

*This primer is not, and should not be construed as, a complete or exhaustive treatment of the subject, nor is it intended to be a substitute for seeking or consulting experienced bankruptcy counsel. It is not intended to be and does not constitute legal advice. Readers are urged to seek advice from, or to consult with, experienced bankruptcy counsel based upon their or their clients' own particular circumstances.*

## **BUSINESS BANKRUPTCY PRIMER**

**Prepared by the Business Bankruptcy Committee  
of the American Bar Association  
Michael St. Patrick Baxter, Chair  
G. Eric Brunstad, Jr., Immediate Past Chair**

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### **OVERVIEW**

This primer is intended to provide guidance to non-bankruptcy attorneys in connection with basic bankruptcy issues that are likely to arise in counseling clients. The primer summarizes the main features of bankruptcy and the different types of bankruptcy proceedings. The primer discusses Chapter 7, Chapter 11, Chapter 12 and Chapter 13 from the debtor's perspective, and includes a section that discusses creditors' rights in bankruptcy cases. This primer does not address relief or remedies that may be available under applicable State law. It is expected that counsel will consider all appropriate State law relief or remedies. However, a discussion of that subject is outside the purview of this primer.

#### **Federal Process**

Bankruptcy is a federal law – governed by the United States Bankruptcy Code. Bankruptcy cases are filed in federal bankruptcy courts. A bankruptcy case is commenced upon the filing of a bankruptcy petition. The person filing the petition is known as the “debtor”, regardless of whether the person is an individual or some other entity like a partnership or a corporation. The petition and accompanying documents are forms that must be completed under penalty of perjury.

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\* This primer, prepared in October 2005 and updated in November 2008, is the product of a task force of the ABA Business Bankruptcy Committee and reflects the law in effect since significant changes were made to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA). The task force consisted of co-chairs Michael St. Patrick Baxter and Michael H. Reed, and members Paul P. Daley, Corali Lopez-Castro, Judith Greenstone Miller, Duane D. Morse, Kaaran E. Thomas and Sharon Z. Weiss. Updates were made by Lisa P. Sumner.

## **Where to File**

Usually, a debtor is required to file the petition in the federal bankruptcy court in the district in which the debtor has its domicile, residence, principal place of business or principal assets for the 180-day period preceding the filing, or the longer portion of that period than any other location. However, the U.S. Department of Justice has issued special guidelines for persons affected by natural disasters. The special guidelines provide that the Department will not raise or support objections to filing in a different location, if the debtor was displaced due to a natural disaster, unless the filing constitutes a systemic abuse or presents extraordinary circumstances.

## **Filing Fees**

The filing of a bankruptcy petition must be accompanied by the required filing fee, unless the debtor is an individual and either qualifies as unable to pay the filing fee or files an application to pay the filing fee in installments and sets out the appropriate basis for such application. The current filing fees are as follows: Chapter 7 -- \$299.00; Chapter 11 -- \$1,039.00; Chapter 12 -- \$239.00; and Chapter 13 -- \$274.00. The filing fee covers only the filing of the petition. It does not include lawyers' fees and other fees that may be required to prepare the petition and other documents required for filing or required during the bankruptcy case.

## **Types of Bankruptcies**

The Bankruptcy Code provides several options for individuals and businesses to liquidate or to reorganize their debts. Each of these options is referred to by its chapter in the Bankruptcy Code. Some options, like Chapter 7 (liquidation), Chapter 11 (reorganization), and Chapter 12 (family farmers and family fishermen), are available to individuals and other legal entities like corporations and partnerships. Chapter 13 (individuals with regular income) is available only to individuals. Chapter 13 permits individuals who are conducting business in their personal names as a "dba" to reorganize their assets and liabilities (including the assets and liabilities of such a business) by proposing a plan to pay creditors from future income. Chapters 12 and 13 provide inexpensive alternatives to the more complicated Chapter 11 reorganization. However, Chapters 12 and 13, unlike Chapter 11, have limits on the amount of debt the debtor can owe to creditors, so that some debtors doing business may not be able to qualify for Chapters 12 or 13.

## **Automatic Stay**

The filing of a bankruptcy case under any chapter of the Bankruptcy Code triggers a statutory injunction against the commencement or continuance of most actions by creditors against the debtor or the debtor's property, such as starting or continuing collection actions, like lawsuits, repossessions, foreclosures and dunning letters or telephone calls. This injunction is referred to as the "automatic stay." The automatic stay is one of the most important features of bankruptcy. It provides the debtor with a breathing spell to get its financial situation in order and make a fresh start. In some cases (Chapters 12 and 13), the automatic stay also protects certain types of persons who are liable with the petition filer from actions by creditors.

## **Discharge**

Each type of bankruptcy offers a discharge of certain debts of the debtor. However, the type of debts discharged and the qualifications to receive a discharge vary with each chapter and also vary among the different types of debtors. For example, a debtor other than an individual can receive a discharge only by having a confirmed plan of reorganization in a Chapter 11 case that proposes to continue the business of the debtor. Once a debt is discharged, it can no longer be collected from the debtor. Creditors are enjoined from collecting their debts except as provided in the plan (in Chapters 11, 12 and 13) or in the discharge order (in Chapter 7). However, if the debt is secured by property of the debtor, like a car or a house, the creditor can continue to collect its debt against the property, subject only to the terms of the plan that might be in place for the debtor.

## **Exemptions**

Certain assets of an individual debtor are exempt by the Bankruptcy Code or by applicable State law from the claims of creditors. Exempt assets can be retained by an individual debtor after filing for bankruptcy and cannot be sold by a trustee in bankruptcy to pay the claims of creditors. Whether an asset is exempt often will depend on applicable State law. While the Bankruptcy Code contains a list of exempt assets, each State is entitled to opt out of the Code's exemptions and adopt its own exemptions. Whether a particular asset is or is not exempt is not always clear and is sometimes the subject of dispute.

## **Plans in Chapters 11, 12 and 13**

Every chapter, except for Chapter 7, contemplates that the debtor will file a plan to pay creditors. Chapter 7, on the other hand, provides for a liquidation of the debtor's assets by a trustee in bankruptcy. The trustee takes title to the debtor's assets, sells non-exempt property, and distributes the proceeds to creditors. Chapter 11 can also be used to liquidate the debtor's assets, but the liquidation must be done under a plan that is approved by creditors. Other Chapter 11 plans, as well as plans in Chapter 12 and 13, provide for the payment of creditors from future income. The failure to perform a plan may result in the dismissal of the bankruptcy case or the conversion of the bankruptcy case to another chapter under which the debtor can still qualify. Usually, these cases are converted to Chapter 7, and the debtor's non-exempt assets are liquidated to pay creditors.

## **Involuntary Bankruptcy**

Creditors holding claims against a debtor may initiate a bankruptcy by filing an involuntary petition against the debtor. Involuntary bankruptcies are available only under Chapters 7 and 11. Where a debtor has 12 or more creditors, an involuntary petition requires the participation of at least 3 creditors who hold unsecured claims totaling at least \$13,475 that are not subject to a bona fide dispute as to liability or amount. In a case where the debtor has fewer than 12 creditors, a single creditor may initiate an involuntary petition, but the creditor must have an unsecured claim of at least \$13,475 that is not subject to a bona fide dispute as to liability or amount. A "bona fide dispute" may involve a reasonable issue of whether the debtor is liable on the debt.

## **Information Required for Filing Bankruptcy**

Generally, before filing for bankruptcy, the debtor will need to compile information including the names, addresses, contact persons of all creditors, together with the type of debt and amount of debt owed. The debtor should also identify the source, amount, frequency, and reliability of the debtor's income, a list of all of the debtor's assets, including equipment, real property, accounts receivable, and a detailed list of the debtor's monthly expenses (e.g., food, shelter, utilities, taxes, transportation, business operations, etc.). The debtor cannot exclude assets or creditors. Failure to include any creditor or asset is a federal crime.

## **SUMMARY OF THE TYPES OF BANKRUPTCIES**

### **Chapter 7**

Chapter 7 is the most common type of bankruptcy. Under Chapter 7, the debtor ceases all operations and goes out of business. Any person that is not a railroad, a bank, or an insurance company can file for bankruptcy under Chapter 7, regardless of the amount of debts.

In a Chapter 7 bankruptcy, the debtor surrenders its assets to a trustee in bankruptcy, who is appointed to liquidate the debtor's assets. The trustee in bankruptcy is responsible for administering the debtor's estate, which mainly involves collecting, liquidating, and distributing the property of the estate. The trustee is also entrusted to bring any legal actions required to collect amounts payable to the debtor or to the bankruptcy estate. These legal actions can include "avoidance actions." These are special causes of action that permit the estate to recover monies paid or property transferred by the debtor before the petition was filed in a way that treated the transferee more favorably than other creditors. In a Chapter 7, the trustee in bankruptcy stands in the shoes of the debtor for purposes of prosecuting these causes of action. Any money collected by the trustee is distributed among the debtor's creditors and, to the extent there is a surplus, to the debtor. Once all the debtor's assets have been fully administered, the debtor can be dissolved, and the debtor has the opportunity for a fresh start.

The entire Chapter 7 process usually takes about four to six months, but this time period may vary depending on the size and complexity of the case.

