Bankruptcy Primer for Small Businesses

Prepared by the 2020 Small Business Reorganization Task Force, Education and Outreach Subcommittee, United States Bankruptcy Court, Central District of California
(Chair: Chief Bankruptcy Judge Honorable Maureen A. Tighe)
One of the purposes of the 2020 Small Business Reorganization Task Force is to educate and provide access on small business reorganization options under the Bankruptcy Code to a wide variety of diverse small businesses in the Central District of California, which consists of seven counties in Southern California. The Central District of California has the largest number of diverse small businesses in the nation.

With this mission, the Education and Outreach Subcommittee of the Small Business Reorganization Task Force has prepared this presentation. As will be discussed, a small business can file a chapter 11 small business case or may elect to be a Subchapter V small business under the newly enacted Small Business Reorganization Act (SBRA), 11 U.S.C. §§ 1181-1195. The Chapter 11 process for small businesses is designed to provide small businesses with an opportunity to reorganize and continue its operations. As a discussion about bankruptcy cannot be complete without alternatives, other options for distressed businesses will also be discussed briefly.

This presentation is provided for information purposes only and does not constitute legal advice.
Bankruptcy Primer for Small Businesses

**DID YOU KNOW?**

- **99%**
  Ninety-nine percent of U.S. businesses are “small businesses” as defined by the Small Business Administration.

- **47.5%**
  “Small businesses” employ 47.5% of workers in the U.S.

- **66%**
  Almost 2 out of 3 small businesses fail by year 10.
Recognizing the magnitude small businesses contribute to our economy and the difficulties they face (worse now with COVID-19), this material is a primer intended to provide and remind small business owners of various options, particularly bankruptcy, available to them when in financial distress.

It is also intended to provide some bankruptcy basics in an effort to make that process more accessible to business owners and remind them, if they so choose, that they can keep their business alive and pay creditors over time.
Topics for Discussion

- **Small Businesses in Financial Distress**

- **Options for Small Businesses in Financial Distress**
  - Court supervised (Bankruptcy and Receivership)
  - Out of Court (Dissolution, Work Outs, Assignment for the Benefit of Creditors)

- **Bankruptcy Option**
  - Basic Principles, Key Terms, Key Parties
  - SBRA – newly enacted streamlined Subchapter V of Chapter 11
  - Key Bankruptcy Benefits (whether Sub V or small business Chapter 11)
    - Automatic Stay
    - 363 Sales
  - Life of Chapter 11/Sub V
  - Summary of Pros and Cons of Chapter 11/Sub V
  - Other bankruptcy chapters available for small businesses

- **Non-Bankruptcy Options**
  - Receivership
  - Out of Court options

- **Tips and Word of Caution**
Financial distress for a business includes:

- Lacking sufficient cash flow to service debts;
- Starting to default on loans;
- Creditors taking collection actions against the business;
- Carrying excessive liabilities;
- Having substantial tax liabilities;
- Facing a pending foreclosure; and
- Confronting a large judgment without sufficient assets to repay.
Options for Small Businesses in Financial Distress

Options to Relieve Financial Stress

- Court Supervised
  - Bankruptcy
  - Receivership
  - Dissolution

- Out of Court
  - Out of Court Workouts
  - Assignment for the Benefit of Creditors
Bankruptcy Basics, Key Terms, and Parties
Bankruptcy law is based on the following principles to address the competing interests of debtors and creditors:

- Providing a “fresh start” for an individual or business from debts such as credit card debt, commercial debt, and many other types of debts through a discharge (elimination).

- Effectuating the orderly and fair liquidation or rehabilitation of the individual or business in bankruptcy.

- Ensuring equal treatment of similarly situated creditors.
Chapter 11 - Key Parties

- **Debtor**: The business (or individual) that filed for bankruptcy.
- **Debtor-in-Possession**: The business (or individual) that is operating in a Chapter 11 bankruptcy.
- **Creditor**: An entity or person who is owed money or obligation from the business in bankruptcy.
- **Bankruptcy Judge**: Specialized set of judges that hear only bankruptcy matters.
- **Office of the United States Trustee (OUST)**: Agency of the U.S. Department of Justice that monitors the businesses’ compliance and operational requirements, *i.e.*, ensuring debtor’s payment of payroll, property taxes & insurance, enforcing debtor’s transactional activity, monthly reporting, and conducting an examination at case outset.
- **Trustee (Chapter 11 or 7 if the case is converted)**: An individual may be appointed in situations to take over operations if management mismanages (usually egregious) or no longer wants to manage, or in situations where the court determines that such an appointment is in the best interest of all creditors and stakeholders.
- **Subchapter V Trustee**: An individual appointed by the OUST in each Subchapter V bankruptcy case, who will work with the small business debtor and its creditors to facilitate the development of a consensual plan.
Chapter 11 - Key Terms

