LESSON 6

LIQUIDATION
(Chapter 7 Bankruptcy Code)

CONTENTS

I. INTRODUCTION

Chapter 7 is the Bankruptcy Code's liquidation proceeding. It is sometimes known as "straight" or "ordinary" bankruptcy. Any Chapter 7 proceeding involves at least three major types of participants: the debtor, the Chapter 7 trustee, and the creditors. A Chapter 7 case is generally started by the debtor filing a voluntary petition. 11 U.S.C. § 301. Creditors may also commence a case by filing an involuntary petition against the debtor pursuant to the provisions of 11 U.S.C. § 303, but the procedures involved in an involuntary case will not be discussed in this text. The references in this text are to a voluntary petition.

After the debtor files the petition, a trustee is appointed or elected, and is responsible for taking possession of and liquidating the debtor's nonexempt assets. The trustee distributes the proceeds to the debtor's creditors in accordance with the legal priorities set out in the Bankruptcy Code; first to creditors with valid security interests in the property liquidated, then to unsecured creditors in accordance with the priority scheme set forth in section 726 of the Bankruptcy Code. The theme of Chapter 7, at least from the creditors' perspective, is fair and equal treatment of their debts in accordance with their relative priorities.

From the debtor's viewpoint, the key to Chapter 7 is the discharge. Essentially, if the debtor is honest in the Chapter 7 proceeding and has followed the requirements of the Bankruptcy Code in dealing with creditors and the court, the debtor will get a discharge under 11 U.S.C. § 727. That discharge will excuse the debtor from paying most of the debts the debtor owed at the time of the petition. Therefore, although the debtor must surrender all nonexempt property in a Chapter 7 case to the trustee for the benefit of creditors, the debtor can keep all exempt property and be discharged from the unpaid balance of most debts. This is true whether creditors are paid 100% of what they are owed, 50% of what they are owed, or, as is most common in a Chapter 7 case, none of what they are owed, from the proceeds of the debtor's nonexempt property. The theme of Chapter 7 from the debtor's perspective is the fresh start it offers the debtor.

II. INITIATING A CHAPTER 7 CASE

A. Eligibility

A Chapter 7 debtor must be a "person," as defined in 11 U.S.C. § 101(41). The definition of "person" includes individuals, corporations, and partnerships, so corporations and partnerships can file Chapter 7 petitions. A corporation can file Chapter 7 even after its charter has been forfeited or it is otherwise not in good standing under the pertinent state law, so long as it still retains corporate power or remains in existence under state law for the limited purpose of winding up the corporate affairs. While individual, partnership and corporate "persons" can file a Chapter 7, only individuals are eligible to receive a discharge. 11 U.S.C. § 727(a)(1). In a Chapter 7 case, a corporation or partnership does not receive a bankruptcy discharge — instead, the entity is dissolved.

Even though certain entities are defined as "persons" under the Bankruptcy Code, Congress has specifically barred them from being debtors under Chapter 7. 11 U.S.C. § 109(b). For example, railroads are excluded from Chapter 7 proceedings and are confined to cases under special Chapter 11 provisions. Insurance companies and certain banking institutions are also ineligible to file a Chapter 7, generally because there are other laws governing the liquidation of these entities.

B. Filing the Petition

A debtor begins a Chapter 7 case by filing a voluntary petition on Official Form 1. A voluntary petition acts automatically as the order for relief, and the automatic stay goes into effect at this time unless the serial filing provisions added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the BAPCPA) apply. 11 U.S.C. §§ 301, 362(a), 362(c)(4). The bankruptcy estate is also created when the petition is filed, and "property of the estate" comes into being. 11 U.S.C. § 541(a). A husband and wife can join in one joint petition. 11 U.S.C. § 302. No other debtors can join in a single Chapter 7 petition, no matter how closely related they are.

An individual debtor, or a husband and wife in a joint petition, must personally sign the petition. A voluntary partnership petition must be joined in by all of the general partners. If one or some of the general partners do not join in the petition, it is treated as an involuntary petition. 11 U.S.C. § 303(b)(3). Limited partners need not join in the petition. Fed. R. Bankr. P. 1004. A voluntary corporate petition must be signed by those authorized to act for the corporation under corporate law, usually the president or another officer of the corporation, as authorized by the board of directors.

The petition provides limited information about the debtor, such as the name of the debtor and all other names used in the last eight years, the last four digits of the debtor's social security or tax identification number, the debtor's address and county of residence or principal place of business, and some general information regarding the type of debtor, the nature of the debtor, the type of bankruptcy being filed, and the estimated number of creditors. Along with the petition, the debtor must also file a list containing the name and address of each creditor. Fed. R. Bankr. P. 1007(a). The specific information about the debtor, the debtor's assets, and the creditors is contained on the supporting documents, or schedules and statements, filed with or shortly after the petition is filed. The BAPCPA amended section 521 to impose additional filing requirements on debtors. Rule 1007 was also amended by interim rules to implement these new filing requirements. The Official Forms were also revised to reflect the changes in the law under the BAPCPA.

