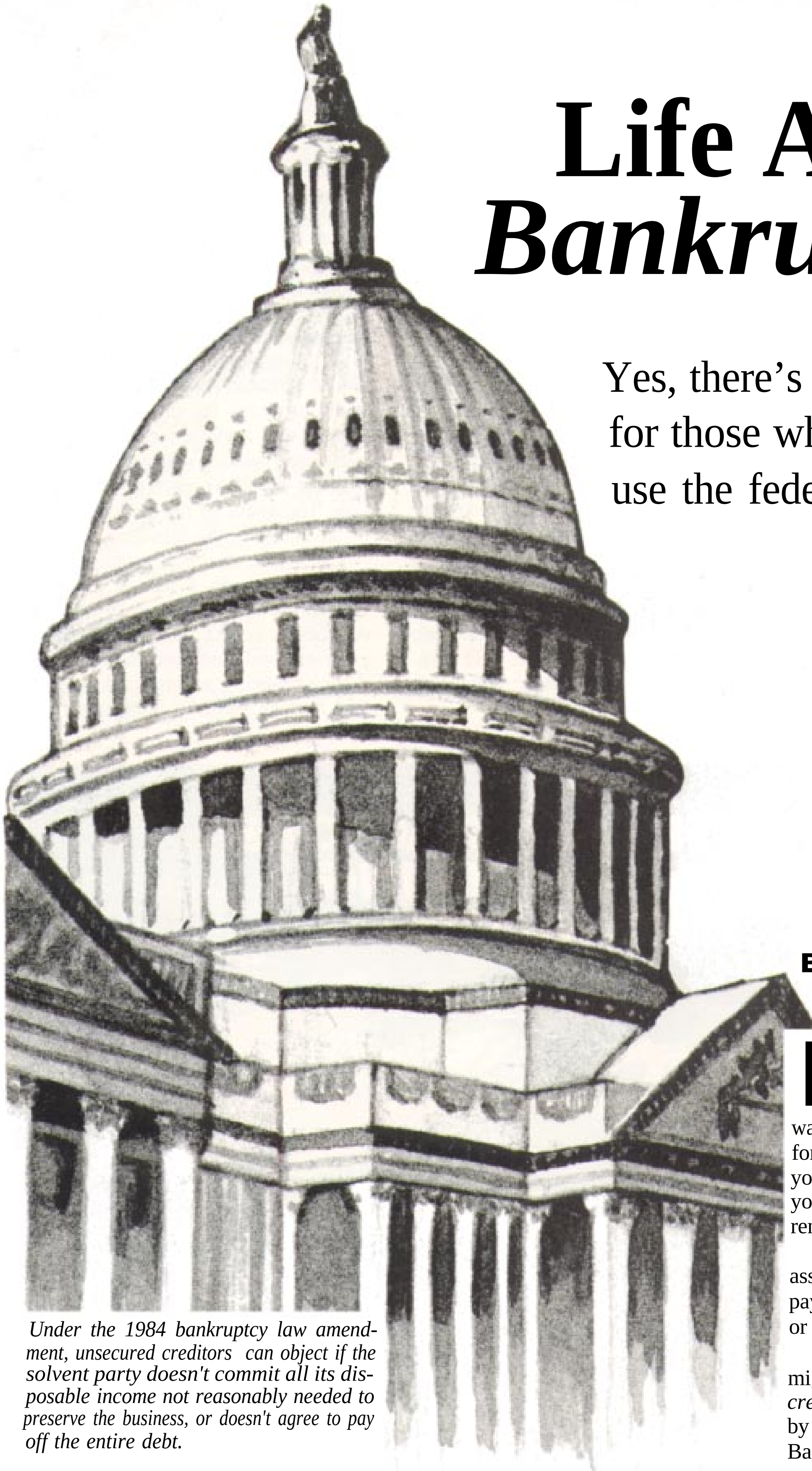
Life After *Bankruptcy?*

Yes, there's life after bankruptcy for those who know how to use the federal bankruptcy law.



