# Understanding Bankruptcy

## What is Bankruptcy?

Bankruptcy is a legal process where an individual or organizational debtor is able to seek some financial relief. A fundamental goal of the federal bankruptcy laws enacted by Congress is to give debtors a financial "fresh start" from burdensome debts.[1] This goal is accomplished through the bankruptcy discharge, which releases debtors from personal liability from specific debts and prohibits creditors from ever taking any action against the debtor to collect those debts. The two biggest issues that face individual debtors in a bankruptcy is the debtor's eligibility to file and whether debtor should receive a discharge of debts – both of which depend on the type of bankruptcy the debtor seeks to file under.[2]

Before a debtor is able to file a bankruptcy under any chapter of the Bankruptcy Code, the debtor must have, within 180 days before filing, received credit counseling from an approved credit counseling agency either in an individual or group briefing.[3] If the debtor does not receive credit counseling within 180 days before filing, the debtor may not be eligible to file. An exception to this rule may apply in an emergency situation or where U.S. trustee has determined that there are insufficient approved agencies to provide the required counseling.[4] Any debt management plans created by the debtor during the credit counseling must be filed with the court.[5]

For individuals, the most common chapters to file for bankruptcy under are chapter 7 or chapter 13 under the federal bankruptcy laws.

## Chapter 7 - Liquidation

Chapter 7 contemplates an orderly, court-supervised procedure by which a trustee takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors, subject to the debtor's right to retain certain exempt property and the rights of secured creditors.[6] Exempt property, or property that will not be liquidated in a chapter 7 proceeding, normally includes the following:

- Motor vehicles, up to a certain dollar value;
- Reasonably necessary clothing;
- Reasonably necessary household goods and furnishings;
- Household appliances;
- Jewelry, up to a certain value;
- Pensions;
- A portion of equity in the debtor's home;
- Tools of the debtor's trade or profession, up to a certain value;
- A portion of unpaid but earned wages;

---

[1] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf
[2] *Id.*
[3] 11 U.S.C. §§ 109, 111.
[4] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf
[5] *Id.*
[6] *Id.*

- Public benefits, including welfare, social security, and unemployment compensation, accumulated in a bank account; and
- Damages awarded for person injury.[7]

On the other hand, non-exempt property, or property that will likely be liquidated in a chapter 7 proceeding, will include the following:

- Expensive musical instruments, unless the debtor is a professional musician;
- Collections of stamps, coins, and other valuable items;
- Family heirlooms;
- Cash, bank accounts, stocks, bonds, and other investments;
- A second car or truck;
- A second or vacation home.[8]

Usually, there is little or no nonexempt property in most chapter 7 cases, which results in few, if any, actual liquidation of the debtor's assets.[9] Cases where there is no liquidation of the debtor's assets are also called "no-asset cases."[10] Likewise, if there are nonexempt properties, then the case is an "asset case."[11] In an asset case, a creditor holding an unsecured claim will receive distributions from the bankruptcy estate only if the creditor files a proof of claim with the bankruptcy court.[12]

One of the barriers for a debtor seeking to file for a bankruptcy under chapter 7 is the "means test," which determines whether an individual debtor qualifies for relief under chapter 7.[13] Debtors with primarily consumer debts, such as credit card debts, will be subject to the "means test."[14] Whether a debtor can pass the "means test" depends entirely on the debtor's average monthly income, and whether the debtor's income exceeds a certain threshold – normally, the state median income.[15] The "means test" threshold is measured in a formula that takes into account the debtor's family size and the six-month average monthly income for a similarly sized family.[16] If the debtor's income exceeds the threshold under the "means test," the debtor may not be eligible for a chapter 7 relief. However, the debtor may still qualify for chapter 7 relief after applying expense deductions under the "means test" form to reduce the debtor's average monthly income below the threshold.[17] Generally, the lower the debtor's income, the more likely it is for the debtor to receive chapter 7 relief.

Another barrier for chapter 7 relief is the restriction that a debtor can only declare a chapter 7 bankruptcy once every eight (8) years.[18] If a debtor had filed for bankruptcy within the last eight

---

[7] http://bankruptcy.findlaw.com/chapter-7/exempt-vs-non-exempt-property-under-chapter-7.html
[8] *Id.*
[9] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf
[10] *Id.*
[11] *Id.*
[12] *Id.*
[13] *Id.*
[14] http://www.nolo.com/legal-encyclopedia/chapter-7-bankruptcy-means-test-eligibility-29907.html
[15] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf
[16] *Id.*
[17] http://www.nolo.com/legal-encyclopedia/chapter-7-bankruptcy-means-test-eligibility-29907.html
[18] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf

(8) years, the debtor may not declare bankruptcy under chapter 7 again until eight (8) years have passed since the last chapter 7 filing.

Usually, a debtor's involvement with the bankruptcy judge is very limited. A typical chapter 7 debtor will not appear in court and will not see the bankruptcy judge unless an objection is raised in the case.[19] Once an individual debtor successfully files for a bankruptcy under chapter 7, the debtor will receive a discharge that releases the debtor from personal liability for certain dischargeable debts.[20] Usually, the debtor receives a discharge a few months after the petition is filed.

### Chapter 13 – Adjustment of Debts of an Individual With Regular Income

Chapter 13 is designed for an individual debtor who has a regular source of income.[21] A debtor may be eligible for relief under chapter 13 if the debtor's unsecured debts are less than $360,475 and secured debts are less than $1,081,400.[22] These amounts are adjusted accordingly with the consumer price index.