C. Supporting Documents

Fed. R. Bankr. P. 1007 requires the Chapter 7 debtor to file the following supporting documents within 14 days after the petition is filed:

1) Schedules (Official Form #6)
    - Schedule A - Real Property
    - Schedule B - Personal Property
    - Schedule C - Property Claimed as Exempt
    - Schedule D - Creditors Holding Secured Claims
    - Schedule E - Creditors Holding Unsecured Priority Claims
    - Schedule F - Creditors Holding Unsecured Nonpriority Claims
    - Schedule G - Executory Contracts and Unexpired Leases

Schedule H - Codebtors
Schedule I - Current Income of Individual Debtor(s)
Schedule J - Current Expenditures of Individual Debtor(s)

2) Statement of Financial Affairs (Official Form #7)
3) Individual Debtor's Statement of Intention (Official Form #8).

As noted above, the BAPCPA amended section 521 to impose additional filing requirements on debtors, including requirements to provide copies of income tax returns to the trustee. See 11 U.S.C. § 521(e). These new tax return filing requirements are more fully discussed in Lesson 4, Creditors, Debtor and the Estate. Another example of the additional filing requirements imposed on debtors under the BAPCPA is the requirement to file a certificate from an approved nonprofit budget and credit counseling agency evidencing the completion of a personal financial management course. See 11 U.S.C. §§ 109(h) & 521(b). A new Official Form 23 was developed for this purpose.

Attorneys should familiarize themselves with the information contained on these forms.

In these schedules and statements, the debtor lists the property being claimed as exempt under Bankruptcy Code § 522, as well as providing specific information about property, creditors, the amounts owed, the debtor's classification of these debts, and transactions occurring before the bankruptcy petition was filed. Under section 522(b), in all states, a debtor is entitled to the exemptions provided under state law, which may be surprisingly generous. For example, Florida exemptions provide, in part, for an unlimited dollar exemption for a homestead of 160 acres outside of a municipality and one-half acre inside a municipality. Texas exemptions provide, in part, for an unlimited dollar exemption for a homestead of 200 acres outside of town and 10 acres within the town limit. In the nineteen states that have not opted out of the federal list of exemptions, a debtor has the choice of using the federal exemptions. 11 U.S.C. § 522(d). In these minority states, a debtor must choose either the state or federal list of exemptions; the two lists cannot be combined. In many Chapter 7 cases, there will be no nonexempt assets with any equity to administer, and the case will be classified as "no asset," in which there will be no distributions to the creditors.

III. ADMINISTRATION OF THE CHAPTER 7 ESTATE

A. Role of the Private Trustee

1. As Interim Trustee

Immediately after a voluntary Chapter 7 petition is filed, the U.S. Trustee appoints an interim trustee. 11 U.S.C. § 701. Interim trustees are required in every Chapter 7 case, and are chosen from a panel of private trustees.

The interim trustee must be disinterested, as defined by Bankruptcy Code § 101(14). Essentially, this means the interim trustee cannot be a creditor, equity security holder, or insider of the debtor, or be an investment banker for the debtor's securities. These prohibitions also extend back to a certain time before the filing of the petition. If no private trustee is able or willing to serve as trustee in a Chapter 7 case, the United States Trustee can serve as trustee. 11 U.S.C. § 701(a)(2).

The interim trustee's major role is to take possession of, preserve, and protect the debtor's nonexempt property until a permanent trustee is chosen. But the interim trustee is still a trustee under the Bankruptcy Code, and enjoys all of the rights and powers of a permanent bankruptcy trustee. If the debtor is not an individual, the trustee displaces those who controlled the debtor and its assets.

2. At the Creditors' Meeting

After the interim trustee is selected, the next thing to happen in the typical Chapter 7 case is the first meeting of creditors. This meeting is also commonly known as the "341 meeting," after the Bankruptcy Code provision mandating it. The creditors' meeting must be held at least 21, but not more than 40, days after the order for relief, which occurs when a voluntary Chapter 7 petition is filed. Fed. R. Bankr. P. 2003(a). All creditors are entitled to at least 21 days notice of the time for holding the 341 meeting, and this notice is generally given by the Bankruptcy Court. Fed. R. Bankr. P. 2002(a)(1). This same notice also gives creditors the deadlines for filing objections to discharge or to the exempt property claimed by the debtor, and if there are any assets to administer, the deadline for filing proofs of claim.

The 341 meeting has two essential purposes. First, the interim trustee and any creditor may examine the debtor. Creditors often find it useful to attend the 341 meeting, as the debtor must attend the creditors' meeting and submit to an examination under oath. In fact, the bankruptcy court could order a recalcitrant debtor to be arrested to compel attendance at the 341 meeting, although usually the court will dismiss the case for failure to attend, or will use the failure as the grounds for denying the debtor a discharge.

