

## **The Basics of Bankruptcy Law: A Practical Guide for Distressed Businesses and Households**

By Dolores Contreras and William Markham, © 2008, San Diego, CA.

**Introduction.** This article addresses the basics of federal bankruptcy procedures as well California insolvency procedures. It also addresses the use of private negotiations to work out unmanageable debt burdens. Before turning to these basic points, a few comments in passing are in order.

**Long-Term Prosperity.** We find ourselves in a nasty stretch of unrelenting bad economic news. Many firms and households can no longer keep up with their debt payments, which perhaps were always difficult to meet, but have now become altogether untenable and ruinous.

In the long run, this phenomenon will probably prove to be a very healthy development for our economy and our society: Private firms and households will reduce their debt burdens and eventually increase their working capital or savings. Rather than take on debt, firms will issue equity in order to raise funding for investment, or they will simply re-invest their profits. Rather than take on debt, households will use earned money to pay for the vacation abroad or the next shopping spree. Over time we will cease to be a nation of debtors forever praying for the next unexpected windfall, and we will evolve into a nation of industrious savers whose accumulated wealth is reinvested in productive endeavors that lead to rising prosperity that is sustainable over time.

On this view the current crisis will prove a watershed in the nation's history: We will get back to the basics of making excellent products and offering excellent services, which we will happily sell to one another and to the rest of the world, using our gains to invest in new ventures and to fund our ongoing prosperity.

**The Short-Term Crisis.** This may all sound wonderful and lovely. But what about the short run? What should a business or household do this week, if its debts far exceed its ability to pay, and the creditors, like a pack of angry, hungry wolves, are howling at the door or over the phone, demanding immediate payment, and threatening horrible evils if payment is not made before the day is done. What can be done to help such debtors for whom there seems to be no way out?

The answer to the immediate problems at hand is likewise the first step to the nation's long-term recovery: First, stop the bleeding. Then heal the underlying problem, so that afterwards you can truly prosper. In other words, first take legal measures to have your debt deemed discharged. Then concentrate on the fundamentals of creating wealth and living prosperously.

**The Fundamentals of Sound Commerce and Living Well.** The fundamentals of creating wealth are simple: *Make a product or offer a service that is so useful to others, that they will pay you more for the product or service than it costs you to deliver it to them!* Keep on making these products and services; improve upon them; sell to more and more customers, and

use and invest the proceeds wisely.

The fundamentals of living prosperously are likewise simple: *Live within your means, spending less each month than you make each month as a general rule. Always remember that life is nothing more than a series of days, each as important as the others, and that on the last day of the series you will die! Therefore try to make the most of each day, devoting as much time as possible to activities, pursuits and passions that really matter to you and that help you, your family and the world to live better. None of these activities, pursuits and passions should ever require you to spend more than you earn in order to enjoy them!* Your authors, one of whom is not so young any more, have learned that often it is the simplest of joys that brings the greatest, most profound happiness!

### **Stopping the Bleeding: Workouts, General Assignments, and Bankruptcy Relief.**

Now that we have gotten these points out of the way, let's turn to the immediate problem at hand – stopping the bleeding caused by an excessive, unsustainable debt burden.

A debtor overwhelmed by debt might first try to negotiate a workout arrangement with its various creditors. Sometimes a plausible threat of bankruptcy is sufficient to persuade creditors that they should compromise and allow the debtor to make voluntary payments over time and even pay less than is owed on each debt.

Sometimes legal relief is required. For certain larger businesses that operate in California, it might make sense to consider making a general assignment for the benefit of creditors rather than seek bankruptcy relief (see below). For most other debtors, the proper recourse will be to seek relief under the federal bankruptcy laws.

**The Federal Bankruptcy Laws.** The federal bankruptcy laws are set forth in the United States Bankruptcy Code, the United States Bankruptcy Rules, and the thousands of court decisions that have interpreted these statutes and rules. These laws are administered by the United States Bankruptcy Courts, which sit in every jurisdiction of the United States. These courts likewise issue new rulings (case law decisions) that interpret and apply existing bankruptcy law to new circumstances.