Under the 1984 bankruptcy law amendment, unsecured creditors can object if the solvent party doesn't commit all its disposable income not reasonably needed to preserve the business, or doesn't agree to pay off the entire debt.

By Jordan E. Cohn

Perhaps your firm is beset by higher rents, increased payroll (from an increased minimum wage or vigorous unions), or low-priced foreign goods. Times are tough, and you're facing the very real prospect your firm will be unable to meet current debts as they mature.

On paper you are solvent—your assets exceed liabilities—but you can't pay creditors with fixtures, equipment, or merchandise held for sale.

It's not a pleasant thought, but you might consider an *arrangement with creditors* through informal means—or by filing a petition in the United States Bankruptcy Court.

Under the bankruptcy law, all legal actions are held in abeyance.

In days gone by, the very word "bankruptcy" was a dirty word. But now it is commonplace for some of America's biggest corporations (such as Continental Airlines and Johns Mansville) to seek protection in the courts from creditors who would force a cessation of business activities.

If you've been experiencing difficulty in meeting current payroll, making deposits of federal withholding and Social Security taxes, or paying bills on time, you and your accountant should sit down and take stock of your current financial condition.

Should this examination show you headed for trouble, you have to face realities. A meeting with both your accountant and your lawyer is essential to chart a course of action.

You could have your attorney call a

meeting of your creditors. Let him or your accountant spell out your financial position. Lay your cards on the table with truthful disclosure.

Then, offer a proposal. Show the creditors your business is a good one with plenty of profit potential, but whose financial woes are only temporary due to current economic conditions.

The proposal could provide payment for all debts in full, with a series of deferred payments designed to give you some breathing space to regroup and to weather the temporary lull in business.

At this point, the creditors have several options. They may decide informally to accept the deferred pay out, or they may appoint a creditors' committee and decide to file an involuntary petition in bankruptcy court against you. The intent of this petition would be to liquidate the business.

Either you, your accountant, or your lawyer, must do a selling job. The creditors' committee must be convinced they'll collect more in deferred payments and continued business, than if they pushed you into bankruptcy—and thereby incurred huge fees for a

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battery of lawyers and court-appointed trustees. Also, creditors must take into account that forced liquidation of assets will bring distress prices, and thus result in almost nothing being available for pro-rata distribution to those creditors who are unsecured.

Danger signals will flash if creditors seem unwilling to accept your proposal for a deferred pay out plan, and seem intent on pursing instead an involuntary bankruptcy.

If this happens you have no choice. You should immediately retain an experienced bankruptcy lawyer who should be apprised of your financial condition.

The immediate advantage of seeking protection under the bankruptcy law is that all legal actions are held in abeyance. That stay is invoked automatically upon filing the petition in bankruptcy, and enjoins all creditor actions including litigation, lien enforcement, foreclosure, or other judicial or extra-judicial action.

The bankruptcy law, which underwent revisions in 1979 and 1984, provides two major types of bankruptcy: liquidation (Chaper 7), and reorganization (Chapters 11 and 13). Which chapter you would file under is determined by a variety of business and practical considerations.

Assuming you will stay in business —thus avoiding liquidation—Chapter 7, which amounts to a decision to terminate the business, would not be appropriate. Both Chapters 11 and 13, on the other hand, allow an individual or a business entity to retain control over their business and financial affairs while they work out a plan to pay their debts.

How, then, do you decide between Chapters 11 and 13? One factor is your form of business. If you're running a sole proprietorship—and if your unsecured debts do not exceed $100,000, while your debts secured by property do not exceed $350,000—you are eligible to file under Chapter 13. Corporations and partnerships are not eligible to file under this chapter, nor are sole proprietorships where debts exceed the above limits.

Once you've filed under Chapter 13 (only debtors can file under this chapter; creditors and debtors can only initiate Chapter 7 or 11 proceedings), you remain in possession of the business and make voluntary payments to creditors according to a payment plan you've drawn up.

Your creditors, both secured and unsecured, may raise objections to your plans. Unsecured creditors can ask the court to disapprove the proposal. If the court agrees, it could affect how much you have to pay.