- **Bankruptcy Estate**: An estate created at the time of bankruptcy filing and defined in the Bankruptcy Code as all legal or equitable interest of the Debtor, including claims and appellate rights.
- **Automatic Stay**: An injunction staying all actions by creditors to recover a claim against the Debtor.
- **Discharge**: Release of debt or debt cancellation.
- **Discharge Injunction**: An injunction against collection or recovery of debt against the Debtor.
- **Proof of Claim**: Form that creditors need file to be paid from the Bankruptcy Estate.
- **Secured Claims**: Claims for debts that are secured by an interest in property (the collateral).
- **Priority Unsecured Claims**: Claims not secured by collateral but have priority over other debts under bankruptcy law.
- **General Unsecured Claims**: Claims that have no priority and are not backed by collateral.
- **Adversary Proceedings**: A lawsuit filed within a bankruptcy case.
New Bankruptcy Law for Small Businesses
• **Small Business Reorganization Act of 2019** enacted in August 2019 and became effective in February 2020.

• Created a **brand new type of Chapter 11 case (Subchapter V)**

• Sub V is intended for small businesses to move through bankruptcy **quickly** and **cheaply** so that they can remain in business afterwards, which benefits the owners, employees, suppliers, customers and others who rely on that business.
To qualify as a Sub V Debtor, the entity must be:

1. A person or company engaged in commercial or business activities (except a person whose primary activity is in the business of owning single asset real estate);

2. Whose total noncontingent liquidated secured and unsecured debts is no more than $2,725,625* (excluding debts owed to one or more affiliates or insiders); and

3. With 50% or more of the debt arising from the commercial or business activities of the person or company.


*The CARES Act temporarily increased the $2,725,625 debt ceiling to $7.5 million; however, the increase expires on or about March 27, 2021.
Highlights of Subchapter V

**Quicker (Expedited Process)**

- Subchapter V Trustee appointed and 341a meeting of creditors set within 24-48 hours
- OUST conducts initial debtor interview within 10 days of case filing
- 341a meeting held approximately 21 days after filing
- Court holds status conference not later than 60 days after case is filed
- 14 days before status conference, Debtor has to file status report re efforts towards consensual plan
- Debtor shall file plan not later than 90 days after petition date
**Cheaper (Significant Savings)**

- No creditor committee unless court orders (savings of tens of thousands of dollars or more on administrative costs)
- No disclosure statement
- Administrative expenses (including trustee fees) may be paid over time through the plan
- Debtors do not pay quarterly fees to the OUST
- Saves money because Debtors get to confirmation (and thus exit bankruptcy) quicker with a streamlined plan (forms are being developed)
Effective (Substantial Incentives for Debtors)

- Only Debtor may propose a plan (i.e. Debtor can still propose plan if debtor has been removed as DIP).
- Debtor does not need to obtain acceptance of plan of even one impaired class of creditors.
- Plan can modify mortgage on his/her primary residence if loan proceeds obtained were used primarily for business purpose (as opposed to acquiring the residence)(this right is not available in other chapter 11, chapter 12 or chapter 13).
- Owners (equity holders) can retain their interests in the business even if plan does not pay unsecured claims in full so long as the Debtor uses “projected disposable income” to make payments under the plan for a minimum of 3 and maximum of 5 years.
- Debtor gets immediate discharge upon confirmation if plan is consensual. If plan is not consensual, then discharge is entered “as soon as practicable” after the Debtor completes all payments.
- Debtor has flexibility to pay administrative claims over life of the plan.
Chapter 11 Bankruptcy
Benefits of Chapter 11

For small businesses in financial distress, bankruptcy (whether under Sub V or Chapter 11) can be a temporary lifeline:

• Filing bankruptcy automatically prevents, or "stays," debt collection actions against the debtor and the debtor's property. As long as the stay ("Automatic Stay") remains in effect, creditors cannot bring or continue lawsuits, make wage garnishments, or even make telephone calls demanding payment.

