



Shutting Down Small Businesses and Bankruptcy Considerations

WCEPC September Meeting
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Bankruptcy is for the “honest but unfortunate debtor”

Grogan v. Garner, 498 U.S. 279, 289-87 (1991)

- Two things to stress to your clients:
 - Keep good records & find a bankruptcy attorney early
 - Failure to accurately disclose assets, income, liabilities, and transfers can mean no discharge – (11 U.S.C. § 727)
 - List of assets: real property, vehicles, equipment, office supplies, inventory, bank statements, accounts receivables, payroll, etc.
 - List of liabilities: leases, utilities, mortgages, judgments, UCC liens, taxes, and all other unsecured debt
 - Don't forget personal assets and liabilities as well!
 - Accurate profit and loss statements as well as bank statements are going to be required by the bankruptcy trustee
 - File timely personal and business income taxes
 - Don't lose your discharge because of sloppy record keeping.

Bankruptcy Basics

- The filing of the bankruptcy petition creates the bankruptcy estate (11 U.S.C. §§ 541, 1306), the automatic stay (11 U.S.C. § 362), and results in a discharge upon completion (11 U.S.C. §§ 523, 524, 727, 1328)
 - What is the estate? (11 U.S.C. §§ 541, 1306)
 - This grants the bankruptcy court control over the debtor's property and a trustee will be appointed to administer the estate
 - The estate consists of practically all property and interests in property which the debtor had at the time that the petition was filed. *Matter of Yonikus*, 996 F.2d 866 (7th Cir. 1993).
 - If the debtor is a sole proprietor in a business, all assets of the business constitute property of the estate.
 - In Wisconsin, this includes almost all community property as well. *In Re Griese*, 132 B.R. 908 (Bankr. E.D. WI 1991).
 - Unless there is a very solid pre-nuptial agreement
 - If the debtor has an interest in a partnership or shares of stock in a corporation, the partnership interest or the shares of stock become property of the estate, but the assets of the partnership or corporation do not. *In re Dreske*, 25 B.R. 268 (Bankr. E.D. WI 1982)

Bankruptcy Basics

- What is the automatic stay? (11 U.S.C. § 362)
 - It's a "fundamental ... protection[] provided by the bankruptcy laws." *Midlantic Nat'l Bank v. New Jersey Dep't of Env'tl. Prot.*, 474 U.S. 494, 503, 106 S.Ct. 755, 88 L.Ed.2d 859 (1986) (quoting S. Rep. No. 95-989, at 54 (1978)).
 - The stay provides the relief most debtors search for: no calls, letters, garnishments, levies, etc.
 - With limited exceptions, creditors are barred from the collection or coercion to collect on debts or on property of the bankruptcy estate
 - Creditors, after being properly notified, who fail to honor the automatic stay, may be sued (via an adversary proceeding) for violation of the automatic stay

Bankruptcy Basics

- ▶ What is discharge? (11 U.S.C. §§ 523, 524, 727, 1328)
 - ▶ An injunction, like automatic stay, that permanently stops creditors from collecting on debts or property of the estate, even after the case closes
 - ▶ Beware: there are exceptions to discharge!
 - ▶ Examples:
 - ▶ Some tax debt
 - ▶ Restitution
 - ▶ Domestic support obligations
 - ▶ Fraud
 - ▶ Willful/malicious injury to another person
 - ▶ STUDENT LOANS

Failed Pizza Chain Dreams & Incomplete Schedules: A Denial of Discharge Story

- ▶ *Layng v. Sgambati*, 584 B.R. 865, 872 (Bankr. E.D. Wis. 2018)
 - ▶ Debtor owned 2 pizza restaurants and was struggling to keep up, especially after a fire and an employee embezzlement
 - ▶ Looking for relief, filed a Ch. 7 bankruptcy, while winding down his business and ended up in hot water with the US Trustee
 - ▶ So what was so egregious what the judge decided to deny his discharge?
 - ▶ Biggest factors:
 - ▶ Omission of creditors
 - ▶ Mischaracterization of the business's income v. personal income
 - ▶ Failure to disclose a gift

Chapter 7 - The “Fresh Start”

Stamat v. Neary, 635 F.3d 974, 978 (7th Cir. 2011)

