community BANKER

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Welcome to the latest issue of the COMMUNITY BANKER.

The Community Banker is prepared by attorneys at Olson & Burns P.C. to provide information pertaining to legal developments affecting the field of banking. In order to accomplish this objective, we welcome any comments our readers have regarding the content and format of this publication. Please address your comments to:

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The attorneys at Olson & Burns represent a wide range of clients in the financial and commercial areas. Our attorneys represent more than 30 banks throughout North Dakota.

CHAPTER 7: LIQUIDATION UNDER THE BANKRUPTCY CODE

The November/December issue of the *Community Bankers' Advisor* provided lenders a general overview of the bankruptcy process. This issue summarizes Chapter 7 bankruptcy, the simplest and most common form.

In a Chapter 7 bankruptcy case, the bankruptcy trustee gathers and sells the debtor's nonexempt assets and uses the proceeds of those assets to pay creditors; priority is given to those creditors with valid liens. In addition, the debtor may keep certain "exempt" property. Most debts are discharged in a Chapter 7 (most but not all – there's no discharge for student loans, child-support payments, unpaid taxes, etc.).

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CHAPTER 7 ELIGIBILITY

To qualify for Chapter 7, the debtor may be an individual, a partnership, or a corporation or other business entity. Not everyone qualifies for Chapter 7; 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 a grant of relief would be an abuse of Chapter 7. If the debtor's "current monthly income" is more than the state median, the Bankruptcy Code requires a "means test" to determine whether the Chapter 7 filing is likely abusive (meaning that the debtor filed bankruptcy even though he *has the ability* pay his debts).

This is a two-part test. The first part calculates the gross income of the household for the 6 months prior to filing bankruptcy. If the household income is less than the state median income for the size of the family, the debtor can file either a Chapter 7 or a Chapter 13. If the household income is higher than the median income, then a complicated set of calculations based upon the actual and allowed expenses of the family are made to see if "there are sufficient funds to repay" a significant amount of the debt. If a debtor has enough disposable income, then the only Chapter he can file are a 13, an 11, or, for family farmers, a Chapter 12.

An individual cannot file under Chapter 7 or any other Chapter if during the preceding 180 days a prior bankruptcy petition was dismissed due to the debtor's **(1)** willful failure to appear before the court, or **(2)** comply with orders of the court, or **(3)** the debtor voluntarily dismissed the previous case after creditors sought relief from the bankruptcy court to recover property upon which they hold liens. Additionally, no individual may be a debtor under Chapter 7 or any other chapter unless he or she has, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group setting.

In a Chapter 7 case, a discharge of debt is only given to individual debtors, not to partnerships or corporations. Corporations, partnerships, and LLCs do not receive a discharge by filing Chapter 7 bankruptcy: a business Chapter 7 is designed to *liquidate* the company's assets and pay its obligations. Since exemptions are not available in a business bankruptcy, all assets of the corporation or LLC are sold and the proceeds distributed among its creditors according to priority. When the business entity files for Chapter 7, it becomes the duty of the bankruptcy trustee to sell off its assets and pay its creditors.

HOW CHAPTER 7 WORKS

A Chapter 7 case begins with the debtor filing a petition with the bankruptcy clerk of court. The debtor must also file: **(1)** schedules of assets and liabilities; **(2)** a schedule of current income and expenditures; **(3)** a statement of financial affairs; and **(4)** a schedule of executory contracts and unexpired leases. Debtors must also provide the trustee with a copy of the tax return or transcripts for the most recent tax year as well as tax returns filed during the case (including tax returns for prior years that had not been filed when the case began). Individual debtors with primarily consumer debts must also file a certificate of credit counseling and a copy of any debt repayment plan developed through credit counseling; evidence of payment from employers, if any, received 60 days before filing;

a statement of monthly net income and any anticipated increase in income or expenses after filing; and a record of any interest the debtor has in federal or state qualified education or tuition accounts. A husband and wife may file a joint petition or individual petitions. Even if filing jointly, a husband and wife are subject to all the document filing requirements of individual debtors. The debtor must provide the following information on the forms that make up the petition: **(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.

