

Bankruptcy Fundamentals: Liquidation, Reorganization, and Tax Issues

When clients face financial distress, CPAs need to understand how bankruptcy works and what it means for taxes. This course covers Chapter 7 liquidation—including the trustee's role and asset distribution—Chapter 11 reorganization for both standard and small business cases, and the critical tax issues that arise in bankruptcy, including debt cancellation, partnership and corporate treatment, and court jurisdiction over tax matters. Whether you're advising a struggling business or working through a client's insolvency, this course provides a solid foundation.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall characteristics of a chapter 7 bankruptcy.
- Identify the provisions of chapter 11 bankruptcy.
- Identify the filing requirements of a bankruptcy filing.

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Chapter 1: LIQUIDATION UNDER CHAPTER 7 OF THE BANKRUPTCY CODE

Chapter Objective

After completing this chapter, you should be able to:

- Recall characteristics of a chapter 7 bankruptcy.

I. AN OVERVIEW OF CHAPTER 7 BANKRUPTCY

Chapter 7 of the United States Bankruptcy Code is the Bankruptcy Code’s “liquidation” chapter. It is a needs-based system. It is used primarily by individuals who wish to free themselves of debt simply and inexpensively, but it may also be used by businesses that wish to liquidate and terminate the business. Under chapter 7, a business stops all operations and goes completely out of business. In order to qualify for relief under chapter 7 of the Bankruptcy Code, the debtor must be an individual, a partnership, or a corporation. Certain types of entities are ineligible for chapter 7 protection, including railroads, domestic insurance companies, and banks.

In a chapter 7 case, a debtor receives an immediate unconditional discharge of personal liability for certain debts in exchange for relinquishing the debtor’s nonexempt assets to the bankruptcy trustee for liquidation and distribution to creditors. Under the Bankruptcy Code, only an individual may obtain a chapter 7 discharge. Thus, corporations and LLC’s are not eligible to receive a discharge under chapter 7.

A chapter 7 bankruptcy case does not involve the filing of a plan of repayment as in chapter 13. Instead, the bankruptcy trustee gathers and sells the debtor’s nonexempt assets and uses the proceeds of such assets to pay holders of claims (creditors) in accordance with the provisions of the Bankruptcy Code.

Part of the debtor’s property may be subject to liens and mortgages that pledge the property to other creditors. In addition, the Bankruptcy Code will allow the debtor to keep certain “exempt” property; however, a trustee will liquidate the debtor’s remaining assets. Accordingly, potential debtors should realize that the filing of a petition under chapter 7 may result in the loss of property.

II. Alternatives to Chapter Seven Relief

Debtors should be aware that there are several alternatives to chapter 7 relief. For example, debtors who are engaged in business, including corporations, partnerships, and sole proprietorships, may

prefer to remain in business and avoid liquidation. Such debtors should consider filing a petition under chapter 11 of the Bankruptcy Code. Under chapter 11, the debtor may seek an adjustment of debts, either by reducing the debt or by extending the time for repayment, or may seek a more comprehensive reorganization. Chapter 11 bankruptcy is discussed in the next chapter.

Sole proprietorships may also be eligible for relief under chapter 13 of the Bankruptcy Code. This course does not discuss the specifics of chapter 13 bankruptcy, because this section of the code is available to individuals and not businesses.

If the debtor's "current monthly income" is more than the state median, the Bankruptcy Code requires application of a "means test" to determine whether the chapter 7 filing is presumptively abusive. The "current monthly income" received by the debtor is a defined term in the Bankruptcy Code and means the average monthly income received over the six calendar months before commencement of the bankruptcy case, including regular contributions to household expenses from nondebtors and including income from the debtor's spouse if the petition is a joint petition, but not including social security income or certain payments made because the debtor is the victim of certain crimes. Abuse is presumed if the debtor's aggregate current monthly income over 5 years, net of certain statutorily allowed expenses, is more than (i) \$12,850, or (ii) 25% of the debtor's nonpriority unsecured debt, as long as that amount is at least \$7,700. The debtor may rebut a presumption of abuse only by a showing of special circumstances that justify additional expenses or adjustments of current monthly income. Unless the debtor overcomes the presumption of abuse, the case will generally be converted to chapter 13 (with the debtor's consent) or will be dismissed.

Debtors should also be aware that out-of-court agreements with creditors or debt counseling services may provide an alternative to a bankruptcy filing.

