

SMALL BUSINESS BRIEF

**STRENGTHENING FEDERAL BANKRUPTCY LAWS:
IMPLICATIONS FOR SMALL BUSINESSES**

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ABSTRACT

Significant changes in the American bankruptcy laws have recently been passed by both Houses of Congress. Although the terrorist attacks of September 11, 2001 have temporarily delayed final approval by President Bush, he has indicated his endorsement of these modifications to the law, and eventual realization is expected. While most of the publicity regarding these proposed changes has focused on their impact upon individuals and their ability to erase personal debts, small businesses are also extensively impacted by these changes. This article first explains bankruptcy law in general as it affects small companies, then discusses the expected changes in the law and their small business implications, and finally suggests appropriate responses for small business owners, managers and their consultants.

INTRODUCTION

Federal bankruptcy law preempts state laws, and therefore, Title 11 of the United States Code governs bankruptcy proceedings in all states. In March of 2001, both the U.S. Senate and House of Representatives each passed a significant set of revisions in the bankruptcy code which would have major impact upon America's small businesses. In July of that year, a joint House-Senate committee was formed to work out the minor differences in the two bills so that final legislation could be submitted to President Bush for signing. While the President indicated his endorsement of the proposed changes in the bankruptcy laws, and quick implementation of the changes had been expected, the terrorist attacks of September 11, 2001 placed many federal legislative initiatives on hold, including this one. Therefore, while final passage of this legislation is expected, the timing is currently unclear.

Most of the focus on these expected modifications to the bankruptcy code has centered on how it will become more difficult for people to erase their debts. More than 1.2 million Americans have turned to bankruptcy in each of the past few years (American Bankruptcy Institute, 2002). These proposed changes in the law will end individuals' ability to use the bankruptcy system to wipe out credit card bills and other loans that are not secured by personal assets, such as homes and automobiles. Much of the impetus for these changes in the law came from intense lobbying to both parties from the credit industry, especially credit card

companies, and the votes in both Houses of Congress were largely bipartisan. Consumer groups have strongly criticized the bills.

What has gone largely unnoticed is that the same bankruptcy laws that govern individuals also govern small businesses and their owners, regardless of whether the small business is organized as a sole proprietorship, partnership, limited liability company (LLC) or corporation. Although the number of business bankruptcies each year (about 35,000 in 2000) is far less than the number of personal bankruptcies, the option of bankruptcy is something a small business owner or manager should understand, and these proposed changes in the bankruptcy law should be of particular interest to small business owners and managers, and to those who assist them. This article first explains bankruptcy law in general as it affects small companies, then discusses the proposed changes in the law and their small business implications, and finally suggests appropriate responses for small business owners, managers and their consultants.

BANKRUPTCY LAW

The purpose of the American bankruptcy law is to provide benefits to both debtors and creditors in a bankruptcy situation. In other words, the law is designed to give relief to debtors from debts they can not pay, and at the same time insure that creditors get paid from whatever assets of the debtor are reasonably available (Moran Law Group, 2002). Bankruptcy proceedings are categorized into "Chapters" which govern different situations in a bankruptcy proceeding. *Chapter 7* is the most common form of bankruptcy and is available to both individuals and all types of businesses. It is a liquidation proceeding in which most of the debtor's assets are sold by a trustee, with the proceeds then distributed to the creditors. However, most earnings of the debtor *after* the case is begun are exempt from the creditors. Thus, Chapter 7 within the current bankruptcy law is popular with individuals (rather than businesses) because it allows these individuals to declare bankruptcy, go through the procedure, and then largely make a "fresh start" to their lives. For businesses, Chapter 7 may be a less desirable option, because it generally forces the liquidation of the company.

But certain other forms of bankruptcy may be employed instead of Chapter 7 liquidation. *Chapter 13* is a repayment plan for individuals (not businesses) in which the debtor keeps his or her property and makes regular payments to a trustee, who then pays the creditors over a period of time. In Chapter 13 some personal income received after the filing of bankruptcy is also subject to payment to creditors.

Primarily for corporations, limited liability companies and some partnerships, *Chapter 11* allows a business to remain in control of its assets and maintain operations under the supervision of the bankruptcy court, often with considerable flexibility in the details and schedule of the payments to the company's creditors. It is the usual choice of businesses that wish to restructure their debt and continue as an ongoing entity. Chapter 11 is central to the issues raised in this article.

See Figure 1 for a summary of the fundamentals of Chapters 7, 11 and 13.

