

BANKRUPTCY BASICS

Frederick P. Corbit
Bankruptcy Judge
United States Bankruptcy Court for the
Eastern District of Washington
904 West Riverside Avenue, Suite 324
Spokane, Washington 99201
(509) 458-5340

A. Foundation of the Bankruptcy Code.

The U.S. Constitution, in Article I, provides in part that Congress can pass “uniform laws on the subject of bankruptcies throughout the United States,” and Congress has done so in enacting, and subsequently amending, the Bankruptcy Reform Act of 1978 (as amended, the “Bankruptcy Code”).

As federal law, the Bankruptcy Code pre-empts state laws to the extent they are inconsistent. For example, a state law that allows for the collection of a debt can be “trumped” by a discharge provided by the Bankruptcy Code.

B. Bankruptcy Courts.

1. **Jurisdiction.** The jurisdiction of the bankruptcy courts flows through Federal District Courts, but the District Courts refer bankruptcy matters to the bankruptcy judges to decide. The reference is made pursuant to Local Rule 83.5 of the United States District Court For the Eastern District of Washington and General Rule 7 of the United States District Court for the Western District of Washington. The scope of the bankruptcy court’s jurisdiction was recently addressed by the United States Supreme Court.

In Stern v. Marshall, 564 U.S. 462, 131 S. Ct. 2594, 180 L.Ed.2d 475 (2011), the Supreme Court held that a bankruptcy court, as a non-Article III court, lacked constitutional authority to enter a final judgment on a state law claim. Also, in Executive Benefits Insurance Agency v. Arkison, 702 F.3d 553, cert. granted 133 S.Ct. 2880 (2013), the United States Supreme Court has recently heard arguments in another case dealing with the scope of the bankruptcy court’s jurisdiction. As of March 19, 2014, the date this outline was prepared, no opinion has been released in Arkison.

2. **Forum.** Bankruptcy proceedings take place in bankruptcy courts, which have separate clerks’ offices and courtrooms from the U.S. District Courts, and are located in every federal district. An appeal from a bankruptcy court decision will go to the federal district court, the bankruptcy appellate panel (“BAP”) or, in some limited cases, the federal circuit court. *See* F.R.B.P. 8003; 28 U.S.C. § 158(d)(2). Each BAP is made up of bankruptcy judges from the federal circuit in which the bankruptcy court is located. An appeal from the district court or the BAP will go to the federal circuit court, and an appeal from the federal circuit court will go to the U.S. Supreme Court; however, the U.S. Supreme Court has discretion whether or not to hear an appeal.

C. The Chapters of Title 11 of the United States Code.

The Bankruptcy Code is codified as Title 11 of the United States Code and contains nine chapters: 1, 3, 5, 7, 9, 11, 12, 13 and 15.

1. **General Chapters.** Chapters 1, 3 and 5 are applicable to all types of bankruptcy proceedings. For example, chapter 1 defines terms used throughout the Code. The proper citation for a section of the Bankruptcy Code would include the title number, the abbreviation for the

United States Code, and a reference to the relevant code section. For example, the proper citation for the Bankruptcy Code section defining “debtor” is 11 U.S.C. § 101(13).

2. Types of Bankruptcies. The other chapters (7, 9, 11, 12, 13 and 15) govern specific types of bankruptcy proceedings.

a. **Chapter 7.** Chapter 7 proceedings are liquidation proceedings for corporations, partnerships or individuals. Liquidations are conducted by chapter 7 trustees.

b. **Chapter 9.** Chapter 9 proceedings involve the reorganization of the debts of a municipality. A trustee is not appointed in a chapter 9 proceeding. Chapter 9 is not relevant to individual debtors.

c. **Chapter 11.** In chapter 11 proceedings, corporations, partnerships or individuals can reorganize their financial affairs. Chapter 11 debtors continue to manage their own affairs as “debtors in possession,” unless a party in interest demonstrates to the bankruptcy court that there is cause to appoint a chapter 11 trustee or convert the case to chapter 7 for the liquidation of the debtor’s assets.