If a debtor seeks bankruptcy relief, it means that the debtor will initiate a bankruptcy case in the local federal bankruptcy court (sometimes the debtor will face a choice of which bankruptcy court to choose as its proper venue).

The general principle in any bankruptcy proceeding is simple: The debtor must file a bankruptcy petition in the local bankruptcy court, disclosing to the court all of its creditors and claimants along with a comprehensive listing of all of its assets, debts, ongoing contracts, possible liabilities, and other such matters. The debtor must simultaneously notify each of its creditors and claimants that it has filed the bankruptcy proceeding. Each creditor and claimant must then file a proof of claim, stating to the court how much it demands from the debtor. The court will assign the matter to an impartial bankruptcy trustee, who will gather more information about the case, make recommendations, and possibly take other initiatives. Then the court will act on the

debtor's petition, rejecting it if it is improperly presented, or approving of it and granting the requested relief, but perhaps with significant modifications.

**Liquidations and Reorganizations.** Typically, a debtor can seek two kinds of relief in bankruptcy: A liquidation of its estate or a reorganization of its debts. A liquidation means that the debtor will be forced to sell all of its non-exempt assets. The proceeds will be used to pay the debtor's debts so far as possible. The bankruptcy court has specific rules for determining how limited proceeds will be used to satisfy debts whose total value exceeds the amount of the sales proceeds. After the proceeds are thus disbursed, the court will deem all dischargeable debts to be discharged. The debtor no longer owes a dime on any of these debts, which rather will be deemed terminated as a matter of law. The debtor can keep its exempt property, and it will continue to owe any debt that the bankruptcy court has deemed to be non-dischargeable.

A corporation or a partnership cannot obtain a discharge of any debt under Chapter 7, even after a liquidation. For such firms, the proper remedy is to have a liquidation sale and decree of bankruptcy, after which the firm can properly dissolve itself under its charter laws. The shareholders of the corporation will bear no personal responsibility for any unpaid debt (unless the creditor is able to "pierce the corporate veil"). The partners of the partnership, having decided to maintain a partnership, will not be so lucky: Each partner will remain personally responsible for all unpaid debts owed by the partnership even after its liquidation and dissolution. For the individual debtor, however, the liquidation is followed by a discharge of all dischargeable debt.

Liquidations are generally governed by Chapter 7 of the United States Bankruptcy Code. Below you will find a step-by-step guide of how they are performed.

The other principal remedy is a reorganization of existing debt. Rather than liquidate its assets to discharge its debt, the debtor proposes a plan of reorganization, offering to pay specified sums each month to its different creditors for a stated period. The debtor's plan typically states that, after the monthly payments have been made, the unpaid part of its debts will be deemed discharged. Thus the debtor can propose to pay pennies on the dollar, in affordable monthly payments, for a period of, say, three years, at the end of which all of its debt will be deemed discharged. Each affected creditor will have occasion to object to the plan, and the bankruptcy trustee will likewise have occasion to make recommendations, request that the debtor make revisions or make its own objections. The court will then decide whether to confirm the plan, and sometimes it will do so but only after it has been substantially modified. In this manner, the debtor can avoid a liquidation of its estate and yet obtain an eventual discharge of its debt.

Reorganizations are generally governed by Chapters 11 and 13 of the United States Bankruptcy Code. Chapter 11 is principally used by firms for the purpose of reorganizing business debt. Chapter 13 is used by individual debtors who seek to reorganize personal/consumer debts. Below you will find a step-by-step guide of how such reorganizations are performed.

**Taking the Initiative.** The bankruptcy court is typically very busy, and it usually acts in response to initiatives taken by the debtor, the debtor's creditors, and the bankruptcy trustee, who is appointed at the outset of the case.

