

Understanding Bankruptcy

By BNET Editorial

published on BNET.com 12/18/2007

At one time, bankruptcy was regarded as shameful—something that left the doors of bankrupt businesses shuttered and forlorn, while individuals huddled penniless on the streets (or in jail), unable to face their friends. Today bankruptcy doesn't carry quite that stigma. With business being covered far more broadly and intently by the mass media, bankruptcy and its specific procedures are better understood, and examples of noted individuals and companies who've overcome it are better known. On occasion, bankruptcy might even be suggested as a viable option, on the premise that it can help someone “wipe the slate clean” and start anew.

“Don't believe it!” many experts counter. Bankruptcy, they declare, should still be avoided unless there is absolutely no other option. Those who've had to endure bankruptcy liken it to a “jungle and not a place one would want to visit,” and warn further that it's anything but painless. Indeed, bankruptcy remains among the most “life-shaking bad events”—along with disability, divorce, loss of a loved one, and severe illness—because of its frightful consequences, which can include almost indelible bad marks on credit reports, marital and family strife, and enduring psychological wounds. Federal statutes govern bankruptcy actions, although state laws can apply, too, given their varying definitions of “property.” Moreover, all laws do change now and then, as the U.S. bankruptcy laws did in October 2005. This is one more reason why bankruptcy should never be taken lightly.

What You Need to Know

Just what exactly is “bankruptcy?”

Officially bankruptcy is best described as a legal procedure directed by a federal court. It is in place to help individuals and businesses deal with their debt problems, either by eliminating them altogether by selling assets—*liquidation*—or by repaying them in an orderly fashion—*reorganization*. Precise rules govern both types of bankruptcy, and there also are exceptions to the rules. All bankruptcies are administered by a bankruptcy court that supervises the proceedings according to Title 11 of the United States Code.

Are there different kinds of bankruptcy?

Yes, several, but two apply to most businesses: Chapter 7 and Chapter 11. A **Chapter 7** bankruptcy, which applies to businesses and individuals is called a “liquidation” or sometimes a “straight” bankruptcy. It is considered complete and total and remains on one's credit report for 10 years. Once declared, Chapter 7 may help to get rid of many unsecured debts and halt, say, a foreclosure, repossessions of assets, wages being garnished, and utility shut-offs. However, filing for Chapter

7 bankruptcy depends on one's disposable income—or, rather the lack of it—as determined by a “means” test that compares monthly income with expenses and debts.

A **Chapter 11** bankruptcy is a more common and less onerous form of bankruptcy, and might be considered a “repayment plan.” It reflects a genuine desire to pay off as many debts as possible.

Chapter 13 bankruptcy applies to individuals and stays on one's credit report, too, but for just seven years. Accordingly, it is the “preferred” type of bankruptcy filing for individuals, and proceeds under a less pressured structure. Under the court's supervision and approval, a filer agrees to monthly payments of some or all incurred debt to a trustee who then distributes among creditors over a three-to-five-year period. Some debt can be eliminated or “discharged.” If a filer has regular income and limited debt, Chapter 13 allows one to keep property such as home or vehicle that otherwise might be lost.

What about “Chapter 11,” once a familiar term?

Chapter 11 still exists for businesses. It is best defined as a form of reorganization available to businesses and partnerships, and remains the usual choice of a business seeking to restructure debt while it continues operating—but under court supervision and largely for the benefit of creditors. The business proposes a plan of reorganization and make changes over time.

What kinds of exemptions do bankruptcy laws allow?

As usual, it tends to vary according to situations and definitions. Generally speaking, certain assets, percentages, or cash values of assets cannot be lost in a bankruptcy action. For example, current U.S. federal exemptions for individuals include:

- \$16,160 in equity in a personal residence;
- up to \$2,575 of the value of a motor vehicle;
- up to \$425 of the value of each item of household furnishings, or wearing apparel, and a maximum total value of \$8,625;
- up to \$1,075 in jewelry held for personal use;
- up to \$1,625 in “tools of the trade” that are deemed essential to earning a living;
- health aids such as a wheelchair;
- a life insurance contract that has not matured, except for a credit life insurance contract;
- the right to receive certain kinds of support, personal injury, and disability payments.

Will a bankruptcy filing absolve all debts?

No. Certain obligations will remain after a filing, such as child support payments for individuals. Nor does bankruptcy eliminate liens on property. It is yet another reason to consider bankruptcy carefully.

What to Do

Avoid Rushing to Judgment about Filing for Bankruptcy

Determining whether or not to file for bankruptcy is the critical first step, and a decision that needs to be made with care and considerable thought. It is a decision that demands that a business ownership exhaustively explore other alternatives and carefully determine what kind of future the business has, including a reorganization. A number of experts contend that most bankruptcy cases can be avoided with the help of counselors and planning.

Get Expert Assistance

This is axiomatic, and should be obvious. No business (or individual proprietor) should even consider filing for bankruptcy without first consulting with qualified attorneys and thoroughly understanding options. This is a critical decision in itself.

Be Completely Honest

Tell the truth, the whole truth and nothing but the truth...always! Bankruptcy filings require sworn statements and carry penalties of perjury if forms and information supplied are found to be deliberately misleading and/or carelessly incomplete. In turn, bankruptcy filings can then be dismissed, leaving debtors at the mercy of creditors and facing even worse financial crises and utterly bleak futures.

