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Six Golden Bankruptcy Rules

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Bankruptcy is not that complicated.

The following six "golden bankruptcy rules" deal with law and not generally with procedure. The reality out there, especially in Los Angeles, is somewhat different than the law. Most Chapter 7 trustees are full time attorneys or other professionals who are assigned some 250 cases per month. They are paid a small fee per case unless there are assets to administer (which is rarely the case) and therefore it is unusual for a chapter 7 trustee to do very much. There are only five Chapter 13 trustees who are buried with cases to administer. Chapter 11 cases in Los Angeles rarely have trustees or creditor's committees or even unsecured creditors watching carefully.

In any event . . .

GOLDEN RULE No. 1: Bankruptcy Doesn't Really Do Anything

Bankruptcy was invented as a creditor's remedy. The basic overriding concept is that forcing creditors to act as a group enhances the value of the assets they are trying to seize in payment of their debts. In a Chapter 7, a trustee is appointed at the outset from a panel of about 20 persons. His job is to seize the assets that the creditors would have seized anyway, i.e., non-exempt assets under state law. The trustee sells those assets and gives the money to the creditors. If there is nothing to sell, which is the usual case, the trustee files a "no asset report" and the case is closed about 6 months after it is filed. The debtor's debts are discharged as of the moment of filing the case. In a Chapter 11 and a Chapter 13, the debtor keeps some or all of his assets, as he chooses, as long as he pays the *value* of those assets to the creditors. If the debtor is going to lose his boat because he did not pay American Express, bankruptcy will not change that except to the extent that he can offer to pay the creditors the *value* of that boat over a period of time and keep it. If the debtor is behind on her house payments,

bankruptcy will not save the house unless she can pay the full amount of the lien over a period of time.

The Bankruptcy Code is a *vehicle* used to get the assets into the hands of the creditors. It is not a substantive law. What you *own* is determined by state law. What you *owe* is determined by state law. *How* it gets to creditors is determined by the Bankruptcy Code when a bankruptcy case is pending.

Suppose a corporation just lost a case and had judgment entered against it for $2 million. Will bankruptcy help? If the net value of the assets, i.e., total equity, is $3 million, the judgment will have to be paid in full. Bankruptcy will simply organize the process of paying the debt. If the assets are worth $1 million, the judgment creditor (and all the remaining unsecured creditors as a group) will have to be paid $1 million, i.e., the amount they would receive if there was no bankruptcy.

GOLDEN RULE No. 2:
The Great Wall of China

Chapter 7 bankruptcy occurs in a moment in time. Whatever you own *at the moment of filing* becomes part of the bankruptcy estate. Whatever debts you owe *at the moment of filing* are discharged unless there is an exception – see Golden Rule No. 5. Assets acquired *after* the bankruptcy petition is filed cannot be seized and debts incurred *after* the bankruptcy filing are not discharged and are not paid by the estate.

The concept of assets is very broad. Property that the debtor owns as well as any *rights to any property* that she owns at the moment of filing are part of the bankruptcy estate. *Rights* to property which are contingent or remote are nevertheless property of the bankruptcy estate if the *rights* to the property *existed at the time of filing*. For example, a real estate agent's right to commission is dependent upon a closing of a sale. An attorney's contingency fee agreement requires a successful conclusion of the case before the right to the fee matures. A contractor must finish the project and a store manager must work a full year to earn a bonus under his employment contract. To the extent that the *work* performed to earn the right to the payment was performed *before* the great wall of China went up, it is property of the bankruptcy estate. If I do work for a client today and file bankruptcy tomorrow morning, the right to get paid by that client belongs to the bankruptcy estate. It does not matter that I have not sent out a bill or have not completed the project to which I was assigned. If it is a contingency fee case, the portion of the work that I have completed pre-petition compared to the total amount of work required to ultimately obtain the contingency fee, is property of the estate. The book I have half written is property of the estate. My right to sue and collect from the guy who crashed into my car, even a moment before the bankruptcy filing, is property of the estate. The right to renew your season seats at the Staples Center is property of the estate. Tax refunds and net operating losses, i.e., the right to reduce a tax obligation this year, are property of the estate. The nature and extent of property rights are determined by state law but if they are rights which exist at the moment of filing, the rights are property of the estate and will be sold by the trustee. Property not ultimately sold by the trustee is "abandoned" back to the debtor.

Similarly, the Bankruptcy Code takes a very broad view of the concept of debt. In fact, bankruptcy lingo does not generally include the word debt. Liabilities or debts are called *claims* and a claim under the Bankruptcy Code is defined as the *right to payment* "whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or

unsecured", Section 101. If a dentist commits malpractice today and files bankruptcy tomorrow, her unfortunate patient has a claim as of the moment of filing. It does not matter that the patient does not realize she has a claim. If I see my doctor an hour before filing, the doctor has a claim against me which is discharged. If I see him on the way home from filing the petition, the claim is not discharged. See Golden Rule No. 5 for the exceptions. *Any* obligation contained in a lease is discharged at the moment of filing unless the lease is formally assumed. Any guarantees the debtor made, of his children's auto loans for example, are a claim at the moment of filing and therefore discharged. The concept of claim is all pervasive.

