

# Bankruptcy

Bankruptcy refers to laws available to debtors who cannot meet their obligations to creditors. Federal courts have exclusive jurisdiction over bankruptcy cases, which means that a bankruptcy case cannot be filed in a state court.

The primary purposes of the laws of bankruptcy are:

- to give an honest debtor a "fresh start" in life by relieving the debtor of most debts
- to repay creditors in an orderly manner to the extent that the debtor has property available for payment

The bankruptcy process is relatively complex and requires the counsel of specialized attorneys who typically focus their practices on either *personal* bankruptcy (for individual debtors) or business bankruptcy (for business entities in financial duress). As this legal guide is created for hospitality business owners, operators, and managers, it emphasizes the most used forms of business bankruptcy. There are two categories of bankruptcy: liquidation and reorganization.

## Liquidation

For businesses, liquidation bankruptcy falls under Chapter 7 of the US bankruptcy code. Chapter 7 bankruptcy is also available to individuals. In Chapter 7, bankruptcy the business does not continue operating going forward. The company dissolves and ceases to exist.

In Chapter 7, a business converts its assets to cash, and the court assigns a trustee to divide the cash among creditors who receive a share based on their relationship to the company.

So-called "secured" creditors, those who issued credit backed by collateral, are prioritized for these funds. In many cases they receive only a fraction of what the debtor owes.

## Reorganization

Chapter 11 is a business reorganization bankruptcy that permits businesses to continue operations while also reorganizing debts through a debt repayment plan. As ominous as "filing for bankruptcy" sounds, Chapter 11 bankruptcy is often a business strategy, not a proverbial "white flag" raised in defeat. Companies often emerge from Chapter 11 bankruptcy stronger and more able to compete in changing economic and market conditions.

In Chapter 11 bankruptcy cases, the court oversees a manageable plan to repay, in part if not in whole, to those whom the company owes money. Chapter 11 allows business interests to go forward, preserving and creating jobs and contributing to the economy. During the COVID-19 pandemic, several lodging and restaurant companies filed for Chapter 11 bankruptcy.

The process is expensive and complicated, which is why small businesses including independent restaurants and hotels have avoided it. Congress recognized this problem and created Subchapter V of Chapter 11, which is described in the next section. For example, in a traditional Chapter 11 case, the debtor must file and distribute a disclosure statement to provide creditors with information regarding the plan. Creditors often dispute the adequacy of the disclosure statement, which leads to delays and court battles.

## Subchapter V of Chapter 11 Under the Small Business Reorganization Act (SBRA) of 2019

For many years, Chapter 11 bankruptcy was impractical for small businesses because of its expense and complexity. Small businesses were often limited to filing Chapter 7 bankruptcy, also known as liquidation, and shuttering their operations.

The barriers for small businesses to enter Chapter 11, with its unique protections and opportunities, was not lost on attorneys, judges, and legislators, giving rise to the Small Business Reorganization Act (SBRA) of 2019. The SBRA created Subchapter V of Chapter 11 of the US bankruptcy code.

The SBRA became effective on February 19, 2020. The timing could not have been better in the wake of the pandemic and its impact on small businesses, including those in the hospitality industry.

It has many of the benefits of traditional Chapter 11. Unlike a Chapter 7 case, the trustee cannot sell the debtor's assets and does not take control over the debtor's business. The trustee is more like an advisor and handler, facilitating the development of a consensual reorganization plan, appearing at major hearings, and ensuring that the debtor makes timely payments under the plan. In a Subchapter V case, however, the debtor pays the trustee and its own legal fees, but not the legal fees of the creditors.

In Subchapter V, the process moves much more quickly than traditional Chapter 11 cases. The Court holds a status conference within 60 days from the filing. At least 14 days before that conference, the debtor must report in writing on the efforts made, and to be made, to get a consensual plan. The debtor must file its plan of reorganization within 90 days from the filing.

Another advantage to Subchapter V is that only the debtor may file a plan, unlike a traditional Chapter 11 case, in which creditors or other parties in interest may file a competing plan.

And Subchapter V helps debtors dodge protracted disputes. In a traditional Chapter 11 case, the debtor must file and distribute a disclosure statement to provide creditors with information regarding the plan so that they can decide if they like the plan or not. Creditors often dispute the adequacy of the disclosure statement, which leads to delays and court battles. Subchapter V does not require a disclosure statement and avoids other technical disputes raised by creditors.

Subchapter V bases the debtor repayment schedule on projected revenue. This could favor small businesses facing a slow climb out of the pandemic as their projections for the ability to repay creditors are as conservative as they will ever be.