The Different Types of Bankruptcy Relief

The law firm of Tucker Arensberg contributes this quarterly column focused on the legal issues that may impact our readers. Tucker Arensberg is a full-service law firm headquartered in Pittsburgh, Pa., USA. Servicing the legal needs of the iron and steel industry, Tucker Arensberg has also provided legal counsel to the Association for Iron & Steel Technology.

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Bankruptcy relief is a legal tool that can be used to help both businesses and individuals who are struggling with debt. A primary purpose of any bankruptcy is to give the honest debtor a "fresh start" through a discharge of its debt. There are several different types of bankruptcy options, each with its own set of rules and procedures, and each with its own processes and nuances. The types of bankruptcy are referred to by the "chapter" of the Bankruptcy Code by which it is governed. This article will focus on the two bankruptcy chapters that are most commonly utilized by businesses facing financial difficulties: a Chapter 11 reorganization and a Chapter 7 liquidation.

While each type of bankruptcy case has its own set of rules and requirements, all bankruptcy cases begin with the filing of a petition with the bankruptcy court situated where the business is either registered, has its principal place of business or maintains its principal assets. After filing the petition, each debtor must also file its schedules of assets and liabilities, a schedule of income and expenses, a statement of financial affairs, and a schedule of executory contracts and unexpired leases. Information that must be included in these documents consists of (1) all creditors, along with the nature and amount of the debt owed to each; (2) the source, amount and frequency of income/revenue earned by the debtor; (3) a complete list of all property, both real and personal, in which the debtor has an interest; and (4) a detailed itemization of the debtor's monthly expenses. The debtor is also required to provide copies of its tax returns for the recent years leading up to the bankruptcy, along with any tax returns filed while the case is ongoing.

Upon the filing of the bankruptcy petition, the debtor — and the debtor alone — is protected by the automatic stay, which prohibits any creditor from collection activities, including the enforcement of a judgment, foreclosure and repossession. If a creditor wishes to move forward with any such activity while the bankruptcy case is pending, it must file a motion for relief from stay and cannot take action until and unless the motion is granted by the court. Certain exceptions to the automatic stay are set forth in the Bankruptcy Code, so it is important to speak with an attorney regarding which actions may go forward in light of a bankruptcy filing.

Within 40 days from the date on which the petition is filed, a debtor must participate in a meeting of creditors conducted by either the appointed trustee (in a Chapter 7 case) or the United States Trustee (in a Chapter 11 case). The meeting of creditors allows both the trustee and all creditors to make inquiries into the information disclosed in the debtor's petition, schedules, and statement of financial affairs and the debtor's financial condition. The debtor, through its principal, must appear at the meeting of creditors and answer these questions under oath.

Chapter 11 — Reorganization

A Chapter 11 bankruptcy is most frequently utilized to allow a business entity to continue operations while reorganizing and repaying its debts to creditors. While an individual with certain levels of assets and liabilities is eligible to file a Chapter 11 case,

for purposes of this article, the focus will remain on businesses.

The assets that become part of the bankruptcy estate varies depending on the type of business entity that the debtor is. For a corporation, the personal assets of the shareholders are not included in the estate. For a sole proprietorship, both the business and personal assets of the owner will constitute the estate. In a partnership situation, circumstances may occur where a partner's personal assets can be used to pay creditors. No trustee is automatically appointed in a Chapter 11 case. Rather, the debtor becomes a "debtor in possession" and remains in possession and in control of its assets. As such, the debtor is tasked with handling such fiduciary tasks as reviewing and objecting to claims, accounting for assets, and filing monthly operating reports with the court. To assist in its duties, the debtor may employ professionals (such as accountants, financial advisors and attorneys) with the approval of the court.

After the meeting of creditors, which is conducted by the United States Trustee, the debtor must file a written disclosure statement and plan of reorganization. The disclosure statement will include information including the nature and history of the business, the key events that led to the bankruptcy filing, the assets and liabilities of the debtor, and other relevant and sufficient information to allow a creditor to make an informed decision whether to accept or reject the proposed plan. In turn, the plan sets forth the debtor's classifications of the creditors' claims and the proposed treatment for each class of creditors. A class of creditors that is "unimpaired" will not be entitled to vote to accept or reject the plan; rather, an unimpaired class is deemed to have accepted the plan because its claims are not being modified and the creditors will be receiving the full value of their claims under the plan. A class of creditors that is "impaired" — meaning that the plan is proposing to modify the creditors' contractual rights or pay the creditors less than the full value of their claims under the plan — will receive a ballot to vote in favor or against confirmation of the plan.

While the debtor is negotiating with its creditors and drafting its plan and disclosure statement, the court will set a bar date by which any creditor seeking to participate in the debtor's proposed plan can file a proof of claim. To participate in the plan, a creditor must file a proof of claim unless its claim is listed in the debtor's schedule and not identified as disputed, contingent or unliquidated. If a scheduled creditor opts to file a proof of claim, the proof of claim will have control over the scheduled amount of the claim.