The examination of the debtor at the 341 meeting is freewheeling. The right to examine the debtor is not confined to the trustee. Creditors also have a statutory right to ask questions, with the examination being under oath and on the record. The scope of the examination is limited only by the requirement that it relate to the debtor's financial affairs, the debtor's discharge or the administration of the estate. Within those confines, creditors and the trustee can ask the debtor any questions. The fact that a question might help the trustee or creditor in pursuing an action against the debtor in the Chapter 7 case does not make the question irrelevant. The 341 meeting, therefore, is a chance for the IRS and other creditors to have discovery on issues such as discharge and dischargeability, and for the trustee to have discovery in pursuit of possible recoveries under the avoiding powers.

The second order of business at the 341 meeting is the selection of the permanent trustee. Unsecured creditors have the right in Chapter 7 cases to elect a permanent trustee for the debtor's estate. 11 U.S.C. § 702. Although the creditors may elect a trustee who is not a member of the permanent panel of private trustees, as a practical matter, this right is very rarely exercised. In the overwhelming majority of Chapter 7 cases, no election is held, and the interim trustee automatically becomes the permanent trustee.

Note: Section 341(c) was amended by the BAPCPA to specifically allow a creditor holding a consumer debt to appear and participate at the section 341 meeting without being represented by an attorney. Because personal income taxes are not consumer debts, this amendment arguably does not benefit the Service. Service employees are still prohibited from participating in section 341 meetings in those jurisdictions where participation in such meetings is considered to be the practice of law.

3. Major Duties of Trustee - 11 U.S.C. § 704

A Chapter 7 trustee has two major roles. In the first, the trustee is to expeditiously liquidate the debtor's nonexempt assets, if any, in a way that maximizes the return to the debtor's unsecured creditors. The second major role is an investigatory one, and the trustee is responsible for investigating the facts and circumstances surrounding the debtor's bankruptcy. For example, the trustee will determine if the debtor has made any fraudulent conveyances of property prior to filing the bankruptcy petition, or if the debtor has property that has not been listed on the schedules and statements. As part of these two major roles, the trustee must file reports with the court and the U.S. Trustee on receipts and disbursements, and must make a final report and final account of the administration of the estate at the end of the case. If any of the trustee’s actions create a tax liability, the trustee must also file the appropriate tax returns on behalf of the estate. 11 U.S.C. §§ 704(a)(8), (9); Fed. R. Bankr. P. 2015(a).

Most Chapter 7 cases involving individual debtors are "no asset” cases, meaning that there are no assets to be liquidated to provide distributions to unsecured creditors because all of the debtor's assets are either subject to valid liens, with no equity remaining, or are claimed by the debtor as exempt. The trustee's fee in a Chapter 7 case is a sliding percentage of the assets the trustee distributes to creditors. Generally, although the statute allows a fee of as much as 25% for very small cases, this will be a fee of 3% of the amount distributed. 11 U.S.C. § 326. In no asset cases, the trustee receives a minimum fee of $60 payable from the debtor's filing fee. 11 U.S.C. § 330(b). A trustee looking at a fee of $60 will not do much in terms of investigating the debtor or the disposition of assets before the bankruptcy petition is filed, or in pursuing any of the possible causes of action that may exist.

As a result, the creditors must act to protect their own interests in such cases. Trustees in no asset cases will usually do no more than conduct a cursory examination of debtors at the 341 meeting to satisfy themselves that no nonexempt assets exist, and file the minimum reports required. Thus, although the Code suggests that the trustee is to oppose the debtor's discharge “if advisable,” a trustee in a no asset case is unlikely to find it "advisable" to go through the time and expense of opposing the debtor’s discharge even if grounds for doing so exist. If there are grounds for objecting to discharge, the creditors should be prepared to pursue the objection on their own, if they want to see any action taken on the issue.

One of the major changes made by the BAPCPA is to impose means testing for individual debtors with primarily consumer debts. If granting relief would be an abuse of Chapter 7, section 707(b)(1) permits the court, the United States Trustee, the trustee or bankruptcy administrator, or a party in interest, to move to dismiss the case or, with the debtor’s consent, convert the case to Chapter 11 or Chapter 13. Further discussion of means testing is set forth below.

4. Property of the Estate

In general, the Chapter 7 estate consists of all legal and equitable interests in property that the debtor held as of the date of the petition, with a few limited exceptions. 11 U.S.C. § 541(a)(1), (b), (c)(2). If the debtor acquires certain limited types of property after the petition is filed, this property will also be included in the estate, but this is rare. 11 U.S.C. § 541(a)(5). Most property that the debtor acquires after the petition is the Chapter 7 debtor's to keep as part of the fresh start, along with the property the debtor exempts under 11 U.S.C. § 522.

