



Bankruptcy

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Background

BANKRUPTCY is a procedure, authorized under federal law, that relieves an individual or corporation of debts. With bankruptcy, debtors rarely escape completely from liability for their debts; instead, they partially or completely repay creditors under an arrangement that is court approved and authorized and in exchange, any remaining debt is forgiven.

Once considered shameful, bankruptcy still is a method of last resort for relieving financial obligations, but in recent decades bankruptcy in the United States has become more common and more acceptable. Individuals can seek the protection of the bankruptcy courts for personal debts such as credit cards, home mortgages, and medical bills, among others. **CORPORATIONS**, farms, and even local governments also can find themselves lacking enough financial resources to pay their debts and can turn to the bankruptcy law for help.

Bankruptcy exists to allow debtors to have a "fresh start," so that they can settle their debts and return to being productive members of society. The goal is to prevent individual debtors from becoming destitute and to prevent **CORPORATE** debtors and other entities from becoming non-existent. At the same time, it is the goal of bankruptcy to repay creditors, at least partially. This is done by having the bankruptcy court **LIQUIDATE**, or sell, the assets of the **DEBTOR** or restructure the debtor's finances so that creditors are paid at least part of what is owed. The bankruptcy court protects the debtor from further debt-collecting actions by the **CREDITOR** so long as the debtor complies with the court's **LIQUIDATION** or restructuring plan. Bankruptcy thereby allows the debtor to emerge from the debt and move forward. This is why bankruptcy is sometimes referred to as "bankruptcy protection" or "bankruptcy relief." A significant deterrent to bankruptcy is the damaged credit rating that results. An individual who files for bankruptcy may have a difficult time obtaining credit for up to seven years or more.

Although federal law generally governs bankruptcies in the United States, states still govern issues and disputes over financial obligations such as rental leases, utility bills, and other contracts involving finances. Federal law concerning these issues over-rides state law once a debtor files for bankruptcy protection. This is warranted by the Constitution and ensures economic stability and uniformity among the states.

History

The evolution of bankruptcy laws in the United States began in England in the sixteenth century. At that time, debtors who would not, or could not, pay their debts unhappily found themselves in debtors prison. By the eighteenth century, public sentiment was shifting with the realization that imprisoning debtors was not only cruel, it also prevented creditors from ever getting paid. New laws developed that allowed debts to be reduced or forgiven in exchange for the debtor's efforts to repay them.

Before the signing of the Declaration of Independence, colonies in the United States followed the earlier, punitive English laws that imprisoned debtors. States developed their own laws regarding debtors after 1776, but these laws lacked uniformity. The U.S. Constitution in 1789 charged Congress with enacting laws concerning bankruptcy and the Bankruptcy Act of 1800 became the country's first uniform bankruptcy law.

But three years after its enactment, Congress repealed the 1800 law over public sentiment that disfavored its emphasis on creditor rights. Congress struggled during the next century to strike the delicate balance between protecting debtors and repaying creditors. In 1841, Congress for the first time permitted debtors to choose whether to obtain bankruptcy relief rather than being forced to do so. Other bankruptcy laws came and went, but the Bankruptcy Act of 1898 and its many amendments lasted for eighty years and became the model for current bankruptcy laws in the United States. The 1898 act established special bankruptcy courts and bankruptcy trustees, charged with the duty of overseeing bankruptcy liquidations and financial restructuring. The Bankruptcy Reform Act of 1978 replaced the 1898 act and, along with amendments passed in 1984, 1986, and 1994, this act is known as the bankruptcy code.

Types of Bankruptcies

There are generally two types of bankruptcy relief. Liquidation, governed by chapter seven of the bankruptcy code and commonly referred to as chapter seven bankruptcy, involves converting the debtor's assets into cash and using the cash to pay the creditors. The bankruptcy code defines how bankruptcy courts and trustees are to prioritize creditors. Some creditors receive only partial satisfaction, or in some cases no satisfaction, of the debt. Once the liquidation and distribution of assets to the creditors is complete, in the case of an individual debtor, the court will forgive any remaining debt. In the case of a corporation, the corporation is rendered defunct upon liquidation and distribution. There is no need to forgive remaining debts of a corporation since the corporation is no longer a legal entity for creditors to pursue.

