

## **LIQUIDATION UNDER THE BANKRUPTCY CODE - CHAPTER 7**

Chapter 7 of the United States Bankruptcy Code is the Bankruptcy Code's "liquidation" chapter. Lawyers sometimes refer to it as a "straight bankruptcy." It is used primarily by individuals who wish to free themselves of debt simply and inexpensively, but may also be used by businesses that wish to liquidate and terminate their business.

### **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. Indeed, 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 a substantial abuse of the provisions of chapter 7. *11 U.S.C. § 707(b)*. A number of courts have concluded that a chapter 7 case may be dismissed for substantial abuse when the debtor has the ability to propose and carry out a workable and meaningful chapter 13 plan. The Bankruptcy Judges Division has prepared a separate pamphlet which discusses chapter 13 of the Bankruptcy Code in greater detail.

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**

The potential chapter 7 debtor should understand that a straight bankruptcy case does not involve the filing of a plan of repayment as in chapter 13, but rather envisions the bankruptcy trustee's gathering and sale of the debtor's nonexempt assets, from which holders of claims (creditors) will receive distributions 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, under chapter 7, the individual debtor is permitted to retain certain "exempt" property. The debtor's remaining assets are liquidated by a trustee. Accordingly, potential debtors should realize that the filing of a petition under chapter 7 may result in the loss of property.

In order to qualify for relief under chapter 7 of the Bankruptcy Code, the debtor must be an individual, a partnership, or a corporation. *11 U.S.C. §§ 109(b); 101(41)*. 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)*.

One of the primary purposes of bankruptcy is to discharge certain debts to give an honest individual debtor a "fresh start." The discharge has the effect of extinguishing the debtor's personal liability on dischargeable debts. In a chapter 7 case, however, a discharge is available to individual debtors only, not to partnerships or corporations. *11 U.S.C. § 727(a)(1)*. Although the filing of an individual chapter 7 petition usually results in a discharge of debts, an individual's 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's filing a petition with the bankruptcy court.<sup>1</sup> The petition should be filed with the bankruptcy court serving the area where the individual lives or where the business debtor has its principal place of business or principal assets. *28 U.S.C. § 1408*. In addition to the petition, the debtor is also required to file with the court several schedules of assets and liabilities, a schedule of current income and expenditures, a statement of financial affairs, and a schedule of executory contracts and unexpired leases. *Fed. R. Bankr. P. 1007(b)*. A husband and wife may file a joint petition or individual petitions. *11 U.S.C. § 302(a)*. (Official Bankruptcy Forms can be purchased at a legal stationery store. They are not available from the court.)

In order to complete the Official Bankruptcy Forms which make up the petition and schedules, the debtor(s) will need to compile 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.

Currently, the courts are required to charge a \$155 case filing fee, a \$30 miscellaneous administrative fee, and a \$15 trustee surcharge (a total of \$200). The fees should 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*. Rule 1006(b) limits to four the number of installments for the filing fee. The final installment shall be

payable 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 \$30 administrative fee and the \$15 trustee fee surcharge may be paid in installments in the same manner as the filing fee. 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)*.

The filing of a petition under chapter 7 “automatically stays” most actions against the debtor or the debtor’s property. *11 U.S.C. § 362*. This 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. Creditors normally receive notice of the filing of the petition from the clerk.

One of the schedules that will be filed by the individual debtor is a schedule of “exempt” property. Federal bankruptcy law provides that an individual debtor<sup>2</sup> can protect some property from the claims of creditors either because it is exempt under federal bankruptcy law or because it is exempt 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 law 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 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. Legal counsel should be consulted to determine the law of the state in which the debtor lives.

A “meeting of creditors” is usually held 20 to 40 days after the petition is filed. If the United States trustee or bankruptcy administrator<sup>3</sup> designates a place for the meeting that is not regularly staffed by the United States trustee or bankruptcy administrator, the meeting may be held no more than 60 days after the order for relief. *Fed. R. Bankr. P. 2003(a)*. The debtor must attend this meeting, at which creditors may appear and ask 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. The trustee also will attend this meeting. It is important for the debtor to cooperate with the trustee and to provide any financial records or documents that the trustee requests. The trustee is required to examine the debtor orally at the meeting of creditors to ensure that the debtor is aware of the potential consequences of seeking a discharge in bankruptcy, including 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. In some courts, trustees may provide written information on these topics at or in advance of 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 either a chapter 11 reorganization case or a case under chapter 13,<sup>4</sup> as long as the debtor meets the eligibility standards under the chapter to which the debtor seeks to convert, and the case

has not previously been converted to chapter 7 from either chapter 11 or chapter 13. Thus, the debtor will not be permitted to convert the case repeatedly from one chapter to another. *11 U.S.C. § 706(a)*.

### **ROLE OF THE CASE TRUSTEE**

Upon the filing of the chapter 7 petition, an impartial case trustee is appointed by the United States trustee (or by the court in Alabama and North Carolina) to administer the case and liquidate the debtor's nonexempt assets. *11 U.S.C. §§ 701, 704*. If, as is often the case, all of the debtor's assets are exempt or subject to valid liens, there will be no distribution to unsecured creditors. Typically, most Chapter 7 cases involving individual debtors are "no asset" cases. If the case appears to be an "asset" case at the outset, however, unsecured creditors<sup>5</sup> who have claims against the debtor must file their claims with the clerk of court within 90 days after the first date set for the meeting of creditors. *Fed. R. Bankr. P. 3002(c)*. In the typical no asset chapter 7 case, there is no need for creditors to file proofs of claim. If the trustee later recovers assets for distribution to unsecured creditors, creditors will be given notice of that fact and additional time to file proofs of claim. Although secured creditors are not required to file proofs of claim in chapter 7 cases in order to preserve their security interests or liens, there may be circumstances when it is desirable to do so. A creditor in a chapter 7 case who has a lien on the debtor's property should consult with an attorney for advice.