The trustee's major goal is to maximize the estate for the benefit of the debtor's unsecured creditors, and the trustee will try to do so in several ways. The first and most obvious way is for the trustee to liquidate the debtor's nonexempt property that is not fully secured by liens. The second is to pursue causes of action belonging to the debtor, such as the right to recover for personal injury. The third is to pursue the trustee's own causes of action to recover money or property transferred by the debtor or seized by creditors before the bankruptcy petition was filed, using the trustee's avoiding powers contained in 11 U.S.C. §§ 542 through 550. For example, under these provisions, the trustee may recover property seized by a creditor in which the debtor still retains an interest, or which the debtor transferred fraudulently prior to filing the petition. Once the property is recovered, it also becomes property of the estate under section 541, and can be liquidated for distribution.

Although the trustee is to liquidate the estate as expeditiously as possible, the speed of the liquidation should be consistent with the best interests of the unsecured creditors. Therefore, if the trustee believes it is in the creditors' interests to keep the debtor's business going to maximize the amount the business will bring in a sale as a going concern, the trustee can continue to operate the business, even in a Chapter 7 case. 11 U.S.C. § 721. The trustee needs to get the prior permission of the bankruptcy court for such continued operation.

5. Sale of Assets

Although "property of the estate" is a very broad term, it does not really define what it is that the trustee will take possession and control of in a Chapter 7 case. For example, exempt property belonging to the debtor is initially property of the estate, but the debtor is permitted to list the property being claimed as exempt in the schedules and statements, and if no objections are made, the property becomes the debtor's. 11 U.S.C. §§ 522(b), (l); Fed. R. Bankr. P. 4003. So in the typical case, the trustee neither takes possession nor control of exempt property. Similarly, the trustee will not liquidate property that is subject to a valid security interest or lien if the debtor has no equity in the property, although it is property of the estate. Even if the trustee takes over such property, the trustee will generally abandon it to the secured creditor under 11 U.S.C. § 554, as there is no benefit to be gained for the unsecured creditors in selling the property.

Therefore, the trustee will not actually take possession of and sell all of the property of the estate that comes under the jurisdiction of the bankruptcy court, but only the property that is not exempt and in which the debtor has equity that can be realized on behalf of the estate. The trustee will sell the property pursuant to 11 U.S.C. § 363, after court approval, in order to convert the debtor's nonexempt interest in the property to cash.

In general, the debtor is not interested in the trustee's disposition of nonexempt property of the estate. The debtor's major interests in a Chapter 7 case are in retaining exempt property and in getting a discharge that covers as many debts as possible. The debtor has very little interest in how creditors fare, unless the debtor has nondischargeable debts that a creditor will be able to collect from the debtor after the automatic stay lifts. In those situations, the debtor wishes those debts to be paid from the property of the estate so the debtor will not be liable for them at a later date.

IV. DISTRIBUTION OF PROPERTY OF THE ESTATE

A. Creditors Holding Secured Claims

In theory, the holders of valid liens or security interests that cannot be avoided by the trustee or the debtor are first in line for distribution in a Chapter 7 case. The holder of a secured claim will either get its collateral, if the trustee abandons it pursuant to 11 U.S.C. § 554 as having no benefit to the estate, or if there is equity in the property and the trustee sells it, the secured creditor will get the proceeds of its collateral to the extent of its claim in the Chapter 7 case. 11 U.S.C. § 725. A secured creditor could also move to lift the automatic stay pursuant to 11 U.S.C. § 362(d), and if the automatic stay is lifted, the creditor could proceed against the property under applicable nonbankruptcy law.

If the creditor is undersecured, with the amount of its claim exceeding the value of the collateral, it has an unsecured claim for its deficiency, assuming that the creditor has recourse in its loan arrangement with the debtor. In the event of a dispute, the bankruptcy court will value the collateral pursuant to 11 U.S.C. § 506(a), to determine whether the creditor is fully secured or not. When there is more than one secured creditor with respect to a piece of property, any priority disputes between the secured creditors are resolved under applicable nonbankruptcy law.

B. Secured Claim of the IRS in Chapter 7

In Bankruptcy Code § 724(b), Congress created a mechanism whereby the money that normally would have been paid to a secured tax claimant, including the Internal Revenue Service, is instead used to subsidize the payment of certain unsecured priority claims. This subordination procedure only applies in bankruptcy cases under Chapter 7, and does not apply to Chapters 11, 12, or 13. In effect, the amount that would be paid to the secured tax claimant is first used to pay all unsecured priority claimants except priority tax claimants under section 507(a)(8). The secured tax claimant is paid only if there is anything left after the specific priority creditors listed in section 724(b) are paid.

This provision does not affect the normal "first in time, first in right" rule if there are lienholders other than the secured tax claimant holding an interest in the property. Senior and junior lienholders are unaffected by the subordination of a secured tax claim, and receive the same amount that they would receive absent this subordination provision**.** Accordingly, pursuant to section 724(b), property of the estate that is subject to a secured tax claim is distributed in the following order:

1. To the holders of liens senior to the tax lien.

2. To priority claims specified in sections 507(a)(1) - (7) to the extent of the amount of the allowed tax claim that is secured by the tax lien.

3. To the holder of the tax lien, to the extent that the priority claims (sections 507(a)(1) - (7)) did not use up the amount of the tax lien under 2 above.

