

Bankruptcy...

Preparation is the Key to Optimizing Outcomes

by Mary Elisabeth Naumann, Jackson Kelly PLLC

Bankruptcy filing rates have remained subdued as we emerge from COVID-19 restrictions. However, most of the governmentally mandated or funded relief measures that have sustained many individuals and businesses are set to expire in the coming months. The removal of the support measures increases the risk of increased bankruptcy filings.

For financial institutions, preparation is critical to optimizing bankruptcy outcomes. In this article, we review bankruptcy basics, outline the practical steps you should take, and highlight significant issues you need to address. Bankruptcy law is complex and nuanced. Often, consulting with counsel early in the process can result in lower costs and better outcomes.

Bankruptcy Basics

Every bankruptcy case begins with a bankruptcy petition. Debtors must also file a Statement of Financial Affairs or “SOFA” and numerous schedules outlining their assets, liabilities, financial condition, and other important information. Debtors have a choice of what type or “chapter” of bankruptcy they want to file, and each Chapter has its own benefits, burdens, and consequences for both debtors and creditors.

Chapter 7 may be filed by individuals or other legal entities. Chapter 7 always involves a liquidation by a third party, a Chapter 7 Trustee. The Chapter 7 Trustee gathers and sells a debtor’s nonexempt assets and distributes any proceeds to creditors.

Chapter 11 cases are most often filed by businesses, but may also be filed by high asset individuals not eligible for Chapter 13. Chapter 11 allows the debtor to run the case, not a trustee. A Chapter 11 can result in a liquidation or reorganization of the debtor’s assets accomplished via a “Plan,” which must be voted on by the creditors. These cases can also involve a creditors committee. Chapter 11 cases are typically the most complex, and expensive, types of cases.

Small Business Debtor Reorganizations (SBRA) cases, or Subchapter V Cases, are a simplified and condensed version of the Chapter 11 process that make reorganization less expensive for debtors with less than \$7,500,000 in debt.

Chapter 12 cases provide a streamlined process (which was the basis for the SBRA) for the reorganization of “family farmers” or “family fishermen” with regular annual income.

Chapter 13 allows individuals who do not qualify for Chapter 11 to reorganize. Chapter 13 debtors must have a regular income and their debt is limited to a statutory threshold.

Practical Steps for Creditors

Check your notice procedures

For financial institutions, preparation before cases are filed is critical. Make sure you have a solid process for handling papers received from a Bankruptcy Court. Designate an employee responsible for coordinating all bankruptcy matters. Bankruptcy proceedings have very strict deadlines. Ensure that bankruptcy notices receive the appropriate and timely attention that they deserve. You can proactively check for filings impacting you via PACER. You can also specify how you wish to receive bankruptcy notices by using the National Creditor Registration Service (NCRS).

Initial Steps

Review the filing

When you receive notice of a filing, immediately review the petition and related schedules. These documents can provide insight into the debtor’s intentions.

Understand the debtor

Immediately review all documentation related to the debtor. At a minimum answer the following questions:

- Are they an account holder?
- Are they a mortgagee?
- Are they a party to a loan? If so, what kind?
- How much money is your organization owed?
- How much money does the debtor hold in your organization’s accounts?

Immediately check the deadlines

Bankruptcy proceedings are driven by deadlines, make sure to be aware of and calendar them throughout the case, including:

- Proof of Claim Bar Date
- Rule 341 Meeting of Creditors
- Deadline to File Objections to Discharge
- Deadline for Objections to a Disclosure Statement
- Deadline for Objections to and Voting on a Plan

Be aware of the automatic stay

Upon a bankruptcy filing, an injunction called the “automatic stay” goes into effect immediately. The automatic stay stops all collection actions against a debtor (for example, wage garnishments, collections, foreclosures, and repossessions).

While there are exceptions, the consequences of violating the stay may be significant. Always presume it applies until you can confirm that an exception exists or you receive relief from the stay from the court.

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Assess secured status

Secured creditors have specific rights in bankruptcy. Immediately assess your position to determine whether a loan is secured. Compile the security documents and assess whether security interests were properly perfected. Determine collateral's nature, location, status, and value. All of this affects the strategy for the bankruptcy case.

Significant Issues

You should develop and document a clear strategy for dealing with each bankruptcy filing. There are a number of significant issues that should be carefully considered in developing the strategy.

Other obligees

A bankruptcy filing protects the debtor and, in most cases, the automatic stay only applies to the debtor. You may have rights against co-obligors or guarantors.

Setoff

If the debtor is both a borrower and a depositor, you may have the right to setoff the amount held on deposit against the amount owed on the loan. These rights are complex, so consult immediately with counsel to determine the best way to protect and then exercise them.

Proofs of Claim

Most cases require creditors to file a proof of claim to obtain any distribution from the debtor. Filing a proof of claim can have unanticipated consequences (such as waiver of a jury trial right), so carefully determine whether you have to file one. While proofs of claim are typically filed with the court, Chapter 11 Debtors often use claims agents and provide specific instructions to file the claims with the claims agent and not with the court, so carefully review court notices.

Discharge exceptions

The result of a bankruptcy can be the entry of an order discharging the debtor from liability for certain debts, barring creditors from taking any action to enforce or collect discharged debts. However, there are exceptions to the discharge, including for certain types of loans and debts and for bad actions, like fraud. Make sure to review the exceptions to discharge to determine whether an exception applies.

End of case planning

The conclusion of a case can result in the discharge of a debt. Make sure that your records reflect the disposition of the debt or account following the conclusion of the case. Significant liability may be associated with attempting to collect on discharged obligations.

Final Notes

Regardless of the type of case filed, creditors should protect their interests by knowing the facts, consulting counsel, and participating meaningfully in the bankruptcy process. To mitigate costs, participation should include communicating early and often with the debtor and other parties-in-interest to try to avoid needless (and expensive) motion practice. Consider involving outside counsel early in the process if the size and complexity of the case so warrant.

Mary Elisabeth Naumann is a member at Jackson Kelly PLLC and has been practicing bankruptcy law for 20 years. JK has a nationwide bankruptcy practice, representing debtors, lenders, creditors, purchasers of bankruptcy estate assets, and trustees and defending clients in post-bankruptcy adversary proceedings involving allegations of breaches of fiduciary duties. Mary Beth can be contacted at mnaumann@jacksonkelly.com or 859-255-9500.