

***The Consumer Finance Podcast*** – Bankruptcy 101 for Consumer Creditors: Automatic Stays, Discharge Injunctions, and Common Pitfalls

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**Guests:** Joe DeFazio, Bradley Knapp, Punit Marwaha

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**Chris Willis (00:00):**

Welcome to [The Consumer Finance Podcast](#). I'm Chris Willis, the co-leader of Troutman Pepper Locke's Consumer Financial Services Regulatory Practice. And today we're going to be doing an introductory session on bankruptcy for consumer creditors and how it works and what the common pitfalls are. But before we jump into that topic, let me remind you to visit and subscribe to our blogs [TroutmanFinancialServices.com](#) and [ConsumerFinancialServicesLawMonitor.com](#) and check out all of our other great podcasts. The [FCRA Focus](#), [Payments Pros](#), [Moving the Metal](#), and [The Crypto Exchange](#). All of those are available on all popular podcast platforms. And speaking of those platforms, if you like this podcast, let us know. Leave us a review on your podcast platform of choice and tell us how we're doing. Now, as I said, today we're going to be talking about the bankruptcy process and bankruptcy litigation for consumer financial services companies and some of the common pitfalls and issues that arise in bankruptcy when consumers declare it. And joining me to talk about that are three of my colleagues. I have Joe DeFazio and Punit Marwaha, who are from our Consumer Financial Services group, and a brand new appearance on the podcast by Bradley Knapp, who's a partner in our bankruptcy and restructuring group.

**Chris Willis (01:12):**

Gentlemen, thanks very much for being on the podcast today.

**Joe DeFazio (01:14):**

Thanks for having us, Chris.

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**Punit Marwaha (01:15):**

Good to be back, Chris.

**Brad Knapp (01:17):**

Great to be here. I look forward to the conversation.

**Chris Willis (01:18):**

Well, I am too, because bankruptcy is unfortunately a common and ever-growing occurrence for our clients when they find themselves creditors in a bankruptcy position. So Punit, let me just start with you. Do you mind just giving the audience an overview of sort of the basics of bankruptcy? Because that I think will be a good framework for the remainder of our conversation.

**Punit Marwaha (01:37):**

Absolutely. There are three main different types of bankruptcies or chapters that a lot of our clients deal with. The two main ones on the consumer end are chapter 13s and chapter 7s. Chapter 13s are akin to a reorganization plan. They generally take three to five years. And the entire purpose of a 13 is to repay your debts over that time frame. Generally, a debtor will file a Chapter 13 plan that proposes how to pay back their creditors. That plan is then confirmed by the bankruptcy court and approved by a third party called a trustee, who represents the bankruptcy estate and what are called the unsecured creditors. Secured debts, things like cars, mortgages, are generally paid in full with a certain percentage rate based on the terms of the plan, which can differ from the contract rate. And then there are unsecured debts which are things like credit cards, general loans, and debts that are not secured by any personal property, which are generally paid at a certain percentage of the total debt owed, and it can be anywhere from 1% to 100%, depending on the plan. There are also chapter sevens. Those ones are a lot quicker.

**Punit Marwaha (02:49):**

Generally they last three to five months, and those are more of a liquidation. With secured debts like cars and houses, generally they have to be reaffirmed or surrendered. Reaffirmed just

means that the debtor will keep on making payments pursuant to the contract. Surrendering means that the debtor is giving up any rights they have in the collateral. But in exchange for that, they are not going to be personally liable for anything owed. So you would give back your car or allow foreclosure to go through on your house. But after the bankruptcy is done and the debtor receives what is called a discharge, they would not owe anything for that debt. With unsecured debts, generally they're just discharged with certain exceptions, and nothing is paid towards the unsecured creditors. Finally, there's also Chapter 11s, which are business reorganizations. They're available sometimes to individuals, but they're usually used by businesses to continue operating while restructuring their debt. In that way, they're similar to a 13. The debtor has to propose a repayment plan and have the plan confirmed by a committee of creditors and the court. It also allows for debtor in possession cases where the business continues to operate. But major decisions, such as selling assets or changing contracts, often requires approval of the court.

**Chris Willis (04:03):**

Okay, thanks very much for that overview. Let's talk about what some of the key provisions in the Bankruptcy Code are that are applicable to consumer financial services. And one thing that people talk about all the time and seem to get in trouble for with some frequency is the automatic stay. So what's going on with that? How does that work?

