Beyond the Discharge: Other Advantages of a Chapter 7 Business Bankruptcy

By Camille J. Iurillo and Sabrina C. Beavens

When a struggling business decides to shut down, the principals are confronted with the difficult decision of how best to wind down the business. Even though a business is not eligible to receive a discharge of its debts, a Chapter 7 bankruptcy offers several benefits that provide for the orderly closing of the business.

1. Silence is Bliss

Collection agencies have always had a reputation for aggressively pursing debts. Our clients describe unrelenting calls, emails, letters, etc. from debt collectors, some of which arguably violate federal and state statutes. Thus, a primary concern to many potential clients is what can I do to make the creditor harassment stop?

The filing of a bankruptcy petition automatically stays collection efforts by creditors. 11 U.S.C. § 362. Further, notice of the bankruptcy is sent to all of the business' creditors by the Bankruptcy Clerk. 11 U.S.C. § 342. Once notice is received, any further collection efforts are deemed a violation of the automatic stay, subjecting the creditor to sanctions. Post-filing, we also instruct our clients to answer the phone and inform creditors of the bankruptcy filing, including the venue and case number. For many businesses, this is the only benefit to the bankruptcy but freedom from unrelenting collection efforts is worth the time and expense of the filing.

2. Closing the Door on Creditors Questioning Liquidation

Dissolving the business outside of a formal bankruptcy proceeding has its appeal. Oftentimes the owners of the business can get the best price for the assets available for liquidation since they know the market best, know the asset, such as its maintenance history, age, etc. In addition, they may be motivated to do the leg work to get the best price for the assets if there are personal obligations which will survive the bankruptcy that could be reduced or satisfied with the proceeds of the sale. However, creditors may question the sale process by the principals and the disbursement of the proceeds. These creditors sometimes assume that since the dissolution was controlled by the principals, some underhanded dealings must have taken place and may sue the owners individually and/or in the scope of their fiduciary duties. Many times these lawsuits are without merit, but the named defendants must still appear and defend to avoid a default judgment.

Of course, the liquidation process itself is complicated. There must be a determination of what assets are subject to liens. How can the assets be sold to maximize their value? Should they be auctioned? Or advertised and if so, where? How are the assets going to be packaged for sale – individually? Or as a group? Proper documentation must be prepared – bill of sales, forms required to transfer title, documentation of efforts to find a buyer to justify the price ultimately accepted, etc.

Thus, the risk of a creditor questioning the liquidation and/or the labor necessary to complete the liquidation outweighs the benefit for many clients.

In contrast, after the bankruptcy is filed, the trustee becomes responsible for liquidating the assets, returning equipment and arranging for secured parties to retrieve their collateral. *See* 11 U.S.C. § 704. Also, the trustee is vested with "special" powers such as selling leases (despite anti-assignment clauses) and avoiding liens and writs of attachment. *See* 11 U.SC. §§ 365, 544 and 547. The additional funds raised by the use of these special powers are especially important if there are priority debts such as trust fund taxes (see below) outstanding.

Lastly, if the principals need to find new employment, selling the assets can be time consuming and distracting. The ability to turn that responsibility over to the trustee is an added value to the bankruptcy filing.

3. Moving Certain Creditors to the Front of the Line

Another situation where it is advantageous to file a Chapter 7 bankruptcy for a business is when assets are available for payment of debts that include personal liability to the principals, but there is a risk that those assets could be lost to another creditor who obtains a judgment and levies on the property.

Principals of businesses face potential personal liability for "trust fund taxes" which are taxes that the company collects from someone else and then fails to turnover to the appropriate government agency. Thus, if the company withholds taxes from employees' paychecks, but fails to later remit the same, the principals are personally liable. The same rule applies for sales taxes collected from customers but not paid to the Department of Revenue.

Therefore, the principals have a personal interest in directing the available business funds to the payment of trust fund taxes and it may not be possible to stop the levy prior to liquidation of the assets. However, upon the filing of the bankruptcy, collection creditors are barred from continuing their efforts and are limited to the proceeds available for their creditor class. Trust fund tax claims are entitled to priority over other general unsecured claims in the bankruptcy. *See* 11 U.S.C. § 507(a)(8). Many times the government will not timely file a Proof of Claim for said taxes, however "an entity that is liable to such creditor with the debtor…may file a proof of such claim" within thirty (30) days after the expiration of the time for the creditor to file the claim. 11 U.S.C. § 501(b); Fed. R. Bankr. P. 3005(a).