The commencement of a bankruptcy case creates an "estate." The estate technically becomes the temporary legal owner of all of the debtor's property. The estate 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. To accomplish this, the trustee attempts to liquidate the debtor's nonexempt property, *i.e.*, property that the debtor owns free and clear of liens and the debtor's property which has market value above the amount of any security interest or lien and any exemption that the debtor holds in the property. The trustee also pursues causes of action (lawsuits) belonging to the debtor and pursues the trustee's own causes of action 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, the power to undo security interests and other prepetition transfers of property that were not properly perfected under nonbankruptcy law at the time of the petition, and the power to 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 debtor's business for a limited period of time, if such operation will benefit the creditors of the estate and enhance the liquidation of the estate. *11 U.S.C. § 721*.

The distribution of the property of the estate is governed by section 726 of the Bankruptcy Code, which sets forth the order of payment of all claims. Under section 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 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 debtor's major interests in a chapter 7 case are in retaining exempt property and in getting a discharge that covers as many debts as possible.

## DISCHARGE

A discharge releases the debtor from personal liability for discharged debts and prevents the creditors owed those debts from taking any action against the debtor or his property to collect the debts. The bankruptcy law regarding the scope of a chapter 7 discharge is complex, and debtors should consult competent legal counsel in this regard prior to filing. As a general rule, however, excluding cases which are dismissed or converted, individual debtors receive a discharge in more than 99 percent of chapter 7 cases. In most cases, unless a complaint has been filed objecting to the discharge or the debtor has filed a written waiver, the discharge will be granted to a chapter 7 debtor relatively early in the case, that is, 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 very narrow and are construed against a creditor or trustee seeking to deny the debtor a chapter 7 discharge. Among the grounds for denying a discharge to a chapter 7 debtor are that the debtor failed to keep or produce adequate books or financial records; the debtor failed to explain satisfactorily any loss of assets; the debtor committed a bankruptcy crime such as perjury; the debtor failed to obey a lawful order of the bankruptcy court; or the debtor fraudulently transferred, concealed, or destroyed property that would have become property of the estate. *11 U.S.C. § 727; Fed. R. Bankr. P. 4005*.

In certain jurisdictions, secured creditors may retain some rights to seize pledged property, even after a discharge is granted. Depending on individual circumstances, a debtor wishing to keep possession of the pledged property, such as an automobile, may find it advantageous to "reaffirm" the debt. A reaffirmation is an agreement between the debtor and the creditor that the debtor will pay all or a portion of the money owed, even though the debtor has filed bankruptcy. In return, the creditor promises that, as long as payments are made, the creditor will not repossess or take back the automobile or other property. Because there is a disagreement among the courts concerning whether a debtor whose debt is not in default may retain the property and pay under the original contract terms without reaffirming the debt, legal counsel should be consulted to ensure that the debtor's rights are protected and that any reaffirmation is in the debtor's best interest.

If the debtor elects to reaffirm the debt, the reaffirmation should be accomplished prior to the granting of a discharge. A written agreement to reaffirm a debt must be filed with the court and, if the debtor is not represented by an attorney, must be approved by the judge. *11 U.S.C. § 524(c)*. The Bankruptcy Code requires that reaffirmation agreements contain an explicit statement advising the debtor that the agreement is not required by bankruptcy or nonbankruptcy law. In addition, the debtor's attorney is required to advise the debtor of the legal effect and consequences of such an agreement, including a

default under such an agreement. The Code requires a reaffirmation hearing only if the debtor has not been represented by an attorney during the negotiating of the agreement. *11 U.S.C. § 524(d)*. The debtor may repay any debt voluntarily, however, whether or not a reaffirmation agreement exists. *11 U.S.C. § 524(f)*.

Most claims against an individual chapter 7 debtor are discharged. A creditor whose unsecured claim is discharged may no longer initiate or continue any legal or other action against the debtor to collect the obligation. A discharge under chapter 7, however, does not discharge an individual debtor from certain specific types of debts listed in section 523 of the Bankruptcy Code. Among the types of debts which are not discharged in a chapter 7 case are alimony and child maintenance and support obligations, 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 criminal restitution orders under title 18, United States Code. *11 U.S.C. § 523(a)*. To the extent that these types of debts are not fully paid in the chapter 7 case, the debtor is still responsible for them 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, debts for willful and malicious injury by the debtor to another entity, and debts arising from a property settlement agreement incurred during or in connection with a divorce or separation are discharged unless a creditor timely files and prevails in an action to have such debts declared excepted from the discharge. *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 United States trustee if the discharge was obtained through fraud by the debtor or 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. *11 U.S.C. § 727(d)*.

## **NOTES**

1. An involuntary chapter 7 case may be commenced under certain circumstances by the filing of a petition by creditors holding claims against the debtor. *11 U.S.C. § 303*.
2. Each debtor in a joint case (both husband and wife) can claim exemptions under the federal bankruptcy laws. *11 U.S.C. § 522(m)*.
3. United States trustees and bankruptcy administrators are responsible for establishing a panel of private trustees to serve as trustees in chapter 7 cases and for supervising the administration of cases and trustees in cases under chapters 7, 11, 12, and 13 of the Bankruptcy Code. Bankruptcy administrators serve in the judicial districts in the states of Alabama and North Carolina.
4. A fee of \$400 is charged for converting, on request of the debtor, a case under chapter 7 to a case under chapter 11. There is no fee for converting from chapter 7 to chapter 13.

5. 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 pledged property on default, in addition to the debtor's ability to pay.