d. **Chapter 12.** Family farmers and fisherman with regular annual income can adjust their debts in chapter 12 proceedings. (Chapter 12 provides farmers and fisherman with options similar to those available to debtors in chapter 13 proceedings.)

e. **Chapter 13.** Individuals, but not corporations, with regular annual income can adjust their debts in chapter 13 proceedings. For cases commenced after April 1, 2013, an individual is not eligible for relief under chapter 13 unless he or she owes less than \$383,175 of unsecured obligations and less than \$1,149,525 of secured obligations. See § 109(e).

Chapter 13 provides useful tools for debtors who want to preserve equity in their homes. A debtor can, over a three to five year period, cure defaults in a mortgage obligation. However, in a chapter 13 plan, a debtor cannot change the terms of a loan secured by his or her home, even if the property is worth less than the secured debt. 11 U.S.C. § 1322(b)(2).

f. **Chapter 15.** Chapter 15 allows for an ancillary U.S. bankruptcy proceeding in order to deal with a case that presents cross-border insolvency issues.

D. Applicable Bankruptcy Rules and Forms.

Relevant to the practical application of the Bankruptcy Code are applicable court rules, including the local bankruptcy rules for each federal district, as well as the Federal Rules of Bankruptcy Procedure (the “Bankruptcy Rules”). These rules apply to motions before the bankruptcy court, and there are special rules that apply to trials before bankruptcy judges. *See* F.R.B.P. 7001, *et. seq.* Also, official bankruptcy forms, such as the form for a proof of claim, are available. *See, e.g.,* Form B10 (Official Form 10) (04/07).

In the Bankruptcy Courts for the Eastern and Western Districts of Washington, bankruptcy petitions are normally filed electronically. Also, the bankruptcy courts in both districts have online information about relevant forms. The online information, which includes

copies of the local rules, can be accessed at: www.waeb.uscourts.gov; and www.wawb.uscourts.gov.

E. Important Sections of the Bankruptcy Code.

To develop a general understanding of the Bankruptcy Code, familiarity with the following sections is important.

1. **Eligibility.** Section 109 provides the conditions one must satisfy in order to qualify for bankruptcy relief under each chapter of the code.
2. **Commencement of Case.** Section 301 allows debtors to voluntarily commence a bankruptcy case, section 302 allows married debtors to jointly file one petition for their community and separate estates, and section 303 provides a mechanism for creditors to file an involuntary petition against a debtor.
3. **Employment of Professionals.** Employment and compensation of attorneys, accountants and other professionals by debtors is subject to bankruptcy court approval. 11 U.S.C. §§ 327, 328, 329, 330, and 331.
4. **First Meeting of Creditors.** In the early stages of all bankruptcy cases, there is a first meeting of creditors where the debtor, in individual cases, or an authorized representative of the debtor in corporate cases, must appear and answer questions under oath about their business and/or financial affairs. 11 U.S.C. § 341. (The 341 meeting is not the place to question a debtor for hours.
5. **Automatic Stay.** Section 362(a), which is applicable to all voluntary and involuntary cases, provides for an automatic stay of most actions against a debtor or the debtor's property, including collection actions and most types of setoffs. The automatic stay may be the most fundamental concept underlying bankruptcy and its scope should not be underestimated. However, there are exceptions to the stay including a provision that allows for the commencement or continuation of a criminal action against the debtor. 11 U.S.C. § 362(b)(1). While the automatic stay protects debtors from a rapid loss of assets to an aggressive creditor, it also protects other creditors from a devaluation of the estate by the same overeager creditors by removing the risk associated with the "first in time, first in right" nature of state law collection.
6. **Relief From Stay.** Section 362(d) allows a creditor to move for relief from the automatic stay.
 - a. **Cause.** The Code provides for relief from the stay upon a showing of "cause including a lack of adequate protection." The grounds for relief are varied and will often be determined according to the specific facts of the case. 11 U.S.C. § 362(d)(1)
 - b. **No Equity.** For creditors such as mortgage lenders, the Code specifically allows for relief in situations where the debtor has no equity in the collateral and the collateral is not needed as part of the debtor's reorganization. 11 U.S.C. § 362(d)(2).