• Small businesses can continue to operate.

• Management can remain in control of the business, unless the court orders otherwise.

• Management can work closely with a bankruptcy attorney and other professionals to attempt to reduce liabilities and give a company a new beginning or a "fresh start" without closing its doors.
Benefits of Chapter 11

Additional benefits:

- **Deferral**: A bankruptcy filing defers the time to make certain payments on certain debts.

- **Financing**: Debtors can borrow money while in bankruptcy in order to finance their reorganization.

- **Cure Defaults**: Debtors use the chapter 11 process to cure defaults on obligations such as mortgages, taxes and other obligations.

- **Reevaluate Contracts**: The Bankruptcy Code allows a debtor to reject unfavorable contracts or unexpired leases.
Benefits of Chapter 11

Additional benefits:

• **Reduce Interest Rate**: Debtors can adjust certain interest rates of loans secured by commercial equipment, vehicle or certain real estate.

• **Sale**: A court may approve the sale of assets “free and clear” of claims, liens and interests. The secured creditors’ claims, liens and interests would attach solely to the sale proceeds. Generally, there is no successor liability for a purchaser.

• **“Cram Down”** - A plan can be confirmed even if a class of creditors votes against the plan of reorganization and they disagree with how they are treated in the plan.

• **“Discharge”**- After confirmation and payment under the terms of the plan, most but not all debts incurred prior to the bankruptcy filing are cancelled.
Benefits of Chapter 11

While operating, a Debtor has various options to restructure financial obligations and reorganize debts in Chapter 11:

• The Bankruptcy Code provides the Debtor a host of powers to remedy operational problems (i.e. reject executory contracts and unexpired leases)

• The Bankruptcy Code allows a small business time and ability to propose a plan that restructures the debtor’s debts and reorganizes the debtor’s business allowing it to continue to operate (through a confirmed or approved plan). Some plans can be a liquidating plan.

• Other “bankruptcy powers” include imposing a plan on dissenters, holding creditors at bay (through the automatic stay) while negotiating with creditors, and getting a clean deal in one wrapped up confirmation order enforceable by a federal bankruptcy judge that is binding on all state and federal courts once it is final and non-appealable.
The filing of bankruptcy creates an injunction staying all actions by creditors to recover on a claim against the debtor.

The purpose of the Automatic Stay: “Provide breathing space to the debtor, prevent harassment of the debtor, assure that all claims against the debtor will be brought in the sole forum of the bankruptcy court, and protect creditors as a class from the possibility that one or more creditors will obtain payment to the detriment of others.” Daff v. Good *(In re Swintek)*, 906 F.3d 1100, 1103 (9th Cir. 2018).

Great tool to use to keep creditors at bay while negotiating and “restructuring” the terms with creditors.
Key Benefit of Chapter 11: Asset Sales

- **Asset Sale**: Companies that lack the financial means or desire to undergo a reorganization have the option to quickly sell all or substantially all of their assets "free and clear" of liens, claims, and interests.

- **For Debtors**: Chapter 11 gives a company the ability to conduct an orderly sale, subject to overbids, to maximize return on the asset.

- **For Buyers**: Buyers are able to acquire assets free and clear of liens, claims and interests, and take advantage of procedures that enable sales to close quickly and obtain certain protections for finality of the sale.

**Marketing**

The company first markets its assets to attract potential buyers.

**The Initial Bid**

The company then selects an offer to set the opening bid for the auction - called the “stalking horse bid”.

**Bid Procedures**

After deciding on a “stalking horse bid,” the company asks the bankruptcy court to establish the bidding process, the auction, and selection of the successful bidder.