### **Chapter 11**

Chapter 11 is primarily utilized by businesses to reorganize and restructure their operations and their balance sheet. The form of relief may be a restructured stand-alone business that continues after bankruptcy in a similar or smaller form or, alternatively, may be a liquidation or sale of the assets of the debtor.

Schedules setting forth the assets, liabilities and financial affairs of the debtor must generally be filed within 15 days of the filing of the bankruptcy petition. An individual from the debtor's business is usually appointed as the responsible person to perform the duties of the debtor-in-possession.

A creditors' committee, generally consisting of the largest unsecured creditors willing to serve, may be appointed by the U.S. Trustee to represent the interests of the unsecured creditors, to investigate the assets and liabilities of the debtor and to negotiate with the debtor over a plan of reorganization.

The debtor is required to file a disclosure statement and plan of reorganization setting forth how it intends to restructure its business. The disclosure statement and plan must contain information sufficient to allow a creditor to make an informed decision on the proposed plan. These documents must be approved by the bankruptcy court as containing adequate information prior to being submitted to creditors. Once the documents are approved, they are mailed to creditors for a vote on the plan. If the debtor obtains sufficient votes in favor of its plan and the plan meets the statutory requisites, the plan will be confirmed by the court. A confirmed plan will bind the debtor and all creditors, regardless of whether they accepted the plan. Unless the plan provides otherwise, the confirmation of a plan discharges the debtor from all debts, except if the plan provides for liquidation of all or substantially all of the property, or the debtor does not engage in business after consummation of the plan.

A Chapter 11 debtor is known as a "debtor-in-possession" after the petition is filed. There is usually no trustee in bankruptcy appointed in a Chapter 11 case. The debtor-in-possession is a fiduciary with respect to creditors and assumes significant duties and responsibilities, including filing monthly operating reports, paying quarterly fees to the U.S. Trustee, and preparing and filing a plan of reorganization. If the debtor fails to comply with its duties and responsibility, a party-in-interest or the U.S. Trustee may seek to convert or dismiss the case or, alternatively, move for appointment of a trustee, who will take over operations of the debtor's business.

Chapter 11 contains special rules for small business debtors. A "small business debtor" is defined as a person engaged in commercial or business activities that has aggregate noncontingent liquidated debts (secured or unsecured) as of the date of the petition or the order for relief in an amount not exceeding \$2,190,000 (excluding amounts owed to affiliates or insiders), and in which either the U.S. Trustee has not appointed a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight to the debtor. A person whose primary activity is the business of owning or operating real property and activities incidental thereto is not eligible to be a small business debtor. In addition, if any member of a group of affiliated debtors has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,190,000 (excluding debts owed to one or more affiliates or insiders), the entity will not qualify as a small business debtor.

There are a number of significant differences between Chapter 7 and Chapter 11. Chapter 7 is a type of bankruptcy where the debtor ceases all operations and goes out of business. Chapter 7 is generally used when the business no longer has value as a going concern. By contrast, Chapter 11 is generally used to reorganize a business to regain profitability. The business does not shut down as a result of Chapter 11. Rather, management continues to run the day-to-day business operations while a plan of reorganization is developed. In addition, Chapter 11 can be used to sell a business as a going concern.

## **Chapter 13**

An individual with regular income who has fixed unsecured debts of less than \$336,900 and secured debts of less than \$1,010,650 is eligible for Chapter 13. Upon the filing of a Chapter 13 petition, a Chapter 13 trustee is appointed by the court or the United States Trustee to administer the case. The trustee's primary responsibility is to act as a disbursing agent, receiving payments from debtors and making distributions to creditors. The trustee will also monitor whether the plan and the debtor comply with the requirements of Chapter 13.

The debtor must file a plan within 15 days after filing the Chapter 13 petition. The plan must provide for the use of at least part of the debtor's future earnings to pay creditors. The payments can last up to five years, depending on the debtor's income. If the debtor completes the plan, the debtor will be entitled to a discharge of most debts. The debtor must devote all disposable income for at least three years to the payment of creditors, unless the creditors can be paid in full with interest prior to that time.

Wages, income from operation of a business, income from real property, interest, dividends, pension plan, social security, retirement income and unemployment compensation can all count as income. Certain types of welfare benefits may also count. However, gifts from relatives and certain types of public assistance payments may not count.

The amount proposed to pay creditors in the plan must be equal to the disposable income. Disposable income will be calculated in accordance with a formula established by the U.S. Department of Justice. A person is not able to file a Chapter 13 if the disposable income is zero.

Many people may prefer not to tie up their future income to pay creditors and would prefer to file a Chapter 7 bankruptcy in which they are not required to do so. Generally, individuals who have disposable income available to pay creditors may not be eligible to file Chapter 7. The Bankruptcy Code is drafted to insure that all individuals who can afford to dedicate future income to pay creditors do so. The choice between filing a Chapter 13 and filing a Chapter 7 (or some other type of bankruptcy) will depend on the individual circumstances, the amount of assets, the type of assets, the amount and type of income, and the amount and type of debt. Notably, the discharge resulting from Chapter 13 is broader than a Chapter 7 discharge.

## **Chapter 12**

Chapter 12 was designed to specifically meet the needs of financially distressed family farmers who generate regular income mostly from their farming operations. The primary purpose of Chapter 12 is to give family farmers facing bankruptcy a chance to reorganize their debts and keep their farms. Family fishermen may be able to qualify for relief under Chapter 12. Chapter 12 is similar to Chapter 13, but it provides for a higher allowance for included debt and special plan provisions.

There are two types of family farmers or family fishermen: (1) an individual or individual and spouse, and (2) a corporation or partnership (but not a publicly traded corporation). There are other eligibility requirements which differ, depending on which category you fall into, and are specifically addressed below.

Upon the filing of a Chapter 12 petition, a trustee is appointed by the court or the United States Trustee to administer the case. Like a Chapter 13 trustee, the trustee's primary responsibility is to act as a disbursing agent, receiving payments from debtors and making distributions to creditors.

The Chapter 12 debtor must file a plan of repayment with the petition or within 90 days. Upon successful completion of all payments under a Chapter 12 plan, the debtor will receive a discharge extinguishing the debtor's obligation to pay any unsecured debts that were included in the plan, even though they may not have been paid in full.

## ALTERNATIVES TO BANKRUPTCY

1. **Question:** Bankruptcy appears to be considered more readily as an alternative today than in the past. Is bankruptcy now considered more of a first resort than a last resort?

*Answer:* Bankruptcy is an option that should be considered as one tool available to a financially troubled business to address its financial problems in an appropriate case. It should not be considered either a "first resort" or a "last resort" but rather one of several possible options to be explored. A Chapter 7 bankruptcy filing will result in the liquidation of the business, and a Chapter 11, 12 or 13 bankruptcy filing can still impose significant burdens and costs on the business.

2. **Question:** What exit strategies other than a Chapter 7 filing should be considered when the owner has determined to terminate the business?

*Answer:* While a voluntary Chapter 7 filing is one method for an orderly liquidation of the business, sometimes it may be more cost-effective to wind down and terminate the business without a bankruptcy filing. This alternative, however, will usually only work where there is sufficient cash or assets that can be readily converted to cash to satisfy all or a substantial part of the company's debts. If a lender has a lien on all or substantially all of the assets of the business, it will usually be desirable for the owner to cooperate with the secured lender in liquidating the assets. Such cooperation might take the form of permitting the lender to foreclose on its collateral without a bankruptcy filing. Where the owner has also given the lender a personal guaranty, such cooperation could influence the lender's willingness to release or cap the owner's personal liability.

3. **Question:** While a business owner usually would like to attempt to preserve the business, should the owner be concerned about investing more of his or her personal wealth in the business?

*Answer:* The owner of a small or closely held business who has substantial personal assets that are not exposed to liability for the debts of the business should, at some point, consider the "don't throw good money after bad" principle. All too often, when a closely held business was founded by the owner and is part of his or her personal vision, there is a tendency to continue to invest or encumber personal assets in the enterprise long after it should

be clear that the business is no longer viable. In such cases, experienced counsel can help such an owner perform a reality check and avoid or minimize further personal losses.

**4. Question: Are there any restructuring alternatives that a company should consider before filing for bankruptcy under Chapters 11, 12 or 13?**

Answer: Yes. Here are some alternatives that should be considered:

The major lender of the business might be willing to agree to some form of accommodation, e.g., restructuring the payment schedule, that would afford the business an opportunity to recover from its current financial distress. The sudden transformation of a large number of performing loans into defaulted loans presents a problem for not only the borrowers but also the lenders. It may be in the best interest of the lender to provide some accommodation to a financially strapped borrower at least for a limited period of time.

Trade creditors are likely to face a similar dilemma in circumstances when a large percentage of their customer base is in financial distress. Some trade vendors may be willing to forgive or at least stretch out payment of pre-existing debt. However, don't expect trade vendors to grant significant new credit outside of bankruptcy. Also, experienced bankruptcy counsel may be able to structure composition agreements or similar arrangements among trade creditors that would avoid a bankruptcy filing.

If you have been affected by a natural disaster, a number of federal, state and perhaps even local programs may provide financial relief. For example, loans may be available through the U.S. Small Business Administration.

None of the foregoing alternatives should be considered as an exclusive option and each of them might be employed as a prelude to, or in tandem with, a bankruptcy.