c. **Multiple Bankruptcies.** If a mortgage lender can demonstrate that the debtor has filed multiple bankruptcies with respect to the same property as part of a scheme to hinder, delay and defraud creditors, the secured lender may be able to obtain stay relief, plus added protection against future bankruptcy filings concerning that property. 11 U.S.C. § 362(d)(4).

7. **Ordinary Course of Business.** In most instances, a trustee or debtor in possession, without prior court approval, may enter into transactions in the ordinary course of business. 11 U.S.C. §§ 363(c)(1) and 364(a). Sales or other transactions outside of the debtor's ordinary course of business, as well as secured borrowings, require an order of the bankruptcy judge.

8. **Cash Collateral.** Pursuant to section 363(c)(2), a debtor cannot use "cash collateral," which includes pledged rents and accounts receivable, without consent of the secured creditor or bankruptcy court approval. It is important for a lender to assert its interest in cash collateral at the outset of the case. 11 U.S.C. § 546(b).

9. **Sales Outside of Ordinary Course.** After notice and a hearing, a trustee or debtor in possession may sell property outside of the ordinary course with court approval 11 U.S.C. § 363(b). The court may also approve a sale free and clear of all liens and claims if certain criteria are met. 11 U.S.C. § 363(f).

10. **Primary Liens.** A trustee or debtor in possession, after notice and a hearing, may obtain a loan secured by a senior lien on property already encumbered by a lien if no other credit is available and the bankruptcy court concludes that the interests of the holder of the existing lien can be adequately protected. 11 U.S.C. § 364(d)(1).

11. **Executory Contracts and Leases.** Contracts or leases, which have performance obligations remaining due to some extent on both sides, are executory. Most prepetition executory contracts or leases, subject to bankruptcy court approval, may be assumed or rejected by a debtor in possession or a trustee. 11 U.S.C. § 365(a).

a. **Rejection Damages.** A debtor is excused from performing on any contract or lease rejected pursuant to section 365(a), but the rejection gives rise to an unsecured, non-priority claim. 11 U.S.C. § 502(b)(6). A contract breached, after being assumed, gives rise to an administrative priority claim, which has to be paid in full before unsecured, nonpriority claims are paid anything. 11 U.S.C. § 503(b)(7).

b. **Contract Cure.** Before an executory contract or lease may be assumed, the debtor or trustee must cure all defaults and provide adequate assurance of future performance. 11 U.S.C. § 365(b)(1).

c. **Loan Contracts.** A debtor's prepetition contract to borrow money may not be assumed. 11 U.S.C. § 365(c)(2).

d. **Real Property Leases.** There are time limits for the assumption of leases of nonresidential real property. 11 U.S.C. § 365(d)(1) and (4).

12. Ipsa Facto Clauses. Clauses in contracts that provide for the termination of the contract in the event one party files for bankruptcy are commonly referred to as *ipso facto* clauses. *Ipsa Facto* clauses are generally not enforceable in bankruptcy proceedings. 11 U.S.C. § 365(e)(1).

13. Proof of Claim. A creditor can file a proof of claim with the bankruptcy court, and a filed claim shall be deemed allowed unless an interested party files an objection. *See* 11 U.S.C. § 502(a). Accordingly, a creditor that timely files a claim need not prosecute that claim in order to share in the distribution from a bankruptcy estate unless another party files an objection to the claim. The form of a proof of claim is included as Form B10 in the Official Forms in Bankruptcy.

14. Secured Status. To the extent a lien secures a claim that is larger than the value of the collateral, a creditor has a secured claim to the extent of the collateral's value and unsecured claim to the extent the claim exceeds the value of the collateral. 11 U.S.C. § 506.

