BANKRUPTCY ORIGINS

Bankruptcy is a uniquely western and somewhat modern legal concept. The ancient Athenians, for example, did not have bankruptcy. Debtors who could not repay their debts owed their entire household to the creditor. The debtor's wife, children, and servants could be forced into *debt slavery* for a period of years until the debt was repaid. The concept continued through modern history with the more infamous debtor's prisons common in England and the American colonies. The word "bankruptcy" derives from the Latin *bancus*, which is a bench or table, and *ruptus*, which means broken. A bank referred to a bench, which the first bankers had in the public places, in markets, fairs, et cetera on which they tolled their money, wrote their bills of exchange, et cetera. Hence, when a banker failed, he broke his bank, to advertise to the public that the person to whom the

bank belonged was no longer in a condition to continue his business.

The concept and origin of bankruptcy law as it is now known in the United States originated in England. English bankruptcy law dates back to 1542 and was originally planned as a remedy for creditors — not debtors. During the reign of King Henry VIII, bankruptcy law allowed a creditor to seize all of the assets of a trader who could not pay his debts. Sometimes, the unfortunate debtor also lost his freedom and was subject to imprisonment for failure to pay his debts. This left the family of the debtor in the position of having to pay the debts to secure his release. As time progressed, however, so did the rights of debtors in England. In the 1700s, for example, debtors were often released from prison and many fled to the United States. Many immigrated to Georgia and Texas, which became known as debtors' colonies. Finally, by the early 1800s in England, debtors were often released from prison and their debts discharged. However, for many years, bankruptcy continued to be a remedy favoring creditors, involuntary in nature and largely penal in character. It was generally used only against traders.

MODERN AMERICAN BANKRUPTCY LAW

Generally, bankruptcy is remedial in nature and relief is sought only after the debtor's economic affairs have deteriorated to the point of collapse. Bankruptcy law is not designed to give either the debtor or the creditor the full entitlement owed under nonbankruptcy law but rather to manage the financial distress and to do the best job possible of preserving what can be saved. Federal bankruptcy law is currently governed by Title 11 of the U.S. Code. It is a collective remedy that, with few exceptions, encompasses all of the debtor's assets and debts. Title 11 fulfills two functions:

1. It affords relief to the debtor by resolving and settling current debts, while at the same time;
2. Protecting creditors and guarding their interests.

Bankruptcy Law is Federal Law

Article I, ß8 of the U.S. Constitution stipulates that Congress has the power "[t]o establish… uniform laws on the subject of bankruptcies throughout the United States." Although state law generally governs the creation, performance, and enforcement of obligations between debtors and creditors, as soon as bankruptcy relief is sought, federal bankruptcy law is brought into effect. When bankruptcy occurs, bankruptcy law interacts with state bodies of nonbankruptcy law in a complex and multifaceted way. Under the Supremacy Clause, bankruptcy law preempts state law to the extent that they are inconsistent, but because in many respects state law is *not* incompatible with bankruptcy law, it is preserved in bankruptcy and forms the basis of rights that are protected and upheld. Thus, through the diversity of state laws not inconsistent with federal bankruptcy law, bankruptcy courts will adjudicate identical issues in different ways with different outcomes in the various states. For example, though ß522 of Title 11 of the U.S. Code provides for a standardized set of exemptions in bankruptcy cases, ß522(b) gives states the option of substituting their own exemption laws.

Federal Bankruptcy Legislation – 11 U.S.C. ß101

There are six types of bankruptcy currently under Title 11 of the U.S. Code:

Chapter 7 – Straight Bankruptcy: is the simplest and quickest form of bankruptcy available. It constitutes basic liquidation for individuals and businesses.

Chapter 9 - **Municipal Bankruptcy**: a federal mechanism for the resolution of municipal debts.

Chapter 11 – Corporate Bankruptcy: used primarily by business debtors, but sometimes by individuals with substantial debts and assets; known as corporate bankruptcy, it is a form of corporate financial reorganization which typically allows companies to continue to function while they follow debt repayment plans.

Chapter 12: rehabilitation for family farmers and fishermen.

Chapter 13: rehabilitation with a payment plan for individuals with a regular source of income; enables individuals with regular income to develop a plan to repay all or part of their debts; also known as Wage Earner Bankruptcy.

