

Business Owner Bankruptcy: Opportunities and Threats

A White Paper Presented by



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A SWOT analysis looks at strengths, weaknesses, opportunities and threats. It's an important analytical capacity to have in our competitive economy, where the line between business success and failure is razor-thin. For small-business owners who fall on the wrong side of the line, threats may seem more abundant than opportunities – but opportunities are also undeniably there.

THREATS

The recognition that current cash flow will never pay all the mounting debts is scary because of the resulting threats.

- ✓ If you personally guaranteed loans to your business, your own wealth might be at risk.
- ✓ Certain creditors, like the IRS, might be able to file liens against your home or seek to levy on a personal bank account.

OPPORTUNITIES

If your business can't pay its mountain of bills, what opportunities exist to resolve issues with your creditors?

- ✓ Direct negotiation is one; bankruptcy is another.
- ✓ If the answer is bankruptcy, what type of bankruptcy filing would be the best way to protect your financial future?

The Role and Scope of Small Businesses in the U.S.

Small businesses perform tremendous services for their customers and are a key driver of the U.S. economy. Because of their small size, they are often much more nimble in filling market niches than bigger, less-responsive corporations.

How small is “small”?

A common definition uses number of employees.

Affordable Care Act (ACA):

< 50 

Distinguishes between small employers, with generally 50 or fewer full-time employees, and large employers, which generally have more than 50 full-time employees.

U.S. Small Business Administration (SBA):

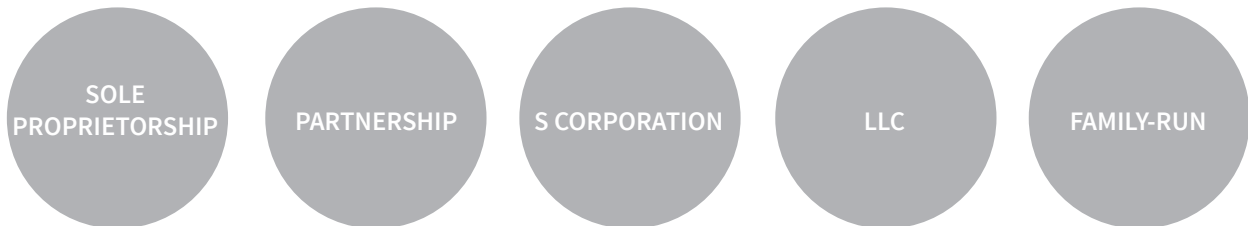
< 500 

Uses a broader definition of small business. The SBA considers a business to be small if it is independent and has fewer than 500 employees.

Obviously, 500 is a lot more than 50. But here is the truly telling statistic: The SBA has found that 80 percent of small businesses have no employees.¹ According to the most recent data, that's 23 million businesses.

Legal Form and Funding

Small businesses have various structures. The legal form may be a sole proprietorship, partnership, S corporation or LLC. Many are family-run, including the proverbial “mom and pop.”



In these closely held businesses, the source of capital is frequently personal savings, and business loans from a local bank or credit union may require that an owner provide personal assets as collateral.

In many respects, then, a small business and its owner are essentially the same. The owner may face personal liability for business debt.

Indeed, even if a business is incorporated, an owner may be on the hook for the company's debt under certain circumstances. This could occur if the owner made a personal guarantee to cover the debt or agreed to put up personal assets — such as a house — to obtain a loan for the business.

When Cash Flow Dries Up

Precisely because of their smaller size, small businesses are more vulnerable to cash flow issues than larger ones. Poor execution, flawed business models, inroads by competitors and changes in consumer preferences all pose threats to businesses.

Financial mismanagement or wrongdoing by a bookkeeper or any other trusted employee can also be devastating, as can a serious illness for a sole proprietor.

Cumulatively, these factors take a toll on business survival.

Nationally, about 80 percent of the businesses started in 2014 made it into 2015. The survival rate also decreases over time. In the past decade, only about half of new businesses survived for five or more years.



1 in 5 businesses didn't make it from 2014 to 2015.

RESTAURANT
BANKRUPTCY
FILINGS HAVE
BEEN ON THE
RISE



These survival rates vary greatly by industry and region of the country. Restaurants, for example, have been struggling so much in recent years that restaurateurs and industry observers have called it a “restaurant recession.”² This is reflected in an increase in restaurant bankruptcy filings.

Regardless of the industry, when a small business starts experiencing severe financial problems, it's time to consider debt relief options — especially since the owner's personal assets may be exposed to collection actions if something isn't done.

Considering Bankruptcy Alternatives

If a business is struggling to pay creditors, it can be possible to negotiate directly with those creditors without filing bankruptcy. Under a workout, creditors agree to relax or adjust repayment terms.

This makes sense only if there is a feasible path to turn the business around.³ All creditors must agree, not merely some of them, and there must be enough cash flow or additional financing to pay at least some, if not all, of the delinquent debt.

