

Bankrupt and Loving It



Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.

— Charles Dickens, *David Copperfield*

BY BRIAN IRION, ESQ.

When I tell other attorneys that a large part of my practice involves bankruptcy work, their responses give me the impression that most lawyers' knowledge of bankruptcy law is very limited and many have no interest in knowing more. It's like workers' compensation law: You either "do it" or you "don't." While it is true the Bankruptcy Code (the "Code"), by its

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numerous internal cross-references, can be much like the Internal Revenue Code and appear daunting, it need not be so.

In today's economic climate, basic knowledge of the Code is a valuable tool every civil litigator and business lawyer should have in his or her toolbox. In this article, I'll try to lay out the basics and help demystify the Code.

BANKRUPTCY IS FOR EVERYONE'S BENEFIT

In economist Adam Smith's book, *Wealth of Nations*, he uses the phrase "invisible hand" to demonstrate how each person acting in his own interest combines to promote the good of the community. The same is true in bankruptcy proceedings.

For debtors, a discharge (11 USC

§727) offers a fresh start to the honest, but unfortunate, or it simply offers a chance through the automatic stay to regroup and analyze how to handle financial problems. For creditors, the bankruptcy process offers disclosure of the debtor's actual financial situation and an orderly liquidation or payment plan without the time, cost, and uncertainty of costly traditional litigation, plus it further stops the race between creditors to be the first to grab the dwindling assets of the debtor. Still other creditors may not want current management in place and may seek the replacement of the debtor-in-possession with a trustee or examiner in a reorganization case. The U.S. Trustee's goal in bankruptcy is to ensure the debtor acts honestly and equitably towards the creditors. This may occur by reviewing the petition, past tax returns, or examining the debtor throughout the case to evaluate which, if any, type of bankruptcy is best for all concerned and, if need be, file a motion to convert a case to that of another chapter or have it dismissed entirely. The bankruptcy case trustee (different from the U.S. Trustee's office) has the goal of getting as many assets into and disbursed through the bankruptcy estate, as the trustee makes a commission based on this throughout.

Rather than fight it or fear it, it is in everyone's best interests to participate in the bankruptcy process and move on with life.

OVERVIEW

The Code is found in Title 11 of the United States Code. It is divided into nine chapters, all but one of which are odd-numbered. Generally, Chapters 1, 3, and 5 apply to all bankruptcies (§103). Chapter 1 deals with global issues such as definitions (§101), the powers of the bankruptcy courts (§105), and limits on who may be a debtor in bankruptcy (§109). Chapter 3 addresses case administration for all bankruptcies, such as how cases

are commenced (§301, 303), who are the officers of the case, including the U.S. Trustee (§307), the case trustee (§321), employment and compensation of professionals (§§327-330), the effect of the automatic stay and when it may be lifted (§362), as well as how to deal with “**executory contracts**,” meaning those not fully performed, save for payment of money (§365). Chapter 5 covers the claims process including allowance of claims, determination of secured status and the like (§§501-511), the debtor’s duties to list all assets and liabilities (§521), the definition of property of the estate (§541), and the trustee’s powers to compel turnover of estate property held by others or return of assets to the estate that were disbursed to some creditors before the case was commenced (§§542-553).

LIQUIDATION BANKRUPTCY

Chapter 7 is known as a liquidation bankruptcy and is the most common form of bankruptcy. There were 5,934 Chapter 7 filings in the Northern District of California in the second quarter of 2011, accounting for 65% of all bankruptcy filings over the period (“<http://www.uscourts.gov/Statistics/BankruptcyStatistics.aspx>”). In a Chapter 7 case, a debtor gives up all non-exempt property to pay creditors and, in return, receives a discharge from most debts (§§541(property of the estate), 522 (exemptions for individuals), 523 (debts excepted from discharge), 727 (discharge)). Corporations do not have exemptions because they do not need to eat, clothe themselves, or otherwise prepare for life after bankruptcy (§522, Cal. Civ. Proc. Code §703.020, §703.130 et seq.). Similarly, corporations do not receive a discharge under Chapter 7 because there is no need for the fresh start. The corporation is no longer engaged in business (§727). Where the debtor is an individual or the debtors are joint individuals, they may be precluded from being Chapter 7 debtors by the “**means test**,” a mechanism found in §707 and intended to prohibit high wage earners from obtaining a discharge when they can repay a substantial portion of their debt. If they

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fail the means test, the debtors must file under Chapter 13 or Chapter 11.