Chapter 15: ancillary and other international cases; provides a mechanism for dealing with bankruptcy debtors and helps foreign debtors to clear debts.

BANKRUPTCY EXPLANATIONS

The most common types of personal bankruptcy for individuals are Chapter 7 and Chapter 13. As much as 65% of all U.S. consumer bankruptcy filings are Chapter 7 cases. Corporations and other business forms file under Chapters 7 or 11.

In **Chapter 7**, a debtor surrenders his or her non-exempt property to a bankruptcy trustee who then liquidates the property and distributes the proceeds to the debtor's unsecured creditors. In exchange, the debtor is entitled to a discharge of some debt; however, the debtor will not be granted a discharge if he or she is guilty of certain types of inappropriate behavior (e.g. concealing records relating to financial condition) and certain debts (e.g. spousal and child support, student loans, some taxes) will not be discharged even though the debtor is

generally discharged from his or her debt. Many individuals in financial distress own only exempt property (e.g. clothes, household goods, an older car) and will not have to surrender any property to the trustee. The amount of property that a debtor may exempt varies from state to state. Chapter 7 relief is available only once in any eight year period. Generally, the rights of secured creditors to their collateral continues even though their debt is discharged. For example, absent some arrangement by a debtor to surrender a car or "reaffirm" a debt, the creditor with a security interest in the debtor's car may repossess the car even if the debt to the creditor is discharged.

The 2005 amendments to the Bankruptcy Code introduced the "means test" for eligibility for chapter 7. An individual who fails the means test will have his or her chapter 7 case dismissed or may have to convert his or her case to a case under chapter 13.

Generally, a trustee will sell most of the debtor's assets to pay off creditors. However, certain assets of the debtor are protected to some extent. For example, Social Security payments, unemployment compensation, and limited values of your equity in a home, car, or truck, household goods and appliances, trade tools, and books are protected. However, these exemptions vary from state to state. Therefore, it is advisable to consult an experienced bankruptcy attorney.

In **Chapter 13**, the debtor retains ownership and possession of all of his or her assets, but must devote some portion of his or her future income to repaying creditors, generally over a period of three to five years. The amount of payment and the period of the repayment plan depend upon a variety of factors, including the value of the debtor's property and the amount of a debtor's income and expenses. Secured creditors may be entitled to greater payment than unsecured creditors.

Relief under Chapter 13 is available only to individuals with regular income whose debts do not exceed prescribed limits. If you're an individual or a sole proprietor, you are allowed to file for a Chapter 13 bankruptcy to repay all or part of your debts. Under this chapter, you can propose a repayment plan in which

you pay your creditors over three to five years. If your monthly income is less than the state's median income, your plan will be for three years unless the court finds "just cause" to extend the plan for a longer period. If your monthly income is greater than your state's median income, the plan must generally be for five years. A plan cannot exceed the five-year limitation.

In contrast to Chapter 7, a Chapter 13 Debtor may keep all of his or her property, whether or not it is exempt. If the plan appears feasible and the debtor complies with all the other requirements, the bankruptcy court will typically confirm the plan and the debtor and creditors will be bound by its terms. Creditors have no say in the formulation of the plan other than to object to the plan, if appropriate, on the grounds that it does not comply with one of the Code's statutory requirements. Generally, the payments are made to a trustee who in turn disburses the funds in accordance with the terms of the confirmed plan.

When the debtor completes payments pursuant to the terms of the plan, the court will formally grant the debtor a discharge of the debts provided for in the plan. However, if the debtor fails to make the agreed upon payments or fails to seek or gain court approval of a modified plan, a bankruptcy court will often dismiss the case on the motion of the trustee. Pursuant to the dismissal, creditors will typically resume pursuit of state law remedies to the extent that a debt remains unpaid.

In **Chapter 11**, the debtor retains ownership and control of its assets and is re-termed a *debtor in possession* ("DIP"). The DIP runs the day-to-day operations of the business while creditors and the debtor work with the Bankruptcy Court in order to negotiate and complete a plan. Upon meeting certain requirements (e.g. fairness among creditors, priority of certain creditors) creditors are permitted to vote on the proposed plan. If a plan is confirmed, the debtor will continue to operate and pay its debts under the terms of the confirmed plan. If a specified majority of creditors do not vote to confirm a plan, the court may impose additional requirements in order to confirm the plan.