**5. Question: Suppose the owner of the business has personally guaranteed all or some of the loans made by the bank to the company or is concerned about potential personal liability for unpaid withholding taxes. May a bankruptcy proceeding be utilized to help the owner eliminate or reduce his or her personal liability under the guaranty or for unpaid withholding taxes?**

Answer: Experienced bankruptcy counsel can attempt to design a strategy in the bankruptcy proceeding, including the formulation of a plan of reorganization, to help the owner reduce or eliminate such potential personal liabilities. However, it should be remembered that, where the debtor is a corporation or other legal entity separate from the owner, bankruptcy counsel represents the company, not the owner. Sometimes a conflict may rise between the interest of the owner in reducing his or her personal liability for the debts of the business, on the one hand, and what is in the best interest of creditors, on the other hand. In some cases, this may require the owner to engage counsel separate from the company's bankruptcy counsel.

#### **SOME EMPLOYEE ISSUES**

**6. Question: Are there certain issues or concerns a business employer should consider before a bankruptcy filing with regard to employees?**

Answer: There are several issues that the business employer should consider before a filing, including the following:

a. Check the applicable State law for possible personal liability of officers and directors for unpaid wages and benefits for periods actually worked.

b. Does the workforce need to be downsized? If the business qualifies as an “employer” subject to the federal WARN Act, the employer may be required to give 60 days’ prior notice of a plant closing or mass layoff to all affected employees or their union representative. This requirement could apply to an employer whether or not the company files for bankruptcy.

c. A bankruptcy filing is likely to increase employee anxiety and heighten the risk of the loss of key employees to competitors. If the company has management or other employees not covered by a collective bargaining agreement who are considered “key employees,” several issues will arise, including the treatment of any written employment contracts and how to provide incentive for such employees to stay with the company. The ability to pay special bonuses or incentives to such employees after the bankruptcy filing in order to retain them is restricted by the Bankruptcy Code.

d. How will the debtor make payroll before and after the filing? The ability to have uninterrupted funding for wage and benefit obligations incurred both prior to and immediately after a bankruptcy filing is crucial. Factors to be considered are sources of funding (e.g., unencumbered cash or lines of credit) and the timing of the filing in relation to pay periods.

e. At all times, both before and after a bankruptcy filing, the officers and directors of the company must take great care to assure that all funds withheld from employee wages for the payment of taxes are separately held and not used for the payment of other debts of the company. Responsible officers can be found personally liable to the IRS for unpaid federal withholding taxes.

f. Payments made under an employment contract to a person considered an “insider” within two years prior to the bankruptcy filing may come under special scrutiny and be recoverable by the bankruptcy estate.

**7. Question: Are there special issues regarding employees that will arise after a bankruptcy filing?**

Answer: Yes, there are several special issues that should be considered, particularly in the context of a reorganization filing. These include the following:

a. If any portion of the workforce or any retirees are covered by a collective bargaining agreement, the company will be required to continue to honor its obligations under the agreement unless and until certain bankruptcy court procedures are followed.

b. If any wages and benefits that were earned for work performed prior to the bankruptcy filing remain unpaid, the company will usually seek bankruptcy court approval to pay such obligations promptly after the filing.

c. Claims for unpaid wages accruing within 180 days before the bankruptcy filing have a fourth-level priority under the Bankruptcy Code up to \$10,950 per employee. Claims for unpaid benefits within the same time period have a fifth-level priority claim up to \$10,950, for a total of \$21,900 per employee.

d. The earnings from services performed by an individual debtor after the bankruptcy filing will be included in his or her bankruptcy estate in a Chapter 11, 12 or 13 case.

## CHAPTER 7 BANKRUPTCY

### 8. **Question:** What is the difference between Chapter 7 and Chapter 11?

**Answer:** Chapter 7 is a type of bankruptcy where the company ceases all operations and goes out of business. Chapter 7 is generally used when the business no longer has value as a going concern. By contrast, Chapter 11 is a type of bankruptcy generally used to reorganize a business so as to regain profitability when management believes that the business still has value as a going concern. The business does not shut down as a result of Chapter 11. Rather, management continues to run the day-to-day business operations, and management and interested parties develop a plan of reorganization pursuant to which the business is reorganized. Chapter 11 can also be used to sell the business as a going concern.

### 9. **Question:** What is the automatic stay?

**Answer:** The filing of a bankruptcy case, under any chapter of the Bankruptcy Code, triggers an injunction against the commencement or continuance of any action by a creditor against the debtor or the debtor's property, such as starting or continuing lawsuits, repossessions, and foreclosures. This injunction is referred to as the automatic stay. The automatic stay is one of the most important features of bankruptcy. It provides the debtor with a breathing spell to get its financial situation in order and make a fresh start.

### 10. **Question:** Will the debtor receive a bankruptcy "discharge"?

**Answer:** A discharge means that the debtor is no longer legally responsible for its debts. However, a corporation cannot obtain a discharge of its debts under Chapter 7. But Chapter 7 can still provide important relief to a debtor by providing an orderly and efficient way to wind up a business.

### 11. **Question:** Will an individual debtor lose all of his assets if he files for Chapter 7?

*Answer:* An individual debtor is entitled to keep certain assets that are either excluded or exempt from the bankruptcy estate. The determination of which assets are excluded or exempt assets is a function of applicable State law or federal law.

12. **Question: What happens in bankruptcy if a debtor can't repay its debts?**

*Answer:* Under Chapter 7, a debtor surrenders all of its assets to a bankruptcy trustee who is appointed to liquidate the company's assets. Any money received by the trustee is distributed, according to priority, among the debtor's creditors. Any surplus is returned to the debtor. To the extent that the money received by the trustee from liquidation is insufficient to repay the debts, the debts technically continue to exist because they are not "discharged". However, to the extent that the Chapter 7 case is closed and the debtor is dissolved, the entire debt is effectively eliminated, whether or not the debtor has repaid it. If a person has guaranteed the repayment of a loan made to a company, it is important to note that the guarantor's liability is not eliminated upon the company's filing for bankruptcy. Accordingly, the creditor may continue to look to the guarantor for payment.

13. **Question: If the debtor expects to receive insurance proceeds in connection with a property loss, is disclosure or payment to creditors required in a Chapter 7?**

*Answer:* If the business expects to receive insurance proceeds, it will have to disclose the insurance proceeds on its bankruptcy schedules. The trustee may have to distribute the net proceeds to creditors. If the debtor is an individual, whether the insurance proceeds will have to be distributed to creditors may depend upon State law and whether the insurance proceeds are exempt assets.

14. **Question: Is a trustee in bankruptcy appointed in every Chapter 7 case?**

*Answer:* A trustee in bankruptcy is appointed in every Chapter 7 case, promptly upon filing of the Chapter 7 bankruptcy petition.

15. **Question: What is the role of the trustee in bankruptcy?**

*Answer:* The trustee in bankruptcy is responsible for administering the debtor's estate, which mainly involves collecting, liquidating, and distributing the non-exempt property of the estate. The trustee is also empowered to bring actions to avoid or set aside certain pre-bankruptcy transfers of the debtor.

16. **Question: What is the Chapter 7 process?**

*Answer:* The Chapter 7 bankruptcy process begins by filing a simple petition with the \$299 filing fee. Along with the petition, or within 15 days of filing, the debtor will be required to file several schedules. These schedules involve considerable financial disclosures about the debtor and its creditors.

Generally, three to four weeks after filing the petition, there will be a meeting of creditors, at which the debtor or its principal will be required to attend. At this meeting, the trustee and creditors may question the debtor about its assets and liabilities. A creditor must file a proof of claim within 90 days of this meeting. The debtor will have an opportunity to object to any claims that are filed.

Once the trustee has determined all assets of, and claims against, the debtor, the trustee will distribute the net proceeds of liquidation that are available for distribution to creditors, pursuant to the priorities for payment established by the Bankruptcy Code. Any money remaining after the creditors have been paid will be distributed to the debtor. The entire Chapter 7 process usually takes about four to six months, but this time period may vary depending on the size and complexity of the case.

**17. Question: Can debts be restructured without filing for bankruptcy?**

Answer: Yes. Bankruptcy is one tool available to address a debtor's financial problems, but is not the only tool. Creditors may agree to restructure the payments or debts without filing for bankruptcy. Indeed, creditors may be more helpful in working with a debtor outside of bankruptcy, to the extent they believe that the debtor's financial troubles are temporary and that the creditors' recovery will be greater outside of bankruptcy. It should be noted that alternatives to bankruptcy may be available under State law.

**18. Question: Can a debtor be placed in bankruptcy involuntarily?**

Answer: Creditors holding claims against a debtor may, under certain circumstances, initiate a bankruptcy by filing an involuntary petition against the debtor. If a debtor has 12 or more creditors, an involuntary petition requires the participation of at least 3 creditors who hold unsecured claims totaling at least \$13,475 that are not subject to a bona fide dispute as to liability or amount. If the debtor has fewer than 12 creditors, a single creditor may initiate an involuntary petition, but the creditor must have an unsecured claim of at least \$13,475 that is not subject to a bona fide dispute as to liability or amount. A "bona fide dispute" may involve a reasonable issue of whether the debtor is liable on the debt, probably more than a subjective belief by the debtor. Generally, the bankruptcy court will only issue an order for relief, which formally puts the debtor into bankruptcy, if the debtor is not generally paying its debts as they become due (unless such debts are the subject of a bona fide dispute).

