Legal Opinions

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Bankruptcy Basics for Businesses

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The current health crisis is causing an economic downturn and placing stress on businesses – big and small. As such, it may be important for businesses to be familiar with basic bankruptcy principles in an effort to avoid violating any of the Bankruptcy Code or Rules.

The Two Main Types of "Business Bankruptcies"

A person or entity that files for bankruptcy is called a "debtor." A "creditor" is a person or entity that has a claim (normally for money) against the debtor. The most common chapters under which businesses file for relief are Chapter 7 and Chapter 11. Individuals may also file under both chapters.

Chapter 7 is a liquidation. It is most often used by businesses that are no longer operating or individuals who wish to liquidate their assets to pay creditors. Typically, in these cases, a trustee is appointed and sells all of the debtor's assets. The trustee then uses the proceeds of the sale to pay creditors' claims.

Chapter 11 is frequently referred to as a "reorganization" bankruptcy or a "business" bankruptcy, as it is often used to reorganize a business while the debtor remains in control. To make things a bit easier, the Bankruptcy Code has a special subchapter to streamline the process for small businesses.

The Automatic Stay

Under both chapters, the automatic stay provides a period of time in which all collection and enforcement activities against the debtor or its property (which becomes property of the bankruptcy "estate" upon filing), including foreclosures and repossessions of property, are suspended and may not be pursued by creditors without court relief. The automatic stay goes into effect automatically when the case is filed. If a creditor violates the automatic stay, it may be subject to sanctions by the bankruptcy court.

Avoidable Transfers

If a creditor has received a payment from the debtor within 90 days of the debtor's bankruptcy, the payment to the creditor may be subject to the debtor or trustee's "avoiding powers" as a preferential transfer. Essentially, the debtor or the trustee can cancel the transaction and force the return of funds from the creditor. The returned funds would then be used to pay all creditors. The purpose of these powers is to avoid unfair prepetition payments to one creditor at the expense of all creditors.

The Bankruptcy Plan

The main focus of a Chapter 11 bankruptcy is approval of the debtor's plan of reorganization. Among other requirements, for the plan to be approved by the bankruptcy court, creditors and other parties in interest must vote to accept or reject it.

When a plan is approved, the debtor is required to make plan payments pursuant to the plan and is bound by the provisions of the confirmed plan, along with creditors and other claimants whose rights are affected by the plan. The confirmed plan creates new contractual rights, replacing or superseding pre-bankruptcy contracts.

Unexpired Leases/Executory Contracts

In Chapter 11 cases, debtors have the option to assume or reject unexpired leases and other "executory contracts." An executory contract is a contract under which the parties still have duties to perform. While the debtor decides to assume or reject the unexpired lease or executory contract, the creditor must continue performance. A business cannot stop acting according to leases or contracts with a customer just because that customer files for bankruptcy.

If the debtor assumes an unexpired lease or executory contract, the debtor must cure any defaults and continue to perform under an assumed lease or executory contract. If the debtor rejects an unexpired lease or executory contract, then the lease or contract is treated as though it were breached on the day the debtor filed bankruptcy (also known as the "petition date").

The Importance of Understanding Bankruptcy Basics

Nearly every business will, from time to time, interact with a customer, vendor or account in bankruptcy. The Bankruptcy Code and Rules are complicated, and it's important for businesses to understand these basics to help limit their liability and protect their interests in a bankruptcy case.

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