Introduction to Bankruptcy-Frequently Asked Questions
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What is bankruptcy?

Bankruptcy is a federal statutory scheme that deals with how to allocate losses in circumstances when there is not enough money to go around. In that sense, bankruptcy deals in reality when other area of the law indulge in the fiction that there is plenty of money to go around and make everyone whole. Bankruptcy does not indulge in that fiction.

What are the policy goals of bankruptcy?

The policy goals are two-fold: 1) the payment of creditors to the extent possible; and 2) the financial rehabilitation of the Debtor. That rehabilitation may include a discharge of existing obligations and fresh start, free of the burdens of past misfortune.

You may vaguely remember something in the Constitution about not impairing the obligations of contracts. Is bankruptcy relief constitutional?

Yes, it is. The Constitution says, "No ***State*** may enact a law impairing the Obligation of Contract." There is no such restriction on the Congress.

What is the Constitutional authority for bankruptcy?

The authority for bankruptcy relief starts with United States Constitution, Article I, Section 8, which empowers the Congress to enact "uniform Laws on the subject of bankruptcies through the United States."

How has Congress exercised its Constitutional authorization to create a uniform national bankruptcy law?

It took the Congress more than 100 years, but eventually Congress enacted the Bankruptcy Act of 1898, which created the predecessor to the system we now use. That Act was amended substantially at the end of the Great Depression in 1938. The Bankruptcy Act, as amended, was the law of the land for many years. Much of the case law precedent established under the Bankruptcy Act of 1898 is still good law.

In 1978, Congress enacted the Bankruptcy Code of 1978, which repealed the Bankruptcy Act of 1898, but retained most of the same principles. The Bankruptcy Code of 1978 was substantially amended in 1984, 1994, and 2005. With those amendments, the Bankruptcy Code of 1978 is the current statute that governs bankruptcy in America. Some of the statutory language is clear, and some of it is opaque. Courts have come to very different conclusions about how to interpret portions of it, and the law differs from Circuit to Circuit. For example, the Fifth Circuit and Third Circuit read some fairly important provisions regarding the allowance of administrative claims quite differently.

Who gets the last say on interpretation of the Bankruptcy Code?

As with any Federal statute, the United States Supreme Court.

How is bankruptcy administered?

The bankruptcy system is administered through the United States Bankruptcy Courts, which are a special type of federal court created by an Act of Congress pursuant to Article I of the Constitution. The bankruptcy judges are appointed by the Courts of Appeals and serve for terms of 14 years, unlike Article III federal judges, who have life tenure. Article III federal judges have jurisdiction to hear bankruptcy cases, but they rarely do, except in appeals. However, Article III federal judges will sometime hear Adversary Proceedings, which are discrete disputes within bankruptcy cases, particularly if one of the parties to the dispute has a Seventh Amendment Constitutional right to have the dispute decided by an Article III judge. Recent case law from the Supreme Court has been expanding that Seventh Amendment right to include more types of disputes that arise in bankruptcy cases.

What is insolvency and how is it different from bankruptcy?

There are two types of insolvency: 1) equitable insolvency, which is the inability to pay debts as they come due. This is sometimes true of debtors who have valuable but illiquid assets that are hard to sell; and 2) balance sheet insolvency, which means that the Debtor's enforceable debts exceed the fair market value of its assets. In other words, if the Debtor sold everything it had, would there be enough value to pay its debts in full? If the answer is "no", the Debtor is insolvent. In bankruptcy terms, this is normally what we mean by the term "insolvency."

Does a Debtor have to be insolvent to file a bankruptcy?

No, it does not. If a Debtor is not insolvent, it may have some explaining to do as to why it filed a bankruptcy petition, but insolvency is not a requirement for bankruptcy. If a Debtor is not insolvent, creditors may try to get the bankruptcy case dismissed for bad faith. However, there are sometime legitimate reasons to file a bankruptcy even if the Debtor is not insolvent.

What types of bankruptcy relief are available?

Relief is available under Chapters 7, 9, 11, 12, 13, and 15.

What is the difference between those Chapters?

