

V. Bankruptcy Concepts

Familiarity with several fundamental bankruptcy concepts and a bit of bankruptcy terminology is helpful in analyzing the bankruptcy issues that most frequently confront state courts. This section discusses the Bankruptcy Code sections and bankruptcy terms that will assist state court judges when bankruptcy issues arise in their cases. The full text of the Bankruptcy Code sections that most frequently affect state courts is provided in Appendix A in the order discussed below.

A. Automatic Stay

Section 362(a) provides for a statutory stay that automatically takes effect upon the filing of any bankruptcy case. The automatic stay can be thought of as an injunction that takes effect the instant a bankruptcy petition is filed. It prevents creditors and others from undertaking collection efforts and otherwise “interfering” with the property of the bankruptcy estate and administration of the case. It facilitates the efficient administration of the case and is a key component in jump-starting the debtor’s “fresh start.”

The Code allows some creditors to continue collection efforts by making certain “exceptions” to the broad injunctive effects of the automatic stay. Section 362(b) lists 28 exceptions to the automatic stay, one of which concerns domestic relations issues. The 2005 amendments expanded the exception to the stay pertaining to domestic support obligations. Another exception allows criminal actions and proceedings to continue despite the bankruptcy filing.

Section 362(c) sets time limits on the stay. For example, the stay terminates when a discharge is granted or when a case is closed or dismissed. Sections 362(d)-(g) describe grounds and procedures to dissolve or, as bankruptcy lawyers say, “lift” the automatic stay even while the bankruptcy case is open. Finally, § 362(k) allows an individual injured by a willful violation of the stay to recover monetary damages.

B. Property of the Estate

“Property of the estate” under § 541 of the Code describes the assets in any particular bankruptcy proceeding that are used to satisfy pre-filing claims as well as the costs of the bankruptcy proceeding. But for the bankruptcy filing, these assets would have belonged to the debtor.

In chapter 7, property of the estate is defined by § 541 as “all legal and equitable interests of the debtor in property as of the commencement of the case.” Some assets, although initially characterized as property of the estate, later exit this category when they are exempted by the debtor, abandoned by the trustee as burdensome or inconvenient, redeemed by the debtor, or sold by the DIP or trustee. In chapter 7, § 541 excludes all of an individual debtor’s earnings from post-petition services from property of the estate. This is consistent with the idea that the filing of the petition begins the chapter 7 debtor’s “fresh start.”

The § 541 definition of property of the estate also applies to reorganizations under chapters 11, 12 and 13. However, both individual and entity debtors in these chapters are expected to fund their plans with

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post-petition income. Consequently, those chapters contain broader definitions of property of the estate, including post-petition income, in addition to § 541 types of assets.

C. Property of the Debtor

Property of the debtor includes all of the property owned by the debtor before the bankruptcy filing or acquired by the debtor after the filing that is statutorily excluded from property of the estate. In addition, property of the debtor includes all property exempted or redeemed by the debtor, as well as property abandoned to the debtor by the trustee.

D. Discharge

In rough terms, a bankruptcy discharge is a forgiveness of pre-bankruptcy debt. It is the principal component of the “fresh start” policy in consumer bankruptcy. Not all debtors receive a discharge; the Code sets forth the circumstances, both pre- and post-petition, that are considered egregious enough to deny the debtor a “fresh start.” In the event the debtor doesn’t obtain a discharge, all debts survive bankruptcy and may be collected after bankruptcy.

A discharge will be granted or denied pursuant to §§ 727, 1141, 1228 or 1328, depending on the chapter in which the case is filed. In chapter 11, 12 and 13 cases, the individual debtor’s discharge is granted (or denied) only after all reorganization plan payments are made. This is typically 3 to 5 years after the case was filed and can be even longer in chapter 11 cases. Occasionally, these debtors can obtain an earlier “hardship” discharge. Chapter 7 discharge occurs much sooner, in part because asset liquidation can be accomplished faster than reorganization.

E. Dischargeable and Nondischargeable Debts

Even where a debtor obtains a discharge, some debts survive bankruptcy and may be collected after the case. Some claims are nondischargeable because of the circumstances under which the debt was incurred, *e.g.*, through fraud, false pretenses or driving while legally intoxicated. Others are not discharged for policy reasons, *e.g.*, marital obligations and student loans. If a debt is nondischargeable, it may be collected after the case is concluded. Even if the debtor receives a general discharge, certain debts may be excluded from that discharge. Section 523 lists the types of debts that are or may be excepted from discharge.

