**Bankruptcy and the Automatic Stay**

Welcome to this podcast on Bankruptcy and the Automatic Stay brought to you by CALI. I am Professor Jennifer S. Martin. The topic of this podcast is some of the basic concepts of bankruptcy, as well as the automatic stay, and some ways you might find to get around it. While most courses on secured transactions focus on U.C.C. Article 9, which is state law, sometimes you will find that a debtor declares bankruptcy. In the event that there is a bankruptcy, the secured creditor will have to know what actions it can and which it can’t take. Recall that while Article 9 is part of state law, bankruptcy law is part of federal statutory law. In addition, bankruptcy matters are actually heard by special federal bankruptcy courts.

At this point, many law students shudder at the possibility of having to learn yet another statutory scheme. When reading cases, though, you will often see some of them arise in bankruptcy court. You will see the appearance of bankruptcy trustees in the cases, as well as debtors in possession. What in the world is that? Well with this in mind, some understanding of bankruptcy is just going to be helpful to your studies. In most cases, though, just a little bit of bankruptcy will go a long way and be enough for a student of secured transactions. Of course, if you want to pursue a career in bankruptcy, you should take a bankruptcy class or enroll in a bankruptcy clinic.

So, how does this all work? We will just stick to the basics. In most cases, a debtor will file a voluntary petition for bankruptcy. While we refer to most bankruptcy petitions as voluntary, in most senses it is not voluntary as the debtor is typically in some type of financial distress, so we don’t necessarily mean voluntary in the ordinary sense here. In light of that though, we need to understand some of the basics about what happens if a debtor declares bankruptcy and what effect would that have on the creditors. Importantly, unsecured creditors tend to only get paid pennies on the dollar in terms of recovery in bankruptcy. Wow, in light of that, a secured creditor’s status then becomes especially important in bankruptcy to those secured creditors, who will seek to protect their interest in the collateral that they have worked so hard to attach their security interest to.

Before we go any further let’s talk about the types of bankruptcies. There are actually several types of bankruptcy and each is referred to according to the chapter of the Bankruptcy Code under which the bankruptcy occurs. For instance, Chapter 7 is often used by individuals, meaning humans, in order to receive a complete discharge of outstanding debts at the end of the bankruptcy. You might’ve at times heard reference to giving people a fresh start. A Chapter 7 bankruptcy actually seeks to do that. On the other hand, Chapter 11 bankruptcy is often referred to as a debtor in possession bankruptcy and can be used by either individuals or by business organizations. Of note, a Chapter 11 bankruptcy involves a debtor proposing a restructuring plan, which is then confirmed by a court, whereby the debtor pays part of the debt to the extent that creditors receive no less than they would have if the debtor had actually filed a Chapter 7 bankruptcy. I know it is a little complicated but stick with me for a while here. At the end of the bankruptcy restructuring, the remaining debt is actually discharged, just like in a Chapter 7. Finally, in a Chapter 13 bankruptcy, individual debtors can propose a restructuring plan of three to five years so long as the debtor meets the qualifications under the Chapter, such as limits on the amount of unsecured and secured debt. Again, the value under this type of plan has to give the creditors at least as much as they would receive if the bankruptcy had been a Chapter 7. What’s important in terms of difference between 7 and then of course 11, and 13 is that under 11 and 13 there are some additional payment plans that are made to the creditors whereas chapter 7 is considered a liquidation.

So, how does someone actually file for bankruptcy? The process of bankruptcy itself involves the filing of the petition, along with filling out forms that make disclosures about the debtor’s assets, debts, income, and the like. The debtor will also file a repayment plan when required by the particular type of bankruptcy filed. The creditors, on the other hand, will file claims with respect to the money owed to them.