An astute debtor, taking full advantage of the bankruptcy laws, can obtain a better result than can a debtor who relies passively on the trustee and the court to administer the case. A debtor might also have valuable legal claims that it might choose to litigate in the form of an *adversary proceeding* against certain creditors or others. Adversary proceedings are in effect independent lawsuits that are conducted within the bankruptcy court according to the United States Bankruptcy Rules.

In the same vein, an astute creditor that is proficient in bankruptcy proceedings can likely obtain a better recovery than will a passive creditor who merely accepts what the court presents to it at the end of the case. A creditor can likewise litigate claims against the debtor, other creditors or others, doing so in an adversary proceeding litigated in bankruptcy court. Creditors can also pool their efforts by establishing a creditors' committee that is represented by one law firm and perhaps by a single manager.

A savvy creditor or creditors' committee will usually prefer to subject the debtor to an examination under Rule 2004 of the United States Bankruptcy Rules. Under this rule, a creditor can thoroughly examine a debtor under oath about every possible matter that bears upon the debtor's assets, debts, contracts, and ability to pay its creditors. These examinations are transcribed and can even be videotaped.

**General Assignments Under California Law.** For distressed businesses, bankruptcy is not the only option. It is also possible to conduct a *general assignment for the benefit of creditors*, which is typically handled by a receiver who disposes of the company's assets and pays its debts according to California's insolvency statutes. The entire proceeding can be much quicker than a bankruptcy in the federal courts.

**Voluntary Workouts of Debt.** In addition, a distressed debtor can always try to negotiate a *workout* of its debts, so that each creditor is paid in accordance with a voluntary workout agreement or composition agreement, by which the debtor pays off as much of its debt as it reasonably can within a manageable period of time.

Below you will find a more detailed discussion of each of the above matters.

### **Liquidation of the Debtor's Estate: A Step-by-Step Guide to a Liquidation Proceeding Under Chapter 7 of the Bankruptcy Code**

Under Chapter 7, a debtor can obtain a discharge all of its dischargeable debt by means of a liquidation of assets. Dischargeable debt is *all debt of any kind*, save for certain specific kinds of debt that are expressly designated as non-dischargeable under 11 U.S.C §522. The principal kinds of non-dischargeable debt are as follows:

1. Certain kinds of taxes.
2. Student loans.
3. Certain kinds of marital debt.
4. Child support.

5. Alimony/spousal support.
6. Certain kinds of recent cash advances and credit purchases.
7. Debts owed because of the debtor's intentional torts.
8. Debts owed because of the debtor's fraud.
9. Fines and citations.
10. Debts that the debtor owes because he or she has caused personal injury or death while operating a motor vehicle.

Excluding the above-listed debts, which can be deemed non-dischargeable during a bankruptcy proceeding, a debtor can use Chapter 7 proceedings to obtain a release of all of its debt. How exactly does this work?

To obtain a Chapter 7 bankruptcy, the debtor must qualify for one. Before filing for a Chapter 7 bankruptcy, the debtor must complete credit counseling and obtain a certificate of completion within 180 days of its bankruptcy filing (a debtor must likewise do so if he seeks a reorganization of personal or consumer debt under Chapter 13).

Relief under Chapter 7 is available to individuals as well as certain kinds of legal entities. (Corporations and partnerships cannot discharge debt under Chapter 7, but they can liquidate assets under its provisions, and some will choose to do so in order to wind up their affairs so that they can afterwards dissolve themselves.)

Individual debtors and sole proprietorships can obtain relief under Chapter 7 only if their petition is not "abusive". In order to prove that the petition is not abusive, a debtor may be required to pass a "means test". The means test determines to what extent a debtor can pay down unsecured claims. The means test will only be required where the following is true: (1) the majority of debt is "consumer debt" (i.e., debt incurred by an individual primarily for personal, family or household purposes); and (2) the debtor earns more than the median income for the state in which the case has been filed.

If both of these conditions are present, the debtor must take the means test. If the debtor passes the means test, he can proceed with a dissolution under Chapter 7. If not, his petition will be either dismissed or, if the debtor consents, it will be converted to a petition for a reorganization of personal debt under Chapter 13.