Chapter 7 is straight liquidation. It is available to individuals, partnerships, corporations, limited liability companies, stockbrokers, commodity brokers, and non-profit organizations. In Chapter 7, the Debtor shuts down operations, if any, and a trustee is appointed to collect the Debtor's assets, sell them, and distribute the net proceeds, if any, to creditors.

Chapter 11 is available to any person or entity that can file a Chapter 7 case, plus railroads. Chapter 11 is intended for reorganization, but reorganization may mean simply an orderly liquidation directed by the owners of the enterprise rather than by a trustee.

Neither Chapter 7, nor Chapter 11 is available to federal insured depository institutions or to insurance companies. The insolvencies of those entities are governed by different statutory schemes, not the Bankruptcy Code. However, bank holding companies can file bankruptcy, and many have.

Chapter 9 is for governmental units, which include cities, counties, hospital districts, municipal utility districts, and publicly owned utilities.

The most famous Chapter 9 cases were the City of Detroit, Michigan, whose bankruptcy recently ended, and Orange County, California, which filed in 1994 after losing several hundred million dollars trading derivatives. The common Chapter 9 cases involve local taxing districts, like hospital districts and municipal utility districts. Texas has seen several municipal utility districts file Chapter 9 cases.

Chapter 12 is for family farmers and fisherman. Chapter 12 filings are rare in this part of the world, but they are quite common in agricultural regions, particular dairy farming areas.

Chapter 13 is reorganization for individuals with a regular income, from any legal source, and relatively small debts. Chapter 13 is reorganization for consumers. There are strict limits on how much the Debtor can owe. Chapter 13 cases usually involve a five (5) year payout to creditors.

Chapter 15 is for American recognition of a foreign bankruptcy proceeding. For example, Target Stores' Canadian subsidiary has filed a bankruptcy proceeding up in Toronto, Canada. If, for some reason, Target wants American recognition of that proceeding, it could file a Chapter 15 petition down here, probably in Minnesota.

Assuming your client could benefit from bankruptcy relief, which Chapter is best?

That depends upon the goals. If the client wants to save a business and reorganize its finances, Chapter 11 is only choice, assuming that goal is feasible. If all your client wants is a decent burial for a failed enterprise, Chapter 7 would make sense. And there is a lot a gray area in between. There are many considerations, particularly for clients who are natural persons. Come see me, and we will talk.

What can bankruptcy do to help the Debtor?

Let's start with the automatic stay. The filing of the bankruptcy petition invokes the protections of the automatic stay of Section 362(a). With a few exceptions, the automatic stay stops collection efforts for any debt that arose pre-petition. It stops foreclosures, garnishments, collection lawsuits, and lien filings. It prevents judgments from being taken or enforced. It stays discovery and prevents hearings from going forward. It gives the Debtor breathing space to stabilize its finances and its operations without having its bank accounts garnished, its assets seized, or its property taken by foreclosure.

What actions are not affected by the automatic stay?

There are twenty-two (22) exceptions to the automatic stay, i.e. actions that can proceed notwithstanding the bankruptcy filing. The most common exception are the following:

1. criminal prosecutions;
2. divorce actions;
3. the enforcement of domestic support orders, including wage garnishment;
4. the actions of governmental entities acting under their police or regulatory powers, such as pollution abatement or product recalls;
5. tax assessments or the attachment of statutory tax liens;
6. the filing of a timely mechanics lien;
7. the settlement, netting out, or termination of a commodity contract, securities contract, or forward contract;
8. the exercise of rights under a securities repurchase contract or a security agreement related to such repurchase contract;
9. the eviction of a tenant under an expired lease of non-residential real property; and,
10. the presentation of a negotiable instrument for payment or the sending of a notice of dishonor.

What happens if you ignore the automatic stay and proceed against the Debtor anyway?

You and your client may be sanctioned with attorneys' fees, actual damages, and in extreme cases, punitive damages and contempt sanctions. I have never seen anyone jailed for a stay violation, but I have sought and obtained attorneys' fees as sanctions for stay violations.

Is ignorance an excuse for a violation of the automatic stay? What if you did not know about the stay?