**Auction and Sale Hearing**

A public auction is held, where the winning bidder is chosen and announced, and the bankruptcy court then holds a hearing to approve the sale of the assets.
Typical Life of Chapter 11 Reorganization

**First Day Motions**
- Seek court approval of use of cash

**Critical Expenses**
- Pay wages and critical suppliers

**Cash**
- Continue cash management systems

**Reclamation**
- Establish procedure for reclamation claims

**Meeting/Hearing**
- Meeting of creditors and case status conference

**Committee**
- Appointment of creditors’ committee (inapplicable under Sub-Chapter V)

**Disclosures**
- Periodic financial and status reports

**Claims**
- Establish claims filing deadline; review claims & object

**Plan**
- Propose and confirm plan to reorganize or liquidate

**Discharge**
- Release of debts owed before confirmation
### Summary: Pros and Cons of Filing Chapter 11

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<tr>
<th>Pros:</th>
<th>Cons:</th>
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<td>• Debtor-in-possession remains in control of assets.</td>
<td>• Financial record keeping and extensive oversight and scrutiny of reporting requirements, which may ultimately benefit the company.</td>
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<td>• Reduce and discharge debts/obligations during the reorganization process.</td>
<td>• Restrictions on the compensation of debtor’s insiders/owners/officers.</td>
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<td>• Preserve the business name, goodwill and customer base.</td>
<td>• Court may reject a proposed reorganization plan if it determines it is not viable, compliant or realistic.</td>
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<td>• Continue to operate while paying off debts.</td>
<td>• Expensive.</td>
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<td>• Trigger the Automatic Stay which prevents creditors from taking any collection action against assets.</td>
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<tr>
<td>• Section 363 Asset Sales.</td>
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<td>• Restructure debts allowing for lower payments to be made over a longer period of time.</td>
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## Ch. 11 Small Business vs. Sub V*

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<tr>
<th>Comparison</th>
<th>Small Business Chapter 11</th>
<th>Sub V</th>
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<tbody>
<tr>
<td>Deadline to File and Confirm Plan</td>
<td>300 days to file Plan; 45 days after filing to confirm Plan</td>
<td>90 days to file Plan; No deadline to confirm Plan</td>
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<tr>
<td>U.S. Trustee Fees</td>
<td>Yes, paid quarterly</td>
<td>No</td>
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<td>Disclosure Statement, describing the Chapter 11 plan of reorganization</td>
<td>Yes</td>
<td>No, unless Court orders otherwise “for cause”; Plan must include a brief history of the business operations of the debtor</td>
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<td>Creditors Committee</td>
<td>Possible, but unlikely</td>
<td>No, but a Subchapter V Trustee is appointed</td>
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<td>Absolute Priority Rule (strict hierarchy of payment among claims of differing priorities)</td>
<td>Yes. To retain ownership of their business without paying creditors in full, (1) creditors must vote to accept the plan or (2) equity holder must pay “new value” to the business in a substantial amount.</td>
<td>No, management retains equity</td>
</tr>
<tr>
<td>Administrative Expenses (actual and necessary expenses incurred during the bankruptcy to preserve the estate)</td>
<td>Must be paid on Plan’s effective date</td>
<td>Can be extended over life of the Plan</td>
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* There are 2 sets of provisions in Chapter 11 for small businesses: Subchapter V and a small business Chapter 11 case. SBRA does not repeal existing provisions of a small business Chapter 11.
Other Bankruptcy Options

In addition to Chapter 11, there are other chapters that a business can utilize (reorganization or liquidation) if qualified:

• If the debtor is operating a sole proprietorship, a **Chapter 13** reorganization is an option. It has to have regular income whose unsecured debts are less than $419,275 and secured debts are less than $1,257,850.

• If the debtor is a family farmer or fisherman with regular annual income, a **Chapter 12** reorganization is an option.

• If the debtor simply wants to stop business operations and walk away without dissolving the business, a **Chapter 7 liquidation** is an option. There are no monetary or type of business restrictions.
Receiverships
Other Court Supervised Options

**Receivership [Cal Civ. Code § 564 et seq.]**

- A receivership is a process or solution that is put in place to protect the company.
- A receivership is a remedy available to preserve and protect assets for the benefit of creditors in the event a company defaults.
- A receiver is an agent of the court, not of any party to a litigation, acts as a neutral, and holds assets for the Court.
# Pros and Cons of Receivership

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<th>Pros</th>
<th>Cons</th>
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| - Provide many of the protections afforded in bankruptcy  
- Less administrative expenses (but can be expensive if the parties are litigious)  
- No Creditors’ Committee expense  
- No plan and disclosure statement | - Company loses control over operation of business to an independent third-party receiver  
- Ability to sell free and clear is not as defined as it is in the Bankruptcy Court  
- Receiver compensation not subject to a cap like a Trustee, but is an agreed hourly rate |
Out of Court Alternatives
Out of Court Options

• **Dissolution**
  • Terminate (dissolve) the company.