If the bankruptcy is a liquidation, the bankruptcy trustee will then liquidate all nonexempt property of the debtor and then distribute the funds from the sale of the nonexempt property to the creditors. There are actually federal bankruptcy rules as to what assets of the debtor are considered exempt. Interestingly, some states have different rules on what is exempt even though this is in bankruptcy court. For instance, in Florida, there is a generous homestead exemption for an unlimited amount of value in a home or property so long as it is not bigger than half an acre if it’s in a town or 160 acres elsewhere. At the completion of the bankruptcy, the debts are discharged and a creditor cannot seek collection.

In bankruptcies governed by debtor plans of repayment it is actually the court that will ultimately confirm the repayment plan proposed by the debtor. During these types of bankruptcies, there is actually not a bankruptcy trustee, but instead the job of the trustee is performed by a debtor in possession of the assets. That’s why in some of the cases you read you will see a trustee as the party in interest and sometimes you will see reference to the debtor being in possession. Sometimes the confirmation of the repayment plan proposed by the debtor is over the objection of the creditors. To the extent that a court confirms a plan over the objection of the creditors, who actually don’t get a vote in that matter, we call this a cram down. Once the court confirms the repayment plan, the debtor then begins the repayment process and so long as all goes well and the debtor makes the required payments, the debtor then gets a discharge at the end of the payment plan and keeps all of the property, not just the exempt property.

One of the most important things about bankruptcy is that it is supposed to give debtors a reprieve from the creditors who may be pressing them to pay outstanding and often long overdue debts. In order to give the debtor a needed reprieve for a fresh start, the Bankruptcy Code uses what’s called an automatic stay. The automatic stay arises under section 362 of the Bankruptcy Code. I often tell my students if you only remember one section of the Bankruptcy Code, this is the one to know -- section 362. The automatic stay in bankruptcy is a very powerful tool in the form of an injunction that arises at the moment the debtor files the bankruptcy petition without any further action by the bankruptcy attorney or the court. In this case, the automatic stay really does mean automatic. Moreover, a creditor does not want to violate the automatic stay or face complaints in front of a bankruptcy judge about impermissible actions. Bankruptcy courts have authority to hold creditors who violate the automatic stay in contempt of court and impose fines and even damages.

Well, what’s special about the automatic stay? Sure it is automatic, but it is more than that. It prevents almost any action that a creditor would take relative to the debtor. Basically, any action that would be taken in terms of collection or enforcement against the debtor would violate the automatic stay. For instance, creditors cannot take judicial or other actions against the debtor, meaning they cannot sue the debtor. Creditors cannot even try to enforce judgments they have already gotten against the debtor, even if they were obtained prior to the filing of the bankruptcy. Importantly, creditors may not attempt to obtain possession over the debtor’s property, which you may recall is one of the most important aspects of being a secured creditor in the first place. Further, creditors cannot seek to create, perfect, or enforce a lien either, or even make any kind of collection actions.

You might be surprised by the power of the automatic stay. But, does this really mean a creditor cannot create or perfect a security interest? Exactly. Does this really mean that a secured creditor cannot exercise its Article 9 right to take possession of the collateral? Again, yes. The automatic stay even prevents actions taken in the United States Tax Court.

So what in the world is a secured creditor to do once the debtor files bankruptcy? It seems like their hands are tied. Well, the secured creditor is just going to have to wait for the administration of the bankruptcy as the bankruptcy court directs. If the assets are going to be liquidated, the court is going to supervise the sale of the collateral and the payment to the secured creditor. If there is a situation where the creditor perceives some type of risk due to the bankruptcy in terms of its collateral and the situation otherwise meets statutory requirements, the secured creditor can file a motion to request a lifting of the automatic stay. If the court agrees with the secured creditor that there is a qualifying ground for lifting the stay, then the debtor will need to provide some type of adequate protection to the secured creditor or surrender the collateral. An example of this might be where the collateral itself is at risk perhaps because there is no insurance covering it.

At this point, you should be able to identify and describe the basic process of bankruptcy, including the various types. You should be able to describe how the automatic stay works and why a secured creditor might want to attempt to lift the stay.

I hope you’ve enjoyed this podcast on Bankruptcy and the Automatic Stay.

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