## CHAPTER 11 BANKRUPTCY

**19. Question: What are the requirements for Chapter 11 relief?**

Answer: To file for Chapter 11 relief, a person must be eligible to be a Chapter 11 debtor under Section 109(d) of the Bankruptcy Code. Subject to exceptions, generally, only a person that may be a debtor under Chapter 7 of the Code may be a debtor under Chapter 11. Persons eligible to file Chapter 7 include individuals, partnerships, and corporations.

**20. Question: What are the duties of a Chapter 11 debtor?**

*Answer:* A Chapter 11 debtor will encounter significant duties and responsibilities, including, but not limited to, filing monthly operating reports with the U.S. Trustee, paying quarterly fees to the U.S. Trustee, negotiating, preparing, filing and confirming a disclosure statement and plan of reorganization. If the debtor fails to comply with its duties and responsibility, a party-in-interest or the U.S. Trustee may seek to convert or dismiss the case or, alternatively, move for appointment of a trustee.

**21. Question: Can the debtor dismiss the bankruptcy petition after filing?**

*Answer:* There is not an automatic right to dismiss the petition after it is filed. Bankruptcy court approval is required to dismiss the petition.

**22. Question: Is it expensive to file for Chapter 11 relief?**

*Answer:* While merely filing for Chapter 11 is not expensive, operating under Chapter 11 can be expensive. The debtor must discharge numerous duties and responsibilities during the Chapter 11 case. In addition, the debtor must pay the fees and expenses of its professionals (lawyers, accountants, etc.), as well as the fees and expenses of the professionals engaged by any creditors' committee appointed in the case. There are significant costs associated with the preparation, filing and distribution of a disclosure statement and plan. In addition, the debtor is required to pay quarterly fees to the U.S. Trustee based on the amount of disbursements made during the quarter.

**23. Question: Are there special rules for small businesses?**

*Answer:* A "small business debtor" is defined as a person engaged in commercial or business activities that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the order for relief in an amount of not more than \$2,190,000 (excluding amounts owed to affiliates or insiders), and in which either the U.S. Trustee has not appointed a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight to the debtor. A person whose primary activity is the business of owning or operating real property or incidents thereto is not eligible to be a "small business debtor." In addition, if any member of a group of affiliated debtors has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,190,000 (excluding debts owed to one or more affiliates or insiders), the entity will not qualify as a "small business debtor." Making this determination when the case is filed may be difficult, and may change depending on whether a committee is appointed and whether the committee is sufficiently active.

The Bankruptcy Code imposes certain reporting requirements on a "small business debtor." Such debtors are required to file periodic reports regarding their profitability for the current and recent fiscal periods and to provide reasonable projections of cash receipts and disbursements compared against actual results and prior projections. The U.S. Trustee is also required to conduct an initial interview with the "small business debtor" prior to the first meeting of creditors. The purpose of this meeting is to evaluate the debtor's viability and to establish a schedule for how the case will proceed. In addition, the "small business debtor" is

required to attach various financial reports (i.e., most recent balance sheet, state of operations, cash-flow statement, and Federal income tax return) to the petition, or sign and attach a statement under penalty of perjury that such documents do not exist and that no tax return has been filed. The debtor must timely file all schedules and statements of financial affairs and other postpetition reports and tax returns, the absence of which may result in the filing of a motion to convert or dismiss the case by the U.S. Trustee. A member of senior management of the debtor is required to attend all meetings scheduled by the court and the U.S. Trustee with counsel. Finally, the U.S. Trustee is granted the right to inspect the debtor's premises, books and records. The debtor must also maintain insurance that is customary and appropriate to the industry.

**24. Question: Will the debtor, if it is a tenant, be able to keep its unexpired commercial lease, i.e., lease of nonresidential real property? What about an unexpired lease of personal property?**

*Answer:* The debtor tenant may continue to occupy its premises post-filing, but must timely comply with all of its obligations under the lease. In addition, clauses in the lease providing for a termination upon the filing of a bankruptcy are not enforceable in bankruptcy. With respect to personal property leases, the debtor may not be able to retain the personal property if it has defaulted on its obligations prior to bankruptcy and is unable to cure such defaults.

**25. Question: Can a tenant that is not paying rent be evicted after it has filed bankruptcy?**

*Answer:* If the debtor is not paying its postpetition rent, the landlord may ask the court to (i) compel the debtor to make such payments, and/or (ii) lift the automatic stay to allow it to evict the tenant.

**26. Question: When must the debtor seek to assume or reject a commercial lease?**

*Answer:* A debtor must make a decision to assume or reject an unexpired lease of nonresidential real property within 120 days of the Chapter 11 filing. The debtor may obtain one 90-day extension of this period upon a showing of cause. Additional extensions cannot be granted without the prior written consent of the landlord.

**27. Question: If no action is taken to assume or reject lease, what happens to the commercial lease?**

*Answer:* If the debtor does not assume the lease within that time period, the lease is automatically rejected, and the leased premises must be immediately surrendered to the landlord. Once the lease is rejected, the landlord will have an administrative expense claim for any rent unpaid for the postpetition period up to the date of surrender of the premises. The remaining claim is treated as an unsecured claim limited to the rent due under the lease, without acceleration, for the greater of one year, or 15% of the remaining term of the lease (but not to exceed 3 years' rent).

**28. Question: When must the Chapter 11 plan be filed and confirmed?**

*Answer:* Only the debtor may file a plan within the first 120 days of petition or order for relief (the “exclusivity period”). Creditors may not file a plan during this period. The court may extend the exclusivity period up to 18 months. The debtor is required to file a plan and disclosure statement within 18 months of the filing of the petition, and to confirm the plan within 20 months of the filing of the petition. If the debtor fails to take such action, competing plans may be filed by creditors or, alternatively, the U.S. Trustee may move to seek to dismiss or convert the case. The bankruptcy court does not have authority to extend these deadlines. In the “small business debtor” context, the debtor must file its plan within 180 days after the filing of the petition. This time period, in the case of small business debtors, may be extended for cause so long as the plan and disclosure statement are filed not later than 300 days after the order for relief. These time periods for a “small business debtor” may be extended, if the debtor demonstrates that it is more likely than not that the court will confirm a plan within a reasonable period of time.

**29. Question: How are taxes paid in a Chapter 11?**

*Answer:* Taxes must be paid in regular installment payments in cash and at least 5 years from the date of the order for relief (as opposed to 6 years from the date of assessment). In addition, as part of formulating a Chapter 11 plan, a debtor may not treat the payment of taxes any less favorably than unsecured creditors. Failure to pay taxes or to timely file tax returns during the Chapter 11 case can give rise to the conversion or dismissal of the case. Moreover, the debtor is required to pay interest on the tax claims at the rate that would be applicable under nonbankruptcy law.

**30. Question: Can the debtor’s utilities be turned off during bankruptcy?**

*Answer:* After the petition is filed, the debtor must offer the utility assurance of payment (defined as basically cash or cash equivalent) that is satisfactory to the utility. If the debtor is unable to make an acceptable arrangement with the utility, the utility may alter, refuse or discontinue service within 20 days of filing with permission from the court or within 30 days of filing without seeking an order of the court. The utility may recover or offset amounts owed against a prepetition deposit without notice or an order of the court.

**31. Question: If the debtor’s sole assets consist of real property, does Chapter 11 provide any opportunities to restructure these assets?**

*Answer:* The Bankruptcy Code contains special provisions governing “single asset real estate” debtors. Single asset real estate means real property constituting a single property or project, other than residential real property with fewer than four units, which generates substantially all of the gross income for the debtor. However, farmers may not qualify for relief under the single asset real estate provisions. If you qualify as a “single asset real estate” debtor, you must commence making monthly interest payments in an amount equal to the then applicable nondefault contract rate of interest on the value of the creditor’s interest (as opposed to the current fair market rate) or file a plan with a reasonable possibility of being confirmed within a reasonable time period within the later of 90 days after the entry of the order

for relief or 30 days after the court determines the debtor is a single asset real estate debtor. If such action is not taken, the creditor will be allowed to move to lift the automatic stay to foreclose on the realty. The debtor may make the monthly payments from rents or other income generated from the property without seeking express consent from the creditor.

## CHAPTER 13 BANKRUPTCY

**32. Question: Can a Chapter 13 be filed for an unincorporated business?**

*Answer:* If an individual is conducting business as a “dba” (in other words, it is not a separate legal entity like a corporation or a partnership), the business will automatically be part of the assets of the individual’s bankruptcy case. If trade credit is incurred in the production of income from the business, the individual is deemed to be a “debtor engaged in business.” A debtor may continue to operate its business unless the court orders otherwise. However, the debtor may not sell property outside of the ordinary course of business or borrow money on a secured basis without permission from the bankruptcy court.

**33. Question: Can the debtor and his spouse file? How about other family members?**

*Answer:* The debtor and spouse can file a joint case under Chapter 13. After the filing, the court determines the extent to which the debtor’s and spouse’s estates should be consolidated. The Bankruptcy Code does not permit family members other than spouses to file joint petitions. Just because spouses file a joint petition does not mean that the spouses can be represented by the same lawyer; there may be conflicting interests between spouses that prevent a single lawyer from representing both.