**Brad Knapp (04:20):**

The automatic stay is a real problem issue for all kinds of companies who are collecting debts. And basically, the day the bankruptcy is filed, the very filing of the petition itself operates as a stay of most actions that were going on before the bankruptcy case. So ongoing foreclosures, ongoing collection activity, all has to come to a halt at the beginning of the case. There are some exceptions to that, but in general, it's just best practice to treat it as a very broad stay. Most action is probably stopped while the stay is in place. If the stay is violated, the Bankruptcy Code has a specific provision that allows for an award of damages, attorney's fees, and in certain circumstances, punitive damages. At the end of the case, the automatic stay goes away and it's replaced with a discharge which is under 11 USC 524. This is similar. If a debt has been discharged in bankruptcy, then it can't be collected further. The remedy for a discharge violation is really a contempt remedy. It kind of sounds as in contempt. But it's not uncommon for

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creditors who think they could just wait out a case and then collect later to find themselves in trouble if a discharge order is entered.

**Chris Willis (05:29):**

There is a further wrinkle on the automatic stay that I've heard clients get wrong before. And that's the difference with a chapter 13, with the co-debtor stay. Do you mind explaining that briefly?

**Brad Knapp (05:40):**

Well, the co-debtor stay is... So typically in a bankruptcy case, the only person protected is the debtor themselves, the person who actually files the case. Now, in rare circumstances you can get that extended. But in 13 there's a co-debtor stay because often there's someone else in the household. You can't avoid foreclosing on the husband and foreclosing the wife, for example. So the stay is a little bit broader. I mean, really the best practice is you have one person in a couple in bankruptcy just to treat it as a stay against the whole while you assess what's going on.

**Chris Willis (06:10):**

Got it. Let's talk too about, you talked about the discharge injunction and the concept of debts being discharged at the end of the bankruptcy proceeding, what exactly is covered and what's not by bankruptcy? What kinds of debts can be discharged and which ones are not subject to discharge? Because there are some that I think can't be discharged. Right?

**Brad Knapp (06:27):**

Right. Well, most debts are discharged. I mean, that's kind of the general rule is that most debts are discharged. Now, secured debts are sometimes you still have your right to act against your security. And that comes up frequently in the consumer finance space is the discharge extends to your personal liability. So the debtor is no longer personally on the hook to make that payment, but there's still the in rem or the property is still liable. So what you see is unsecured debt gets discharged. Secured debt, your rights are generally limited to the collateral. If there's a reaffirmation agreement, that's totally different. That basically is the debtor has agreed with

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court approval to allow that debt to go past discharge as if it was completely normal. There's also some provisions of the bankruptcy code that let a creditor oppose the discharge of a specific debt. That requires filing a lawsuit. It's generally quite fact intensive and difficult to do. But there are grounds. The most common is fraud in the origination of that debt. If a debtor commits fraud on their loan application, for example, you have a ground to bring a lawsuit and say, look, this shouldn't be discharged because this entire debt was procured by fraud.

**Brad Knapp (07:37):**

So that's another way that you can oppose dischargeability. But in general, it's best you see a discharge order to treat it as though the debt has been discharged and do some more analysis to see what your rights are. If you're a creditor.

**Chris Willis (07:49):**

Yeah. And there was some significant regulatory and litigation activity surrounding dischargeability for one of the exceptions to discharge in the bankruptcy code, and that's for qualified education loans. Those are not dischargeable absent a showing of hardship under the current bankruptcy code. But there was a lot of disagreement in litigation and with the CFPB and other regulators during the last administration about what qualified as a qualified education loan. And we won't get into that here, but it is one thing that brought some companies in the industry into the crosshairs during the last few years. But let's jump back into the automatic stay. We've talked about its importance and what it is as a general concept. But what are some of the common particular scenarios where creditors have trouble with the automatic stay?

**Joe DeFazio (08:32):**

Chris, I think one of the issues with the automatic stay that our clients have issues with is, for example, in the auto lending space, pre-petition repossessions is a big one. So let's say a creditor repossesses a vehicle on Monday. The debtor files a bankruptcy on a Tuesday. In many jurisdictions, the creditor is then expected to return the vehicle. Keeping it can be treated as a continued violation of the stay, especially if the creditor uses possession as leverage. We've seen those type of matters before. Another would be wage garnishments. If you receive a notice of a bankruptcy filing, ongoing garnishments must stop immediately. So any funds that you garnish after this day are considered property of the estate and may have to be returned.