4. Timing is Everything

For owners who are able to manage the wind down, they may want to wait to file the bankruptcy if a strategic advantage may be gained by controlling certain parts of the wind down. For example, the owners may be able to maximize the value for saleable assets, compared to the trustee. Also, the bankruptcy process is very slow and the principals may want to use some or all of the remaining assets to pay employees who otherwise would be required to wait until the claims process is complete in bankruptcy court.

Therefore, the decision of whether to file a business bankruptcy is not always an either/or choice. Often, the principals maintain control of the winding down (keeping in mind their fiduciary duties, preference exposure if a bankruptcy case is filed, etc. as discussed in Paragraph 5) until the goals for waiting are met or become unobtainable, and then the bankruptcy is filed, leaving the trustee to complete the process.

5. Caution! Danger Ahead

Sounds great, right? For the cost of the bankruptcy attorney and the filing fee (which may be paid with corporate funds, if available), the principals are able to turn over a major headache to the trustee, the creditors are redirected to the bankruptcy court and, if proceeds are available, certain debts for which the principals may be personally liable are moved to the front of the line. However, there are a few cons to a business bankruptcy that must also be considered.

Two of the trustee's tools to generate funds to pay creditors are preference and fraudulent transfer claims. Generally speaking, the policy of a preference claim is that a debtor cannot "prefer" to pay certain creditors over others. The bankruptcy trustee may avoid the preference payment and the creditor must file a Proof of Claim for its pro rata share of the available assets. The look back period for non-insider payments which may be avoided is 90 days compared to one-year for insiders. 11 U.S.C § 547(b)(4). Most personal guaranty contracts provide that if the creditor must return a payment because it is recovered as a preferential payment, the personal guaranty is reinstated. Also, when the creditor holding a guaranty of an insider has received a preferential payment within one-year of the bankruptcy, the value of the transfer can be recovered from the guarantor. 11 U.S.C. §§ 547(b) and 550(a).

Fraudulent transfer claims under 11 U.S.C. § 547 and the Florida Uniform Fraudulent Transfer Act (Chapter 726, Florida Statutes) are additional claims that a trustee frequently considers when investigating potential claims on behalf of the bankruptcy estate.   While the Bankruptcy Code's look back period is only one-year, the longer four-year period of the Florida Statutes also applies. Transfers of assets by the business and payments outside of the ordinary course of business should be closely scrutinized before the bankruptcy is filed. Explanations about the way certain payments or transfers were booked must be required – if counsel does not ask questions, the bankruptcy trustee certainly will.

Another area of litigation which has gained more attention in the times of corporate scandal that may affect the principals post-bankruptcy is claims for breach of fiduciary duties and self-dealing, especially if there is a director and officer policy available. Again, counsel cannot simply focus on the current status of the business and must understand what was happening in the business long before the initial bankruptcy consultation.

The consequences of exposure to claims may tip the scales for or against filing in the eyes of the principals. It should be noted that many of these claims, for e.g. fraudulent transfer and fiduciary duty, are also available to creditors outside of bankruptcy court. Obviously there is no crystal ball to determine whether creditors will pursue the claims in state court and other variables such as the size the business, the sophistication of the principals, whether the business is owned by individuals or another business, etc. all bear on the potential for claims. Still, filing the bankruptcy may tee up the claims for a bankruptcy trustee who may be willing to pursue claims that other creditors may not have spent their dime chasing.

Conclusion

In sum, there are three primary incentives which weigh in favor of a corporate Chapter 7 bankruptcy: (1) stopping creditor harassment; (2) utilization of a trustee for an organized closure of the business; and (3) protecting payment of certain debts, including trust fund taxes, as a priority debt. Still, there are potential downsides to the filing, such as exposure to questions about the use of corporate funds and assets and officer/director liability claims. Accordingly, the decision of whether to file a business bankruptcy is not a one-size-fits-all analysis and counsel must be cautious when advising clients about bankruptcy as a potential means to wind down a business.

Iurillo & Associates, P.A., located in downtown St. Petersburg, is comprised of **Camille J. Iurillo**, Shareholder, **Gina M. Pellegrino**, Associate, and **Sabrina C. Beavens**, Associate. The primary areas of practice of **Iurillo & Associates, P.A.** are Commercial and Bankruptcy Litigation and Debtors' and Creditors' Rights.