Another possibility would be to find a replacement lender who would then pay off existing creditors. This is not a common scenario, but in certain industries (such as oil and gas), private equity firms or investors may be able to provide such services for troubled businesses.

What Type of Bankruptcy?

If a workout with creditors in lieu of bankruptcy is not feasible, a business owner can obtain debt relief from a bankruptcy filing. But which type of bankruptcy should the owner pursue?

Bankruptcy is never a one-size-fits-all proposition. There are different paths based on different chapters of the Bankruptcy Code.

The most common are:

Chapter 7

So-called *liquidation* bankruptcy discharges many types of unsecured debts for individuals, but also makes nonexempt property available to pay creditors.

Chapter 11

A *reorganization* bankruptcy involves a business or individual filing a plan to keep a business going while paying back creditors over a period of time.⁴

Chapter 13

A *wage earner's* bankruptcy involves adjusting debts for individuals with regular income in exchange for a debtor's agreement to a repayment plan.

- ▶ For business owners, the decision is generally between Chapter 7 and Chapter 11.
- ▶ Chapter 13 repayment plans typically lasts between three and five years.
- ▶ Chapter 13 is a possibility if you run an unincorporated business. Regular income is required for a repayment plan. However, this may not be available if you have put every last nickel into the business.

Chapter 7 vs. Chapter 11

In choosing between Chapter 7 and Chapter 11, it's important to determine the viability of the business. If it is possible to make the business profitable again through a reorganization, Chapter 11 may be worth considering.

Chapter 11 isn't only for big companies going through a restructuring. It could allow you to use future earnings to pay back creditors through a repayment plan similar to Chapter 13.

Business owners who are interested in trying to keep a business going through reorganization should talk with a knowledgeable attorney about their specific situation.

Chapter 11 is expensive to administer, however, because it involves ongoing supervision by a bankruptcy trustee. Determining whether you are eligible for this type of debt reorganization can also be fairly complicated. The Bankruptcy Code contains a detailed definition of the criteria for a "small-business debtor."⁵

Congress enacted the definition in 2005 as part of its last major overhaul of the Bankruptcy Code. Regarding small businesses, Congress had become concerned that it was too difficult to have a reorganization plan confirmed under Chapter 11.⁶

The Benefits (and Downsides) of Chapter 7

If the business isn't worth saving – or if reorganization under Chapter 11 isn't allowed – you can file bankruptcy under Chapter 7. This can get rid of many types of personal and business debt that are unsecured (i.e., debt not secured by collateral).



The fresh start of Chapter 7 discharges debts without impacting future earnings. It means you can take a new job or start another business without having to repay past debts that have been discharged.

The downside of Chapter 7, however, is that you have to use all assets beyond a certain exemption level to pay debts incurred before the bankruptcy filing.

Chapter 7 will also affect your credit and the ability to obtain new financing. But if you have been underwater for awhile, your credit may already have been harmed. By discharging so much unsecured debt, a bankruptcy filing can be a useful step on the path to starting over.

Which Debts Cannot Be Discharged?

TYPES OF DEBTS THAT CHAPTER 7 IS NOT ABLE TO DISCHARGE:

Child or spousal support obligations

Money or services obtained by fraud

Student loans



And then there's tax debt. Small-business owners who file for bankruptcy often have tax issues. State or federal unemployment tax may not have been paid, as well as Social Security. Bankruptcy generally can't get rid of those debts or state sales tax obligations.

For personal taxes that meet certain criteria, however, a bankruptcy filing effectively wipes out tax debt.⁷

Tennessee Bankruptcy Exemptions

Chapter 7 bankruptcy does not require a business owner to give up everything to get rid of dischargeable debts. Under a system of exemptions, the law allows debtors to keep items up to a certain amount.

Though bankruptcy is primarily federal law, that law allows states to opt out of the federal exemption system. Some states allow debtors to choose between a state system of exemptions and a federal system. Other states allow only the state system. In Tennessee, only the state system is applicable.

TENNESSEE LEADS THE NATION IN BANKRUPTCY FILINGS.

Exemptions and other bankruptcy protections are especially important in Tennessee because Tennessee leads the nation in bankruptcy filings. In 2015, there were 36,052 filings in Tennessee — more than twice the national average.⁸

Why is that? It's because Tennessee has laws that tend to favor creditors, much like its neighboring states Georgia and Missouri. Other than bankruptcy, there are very few legal protections for debtors against creditors seeking to garnish wages or foreclose on a house.

An Attorney Who Has Shaped Tennessee Bankruptcy Law

Given these creditor-friendly laws, your choice of bankruptcy attorney is particularly important in Tennessee. Nashville attorney Steven L. Lefkovtiz has shaped Tennessee law and continues to fight to help Tennesseans achieve debt relief every day.



The Homestead Exemption

In Tennessee, the exemption that protects a principal residence (homestead) from creditors is only \$5,000 for individuals. But the statute allows an enhanced exemption amount of \$25,000 for someone who has custody of one or more minor children.