Married debtors must provide this information for his or her spouse, regardless of whether they are filing a joint petition, separate individual petitions, or even if only one spouse is filing so that the court, the trustee, and creditors can evaluate the household's financial position.

Among the schedules that an individual debtor will file is a schedule of "exempt" property. An individual debtor can protect some property from the claims of creditors because it is exempt under federal bankruptcy law or under the laws of the debtor's home state. North Dakota uses its own exemption law in place of the federal exemptions; however, there are certain federal exemptions that can be used in conjunction with state exemptions, such as the exemption of railroad retirement benefits.

Filing a petition under Chapter 7 *automatically* stays or stops most collection actions against the debtor or the debtor's property. The bankruptcy clerk gives notice of the bankruptcy case to all creditors whose names and addresses are provided by the debtor; as long as the stay is in effect, creditors *may not* initiate or continue lawsuits, wage garnishments, or make telephone calls demanding payment.

Between 21 and 40 days after the petition is filed, the case trustee (described below) will hold a meeting of creditors where creditors can question the debtor about debts and property.

TIP: Go, or send your attorney, to the first meeting of creditors because you can find out a lot of things of interest. For example, if you have personal property collateral, ask about its location, use, value, and whether it's insured; ask about appraisals the debtor may have done recently.

Usually, this is the only formal proceeding at which a Chapter 7 debtor must appear. The debtor is under oath and the trustee and creditors may ask questions about the debtor's financial affairs and property. If a husband and wife have filed a joint petition, they both must attend the creditors' meeting and answer questions.

Within 10 days of the creditors' meeting, the U.S. trustee will report to the court whether the case should be presumed to be an abuse under the means test. A debtor may convert a Chapter 7 case to a case under Chapter 11, 12, or 13 as long as the debtor is eligible to be a debtor under the new chapter.

ROLE OF THE CASE TRUSTEE

When a Chapter 7 petition is filed, the U.S. trustee appoints a case trustee to administer the case and liquidate the debtor's nonexempt assets (or all assets in the case of a business debtor). If all the debtor's assets are exempt or subject to valid liens, the trustee will normally file a "no asset" report with the

court, and there will be no distribution to unsecured creditors. Most Chapter 7 cases involving individual debtors are no asset cases. In the typical no-asset Chapter 7 case, there is no need for creditors to file proofs of claim because there will be no distribution. If the trustee later recovers assets for distribution to unsecured creditors, the Court will provide notice to creditors and will allow additional time to file proofs of claim.

If the case appears to be an "asset" case at the outset, unsecured creditors must file their claims with the court within 90 days after the first date set for the meeting of creditors. Although a secured creditor does not need to file a proof of claim in a Chapter 7 case to preserve its security interest or lien, there may be other reasons to file a claim.

Tip: The unsecured creditor in a Chapter 7 case may (if it's an asset case) or may not (if it's a no asset case) file a proof of claim, hope for the best, expect the worst, and will usually write the debt off. The best the secured creditor can do, typically, is try to grab its collateral or get the value of its collateral. Sometimes, a reaffirmation agreement may be in order if the creditor believes it will receive more than the value of its collateral even if the debtor keeps the collateral, but makes some future payments.

Commencement of a bankruptcy case creates an "estate", which technically becomes the temporary legal owner of all 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 so as to maximize the return to the debtor's unsecured creditors. This is done by selling the debtor's property if it is free and clear of liens (as long as the property is not exempt) or if it is worth more than any security interest or lien attached to the property and any exemption that the debtor holds in the property. The trustee may also attempt to recover money or property under the trustee's "avoiding powers." The trustee's avoiding powers include the power to **(1)** set aside preferential transfers made to creditors within 90 days before the petition, **(2)** undo security interests and other prepetition transfers of property that were not properly perfected under nonbankruptcy law at the time of the petition, and **(3)** pursue nonbankruptcy claims such as fraudulent conveyance and bulk transfer remedies available under state law.

TIP: Because of the avoiding powers of a trustee, sometimes a creditor might be better off making arrangements with a debtor that will give the debtor some incentive to wait at least 90 days after payments are made before he files for bankruptcy.

