

# Ten Things That You May Not Know About Bankruptcy

by Hon. Craig A. Gargotta



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Unfortunately, the non-bankruptcy bar and public may base their perception of bankruptcy upon what they see in the news—that is, Curtis James Jackson III, aka 50 Cent, stacking \$100 bills (which Jackson claimed was prop money) to spell out “broke” or Lehman Brothers and General Motors filing Chapter 11 bankruptcy under the guise of “too big to fail.” Although most people have some familiarity with bankruptcy and how it might affect credit, there are some aspects of bankruptcy law that are often misunderstood. As a bankruptcy judge, I thought I would use this column to inform *The Federal Lawyer* readers about some of these misconceptions.

*You cannot keep your collateral without paying for it.* Whether you own a home, car, boat, equipment, or a vacant lot, the fact remains that you cannot keep real or personal property without at least paying for the value of the collateral. Home mortgages or cars purchased within 910 days of a Chapter 13 petition must be paid in full. In restructuring cases (personal or business), the debtor can only retain the property if the debtor pays a stream of payments equal to the present value of the secured debt. In business liquidation cases, a trustee will generally sell property if there is equity in the property and remit the sale proceeds to pay off the secured debt and distribute the remaining proceeds to creditors. In personal liquidation cases, a debtor may keep personal property only if the debtor redeems (i.e., pays the value of the collateral to the secured party) or reaffirms (i.e., reinstates the debtor's in personam liability) and promises to pay off the entire balance of the note at the contract rate.

*You can discharge all of your debt through bankruptcy.* As bankruptcy laws evolved over time, they included an intent for the “honest, but unfortunate debtor” to receive a “fresh start.” Policy considerations rejected a society rooted in debtor's prisons and, moreover, encouraged economic activity and entrepreneurship through insolvency laws that allowed individuals to take more risks with the awareness of a safety net. That said, there were (and are) certain types of debt that Congress mandates must be paid. Tax debts, student loans, home mortgages,

and certain types of misconduct or fraud cannot be discharged absent a bankruptcy judge's determination to the contrary. Over time, that policy has retreated to ensure that certain types of debt, like child support and alimony or judgments for personal injury incident to drunk driving, may no longer be discharged. As a result, individuals who now file bankruptcy may be required to pay more of their debt now than under earlier provisions of the Bankruptcy Code.

*Only affluent individuals benefit by filing bankruptcy.* In this age of Trump there is a misperception that only rich individuals benefit by filing bankruptcy. The reality is that most individuals who file bankruptcy do so because they need the relief. Most bankruptcy filers have modest incomes and are simply trying to keep their home, a car, or pay off their taxes. The majority of individuals who file bankruptcy do so as a last resort.

*People only file bankruptcy because they cannot manage their debt.* This assertion is partially correct. Many people file because they do not understand the consequences of credit nor do they recognize how the accrual of interest prolongs the time to pay a debt. Other causes of filing bankruptcy are loss of employment, divorce, illness, death, or substance abuse. It is not uncommon for the parent of a child dealing with substance abuse to file bankruptcy after the parent has exhausted all resources to pay for treatment. Grandparents may file because their children are unable to care for their grandchildren and a grandparent with limited income has to take on the care of a grandchild. Additionally, given that there has been little wage growth—or even a reduction of wages—over the past decade, many citizens simply do not have any additional disposable income to address increases in the cost of living.

*People can move to states with more generous exemptions laws to avoid paying creditors.* Prior to the 2005 amendments to the Bankruptcy Code, debtors attempted to shield their wealth by purchasing homes in states with unlimited homestead exemptions, such as Florida and Texas. By purchasing or acquiring assets in states with generous exemption

laws, debtors were able to shield themselves from collection from creditors who did not have a security interest in the debtor's homestead or assets. Since 2005, debtors can no longer avail themselves of other states' exemptions laws without first establishing residency in those states. As a result, in limited circumstances, a homestead may not be shielded from liquidation to pay creditor claims.

*Business bankruptcies accomplish little other than bankruptcy professionals getting paid.* Many insolvency professionals, notwithstanding the limits on financing options for their clients or limitations in how they may restructure debt, find innovative ways to preserve value for their clients, pay creditor claims, retain employees, and allow a reorganized debtor to succeed. While the success rate for Chapter 11 cases in which a plan has been confirmed (i.e., approved) is somewhat low, those cases that do succeed result in the payment of a significant dividend (i.e., payment) to creditors.

*Bankruptcy professionals get paid too much.* The cost of bankruptcy can be expensive. Competent representation is not cheap, and bankruptcy lawyers should be compensated similar to attorneys who practice in other fields. Bankruptcy professionals are competent attorneys genuinely interested in advocating for the interests of their clients. They also recognize that the result in bankruptcy should be to pay creditors or to get the broadest discharge possible for their clients.

*Bankruptcy practice is adversarial.* Bankruptcy professionals recognize that most cases will not result in a significant payment to their client. Moreover, the cost of litigation only reduces the "pot" of money available to pay creditor claims. As a result, most bankruptcy professionals competently evaluate the facts of a case and attempt to achieve the largest return or discharge possible for their client. The majority of the matters in bankruptcy court are resolved by agreement, resulting in efficiency of time, money, and a reduction of professional fees in a case.

*Bankruptcy only benefits creditors. Bankruptcy only benefits debtors.* Both statements are incorrect. As an initial matter, bankruptcy or insolvency proceedings were originally used to pay creditors. Thereafter, Congress passed and amended bankruptcy laws generally in response to some financial or fiscal calamity. When the

amendments to the Bankruptcy Act of 1938 were being considered in the early 1970s, a bankruptcy commission was formed to suggest legislation that not only harmonized bankruptcy practice, but also focused on allowing debtors a fresh start free from payment of debt that debtors were unable to pay. In doing so, Congress "federalized" property exemptions, but left open the possibility for states to "opt out" and allow debtors to use state exemptions. Congress also replaced bankruptcy referees with Article I bankruptcy judges, who are selected by their Circuit Courts. The Bankruptcy Code of 1978 modernized insolvency law by including amendments that were not passed in response to a fiscal crisis, but rather attempted to address economic considerations of the time. As such, bankruptcy balances creditor interests by preserving liens and allowing creditors to participate with voting rights in reorganization cases against debtor interests by allowing debtors to shed onerous executory contracts, reduce unsecured debt, and retain collateral that the debtor uses.

*Bankruptcy is easy to do and you do not need an attorney to file a bankruptcy case.* If you have ever paid close attention to the ads portraying how easy it is to incorporate a business or do a will or power of attorney, they generally do not promote how easy it is to file bankruptcy. In fact, individuals cannot file bankruptcy for corporations. Individuals may file their own case, but they do so at great peril. A bankruptcy filing includes not only the bankruptcy petition, but also a schedule of assets and liabilities; statement of financial affairs; creditor matrix; and, if applicable, a plan of reorganization. These forms require the filer's understanding of both bankruptcy law and related state law. As a result, sometimes debtors attempt to file their own cases with poor results. Worse, some debtors engage "petition preparers" to assist them with filing bankruptcy. These petition preparers are limited by statute to just preparing the bankruptcy forms for a small fee, but unfortunately some of these preparers prey upon unsuspecting persons and charge them exorbitant fees to prepare forms that are usually incomplete or do not comport with the law. As such, the case gets dismissed and the individual now has a bankruptcy filing on his or her credit report, without any relief to the debtor, and a possible obstacle in filing a subsequent case. ☉



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