Chapter 13 is the next most common form of bankruptcy, accounting for nearly 34% of all bankruptcy filings in the Northern District of California during the second quarter of 2011. Only an individual or married person can be a debtor under Chapter 13, often dubbed the “**wage earner plan**” bankruptcy (§§109, 1301). In addition, to be a debtor under Chapter 13, the debtor must not have more than \$1,081,400 in secured debt and \$360,475 in unsecured debt. Generally, the debtor who qualifies for and must file a Chapter 13 case due to excessive income in the months leading up to bankruptcy must file, and have approved by the Court, a repayment plan that commits to paying all of the debtor’s “**monthly disposable income**” for a five-year period, at the end of which the debtor will receive a discharge. The estate property includes these post-petition earnings in addition to the normal definition of “**estate property**” under §541 (§1306). The easiest way to describe a Chapter 13 case is to compare it to a Chapter 11 reorganization case. Chapter 13 is a streamlined and simplified reorganization and partial repayment of debts.

With the possible exception of a bankruptcy by a municipality under Chapter 9, a Chapter 11 bankruptcy is easily the most complicated and expensive of the bankruptcies.

Typically dubbed a “**reorganization**” case, it can take on many forms and outcomes. Only 106, or less than 1% of all bankruptcy cases commenced in the second quarter of 2011 in the Northern District of California, were filed under Chapter 11, and only 36 of those were “**business**” reorganizations. Under a Chapter 11 case, the debtor remains in possession of the estate property and is called a “**debtor in possession**” or “**DIP**.” If it is an ongoing business, the debtor is authorized to continue operating the business (§1107-1108) unless ousted by the appointment of a trustee under §1104, usually for misconduct or mismanagement by the DIP. In addition to scheduling all of the assets, liabilities, and ongoing executory contracts (such as leases, financing agreements, collective bargaining agreements, and the like) (§521, Fed. R. Bankr. Proc. 1007), a DIP must both seek approval of the Court to undertake “**out of the ordinary**” expenses such as employing professionals, and regularly report to the Court by filing monthly operating, income, and expense reports. Additionally, DIPs have a limited time to propose a plan of reorganization, create and get approved a “**disclosure statement**,” and lobby creditors to accept the plan (§§1121-1126, §1129). Creditors’ committees are usually appointed under §§1102-1103 to represent unsecured creditors at large and these committees often seek representation, also at the expense of the estate.

DOOMED EARLY

This continuous oversight adds to the ongoing cost of running any business and can overtax it to such an extent that many Chapter 11 cases are doomed in the first several months. The vast majority of Chapter 11 cases end up being converted to Chapter 7 liquidations when no feasible plan of reorganization can be created or approved before this additional burden becomes overwhelming. One may ask why, then, anyone would file a Chapter 11 case. The debtor’s goals in filing for bankruptcy include getting an automatic stay in order to have some

breathing room to reassess how to handle the situation. For businesses in bankruptcy, this also permits the debtor a chance to renegotiate leases, alter borrowing relationships with lenders (sometimes to a lower interest rate or principal reduction), or sometimes reject onerous agreements with labor unions. This higher level of negotiating and maneuvering often escapes the normal unsecured creditor's notice.

THE EFFECT OF THE AUTOMATIC STAY

One of the effects of bankruptcy is the feared and revered “automatic stay” imposed by §362 of the Code. But exactly what does it do?

The automatic stay does stop the vast majority of creditor actions against a debtor. It operates as an injunction (with the power of the Court behind it) to stop

the commencement, continuation of lawsuits, and administrative proceedings;



efforts to enforce money judgments; garnishments and attachments in pre-judgment collection litigation; any act to create, perfect, or enforce most liens; and offset of debts owing to the debtor.