The Bankruptcy Rules that govern objecting to discharge and determining dischargeability of specific debts are Federal Rules of Bankruptcy Procedure 4004, 4005 and 4007. Part VII of the Rules governs procedures for all adversary proceedings in the bankruptcy courts. Those rules generally follow the Federal Rules of Civil Procedure.⁴ Bankruptcy courts apply the Federal Rules of Evidence. In most cases, the status of the obligation as nondischargeable need not be litigated during the bankruptcy case. State courts, as well as bankruptcy courts, can make this decision after the bankruptcy case is closed.

⁴ See Fed. R. Bankr. P. 7002.

F. Claim

A claim is a right to payment, whether or not the right is reduced to judgment, unsecured, unliquidated, unmatured, contingent or disputed. Even a right to equitable relief for breach of a “performance” may be a claim if a right to payment is an alternative remedy for the breach of performance giving rise to the right to equitable relief. An example of this kind of claim is a right to specific performance or injunctive relief.

A party may have a claim for bankruptcy purposes even if its cause of action has not yet accrued under applicable nonbankruptcy law. For example, potential liability as a guarantor creates a bankruptcy claim, as does an obligation to hold someone harmless. This very broad definition of “claim” allows a debtor to discharge obligations that many people would not even consider to be debts yet. The broad definition of “claim” benefits the debtor and is said to facilitate a debtor’s “fresh start,” a new financial life free of much of the debt that precipitated the bankruptcy.

The concept of “claim” is critical for two reasons. First, only claims can be discharged. Second, only holders of timely filed and “allowed” claims may participate in a bankruptcy asset distribution or receive reorganization plan payments. Claim allowance and filing are discussed below.

G. Proofs of Claim, Claim Allowance and Priority Claims

Only holders of claims that are deemed to arise before the bankruptcy case is filed are, generally speaking, automatically stayed from enforcing their claims against the debtor. For example, if after filing for bankruptcy the debtor runs a red light and injures a pedestrian, the tort victim is not stayed from filing suit against the debtor. Although she may not collect the debt from the property of the estate, the stay will not prevent her from filing suit and, if successful, collecting the debt from the debtor’s property during and after the case. The debtor cannot discharge such a claim because, in general, the discharge forgives only pre-petition claims. Since the tort victim does not hold a pre-petition claim, she will not participate in a bankruptcy distribution of assets or receive any reorganization payments.

In order to participate in a chapter 7 distribution of assets or receive plan payments in a chapter 11, 12 or 13 case, a pre-petition creditor must first file a form with the bankruptcy court called a “proof of claim.” Proofs of claim forms (along with many other bankruptcy pleadings) can be found in the Bankruptcy Official Forms. The creditor (or its attorney) simply fills in the blanks on the form and indicates whether the claim is secured or unsecured and, if unsecured, whether the unsecured claim is entitled to priority distribution or payment in bankruptcy. Because there are no nonexempt assets to distribute in most chapter 7 cases, proofs of claim are not ordinarily filed. In the rare event of an asset distribution, proofs of claim must be timely filed in order to share in the distribution. Proofs of claim must always be filed in order to receive reorganization plan payments.

One rather technical aspect of claim “allowance” deserves mention because it pertains to support obligations. Unlike other “unmatured” debts, only overdue support debt creates an allowed claim. As a practical matter, this means that only the past-due portion of a support obligation is entitled to a distributive share of assets in chapter 7. Of course, the past-due support, as well as support due after bankruptcy, survives the discharge. In reorganization cases, it means that the past-due support typically is paid through the plan and that ongoing support payments are usually made directly to the creditor.

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Although similar claims are generally treated similarly in bankruptcy, some unsecured claims receive more favorable treatment than others. This is usually because of the nature of the claimant (support creditors), the circumstances under which the debt was incurred (*e.g.*, false pretenses, fraud) or because the debt was incurred in order to administer the estate itself (the bankruptcy trustee's expenses). The 2005 amendments elevated domestic support obligations (DSOs) to the first level of priority, subject only to the trustee's expenses in liquidating and distributing assets to pay DSO claims. Although DSO claims owed to governmental units are also entitled to first priority, claims owed to individual DSO claimants must first be paid in full before any payment may be made to governmental units holding like claims. However, this is subject to an exception: If the DSO was voluntarily assigned to the governmental unit for collection purposes, it is entitled to the same status as DSOs owed to individual claimants. We will refer to priority DSOs owed to individuals and governmental units to which such claims have been voluntarily assigned for collection as "first-tier DSO priority claims." Other priority DSOs will be referred to as "second-tier" DSO priority claims.