Otherwise, a qualified debtor is free to seek a liquidation of his estate and a discharge of his debt under Chapter 7, using the following procedures:

1. To begin a proceeding under Chapter 7, the debtor files a petition in bankruptcy court along with a comprehensive listing of all known creditors and claimants.
2. Along with the filing of the petition, or no later than 15 days of filing the petition, the following documents must also be filed: (1) summary of schedules that list all assets and liabilities; (2) a schedule of current monthly income, a completed means test, and a listing of expenditures and disposable income; (3) a schedule of executory contracts and

unexpired leases; (4) a statement of financial affairs; (5) a certificate of credit counseling; and (6) a proposed Chapter 13 plan in case the debtor is deemed ineligible to proceed under Chapter 7.

3. At some point after the filing of the petition, the debtor must also provide tax returns and disclose any anticipated increase of income.
4. Upon the filing of the petition, the court appoints an impartial trustee to liquidate (appraise and sell) non-exempt assets. A debtor is entitled to claim certain property as exempt under 11 U.S.C. §522. Property that qualifies as exempt under 11 U.S.C. §522 is determined either by the standard federal exemptions or by such alternative exemptions as might be adopted by the state in which the bankruptcy court sits. For bankruptcy courts in California, the list of property that can be deemed exempt from bankruptcy liquidation is set forth in two sections of the California Code of Civil Procedure §703.140 and §70. When identifying exempt property, the debtor use either list but not both interchangeably.
5. The commencement of bankruptcy under Chapter 7 causes the establishment of the debtor's estate by operation of law, meaning that the estate becomes the legal owner of the debtor's property. If a business is filing Chapter 7, the trustee may operate the business for a period of time if it is deemed beneficial.
6. An individual debtor is entitled to claim certain property as exempt. This is filed as a schedule of exempt property that the debtor claims is not subject to liquidation and is protected from claims of creditors.
7. In addition, if the debtor wishes to keep certain property such as a home or a car, the debtor may file an Individual Debtor's Statement of Intention, in which the debtor can list the property that he wishes to retain, re-affirm the contract for the purchase of this property, and continue to pay for it according to the terms of the purchase agreement. By this proceeding, the debtor reaffirms his obligation to pay for the property in question notwithstanding his bankruptcy.
8. As soon as the petition is filed, an automatic stay takes effect. An automatic stay applies to all of the debtor's creditors and claimants. It enjoins them from seeking to recover any claim or debt outside of bankruptcy court and forces them to submit their claims against the debtor only in the bankruptcy case. A creditor who fails to observe this injunction can be held in contempt of court and subjected to fines. The automatic stay applies to creditor proceedings underway at the time the bankruptcy is filed. Thus it will immediately halt all collection activities, foreclosures and repossessions. Certain kinds of proceedings, however, are not subject to the automatic stay. (See 11 U.S.C. §362(b)). For a creditor that seeks to foreclose on real property, it is a routine matter to obtain relief from the automatic stay, so that the creditor can resume or initiate foreclosure proceedings.
9. Next, the trustee will convene a creditors' meeting, usually 20 to 40 days after the debtor has filed the petition. During this meeting, the debtor is put under oath and asked about

his/her financial affairs and the plan by the trustee and/or creditors.

10. After all of this has been completed, if no action has been taken by a creditor to stop the entry of a discharge, the discharge will be entered and the case will be closed. The trustee will sell the debtor's non-exempt assets and use the proceeds to pay the listed creditors according to priority and otherwise on a pro rata basis; and the court will decree that all of the listed dischargeable debts have been discharged (terminated) as a matter of law. The debtor is now free to move ahead with his life. He will have lost non-exempt assets. His credit will have been severely harmed. He will no longer owe any part of the discharged debt. He can keep exempt assets and re-affirm his obligation to pay for certain kinds of assets such as his house and car.