It does not, however, stop criminal proceedings; professional or drivers' license revocation proceedings; paternity, domestic support

obligations; marriage dissolution cases (except for division of property that is estate property); domestic violence proceedings; interception of tax refunds under the Social Security Act; tax audits or notices of deficiency from the IRS; eviction proceedings of non-residential real property where the lease has expired of its own terms; continued withholding from earnings (Chapters 11, 13); acts to enforce against property that was the subject of a successful relief motion within the previous two years in a prior case; continued eviction of residential property if judgment was entered before the bankruptcy petition was filed; and acts to perfect or continue perfection of lien that relate back (such as mechanics' liens).

WHAT THE BANKRUPTCY ESTATE IS MADE OF

The filing of a bankruptcy petition creates a bankruptcy estate. In a consumer case, it is comprised of all assets of the debtor, and of the spouse's interest in community property; all inheritances, bequests, devises, amounts received from divorce decrees or life insurance policies received within following 180 days; in a Chapter 13, the debtor's earnings through the life of the repayment plan; and

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all transfers avoided by the trustee such as fraudulent conveyances or preferential transfers; minus exemptions allowed to be taken under applicable law once allowed. (§§541, 522, Cal. Civ. Proc. Code §703.010 et seq.; Fed. R. Bankr. Proc. 4003).

WHAT ARE CALIFORNIA'S EXEMPTIONS?

California has two sets of exemptions laws. One is permitted to be used by anyone and includes the statutory homestead exemption; the other is limited to bankruptcy debtors who elect to use the alternative "bankruptcy-like" exemptions (§522, Civ. Proc. Code §703.010 et seq.).

WHAT DEBTS CANNOT BE DISCHARGED?

A discharge generally operates to discharge the debtor from all debts arising before the petition was filed, except

most recent taxes due and unpaid; taxes due for fraudulent returns or unfiled returns; domestic support obligations; fines, penalties, and forfeitures; student loans unless the court determines that requiring payment would impose an undue hardship; death, personal injury damages caused by DUI, or other illegal controlled substances; criminal restitution orders; divorce obligations ordered by the family court;

HOA fees or assessments due after the petition was filed; amounts owed under repayment to pension or profit sharing plans under ERISA; judgments for fraud or defalcation under securities laws; and

If a creditor establishes the following in proceedings in the bankruptcy court debt for money, property, or services obtained by false pretenses (for example, credit card debts incurred just before the bankruptcy petition is filed);

fraud while acting as a fiduciary; or willful and malicious injury, these debts may be found nondischargeable and may survive the bankruptcy process (§§523, 727, 1141, 1328). □

A Convergence of Forces

BY JAMES D. BIERNAT, ESQ.



Chief Justice Tani Cantil-Sakauye

On September 20, 2011, California's Chief Justice, Tani Cantil-Sakauye, met with Bench and Bar at the Historic Court House in Redwood City. The Chief Justice was the keynote speaker at the Annual Speakers' Forum sponsored by the Diversity Committee of the San

Mateo County Bar Association. The evening was also special because Joe Cotchett of Cotchett, Pitre & McCarthy was honored as the inaugural recipient of the SMCBA Diversity Award.

The State Bar's Pipeline Taskforce previously challenged bar members to take steps to promote diversity

in the legal profession. The SMCBA responded by forming a Diversity Committee. Kristina Chung of Ropers, Majeski, Kohn and Bentley, the Diversity Committee's first Chair, was inspired to create a Speakers' Subcommittee. The Chief Justice was contacted by SMCBA member, Ray Buenaventura, and invited to be this year's speaker. The acceptance was immediate and gracious. FYI: Buenaventura (good fortune) is an elected Daly City councilman.

NEW CHIEF JUSTICE

Our new Chief Justice was among the first to arrive and the last to leave the Historic Court House. Upon her arrival, the energy level was palpable. The evening began with a reception and everyone clamoring for one-on-one time with the Chief Justice. "Indefatigable and inspiring" are the descriptive words. With a calm and charming demeanor, Justice Cantil-Sakauye exhibited a deft ability to relate equally well to first-year law students as well as tenured jurists. By her example, Justice Cantil-Sakauye