THE CHANGES IN THE LAW

Most of the publicity about the changes approved by Congress focuses on the impact upon *individuals*. Under the proposed revisions in the law, it would become harder for individuals

to erase debts under Chapter 7, and it would force more people to file under Chapter 13, thus requiring them to repay a portion of their debts from *future* income over a number of years (Day, 2001; Shenon, 2001).

For businesses, and small businesses in particular, the revised law would give faltering firms less time to settle their debts and reorganize. And some small business owners would be required to pay more of their personal debts to creditors over a longer period of time.

FIGURE 1
Federal Bankruptcy Code
Chapters 7, 11 & 13

Chapter 7	Chapter 11	Chapter 13
<ul style="list-style-type: none"> * The most common form of bankruptcy * Available to individuals, married couples, corporations, limited liability companies and partnerships 	<ul style="list-style-type: none"> * Less common * Generally for corporations, limited liability companies and some partnerships 	<ul style="list-style-type: none"> * Less common * For individuals with regular income (including sole proprietorships and general partners of small businesses)
<ul style="list-style-type: none"> * A liquidation proceeding 	<ul style="list-style-type: none"> * A reorganization proceeding 	<ul style="list-style-type: none"> * A repayment plan for individuals
<ul style="list-style-type: none"> * The debtor's non-exempt assets are sold by the trustee * The sale proceeds are distributed to the creditors according to priorities established in the code * Individual debtors get a discharge within 4-6 months of filing the case * Most of the debtor's earnings after the case is begun are beyond the reach of creditors 	<ul style="list-style-type: none"> * The debtor usually retains possession of assets and continues to operate the business under the supervision of the court * The debtor proposes a plan of reorganization, which must be accepted by the creditors and the court * Creditors may be paid from future earnings, some assets, and future re-capitalization 	<ul style="list-style-type: none"> * The debtor keeps property and makes regular payments to the trustee out of future income * The trustee pays the creditors over time * The debtor is protected from collection action during the case

Businesses that are taxable legal entities (corporations, limited liability companies and limited partnerships) would be defined as "small businesses" under the bankruptcy law if they have debts of \$3 million or less. Such companies accounted for more than 80 percent of the nine thousand businesses that filed for bankruptcy under Chapter 11 in 2000. The new law would set a strict timetable for small companies to reorganize; for most small businesses the time limit would be 175 days within Chapter 11. After that time limit, such companies would be required to move into Chapter 7, where they would be required to liquidate their assets (Atlas, 2001). Thus, the basic impact of the proposed changes in the law would be to force many small businesses into closure and liquidation sooner than under the current bankruptcy law.

For small businesses that are legally organized as sole proprietorships or general partnerships, the company's income and debts pass directly to the owner or owners. Thus the company's income is taxed as personal income to the owner(s) rather than as the business' income; and similarly the company's debt is considered the personal debt of the owner(s). Thus, any bankruptcy derived from the business' failure would be a *personal* bankruptcy and not a *business* bankruptcy. As explained above, for these types of small businesses, the new law would more frequently force the small business owner(s) into Chapter 13 (with future income subject to debt repayment) rather than into Chapter 7 bankruptcy. Thus, for small businesses with these types of legal structure (often the smallest of small businesses), the impact of the new law would be to reduce the financial protection of bankruptcy for the owners. Thus, for *all* small businesses, regardless of the legal form of ownership, their creditors will be more strongly protected under a revised bankruptcy law.

As with most laws, there are exceptions to the above generalizations regarding movement from Chapter 11 to 7, and from Chapter 7 to 13. While this discussion covers most typical business situations, a more complex explanation is beyond the appropriate scope of this article, and business owners and managers should seek legal or other expert assistance to determine their specific situation within the law.

With regard to *business* bankruptcies, proponents of the changes say they will preserve the rights of creditors, by speeding up the payment of debts. Furthermore, it is argued that some bankrupt businesses should not be allowed to linger on, but rather should be liquidated sooner than under the current law.

But opponents to the proposed changes in the law are concerned not only for the small businesses that would be affected, but are also concerned about the employees of these companies. While 1.2 million individuals filed for bankruptcy in 2000, the number of *employees* in companies filing for bankruptcy was estimated at two million. Thus the small business implications of the proposed changes to the law would be greater than has been acknowledged. Not only may many small firms that might previously been able to reorganize under Chapter 11 now be forced to liquidate under Chapter 7, but many more employees of small businesses may become unemployed because of these proposed changes. With the American economy currently weak, and the prospects and timing of an economic turnaround unclear, such an increase in unemployment would be especially harmful.