Ignorance of the law is not an excuse. Ignorance of the bankruptcy filing will prevent you and your client from being sanctioned, but once your client learns of the bankruptcy, it must undo anything it did in violation the stay. For example, if your client repossessed a car in violation of the stay, once it learns of the bankruptcy filing, it has to give the car back to the Debtor.

Assuming that the automatic stay does apply, what can a creditor do about it?

The Bankruptcy Code authorizes creditors to seek relief from the automatic stay by motion to the Bankruptcy Court. For example, a creditor can ask the Bankruptcy Court for permission to foreclose a lien, evict a tenant, or to continue litigation against the Debtor outside the Bankruptcy Court.

What are the grounds for relief from the automatic stay?

The Bankruptcy Code says the grounds are "cause" including the lack of adequate protection of a creditor's interest in property, or 1) the creditor has a lien on particular item of property, 2) the Debtor has no equity in the property, and 3) the property is not needed for an effective reorganization. Case law defines what those words mean. The outcome will depend upon particular facts and circumstance.

Other than the automatic stay, what can bankruptcy do for your client?

Bankruptcy allows the Debtor to reject executory contracts and unexpired leases and cap the damages caused by lease rejection. That power can be hugely important if the Debtor is stuck with uneconomic and burdensome lease obligations it needs to shed. That was the motivating factor for the Kmart bankruptcy. It had large number of long-term leases in uneconomic inner city locations that it needed to get out of.

Bankruptcy may allow the Debtor to obtain credit or borrow money on a post-petition basis when otherwise no one would lend money to the Debtor.

Bankruptcy may allow for a quick sale of the Debtor or its operating assets to a new owner or for an orderly liquidation of assets that yields better value than would be realized in a foreclosure or a sheriff's sale.

Bankruptcy may allow the Debtor to sell property that is subject to liens, subject to disputed ownership, or subject to disputes among owners without the consent of the secured lenders, the other claimants to the property, or to the Debtor's minority owners. This a hugely important power, and was the reason for Texas Rangers bankruptcy back in 2010, of which I was a part. It tells the story of a standoff between hedge funds, Hicks, and MLB.

Bankruptcy may allow the Debtor to avoid unperfected liens on property of the estate. For example, if the secured creditor failed to file a mortgage, filed the mortgage in the wrong county (which I have seen), failed to file UCC-1 financing statement, let a properly filed UCC-1 lapse, or failed to properly describe the collateral, the Debtor may be able to avoid that lien, take the property free and clear of liens, and treat the formerly secured creditor as unsecured.

Bankruptcy may allow the recovery of preference or fraudulent transfers. Occasionally, those recoveries can very large. In the *Asarco* bankruptcy, the Debtor recovered a $1.6 billion fraudulent transfer from its corporate parent.

Bankruptcy may allow for a restructuring of debts, such as reduction in the interest rate and extension of the payment term. Bankruptcy may allow a reduction in the total amount of debt, and the rehabilitation of the enterprise.

Bankruptcy may allow the Debtor to get a discharge of some or all of its obligations. For many Debtors, particularly individual Debtors, the discharge is the reason for seeking bankruptcy relief, and it is critically important not to do things many people in financial distress often do that may jeopardize the discharge. How you advise your client on this matter is critical.

How may the Debtor's bankruptcy help a creditor?

Bankruptcy may help creditors in several ways: 1) the automatic stay may prevent other creditors from seizing assets that could be used to help satisfy your client's claim; 2) bankruptcy may prevent the continued dissipation of assets by the Debtor, due either to continuing business losses or intentional acts by the Debtor to dissipate assets; 3) the avoidance powers may allow the recovery of preferences and fraudulent transfers, the proceeds of which can be used to satisfy creditor claims; 4) bankruptcy may put someone else in charge of the Debtor, who is honest and knows what he is doing; 5) bankruptcy requires the complete and honest disclosure of assets and liabilities, under penalty of perjury. It is the best discovery tool there is; and 6) finally, sometimes creditors benefit in the long run from the financial rehabilitation of the Debtor. That is why lenders and trade creditors will often support a reorganization in Chapter 11.

What does bankruptcy not do?