4. To the holders of liens junior to the tax lien.

5. To the holder of the tax lien, to the extent the allowed tax claim is not paid under 3 above.

6. To the estate.

Note: The BAPCPA amended section 724(b) to provide that tax liens are not subordinated to administrative expenses incurred in the prior Chapter 11 case, except for claims for wages, salaries or commissions arising after the filing of the petition.

<u>It is important to remember the following</u>:

- The Service's claim for administrative expenses accruing during the bankruptcy proceeding is entitled to priority under section 507(a)(1) (redesignated as section 507(a)(2) under the BAPCPA). Accordingly, the Service's secured tax claim will be subordinated to the payment of the Service's administrative tax claim, if any. Also, if the Service had received adequate protection for its secured claim in a prior Chapter 11 and notwithstanding this protection, the amount of property subject to the Service’s secured claim decreased in value, the Service is entitled to an administrative expense claim under section 507(b) for the amount of the failed adequate protection and this claim will receive a first distribution under section 724(b).

- Secured state and local tax claims, as well as federal secured tax claims, are subordinated, except for ad valorem tax claims under the BAPCPA.

- As between competing secured tax claims (i.e., a state and federal secured tax claim), the "first in time, first in right" rule continues to apply.

The Chapter 7 trustee may avoid any secured tax claim to the extent that the tax lien secures a nonpecuniary loss (i.e., punitive) penalty. 11 U.S.C. § 724(a). Virtually all of the Service's penalties (e.g., failure to file and failure to pay) are nonpecuniary loss penalties, with the exception of the trust fund recovery penalty. Accordingly, a Chapter 7 trustee may avoid the Service's secured tax claim to the extent the tax lien secures a nonpecuniary loss penalty. The trustee has this avoidance power in addition to the statutory subordination procedure.

C. Distribution of Property of the Estate to Unsecured Creditors

A paramount consideration of a Chapter 7 bankruptcy case is to provide for the orderly distribution of the bankruptcy estate to the creditors, with the order of distribution being found in Bankruptcy Code § 726. This provision specifies the following order of distribution for unsecured claims:

1. Priority claims in the order specified in section 507. (Under the Bankruptcy Reform Act of 1994, the Service's late-filed priority claims will be entitled to first tier distribution if filed before the trustee commences distribution of the estate).

Note: Section 726(a)(1) was amended under the BAPCPA to provide that late-filed priority claims are to be paid with timely-filed priority claims if the late claims are filed before the earlier of: the date that is 10 days after the mailing to creditors of the summary of the trustee's final report; or the date on which the trustee commences final distribution.

2. General unsecured claims, including creditors who filed late because of the absence of notice or knowledge of the case.

3. Other tardily filed unsecured claims.

4. Claims (whether or not secured) for a fine, penalty, or forfeiture, or for multiple, exemplary, or punitive damages to the extent that such claims are not for actual pecuniary loss.

5. Interest at the legal rate from the date of the petition, on any claim paid above.

6. The debtor.

If funds are insufficient to pay all of the creditors in a certain class, the creditors within that class share the available money pro-rata. 11 U.S.C. § 726(b). Additionally, when a case is converted from Chapter 11, 12, or 13, administrative expenses incurred by the Chapter 7 estate are to be paid in full prior to the payment of other administrative expenses incurred by the debtor in the preceding bankruptcy action. Administrative expenses incurred by the Chapter 7 estate include interest accrued on an administrative tax. See United States v. Yellin (In re Weinstein), 272 F.3d 39 (1st Cir.2001).

The Service's tax claim will include any prepetition interest, to be paid in the same order and at the same time as the underlying tax claim. In re Larson, 862 F.2d 112 (7th Cir. 1988). For example, if the Service has a priority tax claim on which interest accrued prior to the filing of the bankruptcy petition, the interest will also be a priority claim.

Prepetition nonpecuniary loss penalties are subordinated in payment to every claim in the Chapter 7 bankruptcy proceeding except post-petition interest and the return of excess funds to the debtor. Accordingly, the Service's prepetition tax penalties (which are virtually all nonpecuniary loss penalties) will rarely, if ever, be paid in a Chapter 7 proceeding. It is extremely uncommon for a Chapter 7 proceeding to fully pay all of the debtor's general unsecured claims, which is a prerequisite to paying nonpecuniary loss penalty claims.

V. DISCHARGE AND DISCHARGEABILITY

A. Discharge v. Dischargeable

While a debtor may receive a discharge under 11 U.S.C. § 727, not all of the debtor's debts may be dischargeable, as certain debts are determined to be excepted from the discharge pursuant to 11 U.S.C. § 523. For example, even when the debtor receives a Chapter 7 discharge, Congress decided that the debtor should still be required to pay certain tax liabilities, and those liabilities have been made nondischargeable. The debtor remains liable for nondischargeable debts after bankruptcy, and creditors with nondischargeable debts can collect from the debtor as if the bankruptcy petition had not been filed.