III. How Chapter Seven Works

A chapter 7 case begins with the debtor filing a petition with the bankruptcy court serving the area where the individual lives or where the business debtor is organized or has its principal place of business or principal assets. In addition to the petition, the debtor must also file with the court: (1) schedules of assets and liabilities; (2) a schedule of current income and expenditures; (3) a statement of financial affairs; and (4) a schedule of executory contracts and unexpired leases. Debtors must also provide the assigned case trustee with a copy of the tax return or transcripts for the most recent tax year as well as tax returns filed during the case (including tax returns for prior years that had not been filed when the case began).

The courts must charge a \$245 case filing fee, a \$75 miscellaneous administrative fee, and a \$15 trustee surcharge. Normally, the fees must be paid to the clerk of the court upon filing. With the court's permission, however, individual debtors may pay in installments. The number of installments is limited to four, and the debtor must make the final installment no later than 120 days

after filing the petition. For cause shown, the court may extend the time of any installment, provided that the last installment is paid not later than 180 days after filing the petition. The debtor may also pay the \$75 administrative fee and the \$15 trustee surcharge in installments. If a joint petition is filed, only one filing fee, one administrative fee, and one trustee surcharge are charged. Debtors should be aware that failure to pay these fees may result in dismissal of the case.

In order to complete the Official Bankruptcy Forms that make up the petition, statement of financial affairs, and schedules, the debtor must provide the following information:

1. A list of all creditors and the amount and nature of their claims;
2. The source, amount, and frequency of the debtor's income;
3. A list of all of the debtor's property; and
4. A detailed list of the debtor's monthly living expenses, i.e., utilities, taxes, transportation, etc.

Filing a petition under chapter 7 "automatically stays" (stops) most collection actions against the debtor or the debtor's property. But filing the petition does not stay certain types of actions listed under 11 U.S.C. § 362(b), and the stay may be effective only for a short time in some situations. The stay arises by operation of law and requires no judicial action. As long as the stay is in effect, creditors generally may not initiate or continue lawsuits, wage garnishments, or even telephone calls demanding payments. The bankruptcy clerk gives notice of the bankruptcy case to all creditors whose names and addresses are provided by the debtor.

Between 21 and 40 days after the petition is filed, the case trustee (described later) will hold a meeting of creditors. If the U.S. trustee or bankruptcy administrator schedules the meeting at a place that does not have regular U.S. trustee or bankruptcy administrator staffing, the meeting may be held no more than 60 days after the order for relief. During this meeting, the trustee puts the debtor under oath, and both the trustee and creditors may ask questions. The debtor must attend the meeting and answer questions regarding the debtor's financial affairs and property. If spouses have filed a joint petition, both spouses must attend the creditors' meeting and answer questions. Within 10 days of the creditors' meeting, the U.S. trustee will report to the court whether the case should be presumed to be an abuse under the means test described in 11 U.S.C. § 704(b).

It is important for the debtor to cooperate with the trustee and to provide any financial records or documents that the trustee requests. The Bankruptcy Code requires the trustee to ask the debtor questions at the meeting of creditors to ensure that the debtor is aware of the potential consequences of seeking a discharge in bankruptcy such as the effect on credit history, the ability to file a petition under a different chapter, the effect of receiving a discharge, and the effect of reaffirming a debt. Some trustees provide written information on these topics at or before the meeting to ensure that the debtor is aware of this information. In order to preserve their independent judgment, bankruptcy judges are prohibited from attending the meeting of creditors.

In order to accord the debtor complete relief, the Bankruptcy Code allows the debtor to convert a chapter 7 case to a case under chapter 11, 12, or 13 as long as the debtor is eligible to be a debtor under the new chapter. However, a condition of the debtor's voluntary conversion is that the case has not previously been converted to chapter 7 from another chapter. Thus, the debtor will not be permitted to convert the case repeatedly from one chapter to another. A fee is charged for converting, on request of the debtor, a case under chapter 7 to a case under chapter 11. The fee charged is the difference between the filing fee for a chapter 7 and the filing fee for a chapter 11. Currently, the difference is \$922. There is no fee for converting from chapter 7 to chapter 13.

IV. ROLE OF THE CASE TRUSTEE

Note

In North Carolina and Alabama, bankruptcy administrators perform similar functions that U.S. trustees perform in the remaining 48 states. These duties include establishing a panel of private trustees to serve as trustees in chapter 7 cases and supervising the administration of cases and trustees in cases under chapters 7, 11, 12, and 13 of the Bankruptcy Code. The bankruptcy administrator program is administered by the Administrative Office of the United States Courts, while the U.S. trustee program is administered by the Department of Justice.