15. Priority Claims. Certain types of claims (including administrative claims, limited amounts of prepetition wages, and most taxes) are entitled to priority over other unsecured claims. 11 U.S.C. § 507. Administrative claims have to be approved by the bankruptcy court and consist of actual, necessary costs and expenses of preserving the bankruptcy estate. 11 U.S.C. § 503(b)(1).

16. Discharge. A debtor's bankruptcy discharge under sections 727, 1141, 1228 or 1328, voids a judgment to the extent that such judgment is a determination of personal liability and operates as an injunction against future collection actions against the debtor by claimants. 11 U.S.C. § 524. (A debtor may discharge personal liability on a loan secured by a mortgage or deed of trust, but the discharge does not eliminate a secured creditor's rights in its collateral.)

a. **Exceptions to Discharge.** There are exceptions to an individual debtor's ability to get debts discharged. *See* 11 U.S.C. § 523(a). Debts excepted from an individual debtor's discharge include, but are not limited to, those that were (a) incurred as a result of actual fraud; (b) incurred by the use of materially false financial statements relied upon by a creditor; or (c) the result of willful and malicious injury by the debtor to another entity or to the property of another entity. 11 U.S.C. § 523(a)(2) and (a)(6).

b. **Timing and Procedures for Exceptions and Objections to Discharge.** A creditor must timely raise an exception or objection to the discharge. A complaint alleging that a specific debt is excepted from a chapter 7 discharge (made pursuant to 11 U.S.C. § 523) or an objection to discharge (made pursuant to 11 U.S.C. § 727(a)) must be filed no later than 60 days after the first date set for the meeting of creditors under 11 U.S.C. § 341(a). F.R.B.P. 4004(a) and 4007(c). Further, the question of whether a debt is dischargeable or if the debtor is entitled to a discharge must be raised in an adversary action. *See* F.R.B.P. 7001(4) and (6).

17. Property of the Estate. The property included in a bankruptcy proceeding includes most of the legal and equitable interests of the debtor on the date the bankruptcy case was commenced. 11 U.S.C. § 541(a).

a. **Exceptions.** There are exceptions to what is included in the property of the estate, including an exception for any property held in trust or in escrow. 11 U.S.C. § 541(b)(1).

b. **Exemptions.** In cases involving individuals, debtors may exempt from property of the estate certain items, including a limited amount of equity in a home and certain personal property. 11 U.S.C. § 522(b)(1). Unless state law provides otherwise, the Bankruptcy Code provides the debtor with the option of selecting either the state or federal schedules of exemptions. 11 U.S.C. § 522(b)(2). Exempt property can be voluntarily transferred by a debtor. Accordingly, a debtor's homestead exemption is subject to a deed of trust, but not a judgment lien. Washington exemptions are set forth in RCW 6.12 and 6.15.

18. Strong Arm Provisions. A trustee or debtor in possession has the power to void certain liens, recover preferential payments, and avoid fraudulent transfers.

a. **Avoiding Liens.** A trustee or debtor in possession has the rights of a bona fide purchaser or hypothetical lienholder. 11 U.S.C. § 544. For example, the claim of a trustee to the debtor's assets has priority over an unperfected, prepetition security interest.

b. **Recovery of Preferences.** In some instances, transfers of property such as a cash payment or the granting of a security interest made by the debtor within 90 days of filing may be recovered by a bankruptcy trustee. 11 U.S.C. § 547. The window is expanded to one year if the transfer was made to an "insider." 11 U.S.C. §§ 101(31) and 547(b)(4)(B). In short, a preferential transfer is one that was made by a debtor, shortly before filing for bankruptcy, that is on account of an antecedent debt, and which enables the creditor to receive more than other creditors. Lenders may have defenses to preference actions if they can demonstrate, among other things, that they received payments in the ordinary course or according to ordinary business terms. 11 U.S.C. § 547(c)(2).

c. **Fraudulent Transfers.** In addition to available state law remedies, a trustee or debtor in possession has the ability to recover fraudulent conveyances made within the two years prior to the bankruptcy filing. 11 U.S.C. § 548. A transfer made by an insolvent debtor for less than "reasonably equivalent value" or with actual intent to hinder, delay or defraud creditors is a fraudulent transfer.