### **Reorganization of Business Debt: A Step-by-Step Guide to a Reorganization Proceeding Under Chapter 11 of the Bankruptcy Code**

If a business wishes to remain in operation but cannot cope with its debt burden, it may seek a court-mandated re-organization and partial repayment of its debt under Chapter 11 of the United States Bankruptcy Code by providing a repayment plan (See 11 U.S.C. §1129).<sup>1</sup> The business will file all of the usual disclosures of assets, debts, creditors, claimants and contracts, along with all other required information, and the creditors and claimants will file their responses and assert their claims. Then the business will propose a plan of reorganization by which it will make periodic payments to its creditors for a stated period of time (typically, it will offer to make monthly payments for five years). The creditors and perhaps the trustee will submit replies and objections to the proposed plan. Finally, the court will rule on the plan, rejecting it or approving of it. Sometimes the court will approve of the plan, but only after important modifications are made to it. If the plan is approved (confirmed), the debtor must honor its terms and conditions. If the debtor does so, its dischargeable debt will be discharged upon its timely performance of the plan. This done, the business will be quit of its old debt and free to prosper without the burden of the old, unmanageable burdens.

If a corporation seeks a reorganization, only the corporation's assets and debts will be considered. If however a sole proprietorship seeks a reorganization, then the proprietor's personal assets and debts are considered, and the proprietor risks losing personal assets during the course of the reorganization. For partnerships, it is sometimes possible to segregate each partner's personal assets and debts from those of the partnership.

By a Chapter 11 proceeding, a business can put into place a plan for settling its debts in manageable manner while remaining in business. *A Chapter 11 proceeding makes sense only if the business will become profitable once the old debts are settled.* If the business operates at a loss and lacks decent prospects of becoming profitable, it cannot be saved by an reorganization of its debts under Chapter 11. Objecting creditors might make this argument when opposing the debtor's plan of reorganization. (On the other hand, a debtor's competitors might complain that

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<sup>1</sup> Chapter 11 is also available to individuals, but owing to its complexity and expensive procedures, individuals who seek reorganization are usually better off filing under Chapter 13.

the debtor, if allowed an overly generous release from its debts, might obtain an improper competitive advantage over them after it emerges from bankruptcy!) Thus the importance of taking enormous care when preparing the proposed plan, so that it can reasonably satisfy the different kinds of objections that might be made to it.

Payment to creditors must be made according to the established rules on creditor priorities. All bankruptcy chapters follow the same priority rules to determine which creditors get paid first. Priority rules may be viewed as levels that determine the order of payment to creditors. Each priority level must be paid in full before the next lower priority level receives payment. The highest level belongs to priority creditors – tax lienors and the costs of the bankruptcy. Next come any secured creditors – i.e., creditors who have a security interest or collateral in the debtor's property. Secured creditors must be paid in full before any payment is made to any unsecured creditor. After all secured creditors are paid in full, then unsecured creditors will be paid.

Most businesses that file a Chapter 11 reorganization follow the standard procedures described below. Certain types of debtors, however, can obtain fast-track approval of their bankruptcy plans. Principally, fast-track relief can be given to small businesses and single-purpose real estate debtors. Here is how these two kinds of debtors are defined for purposes of fast-track relief under Chapter 11:

A “small business debtor” is a legal person engaged in commercial or business activities whose secured and unsecured debts in all do not exceed \$2 million (this refers to non-contingent debt). 11 U.S.C. §101(51D).

A “single-asset real estate debtor” is a debtor whose business revenues are principally or entirely derived from a single property or a single real estate project, excluding a residential property that has fewer than four units. The debtor must also have secured and unsecured debts that in all do not exceed \$2 million (this refers to non-contingent debt). 11 U.S.C. §101(51B).

If a debtor meets the definition of a small business debtor or single-purpose real estate debtor, and if it elects to have fast-track provisions, the entire Chapter 11 process will be placed on a “fast track”, which means that certain hearings will be combined or will not be mandatory in order to expedite the bankruptcy process. If these special provisions are applied, a creditor may seek expedited relief from the automatic bankruptcy stay. Otherwise, most of the pertinent deadlines are shortened for the debtor, making the bankruptcy process faster.