As for *personal* bankruptcies (for sole proprietorships and general partnerships), proponents of the changes have largely ignored the fact that a *business* may be involved. Instead, the arguments deal with improving protection of creditors, as discussed earlier in this article. Issues of business continuity and the protection of employees are peripheral at best.

NATIONAL BANKRUPTCY REVIEW COMMISSION REPORT

The National Bankruptcy Review Commission was an independent commission appointed by the President, Congress and the Chief Justice in 1994 to study issues relating to the Bankruptcy Code and to make recommendations for change. Its report, submitted in 1997, stressed the importance of Chapter 11 for small businesses, and cited this chapter as a tool for saving jobs and protecting creditors. For financially troubled small firms that have the potential for turnaround, the Commission's recommendations are thus in opposition to the proposed new bankruptcy code (National Bankruptcy Review Commission, 2001). As discussed above, the focus was on *individuals*, and not *businesses*, when Congress developed these modifications to the law in response to intensive lobbying.

IMPLICATIONS

For some small business owners and managers, and for those who consult to them, a number of implications arise from these proposed legislative changes. Obviously, it is those small companies which are having financial troubles that should be most interested in these issues.

Such troubled companies fall into two groups: those that have the potential for successful reorganization and those that do not. As the National Bankruptcy Review Commission pointed out, only a minority of small businesses currently in Chapter 11 have a reasonable chance of succeeding as a viable enterprise. The majority of Chapter 11 firms have no realistic prospect of revitalization (National Bankruptcy Review Commission, 2001).

For the former group of mortally weak companies, Chapter 11 will benefit their employees (by keeping them employed) but only prolong the firms' unsuccessful business activities. For the latter group of salvageable businesses, the benefits of Chapter 11 are clearly greater, providing these firms with extra time that may be needed for a successful turnaround and reorganization.

In either case, financially troubled companies should closely review these proposed bankruptcy law changes and the status of the legislation, as they apply to small businesses. Although the advice of an attorney or other expert may be best, the text of the proposed new law is readily available on the internet (at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:s.00420> for the Senate version and at <http://thomas.loc.gov/cgi-bin/bdquery/z?d107:hr00333> for the House version), and much useful information is available in small business assistance books and on the internet (for example, at <http://www.moranlaw.net>). Understanding the law, and especially the differences between Chapters 7, 11 and 13, can be of great value to a small business owner or manager with financial problems and contemplating the filing of bankruptcy.

In general, such owners and managers should consider the decision to file for bankruptcy more carefully in the future, as the impact of bankruptcy may become greater. In particular, an owner or manager of a corporation, limited liability company or limited partnership in such a situation should fully understand the advantages and disadvantages of these two alternative bankruptcy Chapters 7 and 11, in terms of their company's specific situation. What is the realistic chance of viable reorganization? Would it be better to proceed with liquidation quickly? How important is the prolongation of the employment of the firm's workers? Such questions should be carefully answered prior to any bankruptcy decision.

Owners of financially troubled sole proprietorships and general partnerships should similarly understand the proposed *personal* bankruptcy law changes (Chapters 7 and 13), and then relate these changes to the implications for their small businesses and for themselves as individuals. If future income to the individual owner(s), and not just past business income, may be subject to creditors' claims, the decision to file for bankruptcy becomes an even more serious one. And here too the issue of the firms' employees becomes a matter of consideration within the broader decision.

Finally, it should be noted that these modifications to the bankruptcy code would not become effective until 180 days after the enactment of the law. Thus, if and when this legislation is finalized and signed into law, the owner or manager of a small business contemplating bankruptcy will still have another half-year in which to reach a decision and initiate filing for bankruptcy prior to the deadline, if the current provisions of the code seem to be more beneficial to the company and/or the owners than the new provisions would be. Yet the decision to file for bankruptcy should not be based primarily on a time factor criterion. Certainly expert legal advice would be appropriate in this situation.

While this article can provide small business owners, managers and consultants with questions and issues to consider with regard to these proposed changes in the bankruptcy law, it would be inappropriate to suggest answers to these questions or to recommend specific courses of action. As each small business' situation is at least somewhat unique, the advice of an attorney or other expert advisor should be sought.

CONCLUSIONS

The impact and implications of the proposed changes in the United States bankruptcy code upon small businesses have been largely ignored, as the focus has centered on individual personal bankruptcy. This article has summarized general aspects of bankruptcy law, has highlighted the small business issues raised by the proposed changes in the law, and has presented some appropriate matters to be considered by owners and managers of small businesses that may be affected. All small business owners and managers, and those who assist and consult to them, are advised to make themselves aware of these proposed changes to the law.

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