19. Means Test. The means test takes into account the petitioner's income, debt burden, and various allowable living expenses, which can vary significantly according to the debtor's place of residence and particular circumstances. If income minus allowable living expenses exceeds certain levels, a chapter 7 petition is presumed to be abusive and the debtor must consent to the conversion of the case to chapter 11 or 13, or have the case dismissed. 11 U.S.C. § 707(b).

For bankruptcy cases filed between November 15, 2013 and March 31, 2014, the median family income in Washington for a family of 1 was \$52,996, for a family of 2 was \$63,409, for a family of 3 was \$72,286, and for a family of 4 was \$84,970. (\$8,100 was added for each individual in excess of 4). The information on median family income can be accessed at www.usdoj.gov/ust/eo/bapcpa/meanstesting.htm.

20. Setoff. A creditor's right to offset a claim is stayed by a bankruptcy, but is otherwise not affected. 11 U.S.C. § 553.

21. Objections to Discharge. In addition to arguing that a specific debt should be excepted from discharge, a creditor may be able to assert that a chapter 7 debtor is not entitled to the discharge of any debts. *See* 11 U.S.C. § 727(a).

a. **Specific Frauds.** A creditor may object to a chapter 7 discharge for many different reasons, including situations in which a debtor has: (1) concealed property to hinder creditors; (2) knowingly or fraudulently made a false oath in connection with his or her bankruptcy proceeding; (3) failed to explain satisfactorily any loss of assets; or (4) failed to obey the lawful orders of the bankruptcy court. 11 U.S.C. § 727(a)(2), (4), (5) and (6).

b. **No Chapter 7 Discharge for Corporation and Consequences to an Individual Debtor When a Discharge is Denied.** In a chapter 7 case, exceptions and objections to discharge are only relevant when an individual, as opposed to a corporation, is the debtor. Corporations do not get discharges in chapter 7 proceedings and are merely liquidated. *See* 11 U.S.C. § 727(a)(1). On the other hand, individuals in chapter 7 proceedings are not personally "liquidated" and can get their debts discharged. *Id.* Accordingly, if a creditor's claim is excepted from an individual debtor's discharge, or the individual debtor is denied a discharge, the creditor can proceed with collection remedies after the debtor emerges from his or her bankruptcy proceeding.

22. Revocation of a Discharge. If a discharge was obtained through fraud, an interested party may, within a year of when the discharge was granted, request the bankruptcy court to revoke a chapter 7 or chapter 13 discharge. 11 U.S.C. §§ 727(d) and 1328(d). Similarly, if an order confirming a chapter 11 plan was procured by fraud, an interested party may, within 180 days after the entry of the order of confirmation, request the bankruptcy court to revoke the confirmation order. 11 U.S.C. § 1144.

23. Duties of a Trustee. The duties of trustees vary depending on the type of case.

a. **Chapter 7.** A chapter 7 trustee's duties include locating estate assets, liquidating property of the estate, examining claims, and administering the bankruptcy estate. 11 U.S.C. § 103.

b. **Chapter 11.** A debtor in possession has most of the powers of a trustee. 11 U.S.C. § 1107. A debtor in possession or a chapter 11 trustee has the duty to administer the debtor's affairs and, as soon as practicable, file a plan of reorganization. 11 U.S.C. § 1106.

c. **Chapters 12 and 13.** A chapter 13 trustee ensures that a debtor submits a feasible plan, makes timely payments under the plan, and pays creditors according to timely filed claims.

24. Creditors' Committees. Committees of unsecured creditors and equity holders may be formed in chapter 11 cases. 11 U.S.C. § 1102. Committees may hire attorneys and other professionals, subject to the court's approval, and the reasonable fees of those professionals can be paid out of assets of the bankruptcy estate. 11 U.S.C. § 1103.

