a period of three to five years. Arrangements can be made to have these payments made automatically through payroll deductions.

## **Chapter 11**

(Taken from the official Public Information Series Bankruptcy Judges Division brochure on "Bankruptcy Basics" prepared by the Administrative Office of the United States Courts, June 2000)

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

Upon the filing of a voluntary petition for relief under chapter the debtor automatically assumes an additional identity as the "debtor in possession." 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). A written disclosure statement and a plan of reorganization must be filed with the court. 11 U.S.C. § 1121.

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. 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 and the ballots are collected and tallied, the bankruptcy court will conduct a confirmation hearing to determine whether to confirm the plan. 11 U.S.C. § 1128.

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

While individuals are not precluded from using chapter 11, it is more 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 may, themselves, be forced to file for bankruptcy protection. Section 1107 of the Code places the debtor in possession in the position of a fiduciary, with the rights and powers of a chapter 11 trustee, and requires the performance of all but the investigative functions and duties of a trustee. These duties are set forth in the Bankruptcy Code and Federal Rules of Bankruptcy Procedure. 11 U.S.C. §§ 1106, 1107; Fed. R. Bankr. P. 2015(a). Such powers and duties include accounting for property, examining and objecting to claims, and filing informational reports as required by the court and the United States trustee, such as monthly operating reports.

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 filing such reports as are necessary or as the court orders after confirmation, such as a final accounting. The United States trustee is responsible for monitoring the compliance of the debtor in possession with the reporting requirements in a small business case. 11 U.S.C. § 1102(a)(3). A small business case proceeds faster than a regular chapter 11 case because the court may conditionally approve a disclosure statement, subject to final approval after notice and a hearing and solicitation of votes for acceptance or rejection of the plan. Thereafter, the disclosure statement hearing may be combined with the confirmation hearing. 11 U.S.C. § 1125(f). In addition, the debtor has a shortened period of time (100 days from the date of the order for relief) within which only the debtor may file a plan.

## **Chapter 12**

(Taken from the official Public Information Series Bankruptcy Judges Division brochure on "Bankruptcy Basics" prepared by the Administrative Office of the United States Courts, June 2000)

Chapter 12 of the Bankruptcy Code was enacted by Congress in 1986, specifically to meet the needs of financially distressed family farmers. The primary purpose of this legislation was to give family farmers facing bankruptcy a chance to reorganize their debts and keep their farms.

## **Background**

In tailoring chapter 12 to meet the economic realities of family farming, this law has eliminated many of the barriers that family farmers had faced when seeking to reorganize successfully 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 the large corporate reorganization. In addition, few family farmers find chapter 13 to be advantageous, because it was 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 farm reorganizations. At the time of the enactment of chapter 12, Congress could not be sure whether chapter 12 relief for the family farmer would be required indefinitely. Accordingly, the law (which first provided that no chapter 12 cases could be filed after September 30, 1993) currently provides that no cases may be filed under chapter 12

after July 1, 2000. As of June 30, 2000, legislation is pending in Congress to extend that deadline.

The Bankruptcy Code provides that only a family farmer with “regular annual income” may file a petition for relief under chapter 12. 11 U.S.C. §§ 101(18), 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. Allowance is made under chapter 12, however, for situations in which family farmers may have income that is seasonal in nature. Relief under this chapter is voluntary; thus, only the debtor may file a petition under chapter 12. Under the Bankruptcy Code, those eligible to file as “family farmers” fall into two categories: (1) an individual or individual and spouse and (2) a corporation or partnership. Those 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. More than one-half of 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 operation.
3. More than 80% of the value of the corporate or partnership assets must be related to the farming operation.
4. The total indebtedness of the corporation or partnership must not exceed \$1.5 million.
5. Not less than 80% of the corporation’s or partnership’s total debts which are fixed in amount must come from the farming operation owned or operated by the debtor.
6. If the corporation has issued stock, the stock cannot be publicly traded.

### **What Bankruptcy Can and Cannot Do**

Bankruptcy may make it possible for financially distressed individuals to:

1. Discharge liability for most or all of their debts and get a fresh start. When the debt is discharged, the debtor has no further legal obligation to pay the debt.
2. Stop foreclosure actions on their home and allow them an opportunity to catch up on missed payments.
3. Prevent repossession of a car or other property, or force the creditor to return property even after it has been repossessed.
4. Stop wage garnishment and other debt collection harassment, and give the individual some breathing room.
5. Restore or prevent termination of utility service.