In a case that eventually reached the Tennessee Supreme Court,⁹ a married couple with a minor child filed a joint bankruptcy petition and sought to claim an exemption of \$50,000 on their house. The bankruptcy trustee argued that both parents could not count the same child to get the full benefit of the homestead exemption.

The Tennessee Supreme Court rejected the trustee's attempted hair-splitting and accepted Mr. Lefkowitz's argument that each spouse was entitled to a \$25,000 homestead exemption, for a total of \$50,000.

Alimony Arrears

As we noted earlier, alimony is generally not dischargeable in a Chapter 7 bankruptcy. But what if a man is in arrears on an alimony award and one of the former wife's creditors tries to collect from the former husband?

In an important and procedurally complex case posing this question, Steven Lefkowitz represented the former wife. After she filed bankruptcy, a company that hadn't been paid for the furniture it sold her brought a garnishment lien against her former husband.

Mr. Lefkowitz successfully argued that the alimony exemption under Tennessee law was applicable even though it was raised in chancery court rather than bankruptcy court.¹⁰

Fraudulent and Other Questionable Conduct

The courts have long held that a debtor should not be allowed to obtain money, goods or services from a seller by fraud or other dishonest means and then seek to avoid payment by filing bankruptcy. To get the benefit of debt relief through bankruptcy, the filing must be in good faith.

But what does good faith mean? In many cases, a debtor's pre-filing conduct may have been questionable but not outright dishonest. Is bankruptcy relief still available?

Steven Lefkovitz brought this issue all the way to the 6th U.S. Circuit Court of Appeals. On a debtor's behalf, he successfully argued that bankruptcy courts in Tennessee must look to the totality of the circumstances in deciding whether to confirm a bankruptcy filing when there is questionable preplan conduct.¹¹ This requires a consideration of multiple factors on a case-by-case basis.



This precedent is extremely important for many business owners who file for bankruptcy because questionable conduct is commonly cited by creditors when a business gets in dire financial straits. Though such conduct may not be fraudulent, it may involve shades of gray regarding statements made to a lender or supplier as to the viability of the business.



In such cases, *In Oloreeh-baah* stands for the proposition that the bankruptcy court cannot refuse to confirm a bankruptcy filing merely because of vague concern about questionable conduct by the debtor. Rather, the court must weigh the totality of the circumstances in determining whether the filing was in good faith.

Using Bankruptcy Effectively: An Opportunity

There are lots of specific circumstances that can affect decisions about bankruptcy for business owners. From sorting out whose name the assets are in to addressing any financial wrongdoing, it can be messy. So can deciding whether assets should be liquidated or whether the business should be sold and reopened under another name.

But it isn't only high rollers in Chapter 11 reorganization proceedings who can benefit from bankruptcy. If your business is no longer viable, you have an opportunity to use an individual bankruptcy filing under Chapter 7 to get unsecured business and personal debt discharged.



To be sure, filing bankruptcy doesn't flip a magic switch that solves all financial problems; some debt may not be dischargeable and it will take time to rebuild your credit. But bankruptcy can allow you to stop beating yourself into the ground and start moving forward again.

Starting a New Chapter

Moving forward is what a struggling young filmmaker named Walt Disney did when he was starting out. Before he moved to Hollywood and made it big, Disney was a small businessman in Kansas City who got cheated by a company he hired to distribute his early films. Unable to meet his expenses, he filed a business bankruptcy and turned the page on that chapter of his life.

Offering second chances like this is a key goal of our bankruptcy laws. To make the system work, however, you have to make the right moves. A knowledgeable attorney can strategize with you on the best way to avoid the threats and make use of the opportunities.

At Lefkovitz & Lefkovitz in Nashville, that is what we do. We are known for guiding small-business owners toward solutions that work under the bankruptcy laws as applied in Tennessee.

SOURCES

¹ U.S. Small Business Administration, Office of Advocacy, Frequently Asked Questions, published in June 2016.

² “Restaurants Have Pain on the Menu,” Bloomberg (Shelly Banjo), Oct. 21, 2016.

³ Entrepreneur.com, “Alternatives to Declaring Business Bankruptcy,” Mar. 1, 2008.

⁴ USCourts.gov, “Chapter 11 — Bankruptcy Basics.”

⁵ 11 U.S.C. § 101(51D).

⁶ 21 Am. Bank. Inst. L. Rev. 55 (Summer 2013).

⁷ IRS.gov, “Bankruptcy.”

⁸ “Why is Tennessee’s Bankruptcy Rate So High?” Memphis Daily News, May 7, 2016.

⁹ In re Hogue, 286 SW2d 890 (Tenn. 2009).

¹⁰ Storey v. Bradford Furniture Co., 910 S.W.2d 857 (Tenn. 1995).

¹¹ In re Okoreeh-baah, 836 F.2d 1020 (6th Cir., 1988).

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