Post-petition interest on nondischargeable tax debts is also nondischargeable, and the debtor remains liable for payment of the post-petition interest, even if the related tax liability is paid in full or in part by the trustee from assets of the bankruptcy estate. Bruning v. United States, 376 U.S. 358 (1964); In re Artisan Woodworkers, 204 F.3d 888 (9th Cir. 2000). Certain tax penalties may also be nondischargeable under 11 U.S.C. § 523(a)(7), but unlike interest, penalties do not follow the tax. In re Burns, 887 F.2d 1541 (11th Cir. 1989).

B. Grounds for Objecting to the Discharge

In general, matters of discharge and dischargeability in a Chapter 7 case are unrelated to the trustee's administration of the bankruptcy estate. The Court generally gives the creditors notice of the date by which any complaints objecting to the debtor being granted a discharge must be filed at the time they are given notice of the filing of the case and the setting of the 341 meeting. Fed. R. Bankr. P. 4004. In most cases, the Chapter 7 debtor will receive a discharge relatively early in the case, not less than 60 days after the date first set for the creditors' meeting. Fed. R. Bankr. P. 4004(c). Therefore, in any Chapter 7 case except a no asset case, a creditor will have to decide whether to object to the debtor's discharge before the creditor knows whether and how much the creditor will receive when the trustee makes distributions in the case.

Individual debtors are discharged in more than 99% of Chapter 7 cases. The grounds for denying a debtor a discharge in a Chapter 7 case are very narrow and are strictly construed against a creditor or trustee seeking to deny the debtor a Chapter 7 discharge. 11 U.S.C. § 727. But if grounds for denying a discharge exist, the debtor can be denied a discharge in a case begun by either a voluntary or by an involuntary petition. Just because the debtor was forced into Chapter 7 does not mean that the creditors or court owe the debtor a discharge.

Note: As discussed below, the BAPCPA added a means test for individuals filing Chapter 7 cases. Additionally, the BAPCPA added provisions to section 727, such as the requirement to complete an instructional course concerning personal financial management, making it more difficult for debtors to receive a discharge under Chapter 7.

The grounds for denying a discharge to a Chapter 7 debtor pursuant to 11 U.S.C. § 727 are:

1. The debtor is not an individual. Corporations and partnerships do not get discharges in Chapter 7 cases; they can only receive a discharge in a Chapter 11 case.

2. Within one year before the petition, or after the petition was filed, the debtor fraudulently transferred, concealed, mutilated, or destroyed property that would have become property of the estate.

3. The debtor failed to keep or produce adequate books or financial records from which the debtor's financial condition or business transactions might be ascertained, unless the act or failure to act was justified under the circumstances.

4. The debtor knowingly and fraudulently, either in or in connection with the case, made a false oath or account, presented or used a false claim, offered something of value for acting or forbearing to act, or withheld from an officer of the estate entitled to possession any recorded information relating to the debtor's property or financial affairs.

5. The debtor failed to adequately explain any loss of assets or deficiency of assets to meet the debtor's liabilities.

6. The debtor failed to obey a lawful order of the bankruptcy court or to answer a material question on grounds other than a properly asserted Fifth Amendment privilege.

7. The debtor did any of the activities described in paragraphs 1 - 6 above in another bankruptcy case where the debtor was an "insider," within a year before the debtor's own petition was filed, or at any time after the debtor's own petition was filed.

8. The debtor received a discharge in a Chapter 7 or 11 case begun within six years of the filing of this Chapter 7 petition. Under the BAPCPA, this was amended to eight years.

9. The debtor received a discharge in a Chapter 12 or 13 case begun within six years of this Chapter 7 petition where unsecured creditors received less than 70% of their claims under the plan.

10. The debtor executed a written waiver of the discharge after the voluntary Chapter 7 petition was filed or the involuntary petition was approved, and the waiver was approved by the court. A prepetition waiver of the right to a Chapter 7 discharge is unenforceable.

11. The debtor fails to complete an instructional course concerning personal financial management, unless the debtor is found by the court to be unable to complete such course due to incapacity, disability, or active military duty, or the debtor resides in a district found to not have adequate courses available. This provision and the one below were added by the BAPCPA.

12. There is reasonable cause to suspect the debtor of abusing the bankruptcy system or being guilty of certain securities-related felonies.

Note: For purposes of enforcing the tax return filing requirements under section 521(f), there is an off-Bankruptcy Code provision, section 1228 of the BAPCPA, that directs the court not to grant a discharge in an individual Chapter 7 case unless requested tax documents have been provided to the court.

C. Discharge Procedure

To object to the debtor being granted a discharge, a party in interest must bring an adversary proceeding by filing of a complaint within 60 days of the date first set for the 341 meeting. Fed. R. Bankr. P. 4004(a). An objection may be filed by a creditor, the trustee, or the United States Trustee. 11 U.S.C. § 727(c)(1). Continuances of the 341 meeting do not continue the deadline for filing an objection to discharge. The 60-day period can only be extended by a motion filed within the period; the court cannot permit a creditor or trustee to file an objection to discharge after the 60 day period has run, even on excusable neglect grounds. Bankruptcy Code § 727(d) does permit a creditor, the trustee, or the United States trustee to request that a discharge already granted be revoked, but the grounds are extremely limited, and generally the request must be made within one year after the discharge was granted.