The other big one would be foreclosure sales. If a sale is scheduled and the debtor files before the sale goes through, that's a common tactic for borrowers in foreclosure. They typically will file a day or two before the scheduled sale to stop a foreclosure sale. And the reason they do that is they'll halt the foreclosure sale. So even if all the automated sale notices went out, postings all those things, and the judge has ruled in favor of the creditor and the foreclosure is all set to go procedurally as soon as the debtor files, that foreclosure can no longer take place.

**Joe DeFazio (09:47):**

The other would be if a loan naturally matures during the bankruptcy. You typically can't enforce that maturity by demanding payment in full or foreclosing without first getting a relief from the stay. So in the context of consumer finance, those are usually the biggest ones we'll see the automatic stay become an issue for our clients. And there are some practical steps they can take to avoid that. So one of them typically is a system flag. So make sure that as soon as your account is flagged that you learn of a bankruptcy, flag that account, so that every part of the organization: collections, litigation, repossession, foreclosure, payment processing, anybody who's touching the consumer account knows that a stay has been in place and you should cease your activities until you speak with in house counsel or outside counsel. You know, another one would be to make sure you have automated collection activities: letters, calls, garnishments, stop automatically. Many of these violations that we see come from automated systems that nobody thought to shut off. Meaning like letters, for example, a big one in the consumer finance space. A borrower files for bankruptcy and they continue to get collection letters and things of that nature because they're on automated processes. You know, always you can never train your staff enough to be aware of these issues and to escalate them appropriately once the stay goes into effect.

**Chris Willis (11:10):**

That's great practical advice, Joe. Let's follow that up with the other major provision of the bankruptcy code, that being the discharge injunction. What are some common areas that creditors get into trouble in the consumer credit space after there's a discharge injunction in place?

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**Joe DeFazio (11:25):**

Sure. So while the case is pending, the automatic stay protects the debtor, but once that court enters a discharge, the discharge injunction takes over and protects the debtor going forward. So what that does is it prohibits any act to collect a discharged pre-petition debt. That includes filing or ongoing lawsuits, calling or sending collection letters, using negative credit reporting as a leverage to obtain payment. So one of the issues, and I think Brad's touched on it before, is if a creditor knowingly violates the discharge, courts can impose sanctions, including fees and sometimes punitive damages, depending on how significant the stay violations and discharge violations are.

**Chris Willis (12:04):**

Okay, so let's continue this practical discussion and talk about some recurring bankruptcy issues that come up in consumer finance related bankruptcies. I'm sure the audience would really love to hear about those, and frankly, I'm very interested in hearing it too.

**Punit Marwaha (12:18):**

There are a lot of kind of repeat situations that our clients often deal with in the context of bankruptcies. As consumer financial services attorneys, our clients are most often in the role of creditor in these bankruptcy cases. Like Joe said, best practice is to familiarize yourself with bankruptcy basics in order to avoid potential liability. Most of what we see involves either the automatic stay or the discharge injunction. So for secured creditor issues, which would be industries such as mortgage investors, mortgage servicers, auto lenders, in a situation where a debtor files a bankruptcy, the foreclosure must be stopped. However, generally in a chapter 13, the debtor still has to keep up with their ongoing post petition monthly obligations under the underlying mortgage, deed of trust or note. And so in a situation where a debtor files a Chapter 13 bankruptcy but subsequently falls behind other obligations after the bankruptcy was filed, generally the creditor must get court approval prior to initiating any collections. This is generally done through a motion seeking a modification or relief from the automatic stay, where you explain to the court that although the debtor filed a bankruptcy, they have failed to keep up with their payments after the bankruptcy was filed.