6. Lower the monthly payments on debts, including secured debts such as car loans.
7. Allow debtors an opportunity to challenge the claims of certain creditors who have committed fraud or who are otherwise seeking to collect more than they are legally entitled to.
8. Bankruptcy, however, cannot cure every financial problem. It is usually not possible to:
  - A. Eliminate certain rights of secured creditors. Although a debtor can force secured creditors to take payments over time in the bankruptcy process, a debtor generally cannot keep the collateral unless the debtor continues to pay the debt.
  - B. Discharge types of debts singled out by the federal bankruptcy statutes for special treatment, such as child support, alimony, some student loans, certain court ordered payments, criminal fines, and some taxes.
  - C. Protect all cosigners on their debts. If relative or friend co-signed a loan which the debtor discharged in bankruptcy, the cosigner may still be obligated to repay the loan.
  - D. Discharge debts that are incurred after bankruptcy has been filed.

### **Bankruptcy's Effect on Your Credit**

By federal law, a bankruptcy can remain part of a debtor's credit history for 10 years. Whether or not the debtor will be granted credit in the future is unpredictable. In some cases it may actually be easier to obtain future credit, because new creditors may feel that since the old obligations have been discharged, they will be first in line. They also recognize that the debtor cannot again file bankruptcy for at least the next six years.

Debtors have the option after bankruptcy of voluntarily paying some creditors, such as a doctor or hospital, with whom they wish to maintain credit. The payments are voluntary and do not reaffirm the past obligation.

### **About credit counseling agencies**

11 U.S.C. § 342(b)(1)(B)

The following information is taken verbatim from the web site of the Federal Trade Commission. [www.ftc.gov](http://www.ftc.gov)

### **Credit Counseling**

If you're not disciplined enough to create a workable budget and stick to it, can't work out a repayment plan with your creditors, or can't keep track of mounting bills, consider contacting a credit counseling organization. Many credit counseling organizations are nonprofit and work with you to solve your financial problems. But be aware that, just because an organization says it's "nonprofit," there's no guarantee that its services are free, affordable, or even legitimate. In fact, some credit counseling organizations charge high fees, which may be hidden, or urge consumers to make "voluntary" contributions that can cause more debt.

Most credit counselors offer services through local offices, the Internet, or on the telephone. If possible, find an organization that offers in-person counseling. Many universities, military bases, credit unions, housing authorities, and branches of the U.S. Cooperative Extension Service operate nonprofit credit counseling programs. Your financial institution, local consumer protection agency, and friends and family also may be good sources of information and referrals. Reputable credit counseling organizations can advise you on managing your money and debts, help you develop a budget, and offer free educational materials and workshops. Their counselors are certified and trained in the areas of consumer credit, money and debt management, and budgeting.

Counselors discuss your entire financial situation with you, and help you develop a personalized plan to solve your money problems. An initial counseling session typically lasts an hour, with an offer of follow-up sessions.

**Debt Management Plans:**

If your financial problems stem from too much debt or your inability to repay your debts, a credit counseling agency may recommend that you enroll in a debt management plan (DMP). A DMP alone is not credit counseling, and DMPs are not for everyone. You should sign up for one of these plans only after a certified credit counselor has spent time thoroughly reviewing your financial situation, and has offered you customized advice on managing your money. Even if a DMP is appropriate for you, a reputable credit counseling organization still can help you create a budget and teach you money management skills.

In a DMP, you deposit money each month with the credit counseling organization, which uses your deposits to pay your unsecured debts, like your credit card bills, student loans, and medical bills, according to a payment schedule the counselor develops with you and your creditors. Your creditors may agree to lower your interest rates or waive certain fees, but check with all your creditors to be sure they offer the concessions that a credit counseling organization describes to you. A successful DMP requires you to make regular, timely payments, and could take 48 months or more to complete. Ask the credit counselor to estimate how long it will take for you to complete the plan. You may have to agree not to apply for — or use — any additional credit while you're participating in the plan.

**ACKNOWLEDGMENT OF RECEIPT**

The undersigned acknowledges that attorney \_\_\_\_\_ has given me a copy of this disclosure required by Bankruptcy Code § 527(b).

Dated: \_\_\_\_\_

X \_\_\_\_\_