In chapter 7, this means that, subject only to the trustee's expenses incurred in order to pay first-tier priority DSOs, these DSO claims must be paid in full before second-tier priority DSO claimants are paid anything at all. In reorganization cases, first-tier DSO priority claims must be paid in full over the life of the plan and the debtor must remain current in ongoing obligations. Second-tier priority claims need not be paid in full, but only if the debtor devotes all disposable income to the plan for five years. The unpaid balance of the second-tier DSOs is not discharged and may be collected after the case.

H. Domestic Support Obligation (DSO)

Prior to the 2005 amendments, a key concept was "alimony, maintenance and support" owed to a "spouse, former spouse or child of the debtor" and "not assigned to another entity, whether voluntarily, involuntarily or by operation of law." To constitute "alimony, maintenance or support," the obligation had to be in the nature of support as opposed to a property settlement debt or obligation. Support debts assigned pursuant to § 408(a)(3) of the Social Security Act (primarily related to Aid to Families with Dependent Children) or otherwise assigned to a governmental unit were excepted from this anti-assignment language and were accorded the enhanced protections that support debts enjoyed.

The Code continues to distinguish between support debts on the one hand and property settlement debts on the other. However, the amendments clarify and broaden the concept of "alimony, maintenance and support" by introducing a new term, "domestic support obligation" (DSO), and referring to it consistently throughout the amended Code. An obligation must be in the nature of support to constitute a DSO. That term includes both pre-petition and post-petition alimony and support, as well as interest under applicable nonbankruptcy law. A DSO also includes support obligations established before, on or after the bankruptcy case is commenced. In addition to obligations owed to the debtor's spouse, former spouse or child, a DSO includes debts owed to the child's parent, legal guardian, responsible relative and governmental units. A support debt that is voluntarily assigned to a nongovernmental unit for collection purposes is eligible for DSO status, but not if it was the subject of an involuntary assignment or was assigned (voluntarily or not) for purposes other than collection.

Many important changes to enhance enforcement of domestic relations rights and responsibilities were made in 2005. Domestic relations creditors get broad immunities from the automatic stay, which is discussed in detail in Chapters VI and VIII. In addition, the amendments establish a comprehensive set of provisions to enhance the enforcement and collection of DSOs even while the bankruptcy case is pending. DSOs are nondischargeable in every type of case and are entitled to first-tier priority status. This

enhances the collectability of those claims, particularly in reorganization cases. Failure to make ongoing DSO payments is a ground for conversion or dismissal of chapter 11, 12 and 13 cases. Reorganization plans can be confirmed only if they propose full payment of pre-petition DSO claims entitled to first-tier priority and only if the debtor is current on post-filing DSO payments. Moreover, the court may not grant a discharge in chapter 11, 12 or 13 unless the debtor certifies that he or she is current in all post-petition DSO payments and has made all DSO payments called for under the plan. Finally, trustees under all chapters must inform DSO claimants about the resources available to them to collect their claims and their rights under the Code. For good or ill, the bankruptcy court has become an important conduit in the enforcement and collection of support obligations.

I. Property Settlement Obligations

Many, but not all, debts arising in a domestic relations context are support-based. Other obligations serve to fairly apportion marital assets and liabilities. If a debt serves to divide the couple's property rights or obligations, it is referred to as a "property settlement obligation." Property settlement debts are now nondischargeable in all bankruptcy cases, save chapter 13 cases upon completion of all plan payments.

A fair allocation of marital assets is sometimes accomplished by requiring one spouse to make periodic payments to the other for months or even years after the couple divorces. Joint marital liabilities are frequently allocated between the parties by orders requiring one spouse to assume payment of a joint debt. Sometimes that spouse is also required to hold the other spouse harmless for the payment of the debt. Of course, neither the parties nor the court can prevent the third-party creditor from attempting to collect the marital debt from either spouse, but the spouse held harmless would have a cognizable claim for reimbursement from the debtor. Whatever its form, an obligation that serves as a proxy for support is a DSO, whereas a debt that serves to allocate marital property rights is a property settlement obligation.