The second type of bankruptcy relief is called rehabilitation or reorganization. This type of bankruptcy usually gives creditors a better chance of being repaid, although the duration of repayment may be extended. In a reorganization bankruptcy, the debtor may keep assets but must strictly abide by a reorganization plan that the bankruptcy court authorizes. The reorganization plan defines when and how much each creditor will be repaid, but allows the debtor to continue to function as normally as possible. While the reorganization plan is in place the court prevents creditors from pursuing additional payments from the debtor. Over time and with diligence, the debtor repays the creditors according to the reorganization plan. Once the plan is completed, remaining debts are discharged, or forgiven. If the debtor does not comply with the reorganization plan, the court may order that the debtor's assets be liquidated to pay the debts.

The most common forms of reorganization bankruptcies are chapter eleven bankruptcy, which normally applies to individuals and corporations with large and complex debts, and chapter thirteen bankruptcy, which normally applies to individual consumers. The bankruptcy code has a special chapter for family farmers, chapter twelve, but family farmers may opt to file under chapters eleven or thirteen instead. Municipalities seeking bankruptcy protection do so under chapter nine, which mandates reorganization.

Jurisdiction and Procedure

Federal [STATUTE](#) requires that federal district courts maintain [JURISDICTION](#) over bankruptcy matters. District court judges do not preside over bankruptcy cases, however. Instead, units within the district courts manage bankruptcy cases. Federal [APPELLATE COURT](#) judges appoint bankruptcy judges to these units, and these judges, with their specialized knowledge of the bankruptcy laws and rules, preside over bankruptcy cases. Thus, the federal district courts technically have jurisdiction over bankruptcy filings but in practice refer the matters to the bankruptcy judges.

Most bankruptcy cases require that the bankruptcy court appoint a [TRUSTEE](#). The bankruptcy trustee's job is to impartially administer the bankruptcy estate, which includes the assets of the debtor. Once a debtor files for bankruptcy protection, the debtor's assets—savings, houses, cars, jewelry, stocks, and [BONDS](#) are examples of assets—become the bankruptcy estate, and the bankruptcy estate becomes a distinct legal entity separate from the debtor. The trustee represents the bankruptcy estate and at the direction of the bankruptcy judge may sell assets, or otherwise oversees if, when, and how the assets will be distributed to pay the debts.

In 1986, Congress permanently established a central office to oversee the work of bankruptcy trustees throughout the country. The office of the U.S. trustee has trustees, appointed by the U.S. attorney general, in each region of the United States. These appointed U.S. trustees, in turn, appoint and supervise additional trustees, ensuring that trustees do their jobs competently and honestly. U.S. trustees also have the responsibility to monitor and report [FRAUD](#) by debtors and abuse by creditors.

One important aspect of the bankruptcy laws is the "automatic stay." As soon as a debtor files the proper legal documents requesting bankruptcy protection, the automatic stay takes effect. This means that all efforts by creditors to collect from the debtor are, by law, frozen, and a creditor who ignores the automatic stay faces severe penalties. The automatic stay gives the debtor, the trustee, and the court time to determine the proper course of action in getting the debts repaid. A party who has a claim against the bankruptcy estate and shows good cause for not being included in the requirements of the automatic stay may ask the bankruptcy judge for "relief from the automatic stay."

When the debtor complies with the bankruptcy liquidation or reorganization plan and the plan is completed, the bankruptcy judge may discharge any remaining debt and terminate the bankruptcy case. This action also terminates the automatic stay and ends the bankruptcy court's involvement with the debtor. Typically, the debtor is left without any debts since the bankruptcy plan has repaid them or the bankruptcy court has discharged them. Also typically, the debtor is left with a poor credit rating and has difficulty borrowing money, obtaining credit cards, and financing things like homes, cars, and business ventures.

Exemptions from the Bankruptcy Estate

In keeping with the goal of bankruptcy laws to rehabilitate rather than punish the debtor, the individual debtor is permitted to keep some property that otherwise would be included in the bankruptcy estate and liquidated. These are called exemptions. Exemptions ensure that the debtor is able to survive the bankruptcy process without becoming destitute and having to rely on additional government assistance once the process is complete. Property that is commonly deemed exempt from the bankruptcy estate usually includes a home, a personal car, and personal items such as clothing.

The federal bankruptcy statute lists allowable exemptions, and these are followed in some states. But the federal law also permits states to legislate their own list of bankruptcy exemptions. This results in widely varying types and amounts of exemptions that depend on the debtor's state of residence.

State Bankruptcy Exemptions

ALABAMA: Residents may not elect federal exemptions. State exemptions include up to \$5,000 in [HOMESTEAD](#) equity and up to \$3,000 in [PERSONAL PROPERTY](#). Personal items such as family books and photos are exempt.

ARIZONA: Residents may not elect federal exemptions. Residents may exempt up to \$100,000 in homestead property and up to \$4,000 in household furnishings and appliances, food and provisions for use of individual or family for six months, life insurance proceeds, retirement fund, tools or equipment used in a trade or profession.