**34. Question: Why file a Chapter 13 instead of a Chapter 7 bankruptcy?**

*Answer:* Many people would rather not tie up their future income to pay creditors and would prefer to file a Chapter 7 bankruptcy in which they are not required to do so. However, in order to answer this question, a determination must be made as to whether the person is eligible to file a Chapter 7 bankruptcy. Please see the section on Chapter 7. Generally, individuals who have disposable income available to pay creditors may be required to proceed under Chapter 11 or 13. Deciding whether to file a bankruptcy and, if so, what type of bankruptcy to file may not be simple. The choice between filing a Chapter 13 and filing a Chapter 7 (or some other type of bankruptcy) depends on the individual circumstances, the amount of assets, the type of assets, the amount and type of income, and the amount and type of debt.

**35. Question: Can gifts from friends be used to pay creditors?**

*Answer:* Yes. However, they are not required to be so used. Moreover, gifts do not count as part of “regular income” to qualify for a Chapter 13.

**36. Question: Are insurance proceeds from a casualty loss received after filing for bankruptcy required to be used to pay creditors?**

*Answer:* Insurance proceeds received after Chapter 13 bankruptcy, but before the completion of all payments under the plan, may be recoverable from the recipient. The fact that the insurance proceeds were not used to pay creditors, or for the purposes required by the insurance agreement, may affect the right to receive a discharge and may even result in criminal penalties or fines. However, the specific answer to this question will depend on the kind of insurance, whether the proceeds are exempt assets under applicable State law or Federal law, when the right to payment arose, and the terms of the agreement with the insurance company.

**37. Question: What if the debtor changes his mind after filing?**

*Answer:* The bankruptcy case cannot be withdrawn but must be dismissed by the court. The debtor has a right to convert the Chapter 11 case to Chapter 7 at any time (if the debtor is eligible for Chapter 7) and can ask the court for permission to dismiss the bankruptcy case if the case was not previously converted. Generally, the court will not permit a case to be dismissed unless there is persuasive evidence that all creditors either will be paid in full or will not be at risk of nonpayment.

## CHAPTER 12 BANKRUPTCY

**38. Question: If a debtor owns and operates a farm or is a fisherman, but is not otherwise eligible or qualified for Chapter 11 or Chapter 13, is there anything else under the Bankruptcy Code that can provide some relief?**

*Answer:* Yes, Chapter 12 bankruptcy.

**39. Question: Are there special provisions in the Bankruptcy Code for “farmers” or “fishermen”?**

*Answer:* Yes, Chapter 12 is more streamlined, less complicated, and less expensive than Chapter 11. In addition, few family farmers find Chapter 13 to be advantageous, because it was designed for wage earners who have smaller debts than those facing family farmers.

**40. Question: Who can be a debtor under Chapter 12?**

*Answer:* Only a family farmer with “regular annual income” may file for Chapter 12. Allowances are also made for family farmers with seasonal income. There are two types of family farmers: (i) an individual or individual and spouse, and (ii) a corporation or partnership. Chapter 12 also extends to certain family fishermen with similar eligibility requirements.

**41. Question: Are there any other requirements for individuals to qualify for Chapter 12?**

Answer: There are four criteria for an individual to qualify as a “family farmer” under Chapter 12:

- a. The individual or individual and spouse must be engaged in farming operations.
- b. The total debts (secured and unsecured) of farming operations must not exceed \$3,544,525.
- c. Not less than 50% of the total aggregate non-contingent liquidated debts must be related to farming operations (excluding a debt for the principal residence, unless such debt arises out of the farming operation).
- d. The debtor must have more than 50% of his gross income from farming operations in either the tax year prior to filing the Chapter 12 petition or in both the second and third tax years prior to filing the Chapter 12 petition.

A “family fisherman” must satisfy the following criteria:

- a. The individual or individual and spouse must be engaged in a commercial fishing operation.
- b. The total debts (secured and unsecured) of the fishing operation must not exceed \$1,642,500.
- c. Not less than 80% of the total aggregate non-contingent liquidated debts must be related to the commercial fishing operation (excluding debt for principal residence, unless such principal residence arises out of the commercial fishing operation).
- d. More than 50 percent of the gross income of the individual or individual and spouse for the preceding tax year must have come from commercial fishing operation.

**42. Question: What are the requirements for Chapter 12 if the farming or fishing operations are conducted by a corporation or partnership?**

Answer: The requirements are as follows:

- a. More than 50% of the outstanding stock or equity in the corporation or partnership must be owned by one family or by one family and its relatives.
- b. The family or the family and its relatives must conduct the farming or fishing operations, as the case may be.
- c. More than 80% of the value of the corporate or partnership assets must be related to the farming or fishing operations, as the case may be.

d. The total indebtedness of the corporation or partnership cannot exceed \$1,642,500, in the case of a family fisherman, or \$3,544,525, in the case of a family farmer.

e. Not less than 50% of the corporation's or partnership's aggregate contingent non-liquidated debts must be related to the farming operations owned by the corporation or partnership, or, in the case of fishing operations, not less than 80% (excluding a debt for one dwelling which is owned by a corporation or partnership, unless such debt arises out of the operation of the business).

f. If the corporation issues stock, it cannot be publicly traded.

**43. Question: How does Chapter 12 work?**

*Answer:* Chapter 12, like other chapters under the Bankruptcy Code, begins with the filing of a petition and other related forms, including a schedule of assets and liabilities, a statement of financial affairs, a schedule of current income and expenses, a schedule of executory contracts and unexpired leases. These documents are filed with the bankruptcy court where the individual lives, or where the corporation or partnership debtor has its principal place of business or principal assets, within 180 days immediately preceding the bankruptcy filing.

**44. Question: What does a trustee do in a Chapter 12 case?**

*Answer:* Upon the filing of a petition, an impartial trustee is appointed by the court or the United States Trustee to administer the case. Like a Chapter 13 trustee, the trustee's primary responsibility is to act as a disbursing agent, receiving payments from the debtor and making distributions to creditors.

**45. Question: Will filing a Chapter 12 bankruptcy prevent creditors from calling?**

*Answer:* Yes. The filing of a bankruptcy petition provides what is known as an "automatic stay" that stops most actions by creditors to collect money or property owed to them. By law, these types of creditors are required to stop any collection efforts they are pursuing, including lawsuits and telephone calls demanding payment. There are strict penalties for creditors who disregard the automatic stay.

**46. Question: If someone else besides the debtor is liable on the debts, does a Chapter 12 filing prevent creditors from calling this person?**

*Answer:* Similar to a Chapter 13 bankruptcy, a Chapter 12 bankruptcy also provides an automatic stay in favor of an individual who is liable on such debt with the debtor.

**47. Question: Can Chapter 12 discharge debts owed to the government?**

Answer: Yes. The Bankruptcy Code allows a Chapter 12 debtor to treat claims owed to a governmental unit as a result of sale, transfer, exchange or other disposition of any farm asset used in the debtor's farming operation as unsecured claims, provided the debtor receives a discharge. Of course, the taxing agencies must receive at least as large an amount as they would have received had the claim been a prepetition unsecured claim.

**48. Question: How do creditors get paid in a Chapter 12?**

Answer: A Chapter 12 debtor must file a plan of repayment within 90 days of filing the bankruptcy petition, unless the court grants an extension of time based on circumstances for which the debtor should not be held accountable. Plans must be approved by the court and provide for payments of fixed amounts to the trustee on a regular basis. The trustee then distributes the funds to creditors according to the terms of the plan.

**49. Question: How long does the plan last?**

Answer: It usually lasts between three to five years.

**50. Question: Do creditors have to be paid in full?**

Answer: The plan does not have to provide that unsecured creditors be paid in full, as long as the debtor pays under the plan all projected disposable income over the three to five years that the plan is in effect, and as long as the plan provides that unsecured creditors are to receive at least as much as they would receive if the debtor's nonexempt assets were liquidated under Chapter 7. "Disposable Income" is defined as income which is not reasonably necessary for the maintenance or support of the debtor or his/her dependents or for the payment of expenditures necessary for the continuation, preservation, and operation of the debtor's business. Secured creditors must be paid at least as much as the value of the collateral pledged for the debt. One of the features of Chapter 12 is that, in certain circumstances, payments to secured creditors can continue longer than the three-to-five-year period the plan provides for payment to unsecured and priority creditors.

**51. Question: What are the benefits if a plan is approved by the bankruptcy court?**

Answer: If the plan is confirmed by the bankruptcy court, the trustee commences distribution of the funds the trustee has received from the debtor. If the plan is not confirmed, the funds paid to the trustee are returned to the debtor after deducting the trustee's percentage fee and any unpaid claim allowed for administrative expenses. However, the debtor is not entitled to be relieved of his or her financial debts.

**52. Question: Can the plan be changed after it has been filed with the bankruptcy court?**

Answer: On occasion, changed circumstances will affect a debtor's ability to make payments or a debtor may inadvertently have failed to list all creditors. In such instances, the plan may be modified either before or after confirmation.

