

## READING

## THE BANKRUPTCY CODE

The laws for bankruptcy in the United States date back to the 1800s, with significant revisions most recently in 2005. The primary goals of the bankruptcy code include protection of the insolvent debtor, preservation of asset values for creditors, and the promotion of equality of asset distribution among creditors of the same class (generally two classes: secured and unsecured).

The following are nine “chapters” of the bankruptcy code that are of interest to business bankers, and several of them have become labels for different types of bankruptcy situations:

- Chapter 1-C General Provisions
- Chapter 3 Case Administration
- Chapter 5 Creditors, the Debtor, and the Estate
- Chapter 7 Liquidation
- Chapter 9 Adjustments of Debts of a Municipality
- Chapter 11 Reorganization
- Chapter 12 Family Farm Reorganization
- Chapter 13 Adjustments of Debts of an Individual with Regular Income
- Chapter 15 U.S. Trustees

The code’s provisions apply to commercial and consumer debtors of all sizes, from a large corporation to a sole proprietorship and to individual consumers. A business banker should understand all of the code’s provisions.

**Chapters 1, 3, 5, and 15**

Chapters 1, 3, 5, and 15 lay the ground rules for bankruptcy cases. The following are some ground rules or bankruptcy concepts of interest to lenders:

- **Notice** of the bankruptcy filing is sent to all known creditors of the debtor. This notice establishes an “automatic stay” based on the filing date of the bankruptcy
- **Automatic stay** is an injunction that stops lawsuits, foreclosures, garnishments and all collection activity against the debtor the moment a bankruptcy petition is filed
- **Proof of claim** is a written statement filed by a creditor on an official court form and describes the reason the debtor owes the creditor money
- **Priority claims** are unsecured claims that will get paid first, generally for administrative, legal and accounting fees for services requested by the court, as well as most federal or state taxes due
- **Preference period** applies to asset transfers or payments of money by the debtor to a creditor within a 90-day period prior to filing for bankruptcy. This period extends to one year if the credit was an insider, such as a relative of an individual debtor, or a director, officer or person in control of a business debtor. In general, a preference item gives the creditor more than the creditor would receive in a liquidation bankruptcy. Preference item transactions can be reversed by the court. So, a bank’s successful acquisition of additional collateral or extra loan payment during the preference period can be challenged by other creditors, and perhaps reversed
- **Fraudulent conveyances** are similar to preference items in that they can be reversed by the court, except that these transfers of assets or other actions taken by debtor are deliberately intended to hinder, delay, or defraud creditors

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- **Lift of stay** is where the court allows a secured creditor to recover collateral, even if the entire bankruptcy case has not been fully discharged. If the creditor does not achieve a liquidation price to fully cover the secured claim, any deficit cannot re-enter the bankruptcy as an unsecured claim
- **Cram down** is discussed and sometimes threatened by various parties in a reorganization when much time has elapsed and creditors are not reaching agreement on a plan. The name comes from how the court can “cram” an unfavorable plan “down” the throats of the creditors with the least priority, or those with secondary liens or unsecured claims

**Chapters 7, 11, 12, and 13**

Chapters 7, 11, 12, and 13, which cover liquidation, reorganization, family farm reorganization, and adjustments of debts of an individual with regular income, are of interest to lenders because they address specific bankruptcy situations

- **Chapter 7 liquidation** involves collecting all of a debtor’s non-exempt assets, converting the assets to cash, and distributing the cash among the creditors according to the type (generally secured or unsecured) and amount of their claims. The debtor is then discharged from indebtedness. Chapter 7 presents liquidation provisions. These bankruptcies may be voluntary (initiated by the debtor) or involuntary (initiated by the creditors). Exempt assets are applicable in individual cases only, and include all or a portion of the equity in the debtor’s primary residence, some or all of any “tools of the trade” necessary to make a living and other items defined by state laws. In Chapter 7 cases, the court appoints a trustee to administer the liquidation of collateral and distribute proceeds, net of costs, among creditors. To participate in the distribution of proceeds, the bank files a proof of claim
- **Chapter 11 reorganization** usually involves the court appointing a trustee and a committee of creditors to work with the debtor in rehabilitating the business. During the interim, the debtor is allowed to retain possession of the business and to operate it under the supervision of the court. Few Chapter 11 cases succeed. Thus, the business banker should be prepared to convert the bankruptcy filing to Chapter 7 liquidation
- **Chapter 12 family farm reorganization**—When Chapter 12 of the bankruptcy code became law in November 1986, it imposed new restrictions on banks and other creditors liquidating collateral when the borrower is a “family farmer” or “family fisherman” as defined by the code. Chapter 12 bankruptcy applies to individuals or family corporations engaged in farming with aggregate debts of not more than \$1.5 million, of which at least 80 percent must be related to farming or fishing operations. The individuals also must have received more than 50 percent of their gross income from the farming or fishing operation. To file for Chapter 12 bankruptcy, a borrower must demonstrate only cash insolvency, which is defined as the inability to meet financial obligations as they mature
- **Chapter 13 adjustments of debts of an individual with regular income**—In Chapter 13 bankruptcy cases, the court may modify the rights of secured creditors and allow debtors to retain some or all their assets and repay debt over time according to a “best effort” standard, usually three to five years. The definition of an “individual” includes sole proprietorships and business professionals

Regardless of a Chapter 7, 11, 12, or 13 case, when a business files for bankruptcy, an automatic stay goes into effect. A bank does have some legal remedies, but, in general, they are limited. A bank can seek relief from an automatic stay and object to reorganization or repayment plans. However, implicit in these remedies are additional court expenses and the likelihood of a large loan loss.

A bankruptcy filing can have other pitfalls as well. The bankruptcy code stipulates, in certain instances, that a borrower is presumed to be insolvent 90 days prior to bankruptcy, and any transfer of assets to a creditor during the 90-day period may be challenged on the grounds that the creditor received preference over other creditors. Transferring assets includes paying scheduled obligations or setting-off cash collateral. If a preference has occurred, a trustee can compel the creditor to turn over its collateral to the bankruptcy trustee, which would then be sold and its proceeds distributed according to the bankruptcy court’s decisions.

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In short, bankruptcy usually is a no-win situation for the bank. Once a business files for bankruptcy, it becomes a matter for bank counsel, with the business banker's involvement and responsibilities usually limited. So, a business banker's primary job is to avoid having a problem loan progress to bankruptcy.

Nevertheless, a business banker should not allow a borrower to gain leverage in a problem loan situation by threatening to file a bankruptcy petition.

**Six reasons not to cave in to a threat of bankruptcy**

1. Outside of bankruptcy, there are few rules; but inside bankruptcy, there are established rules, many of which work in the bank's favor as (usually) a secured creditor.
2. You even have the added oversight of a court, where some proceedings are under oath, for the added consequence of perjury if the borrower lies or misrepresents.
3. The court will keep you apprised of the actions taken by other creditors via copies of motions and requests they make, and you will have a chance (usually) to object.
4. You can influence the bankruptcy decision by the borrower by diligently using other information such as currency transaction reports (CTRs), shifting of assets, new loans listed on credit reports, etc. The court will want to know the status of all assets and major movements of cash during the period leading up to the bankruptcy filing.
5. Similarly, bankruptcy courts typically demand and get extensive reporting of assets—often beyond what the bank initially obtained to make the loan; some debtors will want to avoid this additional disclosure, plus, the bankruptcy process often is more demanding and complex than most businesses imagine.
6. The court will oversee and enforce compliance with ultimate disposition of the case. Outside of bankruptcy, non-compliance often leads to a repeat of the problem loan.