CALIFORNIA: Residents can elect federal exemptions or California exemptions. California homestead exemptions include up to \$50,000 in home equity for individuals, up to \$75,000 in home equity for heads of households, and up to \$100,000 for seniors or disabled individuals. Ordinarily and reasonably necessary household furnishings and clothing used by the debtor and spouse are completely exempt. Other exemptions include jewelry, heirlooms, and works of art up to \$5,000, tools of trade up to \$5,000 per spouse, cemetery plots.

FLORIDA: Residents may not elect federal exemptions. Homestead is completely exempt. Personal property worth up to \$1,000 is exempt. Personal vehicle up to \$1,000 is exempt. Professionally prescribed health aids are exempt.

IDAHO: Residents may not elect federal exemptions. Homestead equity of up to \$50,000 is exempt. Personal property valued up to \$500 per item or an aggregate of \$4,000 for all items is exempt; jewelry of aggregate value up to \$250 is exempt; personal vehicle up to \$1,500 is exempt; professional books and tools of the trade up to aggregate value of \$1,000 is exempt.

KENTUCKY: Residents may not elect federal exemptions. Real or personal property valued up to \$5,000 used by the debtor as a residence is exempt. Personal property valued up to \$3,000; equipment and livestock valued up to \$3,000 and personal vehicle valued up to \$2,500 are exempt.

MICHIGAN: Homestead exemption of up to 40 acres of land and dwelling house not exceeding \$3,500 in value are exempt. Family pictures and clothing are exempt. Household goods not exceeding \$1,000 are exempt. Seat or pew used by debtor in public house of worship is exempt. **INDIVIDUAL RETIREMENTACCOUNT** is exempt.

NEVADA: Residents may not elect federal exemptions. Homestead equity up to \$125,000 is exempt. Private libraries up to \$1,500 in value and personal belongings up to \$3,000 in value are exempt. Farm trucks, stock, and equipment not to exceed \$4,500 are exempt; tools of the profession not to exceed \$4,500 are exempt. Qualified retirement plans not exceeding \$500,000 in present-day value are exempt.

NEW YORK: Homestead equity of up to \$10,000 is exempt. Personal belongings such as family bible, pictures, school books, one sewing machine, pets and pet food, all clothing and household furniture, one television set, one refrigerator, one radio, one wedding ring, one watch up to \$35 in value are exempt.

OKLAHOMA: Homestead is exempt. Exempt personal property may include all household furniture; cemetery plots; family books, portraits, and pictures; clothing valued up to \$4,000; five milk cows and their calves up to six months old; 100 chickens; two horses and two bridles and two saddles; one gun; one vehicle valued up to \$3,000; ten hogs; twenty sheep; and one year's supply of provisions for stock.

Encyclopedia of Everyday Law: Bankruptcy

RHODE ISLAND: There is no exemption for homestead. Exempt personal property includes clothing up to \$500; furniture up to \$1,000; bibles, school books, and family books valued up to \$300; cemetery plot.

UTAH: Residents may not elect federal exemptions. Homestead equity up to \$10,000 is exempt. Personal property such as burial plots; necessary health aids; clothing not including jewelry and furs; one washing machine; one dryer; one microwave oven; one refrigerator; one freezer; one stove; one sewing machine; beds and bedding are exempt. Personal vehicle up to \$2,500 is exempt. Household furnishings up to \$1,000 in value are exempt. Heirlooms up to \$500 are exempt. Animals, books, and musical instruments up to \$500 are exempt. Tools of trade up to \$3,500 are exempt.

WASHINGTON: Resident may elect state exemptions, federal exemptions, or both. Homestead equity up to \$30,000 is exempt. Personal property that is exempt includes clothing; jewelry, and furs valued up to \$1,000; private libraries valued up to \$1,500 per individual; household furnishings up to \$2,700; two cars; \$100 in cash; and tools of the trade not to exceed \$5,000 in value.

FEDERAL EXEMPTIONS: Residence of debtor up to \$16,150 in value is exempt. Personal vehicle up to \$2,575 in value is exempt. Household furnishings, books, clothing, pets, and other personal items not to exceed \$425 per item or \$8,625 in aggregate value are exempt. Jewelry not to exceed \$1,075 in value is exempt. Tools of the trade valued up to \$1,625 are exempt. Benefits such as social security, [DISABILITY](#), unemployment, [ALIMONY](#), and certain pensions are exempt.

Additional Resources

West's Encyclopedia of American Law. West Group, 1998.

Organizations

American Bankruptcy Institute
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