The *amount* of a creditor's claim is not something that the debtor or the trustee particularly cares about. The claims will be discharged no matter how large they are and the trustee will distribute all of the proceeds of the estate to the creditors no matter how large the total pool. The interest comes from the creditors as they prefer not to be diluted. A creditor's claim is the amount it was owed *on the date of filing*, i.e., including all interest, interest at the default rate in the agreement, late charges, attorneys fees etc. up to the moment of filing. The claim does not grow after the petition is filed except as to some secured creditors and priority creditors.

The Bankruptcy Code says that a claim is "allowed", unless it would not be allowed *under the agreement or under non-bankruptcy law*. For that reason, sometimes litigation commenced pre-petition will continue, usually before the bankruptcy court in the form of a claims objection proceeding, because the court has to determine the *amount* of the claim.

GOLDEN RULE No. 3:
Liens Do Not Go Away
in Bankruptcy

A holder of a lien is considered to own an interest in the property on which the lien is attached and, as we know, Congress cannot take away property without just compensation. A lien which attaches to property, created by agreement or involuntarily, remains attached *throughout the bankruptcy* and remains when the bankruptcy is concluded, no matter what the conclusion. There are almost no exceptions to this rule. The lien must be paid or the creditor will be able to foreclose irrespective of the bankruptcy. A foreclosure is stopped by the automatic stay once a bankruptcy is filed, however, the lien must be paid by someone or the creditor is going to foreclose when the case is over.

In a Chapter 11 or a Chapter 13, the debtor will be allowed to cure defaults and even re-write the *terms* of the loan in some cases, however, the debtor must pay the creditor the amount that the creditor would have received had the bankruptcy not prevented the creditor from proceeding with its foreclosure.

The exception to this rule which comes up most often is the Judgment Lien which impairs an exemption, Section 522(f).

GOLDEN RULE No. 4:
The Automatic Stay and Subsequent
Discharge Injunction Protect
Only the Debtor

The well known automatic stay does not literally stop everybody in their tracks. It is actually fairly specific. It says that creditors may not "commence or continue any act to collect a debt

against the debtor" that could have been brought before the bankruptcy was filed. In addition, a creditor may not commence or continue any act to *enforce a lien* against property that is property of the estate. The creditor may not commence or continue any act to attempt to gain management or control over property of the estate.

The automatic stay protects both the debtor, since the debt is going to be discharged, and the property of the estate, because the trustee is going to sell the asset on behalf of the creditors. It does not protect anyone else nor does it protect property which is not property of the estate. If the trustee does not care because the asset has no equity, the court will grant relief to proceed with the foreclosure.

The automatic stay goes into effect automatically and without notice. Acts which violate the automatic stay are void, at least in the 9th Circuit. There is no consequence to an innocent violation of the automatic stay other than the wasted effort, i.e., the act is void. A willful violation carries mandatory damages including punitive damages if the violation was malicious.

The Discharge Injunction is entered, usually, about four months after the case is filed but is effective, as of the date of filing no matter when it is entered.

GOLDEN RULE No. 5:
All Debts are Discharged
Unless Excepted under
Section 523

All debts are discharged unless one of the exceptions in Section 523(a) applies. This is one of the few rules of law in which *there are absolutely no exceptions*. A debt owed to literally anyone for literally any reason is discharged upon the filing of a bankruptcy petition, if it was a claim as of the petition date, (i.e., a right to payment) unless one of the exceptions in section 523(a) applies.

There are currently 19 parts of section 523(a) providing for the non-dischargeability of specific debts. Most of the exceptions apply automatically, that is, the debt automatically survives the bankruptcy without any action on the part of the creditor. Examples of these are child support, student loans, drunk driving damages and most taxes. The three main exceptions which must be litigated or they are discharged are fraud, defalcation by a fiduciary, and willful and malicious injury to person or property. If a creditor believes that the debt to him, the claim that existed on the petition date, was created by damages caused for one of those four reasons, the creditor must file a complaint and prove the exception at trial. This is true even if a non-bankruptcy court has entered judgment prior to the bankruptcy filing

Examples of Golden Rule No. 5 can be made by looking at some pretty weird debts. Suppose Mr. Jones woke up one morning and found that the bank mistakenly put $10,000 in his account that was not his. He had a great time that day spending the money and filed bankruptcy the next day. The bank has a claim, even if they do not figure it out for months. Is this obligation to the bank discharged? Answer: yes, unless one of the 19 exceptions under section 523(a) applies. The debt is not fraud since fraud is a misstatement of a material fact which is relied upon to the detriment of the listener. It is not a defalcation by a fiduciary unless a fiduciary relationship existed. It is, however, probably willful and malicious injury to person or property. Suppose Mr. Businessman has no workers' compensation and an employee is hurt on the job. The California Workers' Compensation Board gets a judgment against Mr. Businessman and he files bankruptcy. Is the debt discharged? Answer: Yes, unless one of the exceptions under section 523(a) apply. Again, there is no fraud or defalcation by a fiduciary. There is also no willful and malicious injury to person or property unless