Filing for relief under Chapter 11 must be done in the following manner.

1. The petition must be filed. The debtor must list its 20 largest unsecured creditors as well as standard information such as name, identification numbers, location, etc.
2. The following documents must also be filed either along with the petition or within fifteen days of its filing: (1) schedules of assets and liabilities; (2) a schedule of current income and expenditures; (3) a schedule of executory contracts and unexpired leases; and (4) a statement of

financial affairs.

3. As soon as the petition is filed, the automatic stay takes effect. The automatic stay stops all creditor proceedings outside of bankruptcy court, save for certain exceptions. This means among other things that any lawsuits pending against the debtor are automatically stayed by the debtor's filing of a bankruptcy petition and filing of notice of the petition in the pending lawsuit. A creditor can apply to the court for relief from the automatic stay.

4. Upon filing the petition, the debtor becomes a "debtor-in-possession" and is required to act as a fiduciary to the debtor's estate. What does this mean? It means that the debtor owes the highest possible duty to make a full, honest disclosure of its affairs to its creditors and to the bankruptcy court. The debtor may properly engage professionals to assist it in fulfilling this fiduciary duty.

5. Following the filing of the petition, a creditors' committee will be appointed by a trustee. The committee is usually composed of the debtor's major creditors. This committee can work with the debtor to help it to modify its plan of reorganization, and it can object to the debtor's proposed plan.

6. After the debtor has filed its petition, it must file a disclosure statement – i.e., a document that sets forth information about the debtor's assets, liabilities, business, and financial affairs. This statement is meant to provide the creditors with enough information to enable them to make an informed judgment about the debtor's proposed plan. Once the court has approved of the debtor's written disclosure, the debtor can begin seek approval of its plan by its creditors.

7. The next step is the filing of the reorganization plan. For the first 120 days of the bankruptcy, only the debtor-in-possession can file a plan of reorganization (in the case of a small business or single-asset real estate debtor, the period is shortened to the first 100 days of the bankruptcy). The debtor-in-possession must then try to persuade its creditors to approve of its plan within 180 days of the bankruptcy filing. If this does not occur, then any creditor may propose an alternative plan. Before any plan is confirmed by the court, it may be modified. A plan is deemed accepted when it is accepted by creditors who hold two-thirds of the outstanding debt and constitute one-half of the number of debtors.

8. A plan must classify claimants as either secured or unsecured creditors, and it must specify how each class of claims will be treated. A plan will be said to "impair" a creditor if it will pay him less than he is owed or alter his contract with the debtor. A plan that impairs a creditor cannot be confirmed unless it is approved by at least one class of creditors (e.g., all unsecured creditors).

9. Any party-in-interest can file an objection to the confirmation of a plan. The court will only confirm a plan if it finds that (1) the plan is feasible, (2) the plan has been proposed in good faith, (3) no further financial reorganization will be needed, and (4) the plan and its proponents have otherwise complied with the United States Bankruptcy Code.

10. Once the plan has been confirmed, the debtor is discharged from debt that arose before the confirmation. From this point forward, the debtor must follow the plan. New contractual rights established by the plan supercede prior contracts that vary from or contradict the requirements of the plan.

11. After the confirmation, the debtor-in-possession will have the responsibility of following the plan, reporting on the status its progress under the plan, and applying for a final decree.

12. Lastly, after the debtor has fully performed the plan, the court will issue a final decree, closing the case.

### **Reorganization of Personal and Consumer Debt: A Step-by-Step Guide to a Reorganization Proceeding Under Chapter 13 of the Bankruptcy Code**

Chapter 13 provides for reorganization of debt for individuals who have a steady income, but simply cannot meet their current debt obligations. Sole proprietorships with a steady income can also file for relief under Chapter 13. Corporations and partnerships cannot do so.

In order to be eligible to file under Chapter 13, the debtor must have unsecured debt that is less than \$336,900 and secured debt that is less than \$1,010,650. These amounts are revised from time to time to reflect changes in the consumer price index.