Note: The BAPCPA amended section 727(d) to add as basis for revoking a discharge the debtor's failure to satisfactorily explain a material misstatement in a section 603(a) audit or a failure to make required documents available for inspection in such an audit. 11 U.S.C. § 727(d)(4).

If no objection to discharge is filed, an order discharging the individual Chapter 7 debtor will be entered by the court. Fed. R. Bankr. P. 4004(c). In any proceeding to object to the discharge, the objecting party, that is, the creditor, the trustee or the United States Trustee, has the burden of proving each and every element of the ground for denying the debtor a discharge. Fed. R. Bankr. P. 4005. If the debtor is denied a discharge, all creditors will be notified of that fact. Fed. R. Bankr. P. 4004(g), 4006.

VI. MEANS TESTING

Prior to the enactment of the BAPCPA, the court could dismiss the Chapter 7 case of an individual debtor whose debts are primarily consumer debts if the court found that granting relief would be a "substantial abuse" of Chapter 7. Only the U.S. trustee, or the court, could move for dismissal on grounds of substantial abuse. A more stringent test for obtaining relief under Chapter 7, the means test, was put into place under the BAPCPA. The means test is the heart of what has been called "need-based" bankruptcy reform, the concept being that an individual with primarily consumer debts will be permitted to file for Chapter 7 relief only if that chapter's relief is warranted based upon an analysis of whether the debtor can repay a scheduled amount or percentage to unsecured creditors. Granting relief under Chapter 7 is presumed to be an abuse if the debtor's current monthly income (as defined in section 101(10A) and after reduction by allowed expenses), when multiplied by 60 is not less than the lesser of: (i) 25 percent of nonpriority unsecured claims or $6,000, whichever is greater; or (ii) $10,000. (Note that the dollar amounts change under section 104 in three year intervals, beginning back in 1998).

Generally, the expenses taken into account in applying the means test are allowances for food, housing, transportation and other essentials as established in the National and Local Collection Standards used by the Service in evaluating offers in compromise and installment agreements; actual expenses for the categories specified in the Service's "Other Necessary Expense" standards; allowances for payments on secured debts, and allowances for payments on priority claims. There is on-line access to both the National Standards and the Local Standards at www.irs.gov/, and specific directions for locating the standards on line are at I.R.M. 5.15.1, Exhibit 5.15.1-2. Section 707(b)(2)(ii) permits certain deviations from the standards and categories for, among other things, health insurance, reasonable expenses to care for an elderly, disabled, or chronically ill family or household member, and limited school expenses. The debtor is required to include as part of the section 521 schedule a statement of current monthly income and calculations that determine whether the presumption arises, showing how each amount is calculated. <u>See</u> section 707(b)(2)(C).

If the section 707(b)(2) presumption of abuse arises, it may only be rebutted if: (1) the debtor demonstrates special circumstances that justify additional expense or adjustment to the debtor's current monthly income for which there is no reasonable alternative; <u>and</u> (2) the additional expense or income adjustment causes the debtor's monthly income, less expenses, to be below the means test threshold. "Special circumstances" include a serious medical condition or a call to active duty. See section 707(b)(2)(B).

If the means test presumption of abuse does not arise, or if it has been rebutted, before granting relief under Chapter 7 the court must still consider: (1) whether the debtor filed the Chapter 7 case in bad faith; or (2) whether the totality of circumstances of the debtor's financial situation demonstrates abuse (including whether the debtor seeks to reject a personal services contract). See section 707(b)(3).

There are limited "safe harbors" from a section 707(b) dismissal or conversion for abuse. A case cannot be dismissed or converted based on any form of means testing if the debtor is a disabled veteran and the indebtedness occurred primarily during a period of active duty or while the debtor was performing a homeland defense activity. See section 707(b)(2)(D). If the debtor's current monthly income (or in a joint case, the income of the debtor and the debtor's spouse) does not exceed or is below the applicable median family income for the state, a party in interest (other than the judge, the United States trustee, or bankruptcy administrator) cannot file a section 707(b) motion. See section 707(b)(6). If the combined current monthly income of the debtor and the debtor's spouse does not exceed or is below that amount, the court, United States trustee, or bankruptcy administrator cannot file a motion based on the means testing presumption. See section 707(b)(7). (If it is not a joint case, the income of the debtor's spouse will not be considered in qualifying for the section 707(b)(7) safe harbor only if the debtor and the spouse are separated or living apart and the debtor discloses payments received from the spouse.)

