BANKRUPTCY

Options for Small Businesses in Distress

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Bankruptcy: Options for Small Businesses in Distress

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Introduction

According to a 2014 report by the American Bankruptcy Institute’s Commission to Study the Reform of Chapter 11, small businesses often fail due to a lack of adequate financial assistance. Other reasons small businesses do not succeed include the small businesses’ inability to obtain long-term financing, reliance on short-term credit such as personal loans and credit cards, and inability to hire professionals with whom the business owners can consult regarding their financial issues. Filing for bankruptcy may be a way for small businesses in financial distress to deal with their debts. The purpose of this booklet is to provide small business owners with general information on the different bankruptcy options available to them, and determine which option, if any, is right for them. For the purposes of this pamphlet, the "debtor" refers to the business entity filing for bankruptcy.

There are three types of bankruptcies available to small business owners: Chapter 7, Chapter 11 and Chapter 13. The filing of a bankruptcy provides the business debtor with an automatic stay, which stops and stays creditors from collecting on debts owed to the creditor prior to the filing of the bankruptcy. The automatic stay provides the business debtor with a little breathing room, in which the debtor can try to negotiate a settlement with the creditors.

In determining which bankruptcy option is right, business owners should consider:

- **the legal structure of their businesses;**
- **whether they want to close their businesses or keep operating; and**
- **whether the business owners are personally liable for their business debts through personal guarantees.**

Entities such as partnerships, corporations, and limited liability companies (LLCs) exist separate and apart from their owners and partners. The filing of a bankruptcy under any chapter would be filed in the company's name and not the name of any general partner or the individual owner. These business entities cannot represent themselves in their bankruptcy cases and are required to be represented by an attorney. Unlike partnerships, corporations or LLCs, sole proprietors and their businesses are treated as one and will file bankruptcy in the individual business owners' names. Sole proprietors are not required to hire an attorney in order for file for bankruptcy relief and can represent themselves.

The filing of a bankruptcy has serious legal and financial consequences. This pamphlet should not be interpreted as a complete outline of the bankruptcy process. Any party wishing to file bankruptcy is urged to seek bankruptcy advice from an attorney knowledgeable in bankruptcy law before filing.

Chapter 7: Liquidation for Bankruptcy

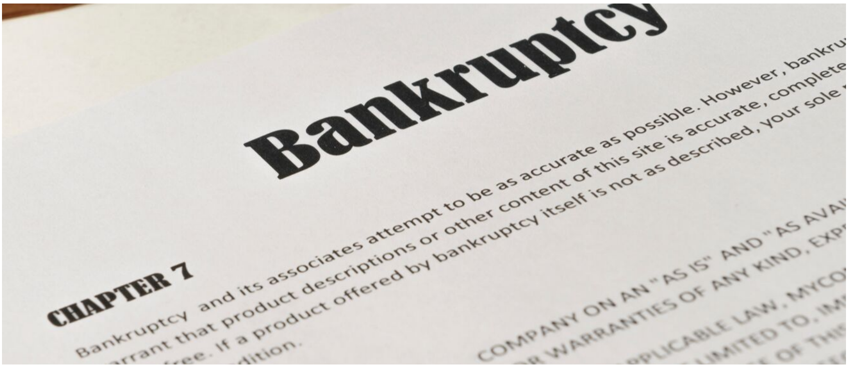
A Chapter 7 bankruptcy is also known as a liquidation. The filing fee for a Chapter 7 bankruptcy is $335. This type of bankruptcy is available to all business entities. Partnerships, corporations, and LLCs should be aware that when filing a Chapter 7 business bankruptcy, the business will to cease to operate. In a Chapter 7 bankruptcy, the small business' assets are liquidated (sold off) by the bankruptcy trustee and the proceeds are used to pay back the business' creditors. A bankruptcy trustee will be appointed to the Chapter 7 case to administer the bankruptcy case and oversee the liquidation of the business. The bankruptcy filing will not provide the business entity itself with a discharge of its debt.

For a business that has not incorporated and operates as a partnership, general partners can be sued and their personal assets and properties may be used to pay creditors any remaining balances if liquidation of the business' assets does not fully pay all the debts of the partnership.

With a corporation and LLC, if creditors find that the business finances were misused, or the corporation or LLC was simply an alter ego for the individual business owners, creditors may sue to have the debt shift from the business onto the individual owners, making them personally liable for the debt.

If this occurs, creditors are then able to go after the individual's personal assets. Further, individuals who have personally guaranteed any business debts of the partnership, corporation, or LLC will be personally liable for such debts and will have to file their own individual bankruptcies in order to discharge their obligations to pay back those creditors.

In general, this type of bankruptcy is ideal for business entities that are struggling with debt and looking for a simple way to close down their businesses. If a partnership, corporation or LLC prefers to remain in business and avoid liquidation, then a Chapter 7 bankruptcy is not right for them.