Unlike Chapter 7, Chapter 13 allows a debtor to keep all of his assets on condition that he makes timely payments in accordance with an approved payment plan.

Under Chapter 13, a debtor proposes a payment plan by which the debtor will pay his creditors in full or in part over a three-year period. This repayment period may be extended for up to five years, but for no longer, and any such extension requires approval from the court. The length of time allowed under any given plan depends upon the debtor's monthly income and whether this income is above or below the state median for a family of the same size as the debtor's. If the debtor earns more than the state median, the plan can be usually extended to five years, but if the debtor earns less, the plan must be limited to three years.

If the debtor timely makes all the payments owed under the plan, all of his debts as of the bankruptcy filing will be discharged, except for debt that is deemed non-dischargeable.

A debtor cannot file for relief under Chapter 13 unless he has received credit counseling within 180 days of the filing. After obtaining credit counseling, the debtor can seek relief under Chapter 13. A proceeding under Chapter 13 proceeds as follows.

1. The debtor must commence the Chapter 13 proceeding by filing a petition and accompanying list of the creditors and claimants.

2. Along with the petition, or within fifteen days of its filing, the debtor must also file the following: (1) summary of schedules, showing the debtor's assets and liabilities; (2) a schedule of the debtor's current monthly income, expenditures and disposable income; (3) a schedule of executory contracts and unexpired leases; (4) a statement of financial affairs; (5) a certificate of credit counseling; and (6) a proposed plan of reorganization under Chapter 13.

3. Upon the filing of the petition, the court appoints an impartial trustee to administer the case. The trustee's principal role is to collect payment from the debtor and distribute it to the creditors.

4. As soon as the petition is filed, the automatic bankruptcy stay takes effect (see above).

5. The trustee will hold a creditors' meeting, which usually occurs 20 to 50 days after the petition has been filed. During this meeting, the debtor is put under oath, and the trustee and any interested creditor ask him about his financial affairs and proposed plan.

6. Payments under the plan must be made to the trustee 30 days after the petition has been filed, even if by then the court has not approved of the plan.

7. Payment must be made in accordance with the standard bankruptcy priorities. Priority rules may be viewed as levels that determine the order of payment to creditors. Each priority level must be paid in full before the next lower priority level receives payment. First, priority claims get paid first, which include taxes and the cost of bankruptcy. Next, secured creditors must be paid in full. Lastly, unsecured creditors are paid. Therefore, the plan must reflect this order of priority. These rules must be followed unless all of the creditors agree to a modification of them.

8. Within 45 days after the creditors' meeting, the bankruptcy judge must hold a confirmation hearing at which it will confirm or reject the plan. The court can confirm the plan on condition that it be modified. The court will confirm a plan only if it finds that the plan is feasible and meets the standards for confirmation set forth in the Bankruptcy Code. Creditors will receive a notice 25 days before the hearing. Any creditor may object to the plan. The court will consider all objections before ruling. If the court rejects the plan, the debtor may submit a modified plan.

9. A debtor may not contract new debt while the plan is in effect, unless all of the following conditions are met: (1) the trustee is notified, (2) the plan is not compromised by the new debt, and (3) the court approves of the proposed new debt.

10. After all payments have been made under the plan, all dischargeable debt as of the date of the filing will be discharged, and the case will be closed.

### **General Assignment for the Benefit of Creditors**

For businesses, an alternative to a proceeding in bankruptcy is to make a general

assignment for the benefit of creditors. A business will choose a general assignment only when it has no interest in reorganizing its debt and wishes to maintain some measure of control over the liquidation of its assets. A business may reasonably conclude that it understands the value of its assets better than would a bankruptcy trustee, and that it prefers to have a general assignment rather than to entrust its liquidation to an unknown, overworked bankruptcy trustee.

A general assignment for the benefit of creditors is an insolvency proceeding that is governed by state law and not the Bankruptcy Code. Since this proceeding is governed by state law, the procedures and laws vary from state to state. This article will discuss assignment for the benefit of creditors as it pertains to California.