Unlike chapter 7, chapter 13 does not require a debtor to liquidate valuable assets, such as the assets listed above. Chapter 13 is used by debtors who do not qualify for chapter 7 relief due to the means test. Instead, chapter 13 allows the debtor to propose a "plan" to repay creditors, typically over three to five years.[23] The debtor's "plan" must be approved by the bankruptcy court, whose approval is based on the Bankruptcy Code's requirements of a confirmation at a confirmation hearing.[24] Usually, the confirmation hearing is the only formal proceeding at which a debtor must appear, which is normally held at the offices of the U.S. trustee. If the debtor's "plan" is accepted, the debtor makes payments to the creditors through the trustee based on the debtor's "plan."[25]

Under the debtor's plan, the debtor must make the required payments before the discharge is received. In the meantime, the debtor is protected from lawsuits, garnishments, and other creditor actions while the plan is in effect.[26] Typically, more debts are eliminated under chapter 13 than chapter 7.[27] Once all of the payments have been made, the debtor's discharge releases all debts disallowed or provided for in the plan with a few exceptions which include the following: certain long term obligations (such as a home mortgage), debts for alimony or child support, certain taxes, debts for most government funded or guaranteed educational loans or benefit overpayments, debts arising from death or personal injury caused by driving while intoxicated or under the influence of drugs, and debts for restitution or a criminal fine included in a sentence on the debtor's conviction of a crime.[28]

---

[19] *Id.*
[20] *Id.*
[21] *Id.*
[22] 11 U.S.C. § 109(e)
[23] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf
[24] *Id.*
[25] *Id.*
[26] *Id.*
[27] *Id.*
[28] *Id.*

## When is bankruptcy become a valid option?

To determine whether bankruptcy is a wise financial move, a debtor should assess the situation that they are in. A debtor should ask themselves the following questions:

1. Do I only make minimum payments on my credit cards?
2. Are bill collectors calling me?
3. Does the thought of sorting out my finances make me feel scared or out of control?
4. Do I use credit cards to pay for necessities?
5. Am I considering debt consolidation?
6. Am I unsure of how much I actually owe?[29]

If a debtor answers "yes" to two or more of the questions above, the debtor ought to give some thought to their financial situation. Bankruptcy is when a debtor owes more than the amount the debtor makes. A debtor should assess their situation: how many assets does the debtor have, and what are the assets' values? How much does money does the debtor owe in bills and loans? If the bills and loans are greater than the debtor's assets, the debtor ought to consider bankruptcy. For help, contact a financial advisor or an attorney.

## Best Practices.

Bankruptcy could be a difficult process to endure. In order to make the bankruptcy process as easy as possible, be sure to consider the following tips:

- Be truthful and fully disclose all information. Failing to list all assets and creditors on the bankruptcy forms can lead to a revocation of the discharge (the debtor is will owe the debts that she sought to discharge through bankruptcy), or may face criminal sanctions.
- Know that a creditor may not request payments for discharged debts. If a creditor attempts collection efforts on a discharged debt, the debtor can file a motion with the court, reporting the action and asking that the case be reopened to address the matter.[30]
- Know that an employer may not discriminate against the debtor.
- Do not abuse the bankruptcy process. 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 an abuse of chapter 7.[31]
- Make sure to receive the credit counseling before filing. If a debtor does not receive credit counseling 180 days before filing bankruptcy, then he or she will not be eligible for a bankruptcy.
- Comply with court orders. An individual cannot file under chapter 13 or any other chapter 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 was voluntarily dismissed after creditors sought relief from the bankruptcy court to recover property upon which they hold liens.[32]
- Know the statute of limitations for your debt. If a long time has passed since a debtor made a payment to the creditor, and the creditor has not contacted the debtor for a long period, then the creditor may have waived any claim to the debtor's money. Be sure to speak to an attorney  or other professional if this situation is applicable.

---

[29] http://www.legalzoom.com/money-matters/bankruptcy/bankruptcy-basics-when-should-you
[30] http://www.uscourts.gov/Viewer.aspx?doc=/uscourts/FederalCourts/BankruptcyResources/bankbasics2011.pdf
[31] 11 U.S.C. § 707(b)
[32] 11 U.S.C. §§ 109(g), 362(d) and (e).

## Common Mistakes.

There are some common mistakes made before and during the bankruptcy process. Here is a short list of them:

- *Repaying money to relatives* -- If you repaid a relative in the year before you filed for bankruptcy, court can require that person to return money distributed, and redistribute those funds equally to your creditors.
- *Hiding creditors* -- List every person or company to which you owe money. You cannot discharge a debt that is not disclosed on your list.
- *Transferring Assets* -- You cannot shift assets to a child's name or give them to a relative just before you file for bankruptcy. Transferring an asset to another will be treated effectively as actively concealing the asset, which could result in fraud.
- *Concealing Assets* -- Bankruptcy laws require that you fully disclose all of all assets. The FBI fraud division, IRS auditors, and the U.S. Trustee examine bankruptcy filings. Even if your assets are not listed in your paperwork, they will be found. It is a federal crime to commit bankruptcy fraud. Do not attempt this.
- *Credit Consolidation* -- The airwaves are inundated with consolidation companies promising to help a debtor "avoid bankruptcy." However, even if a debtor can negotiate lower payments or restructure your debt outside of bankruptcy, the debtor's credit score will be adversely affected and could incur tax liability. Remember that "not-for-profit" does not necessarily mean "free."[33]

[33] http://www.legalzoom.com/bankruptcy-guide/common-mistakes.html