Some debts are not dischargeable in bankruptcy. For example, most federal tax debts, depending upon various factors, especially their age, are non-dischargeable. Bankruptcy may allow your client to stretch out the payment terms, but it won't make the debt go away. For individual Debtors, debts for marital support obligations or marital property settlements are non-dischargeable *per se*. Debts resulting from fraud, theft, breach of some types of fiduciary duties, and most intentional torts are not dischargeable if the injured creditor objects. The Debtor may lose his discharge globally by filing false schedules, destroying records, or by making fraudulent transfers before bankruptcy. However, objections to discharge and complaints to

determine dischargeability of particular debt must be filed quickly or the right to object is lost. If you believe that a Debtor has defrauded your client, committed some act of defalcation, or caused intentional injury of any kind, you must move quickly.

What else does bankruptcy not do?

Bankruptcy does not allow a Debtor to ignore otherwise applicable non-bankruptcy law. For example, if the Debtor needs a permit, a license, or a bond to do something, bankruptcy does not excuse that requirement. If the Debtor is required to pay some tax outside of bankruptcy, it will be required to do so in bankruptcy, though the Debtor may get some additional time.

Generally, bankruptcy will not save assets in which the Debtor has no equity. That is, if the Debtor owes more money against the asset than it is worth, the secured lender will usually get relief from the automatic stay to foreclose. This is one big reason why single asset real estate cases often don't work. For a single asset case to work, someone usually has to bring in some new money.

Finally, bankruptcy won't save a business if it cannot generate positive cash flow from operations. Bankruptcy can restructure debt and shed money losing leases and contracts, but it can't turn a bad business into a good one.

What is a proof of claim, and when should you file one?

A proof of claim is a demand for payment against the bankruptcy estate. It is signed under penalty of perjury, and it is presumptively valid unless an objection is filed. There is usually a deadline called the Bar Date for filing proofs of claim. Late filed claims may be disallowed or subordinated.

If your client believes that it is owed money, should it file a proof of claim against the bankruptcy estate?

Usually the answer is "Yes," but there can be tactical reasons not to file one. The failure to file a proof of claim waives any right to a distribution from the estate, but filing a proof of claim may waive the right to jury trial, which sometimes has tactical value. After consultation, your client might make the tactical decision not to file a proof of claim. If so, this decision must be carefully documented because of the malpractice considerations involved in missing the Bar Date.

Your client has been sued for receiving a preference. What should you do now?

Come see me immediately. Your client may have the right to jury trial. This is a valuable right you want to preserve, at least for settlement leverage. However, this valuable right can be easily waived if you are not careful. There are several defenses to preference claims, but many of them are affirmative defenses that must be specifically pleaded or they are waived.

Your client is in financial trouble. When should you escort him to the insolvency lawyer?

As soon as possible. I can be the doctor or the undertaker for a distressed business. If your client gets to me soon enough, I can be the doctor. If your client waits until it is nearly out of cash, it's too late. Then, I am just the undertaker. I prefer to be the doctor.

If you represent a creditor and believe that bankruptcy is likely, when should you escort you client to the insolvency lawyer?

As soon as possible. There are things a creditor can do to protect itself in the event of a future bankruptcy if can act soon enough. For example, in exchange for forbearance, you might get some collateral, either from the debtor or, even better, a non-debtor affiliate to secure your claim. You might get some language in a forbearance agreement that gives you an advantage if you need to seek relief from the automatic stay. You may be able to get favorable fact findings from a Court that would help you in a subsequent bankruptcy. And, your client needs to know about possible preference exposure.

What is the skill set of an effective bankruptcy lawyer?

An effective bankruptcy lawyer is a generalist. We have to be trial lawyers, transactional lawyers, business lawyers, mediators, and diplomats. Bankruptcy involves litigation, assets sales, financing, bluffing, and deal making. To that point, a debtor cannot afford to fight with everyone. Debtors who try to do so usually fail. Thus, an effective bankruptcy lawyer picks his or her battles carefully. He or she recognizes when to give in, when to negotiate, when to threaten, and when to fight. Therefore, other than knowledge of the Bankruptcy Code, the most important skill we bring is good judgment.