Decide What Kind of Bankruptcy Is Preferable

A Chapter 7 bankruptcy filing makes sense if a business concludes it has no viable future and/or that its debts are simply too overwhelming for any reorganization plan to overcome. About the best that can be said for a Chapter 7 filing is that it is an orderly way to liquidate a business. It also eliminates further loss to shareholders, while helping to ensure creditors that payments made from liquidation

will be done on an orderly and equitable basis, based on claims. A Chapter 7 filing also will help owners pay any taxes they may owe.

A Chapter 11 bankruptcy filing is essentially a repayment plan that enables a company to remain in business while it reorganizes and disposes of its debts in an orderly fashion under the supervision of a court. It also requires the support of creditors, however. A “confirmed” Chapter 11 plan explains and directs how respective creditors’ claims will be paid, and whether in full or in part.

Once any kind of bankruptcy is declared, a court issues an order called an “automatic stay.” It prevents creditors from seizing assets and property, halts pending lawsuits, and sets the stage for the bankruptcy process to proceed.

Know the Language of Bankruptcy

Anyone involved in a bankruptcy proceeding needs to understand certain terms such the ones shown here. Note, however, that this list is a sample and by no means complete.

- **Asset:** Literally anything of value an individual or entity owns, classed as liquid assets (cash) and capital assets (investments).
- **Auction:** A public sale at which items a debtor owns are sold to the highest bidder, and conducted to help a debtor collect cash for assets to help pay creditors; bargain hunters flock to these auctions for good reason—but they, too, need to be careful and know what they are buying.
- **Avoidance:** A provision of the U.S. Bankruptcy Code (see next) that allows a debtor business to avoid certain liens on property or assets.
- **Bankruptcy Code:** Title 11 of the U.S. Code that govern bankruptcy proceeds. Since it is a federal law, it does not vary by state—save for certain exemptions.
- **Credit report:** Data and a summary that shows one’s payment history.
- **Exemption:** Types and values of assets and property that creditors or a bankruptcy trustee cannot seize, and which a debtor can retain. Both individual state and federal statutes define exemptions, which is why they can vary from state to state.
- **Garnishment:** A court-ordered settlement that calls for a creditor to take money owed directly from the paycheck of the debtor in question.
- **Lien:** a creditor’s legal claim on assets or property secured by a debt. A bankruptcy will not necessarily eliminate a lien without a court invoking or initiating certain procedures.
- **Meeting of creditors:** A session at which a debtor (and his counsel) meet with creditors to answer questions and establish values of assets and liabilities—all while speaking under oath; also called a “341 meeting,” in reference to the section of the bankruptcy code that created it.
- **Trustee:** An individual appointed by a court to oversee a reorganization plan and debt repayments, and to represent creditors’ interests.

Understand Applicable Laws

Do not rely completely on legal counsel to lead your business through bankruptcy, because situations may arise that require you to react quickly, for example, a change in federal laws, which may be significant in some cases. Such a change occurred in 2005. Laws also regulate both the reporting of debt information and debt collection practices. For example, bill collectors must identify themselves and send written notice. That being said, however, whenever in doubt, do not act without advice of counsel. Bankruptcy laws are complex, especially those that govern small businesses, proprietorships, and subchapter S corporations.

What to Avoid

You Think You Are Wiping the Slate Clean

You may not be, for bankruptcy does not eliminate every debt. For example, individuals filing bankruptcy still must make alimony and child support payments and pay taxes. They must also repay student loans unless they can prove doing so will be an “undue burden”; however, that is very difficult standard to prove. And, if creditors convince a judge that certain debts owed should “survive” the bankruptcy action, they might remain, too. Nor can one keep property when a creditor has an unpaid mortgage or lien on it.

You Assume You Can “Bury” the Experience

Bankruptcy itself “is for life,” as a crusty advisor might warn. And it is not likely an action you can easily hide in some closet. For example, both loan application and job application forms routinely ask “Have you ever filed for bankruptcy?” Note the word “ever.” If you lie to get a loan because a bankruptcy action is very old, technically you still have committed criminal fraud in the United States. And, it can be challenging for, say, consultants who have filed for bankruptcy to resume their careers.

You Are Dishonest

Do not even think about it!

Where to Learn More

Books:

Alderman, Miles H., Jr., Chapter 11 Business Reorganization: For Business Leaders, Accountants and Lawyers. Outskirts Press, 2007.

Elias, Stephen, The New Bankruptcy: Will It Work for You?, 2nd ed., NOLO, 2007.

Pusateri, James A., and Karen Kressin, and James J. O'Malley, Small Business Bankruptcy Reorganizations. Beard Books, 2007.

Newtaon, Grant A., Corporate Bankruptcy: Tools, Strategies, and Alternatives. Hoboken, NJ: Wiley, 2003.

Web Sites:

Creditworthy Co: www.creditworthy.com/topics/bankruptcy.html

Moran Law Group: www.moranlaw.net/siteguide.htm

lawyers.com: <http://bankruptcy.lawyers.com/commercial-bankruptcy>

CityLegalGuide.com: www.citylegalguide.com

daveramsey.com: www.daveramsey.com/etc/search/?strSearch=bankruptcy

U.S. Courts: www.uscourts.gov/bankruptcycourts/bankruptcybasics.html