On the other hand, secured creditors actually vote on the proposals, again affecting your pay out. Thus, if a secured creditor doesn't agree to "settle for less" under your plan, you must sur-

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render the collateral or make payments equal to the collateral's present value.

Under the 1984 bankruptcy law amendments, unsecured creditors can object if you don't commit all your disposable income (i.e., income received by the debtor which is not reasonably necessary for the preservation and continuation of the business), or agree to pay off the entire debt.

Under Chapter 13, you can continue to take a "reasonable" draw each week. As for what is reasonable, this would depend on your circumstances. If a creditor felt you were living too luxuriously, he could petition the court to restrain the amount you withdrew.

Normally, there is a three-year period under Chapter 13 in which to pay creditors, though the court may approve a payment plan of as long as five years.

Partnerships or corporations that are unsuccessful in settling with a creditors' committee may have to file for protection under Chapter 11. You remain a debtor in possession and, subject to some court scrutiny, you go about your business. When you file, you receive the automatic stay that protects you from claims against your property.

A plan must he drawn and submitted to the bankruptcy court. Generally you offer to pay unsecured creditors a certain percentage upon approval of the plan. (Unlike Chapter 13, under Chapter 11 "impaired" creditors who will receive less than 100 percent of their claim must accept the plan. Once that happens, other creditors can be forced to go along with the plan.) Remaining debts are satisfied by periodic payments, or by other forms of payments such as a distribution of stock.

If you can get an infusion of new capital, you can make an outright offer to settle for a percentage on the dollar amount owed, plus some periodic payments, in full satisfaction of all amounts due.

Again, creditors are faced with a dilemma: agree upon a long-term payout, or accept a partial plan plus some token payments in full settlement. They will think twice about forcing a complete liquidation if it means getting less than either of your plans offer.

One advantage of Chapter 11, compared to Chapter 13, is the absence of any specified time to complete the repayment plan (though the court takes into account the time proposed in deciding whether to approve the plan).

On the other hand, Chapter 11 proceedings involve creditor committees, more detailed plans, and lots of red tape. You may find yourself spending enormous amounts of time on bankruptcy-related matters, at the expense of your business.

Of course, if creditors allow you to stay in business under Chapter 11, you'll most likely be put on a C.O.D. basis for new purchases.

What are the tax consequences of going broke, where debts are settled at less than 100%? First, let's take the situation where you settle a debt outside of a bankruptcy proceedings.

Cancelled debts are generally income to the debtor. If you settled a debt by delivering to your creditor property that cost you less than the amount owed, the difference to you is income—UNLESS you are insolvent.

If you are insolvent before the cancellation of a debt, but solvent after the cancellation, you realize income to the extent the transaction makes you solvent (the amount by which the fair market value of your assets is more than your liabilities after the cancellation). If you are insolvent both before and after the cancellation, you realize no income.

However, if you are involved in a bankruptcy proceeding and settle with creditors for less than 100 cents on the dollar, even if solvent you realize no taxable income.

If possible, always try alternatives to bankruptcy such as informal agreements with creditors. Bankruptcies can be expensive in many ways. Attorney's fees, in particular, can become exorbitant in the course of a lengthy bankruptcy proceeding. You also lose some freedom of action through constant judicial scrutiny.

In addition, bankruptcy proceedings can damage your credit and reputation—customers lose confidence in your ability to pay and may decline to renew contracts or creditors may refuse further credit. Never forget, also, you have a moral obligation to pay off debts to the best of your ability.

But bankruptcy, when unavoidable can offer another chance to put together a viable operation. Pay-out gives you time to recoup during the slow period. And outright forgiveness of a major portion of debt gives you a chance to run clearance sales to raise cash, revamp your operation, and once again put your business on a profitable basis.

About the author: Jordan E. Cohn holds a B.A. degree from Harvard University and a J.D. from University of Southern California. He engaged in the practice of law for many years. He has written extensively for trade and professional magazines.