Chapter 7 bankruptcy provides sole proprietors with the opportunity to obtain a discharge of both their business and personal debts. Also, the Chapter 7 bankruptcy provides individuals with exemptions (protections) on certain assets and properties. Exemptions are not available to partnerships, corporations or LLCs. Property that is exempted (protected) will not be sold off in order to pay back the sole proprietor’s creditors. This is an important benefit for those sole proprietors with service-related businesses because being able to protect both personal and business assets by utilizing certain types of bankruptcy exemptions will allow the sole proprietors to continue to operate their businesses. Any assets that are not exempted (protected) will be sold off by a Bankruptcy Trustee and the proceeds will be used to pay back the sole proprietor’s creditors. Sole proprietors choosing to file Chapter 7 bankruptcy should be aware that in addition to paying the required filing fee, they must also complete required pre-bankruptcy credit counseling and post-bankruptcy debtor education courses.

Chapter 11: Reorganization Bankruptcy

Another option for a small businesses facing financial distress is a Chapter 11 bankruptcy. A Chapter 11 bankruptcy is frequently referred to as a "reorganization" bankruptcy. It is available to all business entities. A Chapter 11 bankruptcy allows business owners to continue to operate the business while proposing a plan of reorganization to reduce their debts or pay their creditors over time. In addition, a confirmation of the reorganization plan by the bankruptcy court discharges the debtor from most of its debts. However, individuals who personally guaranteed any debt might be forced to file for personal bankruptcy protection.

Typically in a Chapter 11 case, the debtor will continue to operate its business as a “debtor in possession.” This means that the debtor continues to control the assets and properties of the business while managing the business in order to increase its value and reduce its debts.

The administration of the bankruptcy case is overseen by a U.S. Trustee. A U.S. Trustee works under the Department of Justice and is responsible for supervising bankruptcy cases. The U.S. Trustee may also appoint a creditors' committee, which is comprised of unsecured creditors with the largest claims and who are willing to serve on the committee, to represent the interests of all unsecured creditors. This committee's duties include, but are not limited to, consulting with the debtor on the administration of the bankruptcy case, investigating the debtor's business operations, and participating in formulating or negotiating a Chapter 11 plan that would be approved by the bankruptcy court.

The filing of a Chapter 11 can be expensive for small business debtors. The filing fee for a Chapter 11 bankruptcy is $1,717. The debtor may be required to pay quarterly fees to the U.S. Trustee for each calendar quarter until the Chapter 11 case is closed, dismissed or converted to another chapter under the bankruptcy law. The amount of the fees depends on the debtor's quarterly disbursements but the minimum amount is $325.00. Additionally, the creditor's committee, with the bankruptcy court's approval, may hire professionals such as attorneys, accountants and others to represent or help perform duties of the committee. These professionals are hired at the expense of the debtor.

There are special provisions in the bankruptcy law that help simplify the bankruptcy process. For example, the bankruptcy court can order that a creditors' committee not be appointed if the debtor is a small business debtor.

In order for a business to file a Chapter 11 as a small business debtor, the business must show that (1) it is engaged in business or other commercial activities and is not in the business of owning or operating real property, with no more than $2,725,625 in unsecured and secured debts as of April 1, 2019, and (2) that a creditors' committee has not been appointed by the U.S. Trustee.

Because the filing of a Chapter 11 can be expensive and more complicated than other types of bankruptcies, it is advisable that small businesses considering this type of bankruptcy consult a bankruptcy attorney to get a more detailed understanding of their options and obligations.

Chapter 13: Readjustment of Debts for Individuals

A Chapter 13 bankruptcy, available only to individuals, allows for the adjustment of debts for individuals with regular income. Therefore, this option is only available to businesses operating as sole proprietorships. The debtor proposes a “plan” to the Court to provide for the payment of all of their priority and secured debts and a portion of their unsecured debts over a period of 3 to 5 years out of their “disposable income”. In a Chapter 13 bankruptcy, debtors will be allowed to keep non-exempt assets as long as the debtor makes payments to his/her creditors as provided in the Chapter 13 plan filed by the debtor with the bankruptcy court.

In order for a sole proprietor to file for Chapter 13 relief, the proprietor cannot owe more than $419,275 in unsecured debt and $1,257,850 in secured debt. Additionally, sole proprietors must complete required pre-bankruptcy credit counseling and post-bankruptcy debtor education courses.

Conclusion

Determining which type of bankruptcy is best for small business owners depends on their own circumstances, the type of their business entity, and whether their intention is to continue running the business. A debtor considering filing for bankruptcy protection is strongly encouraged to consult an attorney knowledgeable in bankruptcy law[1].

[1] Recent changes to the bankruptcy law will help simplify a Chapter 11 bankruptcy filing for small businesses. The Small Business Reorganization Act was signed into law on August 23, 2019 and will go into effect in February 2020.