25. Appointment of a Trustee. Upon cause shown, the court can appoint a chapter 11 trustee to take over for a debtor in possession. 11 U.S.C. § 1104.

26. Conversion or Dismissal of Chapter 11. Upon cause shown, the court may convert a chapter 11 case to chapter 7 or dismiss the case. 11 U.S.C. § 1112.

27. Who May File a Chapter 11 Plan. A debtor in possession has the exclusive right to file a plan of reorganization for 120 days, but the court may for cause shorten or lengthen that period. 11 U.S.C. § 1121. When the exclusive period expires, other interested parties including creditors, may present a plan of reorganization to the bankruptcy court.

28. Contents of Chapter 11 Plan. Under a plan, claims are classified and the treatment of those claims is specified. 11 U.S.C. § 1123. There are different types of “reorganization” plans that can be proposed. A plan can provide for liquidation of the debtor, payment of the debtor’s obligations over time, extinguishing existing shares and issuing new shares to creditors on account of their claims, etc.

29. Disclosure Statement. A chapter 11 plan, submitted to creditors for vote, must be accompanied by a bankruptcy court-approved disclosure statement that contains sufficient information for creditors to make an informed judgment about the plan. 11 U.S.C. § 1125.

30. Chapter 11 Plan Confirmation. The court will confirm a chapter 11 plan only if certain requirements are met. 11 U.S.C. § 1129(a). One of the requirements is that the bankruptcy court must find that the plan was proposed in good faith. 11 U.S.C. § 1129(a)(3).

31. Priority of Distribution in Chapter 11. Unless a class of creditors votes in favor of the chapter 11 plan, the plan cannot provide for a distribution to any class of creditors junior to that class. 11 U.S.C. § 1129(b)(2)(B). For example, if unsecured creditors are not paid in full, and they object to a plan that provides that stockholders will retain an interest in the reorganized debtor on account of their prepetition stock, the plan cannot be confirmed. (In this hypothetical, the plan cannot provide that a stockholder will retain an interest in the debtor; however, in appropriate cases, and even if unsecured creditors are not paid in full, a prepetition stockholder can acquire an interest in a reorganized debtor by providing new value.)

32. Effect of Confirming a Chapter 11 Plan. The provisions of a confirmed chapter 11 plan bind the debtor and its creditors. 11 U.S.C. § 1141. The confirmation of a plan discharges the debtor from most debts that arose before the date of confirmation. 11 U.S.C. § 1141(d)(1)(A). There are exceptions to the discharge for debts excepted from discharge under section 523, and where: (i) a debtor would be denied a discharge under section 727(a); (ii) the plan provides for liquidation of all assets; and (3) the debtor does not engage in business after consummation of the plan. 11 U.S.C. § 1141(d)(2) and (3).

33. Chapter 12 and 13 Plans. Disposable earnings of the debtor are paid to a standing trustee, for up to a 5-year period, to fund a plan of reorganization. 11 U.S.C. §§ 1222 and 1322.

34. Chapter 12 and 13 Discharges. A discharge under chapter 12 or 13 is broader than what is available under chapter 7. 11 U.S.C. §§ 1228 and 1328.

F. Adversary Proceedings.

Adversary proceedings are the equivalent of lawsuits filed within the bankruptcy forum and are governed by Part VII of the Federal Bankruptcy Rules (Rules 7001 through 7087). Adversary proceedings include but are not limited to, proceedings to: recover money; determine the extent of a lien; or a proceeding to obtain an injunction.

G. Removal of a State Court Case.

Proceedings related to a bankruptcy can be removed to federal court in the district where the bankruptcy proceeding is pending. 28 U.S.C. §§ 1452 and 1334. However, the court receiving the case may remand on any equitable ground and that decision is not reviewable on appeal. 11 U.S.C. § 1452(b).