**53. Question: What happens once the plan is confirmed?**

*Answer:* The debtor must make regular payments to the trustee. Further, while confirmation of the plan entitles the debtor to retain property as long as payments are made, the debtor should not incur any significant new credit obligations without consulting the trustee, because they may impact upon the successful execution of the plan. Failure to make the plan payments may result in dismissal of the case. In addition, the court may dismiss the case or convert the case to a liquidation case under Chapter 7 of the Bankruptcy Code, upon a showing that the debtor has committed fraud in connection with the case.

**54. Question: What is the benefit of completing all plan payments?**

*Answer:* Like a discharge under Chapter 13, upon successful completion of all payments under a Chapter 12 plan, the debtor will receive a discharge which extinguishes the debtor's obligation to pay any unsecured debts that were included in the plan, even though they may not have been paid in full. After the discharge has been granted, those creditors whose claims were provided for in full or in part under the plan no longer may initiate or continue any legal or other action against the debtor to collect the discharged obligations.

**55. Question: Are all debts included in the discharge?**

*Answer:* Certain categories of debts are not discharged in Chapter 12 proceedings. In fact, the discharge is more limited in Chapter 12 than it is in a Chapter 13 case. Those categories include debts for:

- a. alimony and child support;
- b. money obtained through filing false financial statements;
- c. debts for willful and malicious injury to person or property;
- d. debts for death or personal injury caused by the debtor's operation of a motor vehicle while the debtor was intoxicated; and
- e. debts from fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny.

**56. Question: What if the debtor cannot complete the payments under the Chapter 12 plan?**

*Answer:* If payments under a plan are not completed due to circumstances for which the debtor should not justly be held accountable, and other statutory criteria have been met, a debtor may be excused from completing payments under a plan of reorganization. If the court finds that such circumstances exist and that unsecured creditors already have received at least what they would have received if the debtor's estate had been liquidated under Chapter 7 of the Bankruptcy Code, the bankruptcy court may grant the debtor a discharge of all unsecured debts provided for in the plan or disallowed by the court, with the exception of those types of debts which are excepted from discharge. Injury or illness that precludes employment sufficient

to fund even a modified plan may serve as the basis for a discharge. A discharge granted under these circumstances is often referred to as a hardship discharge.

## **CREDITOR PERSPECTIVE**

This section focuses on the rights of a creditor who is owed a debt by a debtor in bankruptcy. The questions are raised and answered in relation to a corporate debtor, but in most instances, the answer is the same for an individual debtor.

**57. Question: Can a guaranty of a company's debt by a stockholder or principal be enforced after the company goes into bankruptcy?**

*Answer:* Yes. The automatic stay that comes into force upon the bankruptcy of the company generally does not apply to the stockholders and principals of the company. Accordingly, collection action may proceed against the guarantors unless the bankruptcy court enjoins such actions.

**58. Question: What is the role of creditors in a Chapter 7 bankruptcy proceeding?**

*Answer:* In a Chapter 7, a bankruptcy trustee is appointed by the U.S. Trustee to collect all the assets of the debtor, reduce non-exempt assets to cash, and distribute the proceeds in accordance with the priorities established by the Bankruptcy Code. In effect, the bankruptcy trustee is the representative of all creditors. Creditors are treated equally by the trustee in accordance with the priority of their claims.

Creditors may file proofs of claim in a proceeding setting forth the debts owed by the debtor and support their claim with invoices or other evidence of the debt. If a debtor incurred a debt by fraud, or by perpetrating a willful and malicious injury, or if the claim is for child support or other exceptions from discharge, the creditor may file a complaint against the debtor to have the claim declared non-dischargeable. After the bankruptcy case closes, a claim determined to be non-dischargeable will still be owed to the creditor in the full amount of the claim. Similarly, a creditor or group of creditors under certain circumstances can assert a claim against the debtor for abuse of the bankruptcy proceeding, among other grounds, and ask the court to deny the discharge to the debtor in its entirety. Except in cases of unusual abuse, such a denial of discharge happens infrequently.

**59. Question: What is the role of the debtor in a Chapter 7 bankruptcy proceeding?**

*Answer:* After a Chapter 7 petition is filed, a debtor, whether an individual or a corporation, has a limited role in the proceeding. The debtor must file a schedule of all its assets and liabilities, and an individual debtor must file a schedule of its exempt property, i.e., property that, under state or federal law, a debtor is allowed to keep after bankruptcy to ensure a fresh start. Corporations have no exempt assets. The debtor must appear under oath at a meeting of creditors to answer questions about its assets, liabilities and business affairs.

**60. Question: Is management supplanted or displaced by an appointed official in bankruptcy?**

*Answer:* In a Chapter 7 bankruptcy, management is automatically replaced by a trustee. If any business is to be continued (which is unusual), the trustee, not management, would operate the company. In a Chapter 11 bankruptcy, management usually remains in control of corporate operations; management is usually replaced only when there are proven allegations of fraud, dishonesty, incompetence, or gross mismanagement either before or during the bankruptcy proceedings.

**61. Question: To what extent, if any, is the government involved?**

*Answer:* Except as actual creditors, federal and state governments have virtually no role in a bankruptcy. The one exception is the U.S. Trustee, who is appointed by the Attorney General of the United States in each of 21 regions into which the country has been divided. The U.S. Trustee has an administrative role in the case, and may appear and be heard in any bankruptcy case. The U.S. Trustee appoints bankruptcy trustees in Chapter 7 cases and, when directed by the court, in Chapter 11 cases.

**62. Question: What is the official committee of unsecured creditors?**

*Answer:* In a Chapter 11 proceeding, the U.S. Trustee appoints an official committee of unsecured creditors from among the largest unsecured creditors. This committee can retain counsel, accountants, financial advisors, and other professionals (paid for by the debtor), to help the committee understand why the debtor filed for bankruptcy and to evaluate the debtor's plan of reorganization. The committee is effectively the debtor's adversary in formulating and negotiating a reorganization plan.

**63. Question: What are the benefits, risks and duties of serving on a creditors' committee.**

*Answer:* After the case is commenced, the U.S. Trustee reviews the list of the top 20 unsecured creditors of the debtor, and generally appoints the largest seven creditors that are representative of the class of unsecured creditors to serve on a committee. The committee consults with the debtor over the administration of the estate, investigates acts, conduct, assets, liabilities and financial condition and operations of the debtor, participates in the formation of a plan, may request the appointment of an examiner or a trustee, and performs such other services as are in the interests of the unsecured creditors. An individual creditor serving on the committee is subject to a statutory duty to maintain as confidential the information it receives while serving on the committee. The members are required to act in the best interests of the creditor body as a whole, as opposed to representing its own individual interests. As long as the individual complies with its statutory duties, he or she will not face any personal liability. In addition, the costs of the professionals engaged by the committee, and the costs and expenses incurred by individual members of the committee (excluding the fees and expenses of its individual professionals) will be reimbursed by the debtor. Serving on the committee provides creditors with additional information, generally beyond what creditors not on the committee are entitled to receive, and the ability to negotiate with the debtor over a plan.

**64. Question: If a creditor is not among the 20 largest unsecured creditors, is there a way to gain appointment to the Committee?**

*Answer:* The creditor may petition the court to be placed on the committee. The court may change the membership of a committee if it determines that the change is necessary to ensure adequate representation of creditors and equity security holders. The court may also order the U.S. Trustee to increase the number of members of the committee to include a creditor that is a small business concern if the court determines that the creditor holds claims (of a kind not represented by the committee) the aggregate amount of which, in comparison to the annual gross revenue of that creditor, is disproportionately large.

**65. Question: How are claims asserted in a bankruptcy proceeding?**

*Answer:* In a bankruptcy proceeding, claims are filed by creditors on a form called a proof of claim. Creditors will receive notice of the deadline by which proofs of claim must be filed. If they miss the filing date, they risk disallowance of their claim. In certain Chapter 7 cases in which there are no assets to distribute, creditors are generally instructed that there is no need to file a proof of claim.

**66. Question: What are the priorities in the distribution of a debtor's assets?**

*Answer:* The Bankruptcy Code contains the priority for the distribution of the assets of the debtor. Secured creditors come first; next is court-ordered support of a spouse or child; then the administrative expenses of the case (trustee, creditors who supplied credit, accountants); certain unsecured claims in an involuntary case; wages; certain employee benefit plans; farmer and fisherman claims; consumer deposits; tax claims; adequate protection payment of secured creditors; and lastly, general unsecured creditors. A number of these distributions are subject to a cap.

**67. Question: Can mutual debts be set off in a bankruptcy proceeding?**

*Answer:* Generally, mutual debts between a debtor and a creditor incurred prior to bankruptcy may be set off. However, once one of the parties becomes subject to a bankruptcy proceeding, the permission of the bankruptcy court must be obtained before any setoff can be effected.

**68. Question: Are any pre-bankruptcy payments or transfers by the debtor recoverable for the benefit of creditors?**

*Answer:* The guiding principle of the Bankruptcy Code is that all similarly situated creditors are treated alike. To the extent that a creditor has received better treatment than other creditors, such as a payment on an old debt on the eve of bankruptcy, a termination of a below-market lease, or a payment for goods in excess of their fair market value, such transfers can be set aside or reversed. Avoidance actions may be brought in the bankruptcy case to set aside or reverse these payments or transfers.