A business cannot conduct a general assignment until it has satisfied its own internal by-laws for approving of such an action. A partnership vote might be required, for example, or approval must be given in the authorized manner by a regularly convened meeting of the board of directors, etc.

*Unlike a bankruptcy proceeding, a general assignment does not impose an automatic stay against the business' creditors.*

In an assignment for the benefit of creditors, the insolvent business liquidates its assets by choosing an assignee – typically, a professional “liquidation professional” that acts as a receiver of the distressed business. The assignee plays a role similar to that of a trustee in a bankruptcy proceeding, except that in an assignment for the benefit of creditors, there are no court proceedings.

To begin the process, the assignee usually requires an up-front fee along with a percentage of the assets that are sold. Once an assignee has been chosen, the business and the assignee enter into a formal assignment contract. In this contract, the business transfers all titles, custody and control of its assets to the assignee, who then sells them and applies the proceeds to pay the business' creditors in accordance with the California insolvency statutes, which are essentially identical to the federal bankruptcy statutes on the matter of creditor priorities.

Proceedings under a general assignment are conducted as follows:

1. The business must provide the assignee with a list of creditors and all interested parties, including contact information and the amount that each creditor is expected to claim.
2. Within 30 days of acceptance of the formal written assignment, the assignee must notify these creditors and/or interested parties, providing a date by which all their claims must be submitted to the assignee. The date provided by the assignee must not be less than 150 days and no more than 180 days from the date of notice.
3. The assets are sold by the assignee. The assignee pays the creditors according to the priorities established by California law, which are the same as federal bankruptcy priorities. Unlike in bankruptcy proceedings, assets cannot be sold free and clear of liens

or security interests unless the lienholder consents to the release of its lien. Nor need any party to a contract with the business be forced to assent to the assignment of the contract.

4. After the assets have been sold and the creditors paid so far as possible in accordance with the insolvency priorities, the business will be deemed to have liquidated its assets. It may now complete the winding up of its affairs and then proceed to dissolve itself.

### **Conclusion.**

Bankruptcy and insolvency can be discouraging proceedings that subject everyone concerned to anxiety and disquiet: The debtor may inwardly accuse himself of failure or feel ashamed. Creditors might be angry or anxious that they will not be treated fairly and will suffer losses that they cannot afford.

Bankruptcy, however, brings fairness and finality to an unmanageable situation, sparing the debtor from a lifetime of ruin and infamy, yet allowing the creditors reasonable relief that the debtor can actually afford. It can prove a deeply dissatisfying process for everyone concerned. Winston Churchill, if asked to comment on our bankruptcy laws, might have quipped that it is a rotten system, even the worst possible system, but that it has one simple advantage: It is better than all the alternatives! (Or he might have said that it is a hopeless morass that ought to be repealed and replaced by an entirely different system!)

At present the world finds itself at a difficult pass. The authors have confidence in the future and in our nation's ability to withstand and then rise above the challenges that confront us now. During these difficult times, however, many businesses and households will find that they can no longer manage their debts. Bankruptcy provides lawful, sensible relief for such debtors. It has always provided this relief, which will be needed more than ever by a larger number of firms and people.

If a debtor undergoes a bankruptcy, its credit will be impaired or even ruined for a limited period, and it might be required to sell assets or make other meaningful compromises in order to pay some of its debt. The remainder will be forgiven. At the end of the process the debtor will have no more debt.

After bankruptcy, the debtor can turn to better tasks: A freshly reorganized business can devote itself to its proper calling – offering a useful product or service that it can sell at a profit to willing customers. Individuals who have liquidated their estates or reorganized their debt can devote themselves fully to prosperous pursuits, unburdened with debts and the clamoring of snarling bill-collectors.

A better day lies before us, and in the meantime the bankruptcy laws offer a necessary respite and cure for many who find themselves overwhelmed with unmanageable debt. If nothing else, the authors of this article hope that it provides a helpful overview of bankruptcy law and general assignments for the benefit of creditors.

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