If the debtor is a business, the court may authorize the trustee to operate the business for a limited period of time, if operating it will benefit creditors and boost the liquidation of the estate. Distribution of funds is by class. 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 only paid if all other classes of claims have been paid in full. Keep in mind the debtor's end game. **The debtor's goal in a Chapter 7 case is to retain exempt property and to receive a discharge that covers as many debts as possible.**

THE CHAPTER 7 DISCHARGE

A discharge releases individual debtors from personal liability for most debts (they no longer have to pay these debts) and prevents the creditors owed those debts from taking *any* collection actions against the debtor. Generally, excluding cases that are dismissed or converted, individual debtors receive a discharge in more than 99 percent of Chapter 7 cases. In most cases, unless a party in interest files a complaint objecting to the discharge or a motion to extend the time to object, the bankruptcy court will issue a discharge order relatively early in the case – generally, 60 to 90 days after the date first set for the meeting of creditors. The grounds for denying an individual debtor a discharge in a Chapter 7 case are narrow and are interpreted against the moving party. Among other reasons, the court may deny the debtor a discharge if it finds that the debtor **(1)** failed to keep or produce adequate books or financial records, **(2)** failed to explain satisfactorily any loss of assets, **(3)** committed a bankruptcy crime such as perjury, **(4)** failed to obey a lawful order of the bankruptcy court, **(4)** fraudulently transferred, concealed, or destroyed property that would have become property of the estate, or **(5)** failed to complete an approved instructional course concerning financial management.

Secured creditors may retain some rights to seize property securing an underlying debt even after a discharge is granted. Depending on individual circumstances, if a debtor wishes to keep certain secured property (such as a motor vehicle), he or she may decide to reaffirm the debt. A reaffirmation is an agreement between the debtor and the creditor that the debtor will remain liable and will pay all or a portion of the money owed, even though the debt would otherwise be discharged in the bankruptcy. In return, the creditor promises that it will not repossess or take back the pickup or other property so long as the debtor continues to pay the debt.

TIP: A secured creditor will generally either get its collateral or get paid for its collateral if the creditor watches out for its interests. In consumer Chapter 7 cases, the debtor must elect whether to surrender the collateral, redeem or pay for the collateral or reaffirm the debt and make payments. If the debtor does not surrender the collateral, redeem the collateral or enter into an acceptable reaffirmation agreement, then the creditor will have to either get a lift of the stay, get the Chapter 7 trustee to abandon the collateral (in which case it will no longer be property of the estate, and thus no longer protected by the automatic stay), or wait for the case to be closed. Reaffirmation agreements, which generally must be done and filed before the debtor obtains a discharge, serve to keep the personal obligation to pay the debt from being discharged. Typically, unless there is a bankruptcy court order to the contrary, the lien created by the security agreement or mortgage will survive the discharge, but for a time, will be unenforceable because of the automatic stay.

If the debtor decides to reaffirm a debt, he must do so before the discharge is entered; a written reaffirmation agreement must be signed by the debtor and filed with the court. Among other things, disclosures must advise the debtor of the amount of the debt being reaffirmed and how it is calculated and that reaffirmation means that the debtor's personal liability for that debt will *not* be discharged in the bankruptcy. The disclosures also require the debtor to sign and file a statement of his or her current income and expenses which shows that the balance of income paying expenses is sufficient to pay the reaffirmed debt. If the balance is not enough to pay the debt to be reaffirmed, there is a presumption of undue hardship, and the court may decide not to approve the reaffirmation agreement. However, the

debtor may repay any debt voluntarily, whether or not a reaffirmation agreement exists.

The court may revoke a Chapter 7 discharge on the request of the trustee, a creditor, or the U.S. trustee if **(1)** the discharge was obtained through fraud by the debtor, **(2)** the debtor acquired property that is property of the estate and knowingly and fraudulently failed to report the acquisition of the property or to surrender the property to the trustee, or **(3)** the debtor (without a satisfactory explanation) makes a material misstatement or fails to provide documents or other information in connection with an audit of the debtor's case.

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