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**Punit Marwaha (13:37):**

In most cases, if the debtor is not keeping up with their post petition obligations, courts will generally allow foreclosure to proceed. Since the bankruptcy only covers debts as of the time the bankruptcy case was filed, anything that might come due afterwards would generally be collectible. It's just the added step of having to go through the bankruptcy court to get approval for it. With auto lenders, as Joe said, with repossessions that occur prior to a bankruptcy being filed, the collateral generally has to be returned upon the debtor filing of bankruptcy. There are certain steps that creditors can take to protect themselves in a chapter 13. The first would be to take a look at the plans that are being proposed. Generally, they have to pay back the full amount of the secured debt as well as some interest. And if there's any issues with the amount that's being paid, creditors always have the option of objecting at the confirmation of the plan. Generally, the best practice is to seek either modification of the stay or annulment of the stay, if there's any question as to whether a collection action can occur in a bankruptcy. Just rather be safe than sorry. It's always easier to go through the courts and get their approval rather than ask for forgiveness later when you're dealing with a sanctions motion. For chapter sevens, the secured debt is surrendered. The collateral is generally going to be returned to the creditor. But, as Brad said, any personal liability of the debtor is going to be wiped out upon the eventual discharge. So the creditor would keep their in rem right to the property, but any personal liability of the debtor would be extinguished. If a secured debt is reaffirmed, then the debtor has to continue with their contract obligations. So let's just say for the example of a car payment, if the debtor is proposing to reaffirm, generally the debtor would fill out a reaffirmation agreement with the creditor, get that approved by the court, and from there they just have to keep on making their payments almost as if the bankruptcy wasn't happening. Lots of times with these reaffirmation agreements you can put some language in there such as if the debtor subsequently falls behind, the creditor can notify the court and the automatic stay would automatically terminate as to that specific debt, allowing collection actions/repossessions to occur. For unsecured creditors, things like garnishments, they must stop upon the filing of the bankruptcy petition. As Joe said, any funds taken after the case was filed must be returned. Otherwise there is potential liability for violating the stay. Generally there has to be under section 362 of the Code, some willful action to collect a pre-petition debt. So we have seen defenses before where a creditor didn't get notice that a bankruptcy case was being filed. Though it might be a technical violation of the stay, if there's any collection activity that occurs

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generally it's just best to really try to keep everything at the status quo as of the day the case was filed. Also, when a bankruptcy is filed, collection calls/letters must stop upon the bankruptcy case being filed and really just have to stop any acts to collect the debt that were incurred prior to the bankruptcy being filed.

**Chris Willis (16:46):**

Punit, thanks very much for that rundown of common issues. There's one other thing that I'm curious about and the audience probably is too, because occasionally I hear things about preferences in bankruptcies and preference payments. I have no idea what that means, but I imagine one of you is about to tell me what that means and how it can come up in the context of a consumer bankruptcy.

**Joe DeFazio (17:04):**

Chris a preference action is a tool that allows a trustee or a debtor in possession to claw back certain payments made shortly before the bankruptcy filing so they could be redistributed among all creditors. I actually just dealt with this related to a large retail bankruptcy. So typically what happens is the look back period is 90 days before the filing for regular creditors and it could be longer for insiders. So in some jurisdictions state law can effectively make that reach beyond 90 days. And these often target things like large loan payments just before filing, significant credit card payments, transfers out of bank accounts, and then sometimes even in the context I was speaking of the buying or transactions related to merchandise. So a lot of times there are defenses to these and like those were just payments made in ordinary course of business or there was new value provided to the debtor. But responding to the preference demand letter still requires a lot of time and documentation. So for the creditors, the key there is to take these demands seriously, pull up your payment histories and related documentations and evaluate whether a settlement or defense makes more sense. From a practical advice standpoint, a lot of times a settlement often makes sense with the trustee. There's probably more detail we could share, but we don't want to put the audience to sleep with that.

**Chris Willis (18:27):**

Well, I really appreciate the detail. Thanks a lot Joe. And Punit and Brad, thanks for being on the podcast today as well. It's great for us to be able to showcase to the audience the

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expertise that we have even within Consumer Financial Services on this, but also our close collaboration with partners like Brad who do bankruptcy for a living, who can provide us tons of technical expertise when the situation calls for it. So I appreciate all of you being on the podcast today. And of course thanks to our audience for listening today as well. Don't forget to visit and subscribe to our blogs [TroutmanFinancialServices.com](http://TroutmanFinancialServices.com) and [ConsumerFinancialServicesLawMonitor.com](http://ConsumerFinancialServicesLawMonitor.com) and while you're at it, why not visit us on the web at [Troutman.com](http://Troutman.com) and add yourself to our Consumer Financial Services email list. That way we can send you copies of the alerts and advisories that we release from time to time, as well as invitations to our occasional industry only webinars. And of course, stay tuned for a great new episode of this podcast hitting your feed every Thursday afternoon. Thank you all for listening.

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