**69. Question: What happens to existing contracts when one of the parties becomes subject to a bankruptcy proceeding?**

Answer: Most contracts fall into two categories: executory and executed. Executory contracts are those for which performance is still owed by both sides, e.g., landlord/tenant. An executed contract is one in which only one party must still perform, such as a promissory note where there is only an obligation to pay by the debtor. With few exceptions, executory contracts can be either rejected (i.e., breached by the debtor), assumed (i.e., performed by the debtor), and/or assigned by the debtor to a third party. Because certain executory contracts can be quite valuable, e.g., a lease at below-market rent or a supply contract at advantageous prices, there is much negotiation in a bankruptcy proceeding as to who will get the value of the contract.

If the debtor finds the contract costly or burdensome, it simply rejects it, and once it is rejected, does not have to perform under it. The creditor files a proof of claim for damages. Certain contracts, such as employment contracts and real estate leases, have maximum caps limiting the amount of actual damages. Alternatively, if the contract is valuable to the debtor's continued operations or to third parties who would pay for it, the debtor can assume the contract and perform it, or assume it and assign it to a third party for value. In either case, the debtor must pay any amount that was due prior to the proceeding or incurred and not paid during the proceeding, i.e., the debtor must bring the contract current. The debtor must also demonstrate that it has the ability to perform under the contract (i.e., get out and stay out of bankruptcy). A third-party purchaser would have to make a payment to the debtor which the debtor would use in part to cure any arrearage and demonstrate that it, too, could perform under the contract.

The non-bankruptcy party has to more or less wait for the debtor to decide whether it wants to assume or reject the executory contract. In the meantime, the debtor must pay currently under real estate leases and within 60 days for personal property leases, but does not have to cure any arrearages until after it makes a decision to assume.

Chapter 7 trustees must assume or reject executory contracts within 60 days. To level the playing field, the Code places time limits upon the Chapter 11 debtor for assumption or rejection. The time for assumption or rejection is 120 days for real estate leases, but the court may further extend the period by 90 days. The non-debtor party may also petition the court to shorten the time in which the debtor may assume or reject a contract.

**70. Question: How long does it take to get money from a bankruptcy proceeding?**

Answer: The time for getting money owed on a claim from a bankruptcy proceeding varies depending upon the chapter proceeding, the complexity of the case, the amount of assets available, and whether it is a Chapter 11 reorganization that fails and is followed up by a liquidation. In a Chapter 13, plan monies should flow to creditors within a couple of months of filing. In other proceedings, there is no uniform answer. Some Chapter 7's have dividends within eight to ten months; two years is perhaps more the average. Prepackaged Chapter 11's can be confirmed quickly, and monies often flow within 30-90 days. In most

large Chapter 11's, confirmation takes a number of years, and dividends to creditors for pre-petition claims can only be paid at its end. Chapter 11's which were filed to sell assets as a going concern often generate dividends in 12 to 18 months. Chapter 11's that start as reorganizations, but end up selling their assets and liquidating, often have a two- to four-year wait.

**71. Question: Can collection action be taken against a business that has filed bankruptcy?**

*Answer:* A bankruptcy filing triggers an automatic stay -- a form of injunction -- that prohibits actions to collect debts that arose before the bankruptcy filing. The automatic stay is very broad. It prohibits not only filing a lawsuit against the debtor but also the exercise of self-help remedies such as seizing property, applying a security deposit, evicting a tenant, changing the locks at leased premises, setting off mutual debts and a variety of other actions. Violations of the automatic stay can result in sanctions by the bankruptcy court, including a requirement to pay damages to the debtor. Collection action can only be taken if the bankruptcy court grants relief from the automatic stay. There are special and limited grounds for obtaining such relief.

**72. Question: What are the remedies of a vendor who delivered goods to a business shortly before it filed bankruptcy?**

*Answer:* The automatic stay prohibits repossession of the goods unilaterally. Depending on when the goods were delivered, however, the vendor may be able to recover the goods through the bankruptcy process or to receive payment for the goods on a priority basis.

A vendor cannot recover goods delivered before the bankruptcy unless the goods were delivered within 45 days before the case was filed and the vendor filed a reclamation notice in the bankruptcy case by the later of the 45th day after the debtor's receipt of the goods or the 20th day after the start of the bankruptcy case. If a reclamation notice is timely filed, the vendor may be able to recover the goods or, if not, may be able to receive payment in full of the purchase price. The vendor may be able to receive payment even if it does not file a reclamation notice within that period and therefore cannot recover the goods; it may be able to receive payment for goods delivered within 20 days before the start of the case.

**73. Question: Can a vendor refuse to supply additional goods or services to a customer that has filed for bankruptcy?**

*Answer:* A vendor cannot condition delivery upon payment of amounts the debtor owes for goods or services provided before the bankruptcy. Doing so would violate the automatic stay that goes into effect when a bankruptcy case is filed. Furthermore, a company that is in bankruptcy is prohibited from paying pre-bankruptcy debts before the conclusion of the case.

Whether a vendor can stop doing business with the debtor depends on whether the vendor has a contract to provide additional goods or services. If yes, the vendor must continue to perform even though the debtor was in default before the bankruptcy was filed.

In return, the debtor must pay on a timely basis for goods and services provided during the bankruptcy case, and must also perform other obligations under the contract that arise after the start of the bankruptcy case. At some point during the bankruptcy process, the debtor must decide whether it wants the contract to continue in effect after the bankruptcy case is over. If it decides to keep the contract, it must cure the pre-bankruptcy default by, among other things, paying you any prepetition amount owed. If the debtor decides not to keep the contract, the debtor can reject it, in which case the creditor will be entitled to share in any distributions that are made to general unsecured creditors in the bankruptcy case. Regardless of what the debtor decides to do about the contract, it must pay the creditor in full on a current basis for goods and services provided at the debtor's request during the bankruptcy case.

If the vendor does not have a contract with the debtor, it is not obligated to continue doing business with the debtor. Alternatively, the vendor can insist that the debtor pay in advance or on a C.O.D. basis for any goods or services provided during the bankruptcy case. If the vendor provides goods or services on open account during the bankruptcy, the debtor is required to pay for them in full when payment is due. If it fails to do so, the vendor can terminate further performance and ask the bankruptcy court to require the debtor to make immediate payment.

**74. Question: If a vendor supplies goods and services to debtor in bankruptcy, what assurance of payment is there?**

*Answer:* The vendor's right to be paid for goods or services provided during the case is treated as a priority claim in the bankruptcy case. Such a claim for goods or services provided during the case must be paid in full before any money can be distributed to holders of unsecured pre-bankruptcy claims. Nevertheless, that priority is not an absolute guarantee of payment: If the expenses of the bankruptcy case cannot be paid in full, the creditor will recover only a percentage of its claim. See previous question for a discussion of additional steps the vendor can take to protect its rights.

**75. Question: Can a landlord evict for non-payment of rent a business tenant that has filed bankruptcy?**

*Answer:* Landlords have special rights but also are subject to special restrictions when a business tenant under an unexpired lease of nonresidential real property files bankruptcy. The discussion below provides a general overview of these rights and restrictions, but the application of these rights and restrictions depends on the specific facts and circumstances of the case.

The automatic stay, which goes into effect when a bankruptcy case is filed, prohibits the landlord from evicting a bankrupt tenant for non-payment of rent that was due before the bankruptcy filing. Once the bankruptcy case is filed, the tenant has a period of time to decide whether to keep or reject the lease. The length of this period depends on whether the bankruptcy case was filed under Chapter 7 (liquidation) or Chapter 11 (reorganization) of the Bankruptcy Code. In a Chapter 7 liquidation, a trustee will be appointed and must decide within 60 days after the start of the case whether to keep or reject the lease. In a Chapter 11 case, the

tenant normally has a longer period to decide whether to keep or reject the lease, but this period cannot exceed 210 days.

For the tenant or trustee to keep the lease -- in other words, to assume it -- it must obtain an order from the bankruptcy court authorizing the assumption, and that order must be entered before the expiration of the decision period. If the tenant or trustee does not obtain such an order during the decision period, the lease is automatically rejected as of the end of the decision period.

During this decision period, the tenant or trustee must pay rent and perform its other obligations under the lease that come due after the bankruptcy filing, but it need not cure the pre-bankruptcy defaults unless and until it decides to assume the lease. If the tenant or trustee fails to pay rent or otherwise breaches the terms of the lease during the bankruptcy case, the landlord can ask the bankruptcy court to require the tenant to cure the breach and to decide immediately whether to assume or reject the lease.

To assume the lease, the tenant or trustee must cure any pre-bankruptcy defaults and demonstrate to the satisfaction of the bankruptcy court that it will be able to perform its obligations under the lease in the future. The tenant or trustee can also request the court's permission to assign the lease to a third party, even if the landlord does not consent. In order to obtain approval of such an assignment, the tenant or trustee must cure pre-bankruptcy defaults and the new tenant must demonstrate that it can perform the tenant's obligations under the lease.

If the lease is rejected, the landlord will have a claim for damages. The claim will include unpaid pre-bankruptcy rent, damages caused by non-monetary defaults, and damages attributable to the loss of the future rental stream. The last of these components may be subject to a cap under the Bankruptcy Code. This claim will share on a proportionate basis in whatever assets are available for distribution to general unsecured creditors.

If the tenant or trustee does not vacate the premises after the lease is rejected, the landlord may request the bankruptcy court to order the tenant or trustee to do so or may obtain relief from the automatic stay to permit the landlord to obtain possession of the premises using applicable State law procedures.