it can be shown that Mr. Businessman did not carry workers' compensation *for the purpose of and with the intent to* see the employee and/or the Workers' Compensation Board injured. Suppose an attorney is accused of malicious prosecution. Is that debt discharged? Answer: Yes, unless one of the exceptions in section 523(a) applies. At trial, the creditor would have to prove not malicious prosecution under California law but that he was injured by willful and malicious injury to person or property. What about sanctions assessed against an attorney? The debt is discharged unless it was caused by the willful and malicious conduct of the debtor. Can the State Bar punish the offending debtor attorney? Yes, unless it is attempting to collect a debt which has been discharged. Can it withhold the attorney's right to practice law? No (section 525). What about court ordered restitution? Yes, unless one of the exceptions of Section 523(a) applies. Exception 7 applies to fines payable "to a governmental unit and not compensation for a pecuniary loss." What about attorney's fees awarded against the contemnor in a contempt action? Yes, unless one of the exceptions of Section 523 applies. What about creditors who do not get notice of the bankruptcy? Yes, unless one of the exceptions of Section 523 applies. Section 523(3) states that debts are not discharged if the creditor does not get *actual* notice *in time to file a complaint or file a proof of claim*. The 9th Circuit has severely restricted this rule in "no asset cases" and remember, nearly all cases are "no asset cases." Suppose I have accidentally created a hazardous waste dump on my property. The California Clean-up commission (or whatever it is called) goes after me. I file chapter 7. Is the debt discharged? Answer: Yes, unless one of the exceptions under section 523(a) apply. There is no willful and malicious injury to person or property unless it can be shown that I intentionally dumped the stuff on my land.

The discharge includes secured debts but remember liens don't go away in bankruptcy – Golden Rule No. 3. The debtor does not owe his mortgage or auto loan after the filing but if he doesn't make the payments and goes into default under the agreement, the creditor can foreclose.

The point of all of these examples is that the determination of non-dischargeability depends on the *exact language* of section 523(a). That determination is made under federal law. The scope of the trial is generally considerably more narrow than trial would have been in state court. Unless the creditor proves at trial that the exact language of section 523(a) has been met, the debt, no matter what it is for, is discharged. As to the debts which automatically survive bankruptcy such as most taxes, the debtor may defend himself in subsequent non-bankruptcy court proceedings by arguing that the debt has been discharged i.e., no Section 523(a) provision applies.

GOLDEN RULE No. 6:
If You Play Games, You
Lose Your Discharge

The discharge granted under Section 727 and enforced under Section 524 is obviously the biggest benefit to the typical person filing Chapter 7. The discharge is granted only to individuals, i.e., corporations, LLCs, partnerships, and trusts do not receive a discharge in chapter 7 – ever. Those entities can receive a discharge only in a chapter 11.

Creditors, the chapter 7 trustee or the US Trustee may object to entry of the discharge on one of ten grounds. Four of the grounds are basic public policy reasons: only individuals receive a discharge as stated above and only once every eight years (yes, its eight years, not seven). There are three grounds for denying the discharge based on bad acts before filing the case and three grounds for bad acts during the case.

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The pre-petition "bad acts" include transferring or concealing assets to delay, hinder or harass creditors, failure to explain where assets went, and failure to maintain books and records (so that creditors can determine where the assets went). Putting property in someone else's name, giving a family member a lien, "selling" property to a family member before filing will result in a denial of the discharge. "Losing" the money you had at the race track, "losing" your records, the unexplained disappearance of other assets will result in a denial of the discharge.

The post-petition bad acts include lying on the schedules or to the trustee, i.e., the false oath, failure to cooperate with the trustee and failure to cooperate with the court. It can readily be seen that the discharge is a "carrot" handed to the debtor who cooperates with the trustee and the process by turning over all assets available to be liquidated for the benefit of the creditors and cooperating with the trustee in completing that process.

The discharge is granted automatically. To have the discharge denied, a complaint must be filed within 60 days after the first meeting of creditors. If no complaint is filed, the discharge can only be attacked by requesting its revocation. The only basis for revocation is that the debtor committed fraud which could not have been discovered within the sixty day time limit.

The fact that the discharge is a *reward* for turning over his assets and cooperating with the liquidation cannot be overstated. The courts are actually very casual about denying the discharge when the perception is that the debtor tried to get a "head start" instead of a "fresh start, if the debtor has engaged in virtually any efforts to prevent the trustee from seizing and selling assets.

If the discharge is denied, the chapter 7 case does not end. The trustee still does his job by suing the transferee of the assets, by unwinding pre-petition activities of the debtor, by forcing the debtor to cooperate through contempt if necessary. He still gathers and liquidates the assets when the discharge is denied. The only difference is that creditors who are unpaid when the case ends, may sue the debtor on the debt and collect against post-bankruptcy assets.

The essay should not be construed to provide legal advice to any person or entity and should not be relied upon for the resolution of any specific issue. There are many exceptions to everything and the reader is advised to seek competent legal counsel before making any legal decisions in the bankruptcy field or any other field.