All creditors will have the opportunity to object to both the disclosure statement and confirmation of the proposed plan. Once the disclosure statement is approved by the court, a confirmation hearing will be scheduled along with a deadline for each creditor entitled to vote to submit a ballot to the debtor. At the time of the confirmation hearing, the court will consider whether all requirements for plan confirmation are satisfied and, if the requisite number and amount of claims have voted to accept the plan, the plan may be confirmed.

Confirmation of the plan of reorganization will generally discharge all debtors, including business entities, from most types of pre-confirmation debt. Again, there are certain debts that are not discharged in a Chapter 11 case, and your counsel can explain those to you. The debtor will be required to make play payments as set forth in the confirmed plan. The provisions of the confirmed plan constitute the new contractual terms to which parties are bound, superseding any pre-petition contracts.

Chapter 7 — Liquidation

A Chapter 7 bankruptcy case may be filed by a partnership, corporation or other business entity. Relief under this chapter of the Bankruptcy Code is available regardless of the amount of a debtor's debt, and the debtor does not have to be insolvent at the time of filing. In a business context, a Chapter 7 bankruptcy is only appropriate for a debtor who does not intend to remain in operation. Unlike a Chapter 11, a Chapter 7 debtor does not file a plan to reorganize and repay its creditors. Instead, in a Chapter 7 bankruptcy, an appointed trustee will analyze, gather and sell the debtor's non-exempt assets, and from that liquidation, assets will be distributed to the debtor's creditors. Importantly, under Chapter 7, a discharge is only available to an individual — not a partnership, corporation or business entity.

After the meeting of creditors is held and concluded, the Chapter 7 trustee will make a determination as to whether any non-exempt assets exist to liquidate for the benefit of creditors. If no assets can be identified, the Chapter 7 trustee will deem the case to be a "no asset" case and unsecured creditors will receive no distribution. If assets do exist, unsecured creditors will then be able to file a proof of claim setting forth the debt owed and the supporting documentation for that debt within 90 days after the date of the meeting of creditors. Unsecured creditors who do not file a timely proof of claim will not be entitled to any distribution from the trustee. Secured creditors do not need to file a proof of claim in a Chapter 7 case to protect its security interest or lien; however, filing a claim could be beneficial to a secured creditor in certain instances.

It is the Chapter 7 trustee's role to liquidate the debtor's non-exempt assets in a manner that will maximize the funds available to unsecured creditors. When assets are sold in a Chapter 7 case, the sale

will generally be "free and clear" from liens and encumbrances. The trustee can also add value to the bankruptcy estate by recovering money through its "avoidance powers" which include, for example, (1) setting aside payments/transfers made to creditors within the 90 days immediately prior to the bankruptcy filing; (2) analyzing and undoing any security interests or other pre-petition property transfers that were not properly perfected under applicable non-bankruptcy law prior to the filing; and (3) pursuing fraudulent transfers/conveyances and other state law actions that could bring money into the bankruptcy estate.

Once the trustee's liquidation of assets is completed, funds will then be distributed to claimants under a priority scheme mandated by the Bankruptcy Code. Section 727 of the Bankruptcy Code provides for six classifications of claims, and each class must be paid in full before the next class receives any distribution.

Upon conclusion of the case, an individual is entitled to a discharge of his or her personal liability for most debt, subject to certain exceptions, including, for example, domestic support obligations, certain taxes and student loans. A discharge would not remove a lien from property.

Possible Alternatives to Bankruptcy

If a business does not wish to pursue either a reorganization or liquidation through bankruptcy, other restructuring options could be considered, such as debt restructuring, asset sales, or mergers and acquisitions. Determining whether bankruptcy or restructuring is advantageous depends on a number of factors, including the size and complexity of the business, the amount of debt, and the likelihood of success. It is important to consult with a professional to determine which options are best for your business.

The Pros and Cons of Bankruptcy and Restructuring

The process of bankruptcy and restructuring can be complex and time-consuming. Both have positive and negative consequences for businesses.

Positive Consequences:

- Bankruptcy and restructuring can help businesses to get back on their feet by reducing their debt load and giving them a fresh start.
- Bankruptcy and restructuring can allow businesses to reorganize their operations and become more efficient.
- Bankruptcy and restructuring can help businesses to attract new investors.

Negative Consequences:

- Bankruptcy and restructuring can impact a business's reputation, though there are viable ways to mitigate this impact.
- Bankruptcy and restructuring can make it more difficult for a business to obtain financing in the future.
- Bankruptcy and restructuring can lead to job losses.

The Role of Lawyers and Accountants in Bankruptcy and Restructuring

The process of bankruptcy and restructuring can be complex, time-consuming and stressful. Attorneys and other professionals, such as accountants, can assist businesses in navigating the legal, financial and reputational issues involved and can provide advice on the best course of action for your business. Attorneys also play a vital role in negotiating with lenders and other creditors to modify or reduce debt which typically involves filing a petition with the bankruptcy court, negotiating with creditors and developing a plan for repaying debt. ✦