**76. Question: Can a service provider assert a lien on the property of a person who has filed for bankruptcy?**

Answer: If State law allows a mechanic's lien or similar rights against the property on which services were rendered, the service provider can assert that lien or those rights in the bankruptcy case. Depending on State law, having such a lien may entitle the service provider to be paid in full for pre-bankruptcy services, at least to the extent of the value of the property.

**77. Question: What are the rights of a lessor of equipment when the lessee files for bankruptcy?**

Answer: Equipment lessors have special rights, but they are also subject to special restrictions when a business lessee files bankruptcy. The discussion below provides a

general overview of these rights and restrictions, but the application of these rights and restrictions depends on the specific facts and circumstances of the case.

The automatic stay, which goes into effect when a bankruptcy case is filed, prohibits the lessor from repossessing the leased equipment for non-payment of rent that was due before the bankruptcy filing. Once the bankruptcy case is filed, the lessee has a period of time to decide whether to keep or reject the equipment lease. The length of this period depends on whether the bankruptcy case was filed under Chapter 7 (liquidation) or Chapter 11 (reorganization) of the Bankruptcy Code. In a Chapter 7 liquidation, a trustee will be appointed and must decide within 60 days after the start of the case whether to keep or reject the lease. As a practical matter, a Chapter 7 trustee is unlikely to decide to keep an equipment lease. This means that the lease will be rejected within 60 days after the bankruptcy filing. In a Chapter 11 case, the lessee normally will wait until the end of the bankruptcy case to decide whether to keep or reject an equipment lease. In order for the lessee to keep the lease -- in other words, to assume the lease -- it must obtain an order from the bankruptcy court authorizing the assumption.

Unless and until it assumes the equipment lease, the lessee may retain the equipment and need not cure the pre-bankruptcy defaults. Lessees of equipment that is being used in an ongoing business normally will make monthly payments under the lease as long as the equipment remains in use. In addition, the Bankruptcy Code requires the lessee to make all scheduled payments and perform other obligations under the lease beginning 60 days after the bankruptcy filing and continuing until the lease is assumed or rejected. If the lessee fails to make these payments, the lessor can apply to the bankruptcy court to require the lessee to perform. The equipment lessor also can ask the bankruptcy court to require the lessee to decide immediately whether to assume or reject the lease.

In order to assume the equipment lease, the lessee must cure any pre-bankruptcy defaults and demonstrate to the satisfaction of the court that it will be able to perform its obligations under the lease in the future. The lessee can also request the court's permission to assign the lease to a third party, even if the lessor does not consent. In order to obtain approval of such an assignment, the lessee must cure pre-bankruptcy defaults and the substitute lessee must demonstrate that it can perform the lessee's obligations under the lease.

If the lease is rejected, the lessor will have a claim for damages. The claim will include unpaid pre-bankruptcy rents, damages caused by non-monetary defaults, and damages attributable to the loss of the future rental stream. This claim will share on a proportionate basis in whatever assets are available for distribution to general unsecured creditors.

If the lessee does not return the equipment after the lease is rejected, the lessor may request the bankruptcy court to order the lessee to do so or may obtain relief from the automatic stay to permit the lessor to obtain possession of the equipment using applicable State law procedures.

**78. Question: Does a vendor on an open account have to continue to sell goods on open account after the customer has filed bankruptcy?**

*Answer:* The vendor does not have to continue to sell goods on open account during the bankruptcy case. Instead, the vendor can require payment in advance or on delivery. Note, however, that the vendor cannot condition delivery upon the customer's payment of pre-bankruptcy arrearages.

**79. Question: If a supplier has filed bankruptcy with outstanding purchase orders, can the customer cancel the orders and buy from another supplier?**

*Answer:* The customer cannot cancel the orders if it has a contractual obligation to buy the goods. Whether the arrangement with the supplier amounts to a contract is determined by applicable State law. If held to be a contract, and the supplier continues to perform during the bankruptcy, the customer must pay for the goods in accordance with the terms of the contract.

**80. Question: If a creditor was paid within 90 days of the filing of the petition on a past-due debt, is there an enhanced basis to defend the payment?**

*Answer:* Yes. A preference is a payment or transfer received within 90 days of the filing of the petition (or one year in the case of insiders) on account of an antecedent debt that allows the creditor to receive more than it would have if the case had been filed as a Chapter 7 and liquidated. Allowing recovery of preferences fosters the goal of equality of distribution among creditors.

One of the primary bases upon which creditors attempt to defend the payment is based on the ordinary course of business defense. As long as the creditor can demonstrate that the debt was incurred in the ordinary course of business or financial affairs of the debtor and the creditor, and either the transfer was made in accordance with ordinary business terms or was ordinary between the parties, it constitutes a complete defense.

In addition, a minimum floor has been established for seeking recovery of commercial transfers as preferences. If the preference is below \$5,000, a creditor now may assert an affirmative defense that the amount sought is outside the statutory limits to negate the preference. In addition, if the nonconsumer preference sought to be recovered is less than \$10,000, the debtor or trustee must pursue recovery of the preference in the district in which the defendant creditor resides, as opposed to where the bankruptcy case is pending, unless the creditor defendant is an insider.

\* \* \* \*

## GLOSSARY

**“Assumption”** -- The election by a debtor to perform its obligations under an unperformed contract or an unexpired lease. Assumption must be approved by the bankruptcy court.

**“Automatic Stay”** -- A statutory injunction that comes into effect automatically and immediately upon the filing of a bankruptcy petition that prohibits virtually all collection activity by creditors against the debtor or property of the debtor without permission from the bankruptcy court.

**“Bankruptcy estate”** -- The fictional entity created upon the filing of a bankruptcy petition that includes all of the assets and properties of the debtor.

**“Case”** -- A bankruptcy proceeding.

**“Cause”** -- Grounds for the requested relief.

**“Chapter 13 trustee”** -- The individual appointed by the United States Trustee to serve as trustee in Chapter 13 cases.

**“Confirmation”** -- The process by which the bankruptcy court evaluates whether the proposed plan of reorganization is accepted by required majorities of creditors and complies with the applicable provisions of the Bankruptcy Code

**“Debtor”** -- The individual, company, partnership or other person who files for bankruptcy or is involuntarily put into bankruptcy.

**“Debtor-in-possession”** -- A Chapter 11 debtor who continues to remain in control of its assets and business.

**“Discharge”** -- The statutory release obtained in a bankruptcy case that releases the debtor from the obligation to pay its debts.

**“Disclosure Statement”** -- The document prepared and filed by the debtor in conjunction with a plan of reorganization, which must contain adequate information about the debtor, its operations and the proposed treatment of creditors under the plan to enable creditors to make an informed decision on whether to accept or reject the plan.

**“Disposable income”** -- Income that is not reasonably necessary for the maintenance or support of the debtor and his or her dependents or for the payment of expenditures necessary for the continuation, preservation and operation of the debtor’s business.

**“Estate”** -- All assets and properties of the debtor once the debtor files for bankruptcy.

**“Exempt Assets”** -- Assets that are not subject to the claims of creditors and that may be retained by a debtor after bankruptcy.

**“Individual”** -- A human being.

**“Insider”** -- If the debtor is a corporation, an insider is a director, officer, person in control of the debtor or a relative of such people.

**“Non-Exempt Assets”** -- Assets that are not exempt assets.

**“Office of the United States Trustee”** -- A branch of the U.S. Department of Justice that is responsible for the overall monitoring of bankruptcy cases.

**“Order for relief”** -- The order of the bankruptcy court that formally puts the debtor into bankruptcy. In the case of a voluntary bankruptcy, the order for relief is issued automatically upon the filing of the bankruptcy petition. In the case of an involuntary bankruptcy, the order for relief is issued following the bankruptcy court hearing on whether the debtor is paying its debts generally as they become due.

**“Petition”** -- A specific form filed with the bankruptcy court in order to initiate a bankruptcy proceeding.

**“Plan of Reorganization”** -- A written plan or proposal that specifically details how the assets and liabilities of the debtor will be restructured or sold to satisfy creditors and to return the debtor to profitability or to liquidate the debtor.

**“Proof of Claim”** -- A written claim filed in a bankruptcy case to formally assert a claim against the debtor.

**“Property of the Estate”** -- All rights, title and interests of the debtor held upon the filing of the bankruptcy and all proceeds, profits and products of such rights, title and interests.

**“Regular income”** -- Income sufficiently stable and regular to enable an individual to make payments under a plan.

**“Rejection”** -- The election by a debtor to breach and not perform its obligations under an unperformed contract or unexpired lease. Rejection must be approved by the bankruptcy court.

**“Small business debtors”** -- A person engaged in commercial or business activities that has aggregate noncontingent liquidated debts in an amount not exceeding \$2,000,000 (excluding amounts owed to affiliates or insiders), and in which case either the U.S. Trustee has not appointed a committee of unsecured creditors or the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight to the debtor

**“United States Trustee”** -- The officer from the Office of the United States Trustee who is responsible for the monitoring the bankruptcy case.

## OTHER RESOURCES

[www.abiworld.org](http://www.abiworld.org)

[www.clla.org](http://www.clla.org)

[www.abanet.org](http://www.abanet.org)

[www.nacm.org](http://www.nacm.org)

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