Bankruptcy Basics: What Every Business Department Should Know

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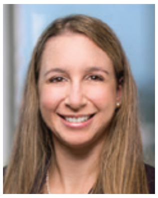

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When a client or customer files for bankruptcy, a business' treatment of that customer's account must change. Many businesses have dedicated bankruptcy departments or teams that deal with these accounts. However, it can take a while before the account is flagged or transferred to the bankruptcy team. Further, some smaller business bankruptcy teams are comprised of other department employees just wearing a "bankruptcy hat" when working on those accounts. It is under these circumstances when businesses are at a greater risk of violating the Bankruptcy Code and Bankruptcy Rules due to an innocent lack of awareness of bankruptcy requirements.

Discussed in this article are some of the bankruptcy basics on which business leaders should train all employees to ensure the Bankruptcy Code and Bankruptcy Rules are not inadvertently violated.

High Level Overview: Chapters 7, 13 and 11

A customer that files for bankruptcy is called a "debtor." Persons and businesses that have claims, usually for money, against the debtor are called "creditors." Creditors can be secured, where their claims are secured by collateral, or unsecured. The Bankruptcy Code treats secured and unsecured creditors differently.

The Bankruptcy Code has multiple chapters under which debtors may file for relief. The most common chapters are 7, 13 and 11.

Chapter 7 bankruptcy is a liquidation. This chapter is most often used by businesses that are no longer operating or individuals who either have very few assets or wish to liquidate their assets to repay creditors. If Chapter 7 debtors have assets that can be liquidated, the assets are sold by a bankruptcy trustee, and the proceeds from the sale are given to creditors. Typically, Chapter 7 cases last about 90 days, but cases that involve liquidation and sale of assets may continue for longer and involve litigation. Chapter 7 debtors usually receive a discharge of their debts at the end of a Chapter 7 case.

Chapter 13 differs from Chapter 7 in several ways. Only individuals may file for Chapter 13 bankruptcy. Chapter 13 debtors generally have too great a disposable monthly income to qualify for Chapter 7 or have equity in their residences they would like to keep rather than liquidate and distribute to creditors. Debtors in Chapter 13 repay creditors over a three- to five- year payment plan. If debtors successfully complete payments under their Chapter 13 plans, they will receive a discharge of many of their remaining debts.

Chapter 11 is the preferred option for businesses seeking to reorganize or higher income individuals whose debts are above the limits to qualify for Chapter 13. These bankruptcy cases generally involve a structured sale of assets, a liquidation or a business reorganization. Businesses that file for Chapter 11 bankruptcy usually continue operating. The Chapter 11 bankruptcy provides relief to the debtors by bringing most of its creditors to the bargaining table so the debtors can restructure or reorganize their debts and business. Chapter 11 debtors file a plan that is voted on by creditors and, once approved by the bankruptcy court, constitutes a binding contract regarding the debtors' debts and obligations. Typically, much more negotiation between debtors and their creditors occurs in a Chapter 11 bankruptcy, and these cases tend to last longer and involve more litigation than cases filed under other chapters.

The Automatic Stay

When a bankruptcy case is filed, an automatic stay is imposed by the Bankruptcy Code. This automatic stay generally prevents creditors from taking any further collection action against the debtor without the bankruptcy court's permission.

Additionally, if the debtor is involved in litigation in another court, a notice of the bankruptcy case may be filed, in which case, the non-bankruptcy litigation is halted.

The automatic stay is one of the most important aspects of a bankruptcy filing for business employees to understand. Violations of the automatic stay, where creditors continue collection efforts, expose businesses to liability and can result in significant penalties.

Even though collection efforts must stop due to the automatic stay, other federal laws require continued communication with customers about debts they owe, such as monthly mortgage statements. These communications could be construed as stay violations if they are not drafted properly. Steep penalties may result from stay violations, and it therefore may be prudent for businesses to involve a bankruptcy attorney to ensure customer communications comply with both the Bankruptcy Code and Rules, as well as other federal laws.

Under certain circumstances, creditors file motions in the bankruptcy court seeking relief from the automatic stay, which would mean the automatic stay would no longer apply to a particular property, such as a house, a vehicle or account. For instance, if a debtor files for Chapter 13 bankruptcy and stops making car payments, the creditor that provided financing which is secured by the car may file a stay relief motion to foreclose upon and repossess the car. If stay relief is granted, and if the bankruptcy court order doesn't provide otherwise, businesses must wait for 14 days before taking action that would otherwise violate the stay, such as repossessing a vehicle.

Unexpired Leases and 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 lease or executory contract, the creditor must continue performance. This means that a business cannot stop acting according to leases or contracts with a customer just because that customer filed for bankruptcy.

If a debtor assumes an unexpired lease or executory contract, the debtor must cure any defaults, including those that occurred prior to filing for bankruptcy. Alternatively, the debtor must provide adequate assurances that the defaults will be cured promptly. The debtor must continue to perform on an assumed lease or executory contract. If the debtor defaults after assuming the lease or executory contract, then the creditor may have a claim for damages against the defaulting debtor that is granted higher priority over other creditor's claims.

If the debtor rejects an unexpired lease or executory contract, then the lease or contract is treated as though it was breached as of the day the debtor filed for bankruptcy, and the creditor may have a claim for damages. A creditor may stop performing under a lease or executory contract once a debtor rejects it and the bankruptcy court enters an order approving of the rejection.

The Effect of Confirmed Plans

Often, creditors' claims arise from prebankruptcy contracts with debtors. When a bankruptcy plan is confirmed, which means the debtor has met the Bankruptcy Code's requirements and the court has entered an order approving the bankruptcy plan, the confirmed plan becomes, for all intents and purposes, a modification of the creditor's contract with the debtor. Accordingly, it is important for businesses to reconcile the debtor's account to comply with any modifications to the treatment of the debtor's account provided for in the confirmed plan.

Additionally, any terms from prior contracts with the debtor not included in the confirmed plan will no longer apply, unless they are provided for in the confirmed plan or the court's order confirming the plan. For Chapter 11 cases, it may be a good idea to involve the legal department or a bankruptcy attorney early in the case to negotiate plan terms regarding the business' claim, and, if necessary, object to confirmation of the plan. Although businesses may have an opportunity to object to the way they are treated under a plan, bankruptcy cases have strict deadlines that must be met. Involving attorneys earlier in the case helps prevent the possibility of missed deadlines and unfavorable plan treatment.

Confirmed plans may impose additional requirements on creditors, as well. For instance, a plan may require that a creditor send a new payment schedule, or a monthly statement that includes particular information not on the creditor's standard statements. For this reason, it is very important that businesses carefully read the confirmed plan, and the bankruptcy court's order confirming the plan, to ensure the business makes any necessary changes to the account or way the account is treated. Failing to comply with a confirmed plan creates liability for businesses that could result in substantial penalties.

The Importance of Understanding Bankruptcy Basics

It is not uncommon for customers to file for bankruptcy relief. The Bankruptcy Code and Bankruptcy Rules are complicated, and as such, it's a good idea for businesses to transfer accounts impacted by bankruptcy to a specialized bankruptcy department or team. However, nearly every business department will, from time to time, interact with a customer, vendor or account in bankruptcy. Accordingly, business leaders should be sure all employees understand these bankruptcy basics to limit the business's liability and ensure issues that require escalation will be promptly identified.

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