• **Out of Court Workouts**
  • Financial rescue of a company outside of formal bankruptcy and insolvency laws. Most chapter 11 practitioners can advise on out of Bankruptcy Court workouts.

• **Assignment for the Benefit of Creditors [Cal Civ. Code §§ 493.010 to 493.060]**
  • A California State law alternative to liquidation under Chapter 7 bankruptcy law. In an assignment, the business transfers all of its assets and liabilities to another individual or business (the assignee).
## Pros and Cons of Dissolution

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<th><strong>Cons</strong></th>
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<tr>
<td>• Creates finality for business closure.</td>
<td>• Costs money (compared with just disappearing)(but probably least expensive of the all out-of-court alternatives).</td>
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<td>• Attorney takes all collection calls for business.</td>
<td>• Have to be in good standing to dissolve.</td>
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<tr>
<td>• Stops running of business taxes and requirement of filing taxes returns.</td>
<td>• Not as protected as bankruptcy, ABC, receivership.</td>
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<tr>
<td>• Prevent minority owners/principals from suing majority.</td>
<td>• Principals can still be sued by creditors (although unlikely).</td>
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<td>• Puts creditors on notice that the business can no longer incur business debts.</td>
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<td>• Dissolved entity can distribute funds as part of its wind down (if not dissolved, and company gets money, company has to be reinstated to deposit cash).</td>
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## Pros and Cons of Workouts

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<th>Pros</th>
<th>Cons</th>
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</table>
| **Out of Court Workouts** | • Less administrative expense  
• Informal; flexible  
• Private and unsupervised  
• Avoid “stigma” of a bankruptcy filing  
• Fast  
• Liquidation of assets | • No automatic stay  
• Refusal by creditors to consent to workout arrangement  
• Rules to determine validity of creditor claims and set priorities of payments |
## Pros and Cons of ABC

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| **Assignment for the Benefit of Creditors (“ABC”)**  | • No automatic stay  
| • Simple transfer in trust  
| • Less cumbersome  
| • Less administrative expense  
| • Faster and flexible liquidation process  
| • Publicity minimized | • No Court approval of sale transaction  
| | • Certain types of contracts & leases cannot be assigned without the consent of the contracting or leasing party  
| | • Creditors may enforce contractual provisions that make an ABC prohibitive  
| | • No sale free and clear of liens |
Tips and Word of Caution
Tips: Gather Your Documents

If the business is going through financial distress, it is best to start gathering documents you will likely need:

- **Financial documents**
  - Federal and state tax returns (last 3 years)
  - Balance sheet, profit and loss statements, cash flow statements (last 3 years) and projections
  - Bank statements (last 3 years)

- **Corporate documents**
  - Proof of good standing, by-laws, minutes, corporate resolutions, stock ledgers
  - Operating agreements, member unit ledgers, partnership agreements

- **Insurance policies**
  - Including coverage of real property, personal property, business (D&O), and workers’ compensation

- **Ownership documents**
  - Certificates of title
  - Grant deeds

- **Licenses** (including any city permits and professional licenses)
- **Documents relating to lawsuits, liens, judgments, loans or notices from taxing authorities**
Word of Caution:
Be Prepared to Follow the Bankruptcy Code and Rules

• To ensure success of the bankruptcy case, the Debtor must do the following:
  • Maintain full disclosure to the Office of United States Trustee;
  • Continue to comply with court orders;
  • Continue to maintain accurate financial records;
  • Continue to update insurance and licensing; and
  • Assure that the parties are working towards a Plan of Reorganization.

• If the Debtor does not comply with the Bankruptcy Code and Rules:
  • A trustee may be appointed to take over management;
  • The case may be converted to Chapter 7;
  • The case may be dismissed; and
  • Managers and owners may be subject to lawsuits for breach of fiduciary duties.
Obtain Competent and Experienced Counsel

This presentation provides general information about the bankruptcy and other options for financial distressed businesses. Nothing contained herein is intended to be construed as legal, financial or other advice, to address any specific legal inquiry, nor to act as a substitute for independent legal research or obtaining separate legal advice regarding a specific legal situation.

It is always best to consult a competent and experienced bankruptcy attorney about your legal rights and responsibilities in your particular case.