

Bankruptcy 101 FAQs

By Tamar Dolcourt,
Senior Counsel, Foley & Lardner LLP

1. What is bankruptcy?

Bankruptcy is a process in federal court by which the party that files a bankruptcy (the “debtor”) can obtain a “fresh start” and have his debts restructured or eliminated. The federal Bankruptcy Code and Federal Rules of Bankruptcy Procedure govern these cases.

2. What are the types of bankruptcies?

Chapter 7 (for individuals or companies): A liquidation of any assets of the debtor owned before the bankruptcy filing, with proceeds paid to creditors in accordance with the priority scheme of the Bankruptcy Code. Companies in Chapter 7 cease to operate. For individuals, debts that are not paid are discharged and the individual is no longer liable on them.

Chapter 9 (municipal bankruptcies): A process by which municipalities (but not states) may adjust their debts, but not liquidate.

Chapter 11 (generally for companies and individuals in rare cases): debtors can restructure their debts and amounts owed to creditors and either reorganize, sell their assets, or liquidate. Debtors pay their obligations pursuant to a plan over a certain period of time.

Chapter 12 (for family farmers and fisherman): similar to Chapter 13 discussed below.

Chapter 13 (reorganization for individuals): individuals pledge to use a certain portion of their monthly income to repay their debts over 3-5 years, and obtain a discharge once those payments are complete.

3. How are debts paid in bankruptcy?

The priority payment scheme of the Bankruptcy Code requires that debts be paid in the following order, and that no amounts can be paid to a class below the one above it unless the higher priority class is paid in full:

- a. Secured debts (those where the creditor has a lien on the debtor's assets)
- b. Administrative claims (unsecured claims for goods and services which are provided to the debtor during the bankruptcy case, these claims must be paid by the end of the bankruptcy case in full)
- c. Priority unsecured claims (unsecured claims arising before the case was filed in certain categories that have been given legislative priority, including wages and other employment benefits earned within the 180 days before the bankruptcy filing, up to \$13,650)
- d. General unsecured claims (non-priority unsecured claims, usually trade creditors like vendors)
- e. Equity holders (those who own the company, generally there is nothing left for these parties)

4. What happens when a company files bankruptcy?

- a. The automatic stay arises upon filing the bankruptcy case. The automatic stay halts any action against a debtor or its property. For example, pending court cases are stayed, and new cases may not be filed, nor may other actions to collect debts be taken. Almost any action which can impact the debtor's operation in bankruptcy or its property must be stopped. Parties who take such actions risk sanctions and being ordered to pay the debtor's attorneys' fees.
- b. In addition, once a company files bankruptcy, it cannot transfer any of its property other than in the ordinary course of business without court approval.
- c. Debtors are required to file lists of all of their creditors and notify those creditors and other parties in interest (including parties with whom they have contracts) of the bankruptcy case.

5. What happens to contracts in bankruptcy?

If the company is operating, and the contract is "executory" (meaning that both sides still have obligations to be performed), the non-debtor party must continue to perform the contract according to its terms until the debtor decides how it will treat the contract. The debtor has until the time the plan is confirmed to decide how to treat the contract, other than for certain real estate leases. While the non-debtor party must continue to meet its obligations, amounts owed for services performed or goods sold to debtors after the bankruptcy is filed must be paid as administrative claims (higher priority). For example, if a party has an employment contract with a debtor, he or she must continue to work but the wages earned after the bankruptcy is filed will be paid in full. However, if a party refuses to perform a contract, the debtor may bring an action to force the party to do so.

6. How do creditors get paid for amounts owed to them that arose before bankruptcy?

Once a bankruptcy is filed, the court will establish a bar date, a deadline by which all claims must be filed. All creditors should be given notice of the bar date as part of the case. It is very important that all creditors file a claim by the deadline because failure to do so waives all of the creditor's right to collect any amount on the claim.

The debtors are entitled to object to any filed proofs of claim, so when a claim is filed, it is important to include all of the required information and the backup documentation that supports the claim. The proof of claim form itself is very straightforward. If a party receives an objection to its proof of claim, it must respond to the objection or the claim will be denied.

Claims for wages or other priority claims can be indicated on the claim form. Priority unsecured claims up to their maximum amount are paid at a higher priority than general unsecured claims.

7. How does a bankruptcy case end?

- a. Sale of Assets: a debtor can sell its assets in bankruptcy, and the party buying the assets will obtain them free and clear of any claims. One valuable asset that debtors often include in asset sales are their executory contracts. Debtors are entitled to assume and assign these contracts to a new buyer, and that buyer must accept all of the terms of the contract. Furthermore, the debtor or the buyer must "cure" the contract by paying any amounts that are owed under the contract in full, including those that arose before the bankruptcy filed. For example, if there is an employment agreement that a buyer wishes to assume, any unpaid amounts for wages or deferred compensation would have to be paid before the contract could be assigned. All creditors and any parties to contracts proposed to be assumed and assigned receive notice of the sale and are entitled to object to the sale.
- b. Reorganization: the debtor can prepare a plan of reorganization that allows it to restructure its debts and shed certain obligations, such as claims that arose before the bankruptcy. The debtor must provide notice of its plan, and how it will repay its debts (generally not in full) and allow all creditors to vote on the plan.
- c. Liquidation: a debtor may find itself unable to sell its assets or reorganize, and will therefore be required to liquidate its assets, pay what it can, and close its doors. A plan of liquidation will also require a vote of the creditors. It is also common for a debtor to liquidate its remaining assets after an asset sale.

8. Final tips

- a. In an ideal world, it is best to retain an attorney if you are notified that a company you have a relationship with has filed for bankruptcy. An attorney can advise you on all aspects of the case, including contract and claim issues and assist you if any disputes arise about how much you are owed.
- b. Even if you don't retain an attorney, you must follow the Bankruptcy Code, including not taking any actions which could violate the automatic stay.
- c. If you get a notice about a bankruptcy filing, or a bar date, or contract assumption, do not ignore it. You must abide by any deadlines set by the court, or established by the Federal Rules of Bankruptcy Procedure.

Tamar Dolcourt is a Senior Counsel with the law firm of Foley & Lardner LLP. Her practice involves all aspects of bankruptcy representation, including working with debtors, secured creditors, unsecured creditors, and creditors' committees in Chapter 11 cases throughout the country. She can be reached at tdolcourt@foley.com.