VII. CONVERSION AND DISMISSAL

A. Conversion of a Chapter 7 Case to Another Chapter

A Chapter 7 debtor has broad rights to convert a Chapter 7 case to one under Chapter 11, 12 or 13. 11 U.S.C. § 706. The debtor has virtually an absolute right to convert the case to another chapter at any time during the course of the Chapter 7 case. Of course, to be able to convert the case to Chapter 11, 12 or 13, the debtor must be an eligible debtor under the chapter to which the debtor seeks to convert. 11 U.S.C. § 706(d). For example, a Chapter 7 debtor who owes more than the allowed amount of noncontingent, liquidated, unsecured debts could not convert a Chapter 7 case to Chapter 13. 11 U.S.C. § 109(e).

Creditors' rights to force a conversion of a Chapter 7 case to a case under another chapter are much more limited. In fact, neither creditors nor the court can convert a Chapter 7 case to either Chapter 12 or 13 unless the debtor consents to the conversion. 11 U.S.C. §§ 706(b), (c). The Bankruptcy Code does not permit a debtor to be forced into a case under either of these chapters involuntarily on a direct petition or indirectly by means of a conversion from another chapter.

Courts show similar reluctance to convert a Chapter 7 case involving an individual debtor to a Chapter 11 case involuntarily. Although conversion to Chapter 11 on a creditor's motion over a debtor's objection is theoretically possible, the courts are usually unwilling to force an individual Chapter 7 debtor into a reorganization proceeding involuntarily. There is usually no similar reluctance when the debtor is not an individual.

Note: As discussed above, the new means testing provisions under the BAPCPA may result in more Chapter 7 cases being converted to Chapter 11 or 13 cases where the court finds that granting relief under Chapter 7 would be an abuse and the debtor consents to the conversion.

Conversion of a Chapter 7 case to another chapter terminates the services of the Chapter 7 trustee. To convert a Chapter 7 case to another chapter, a motion is filed, and the proceeding is handled as a contested matter. Fed. R. Bankr. P. 1017(f). All parties in interest must be given notice of the motion. Fed. R. Bankr. P. 2002(a)(4).

B. Dismissal of Chapter 7 Cases

A party in interest may move for a Chapter 7 case to be dismissed for cause. 11 U.S.C. § 707(a). The debtor, creditors, or the trustee can seek such a dismissal, for, among other things, unreasonable delay by the debtor that is prejudicial to creditors, failure to pay filing fees, or failure to file the required schedules and statements. There are two important points to keep in mind about the dismissal of Chapter 7 cases. The first is that the grounds for dismissal are not limited to the grounds set out in the statute, as those grounds are only illustrative. The court can dismiss a Chapter 7 case on other grounds as well, the most important of which is the debtor's bad faith in filing the petition.

The second point to keep in mind is that dismissal of a Chapter 7 case under section 707(a) can only be for cause. This is most important to debtors, because it means that a debtor does not have an absolute right to dismiss a Chapter 7 case even if it is begun on a voluntary petition. Therefore, a debtor cannot be assured of being able to get out of a Chapter 7 case that the debtor later decides was improvidently filed, as the decision whether or not to permit the debtor to dismiss a Chapter 7 case lies in the discretion of the bankruptcy judge.

In fact, courts are often reluctant to allow a debtor to dismiss a Chapter 7 case when there is any suggestion that a dismissal will prejudice any creditor or creditors, even if no creditor opposes the dismissal. The trustee has the standing to object to dismissal either as a representative of creditors, or in the trustee's own right because fees and expenses have not been paid. On the other hand, if all creditors affirmatively agree to a debtor's request to dismiss the case, the case should be dismissed unless the trustee has not been paid.

It is worth repeating that a debtor does not have an absolute right to get out of a Chapter 7 case once filed. Thus, a court may well refuse to allow a debtor to dismiss a case in order to be able to refile and include post-petition claims. Similarly, the debtor does not have a right to get out of a Chapter 7 case because property thought to be exempt turns out to be nonexempt or because other assets are discovered which will be lost to the trustee. Nor will a debtor be allowed to dismiss a Chapter 7 case to permit the six-year bar (eight years under the BAPCPA) on successive discharges to run, with the debtor then refiling. In fact, the debtor cannot even be sure of getting out of a Chapter 7 case by showing that creditors will be paid in full outside of bankruptcy. On the other hand, if the debtor can show that creditors' chances of getting paid will be enhanced by the dismissal of the Chapter 7 case, the case should be dismissed.

Procedurally, a motion to dismiss under section 707(a) is filed and is handled as a contested matter. Fed. R. Bankr. P. 1017(f). The burden is on the moving party to show cause for the dismissal. All creditors must be given notice of the motion to dismiss, unless the motion is based on section 707(a)(3), failure to file schedules and statements, or section 707(b) or for failure to pay the filing fee. Fed. R. Bankr. P. 2002(a)(4).

Prior to the BAPCPA, the court could dismiss a case *sua sponte*, or the United States Trustee could move for a dismissal, under Bankruptcy Code § 707(b) if the granting of relief would be a substantial abuse of Chapter 7. As more fully discussed above, section 707(b) was substantially amended by the BAPCPA to eliminate the substantial abuse standard and to impose means testing.