When a chapter 7 petition is filed, the U.S. trustee (or the bankruptcy court in Alabama and North Carolina) appoints an impartial case trustee to administer the case and liquidate the debtor's nonexempt assets. If all the debtor's assets are exempt or subject to valid liens, the trustee will normally file a "no asset" report with the court, and there will be no distribution to unsecured creditors. Most chapter 7 cases involving individual debtors are no asset cases. But if the case appears to be an "asset" case at the outset, unsecured creditors must file their claims with the court within 90 days after the first date set for the meeting of creditors. Unsecured debts generally may be defined as those for which the extension of credit was based purely upon an evaluation by the creditor of the debtor's ability to pay, as opposed to secured debts, for which the extension of credit was based upon the creditor's right to seize collateral on default, in addition to the debtor's ability to pay. A governmental unit, however, has 180 days from the date the case is filed to file a claim. In the typical no asset chapter 7 case, there is no need for creditors to file proofs of claim because there will be no distribution. If the trustee later recovers assets for distribution to unsecured creditors, the Bankruptcy Court will provide notice to creditors and will allow additional time to file proofs of claim. Although a secured creditor does not need to file a proof of claim in a chapter 7 case to preserve its security interest or lien, there may be other reasons to file a claim. A creditor in a chapter 7 case who has a lien on the debtor's property should consult an attorney for advice.

Commencement of a bankruptcy case creates an “estate.” The estate technically becomes the temporary legal owner of all the debtor’s property. It consists of all legal or equitable interests of the debtor in property as of the commencement of the case, including property owned or held by another person if the debtor has an interest in the property. Generally speaking, the debtor’s creditors are paid from nonexempt property of the estate.

The primary role of a chapter 7 trustee in an asset case is to liquidate the debtor’s nonexempt assets in a manner that maximizes the return to the debtor’s unsecured creditors. The trustee accomplishes this by selling the debtor’s property if it is free and clear of liens (as long as the property is not exempt) or if it is worth more than any security interest or lien attached to the property and any exemption that the debtor holds in the property. The trustee may also attempt to recover money or property under the trustee’s “avoiding powers.” The trustee’s avoiding powers include the power to: set aside preferential transfers made to creditors within 90 days before the petition; undo security interests and other prepetition transfers of property that were not properly perfected under nonbankruptcy law at the time of the petition; and pursue nonbankruptcy claims such as fraudulent conveyance and bulk transfer remedies available under state law. In addition, if the debtor is a business, the bankruptcy court may authorize the trustee to operate the business for a limited period of time, if such operation will benefit creditors and enhance the liquidation of the estate.

Section 726 of the Bankruptcy Code governs the distribution of the property of the estate. Under section 726, there are six classes of claims; and each class must be paid in full before the next lower class is paid anything. The debtor is only paid if all other classes of claims have been paid in full. Accordingly, the debtor is not particularly interested in the trustee’s disposition of the estate assets, except with respect to the payment of those debts which for some reason are not dischargeable in the bankruptcy case. The individual debtor’s primary concerns in a chapter 7 case are to retain exempt property and to receive a discharge that covers as many debts as possible.

How Are Assets Divided in Bankruptcy of a Public Company?

1. Secured Creditors - often a bank, is paid first.
2. Unsecured Creditors - such as banks, suppliers, and bondholders, have the next claim.
3. Stockholders - owners of the company, have the last claim on assets and may not receive anything if the Secured and Unsecured Creditors’ claims are not fully repaid.

The investors who take the least risk are paid first. For example, secured creditors take less risk because the credit that they extend is usually backed by collateral, such as a mortgage or other assets of the company. They know they will get paid first if the company declares bankruptcy.

Chapter 1: TEST YOUR KNOWLEDGE

The following question is designed to ensure that you have a complete understanding of the information presented in the chapter (assignment). It is included as an additional tool to enhance your learning experience and does not need to be submitted in order to receive CPE credit.

We recommend that you answer the question and then compare your response to the suggested solution on the following page before answering the final exam question(s) related to this chapter (assignment).

1. What is the Bankruptcy Code's liquidation chapter:
 - A. chapter 7
 - B. chapter 9
 - C. chapter 11
 - D. chapter 13