- Chapter 7: is it a complete wipe out of debt?
 - Remember there are exceptions to discharge
- Chapter 7 is available to all “persons,” including “individuals,” partnerships, and corporations.
 - However, discharge only applies to the “individuals”
- The trustee in a Chapter 7 will collect all the debtor’s unexempt assets and supervise the liquidation of assets
 - Common misconception: filing a Ch. 7 means I will lose EVERYTHING!
 - Exemptions can protect assets
- The trustee will then distribute the proceeds to creditors in order of their priority as determined by the Bankruptcy Code.
- Some other things to remember:
 - At least one court hearing (11 U.S.C. § 341) called the meeting of the creditors
 - 2 credit counseling course requirements for debtors who are individuals

Chapter 13 - The Reorganization

- Chapter 13 is available to individuals with regular income
 - It allows debtors to avoid the liquidation of assets under Chapter 7 and attempt to pay at least some dividend to unsecured creditors
 - It also affords debtors the opportunity to pay mortgage arrears (stop foreclosures), pay vehicle notes (stop repossessions), and pay priority tax/domestic support obligation claims
- Chapter 13 has debt limits (11 U.S.C. § 109(e))
 - \$419,275 of noncontingent, liquidated, unsecured debt; and
 - \$1,257,850 of noncontingent, liquidated, secured debt.
- In a Chapter 13, the debtor will submit a plan (11 U.S.C. §§ 1321, 1322) that utilizes the debtor's disposable income to make payments to creditors.
 - A Chapter 13 plan runs at a minimum 36 months up to a maximum of 60 months (although the CARES Act allows debtors to extend the plan past 60 months if plan was confirmed on or before March 27, 2020)
- The trustee in a Chapter 13 Bankruptcy will evaluate the plan for confirmation purposes (11 U.S.C. § 1325)
- The Chapter 13 trustees will also receive plan payments and make distributions to creditors according to the plan (11 U.S.C. § 1326)
- Same requirement for meeting for creditors hearing and 2 credit counseling courses, along with a Form 2831 certification upon completion of the plan
- At the end of the plan the debtor, all remaining debt will be discharged unless the debt is deemed non-dischargeable
 - More debts are dischargeable under Chapter 13 than Chapter 7

Chapter 11 Subchapter V

- Chapter 11, Subchapter V is intended to be used by businesses to organize their debts and occasionally to sell assets free and clear of liens
- Subchapter V is a new provision of the Bankruptcy Code beginning in February 2020, which makes chapter 11 more cost effective for a small business by removing some of the costly aspects of chapter 11
- Subchapter 5 is available to individuals and entities with debts not exceeding \$2,725,625 (\$7.5 million through March 27, 2021) who incurred at least fifty percent (50%) of their debt in connection with a business or commercial activity
- Like Chapter 13, the debtor will propose a plan to restructure its debt and use its disposable income to make payments to creditors over three to five years
- Individuals and corporations are eligible for a discharge in chapter 11

What about exemption planning?

- ▶ “There is nothing unlawful about structuring one’s assets to take advantage of the bankruptcy laws as Congress and the Wisconsin Legislature have seen fit to write them. Judge Learned Hand famously wrote about tax planning that “there is nothing sinister in so arranging one’s affairs as to keep taxes as low as possible. Everybody does so, rich or poor; and all do right, for nobody owes any public duty to pay more than the law *424 demands: taxes are enforced exactions, not voluntary contributions.” *Commissioner v. Newman*, 159 F.2d 848, 850–51 (2d Cir. 1947) (Hand, J., dissenting). The same applies to bankruptcy planning; no debtor owes her creditors more than the law demands. See *In re Smiley*, 864 F.2d 562, 566 (7th Cir. 1989) (noting that the law allows a debtor “to make full use of the exemptions to which he is entitled under the law”)” *Wittman v. Koenig*, 831 F.3d 416, 423–24 (7th Cir. 2016)
- ▶ In Wisconsin, individuals can use either the state exemptions or the federal exemptions but not both; in other states, individuals are restricted to either federal or state exemptions depending on each state’s laws
- ▶ Businesses may not claim exemptions
- ▶ Wisconsin exemptions are found in Wis. Stat. § 815.18
- ▶ Federal Exemptions are found in 11 U.S.C. § 522(d)

What could go wrong? The Trustee's Powers

- ▶ Bankruptcy Trustee can avoid, unwind, or recover certain transfers
 - ▶ Strong Arm Powers – 11 U.S.C. § 544 – Trustee can use any federal law to avoid a transaction, § 544(a), or any state law to do the same, § 544(b). Trustee's hypothetical bona fide purchaser status takes free of any unrecorded interest. Trustee's hypothetical lien holder status allows to prime unperfected interests. Therefore, can avoid unrecorded mortgages or unperfected liens.
 - ▶ Fraudulent Transfers – 11 U.S.C. § 548(a) – Two-year statute of limitations (four years under state law); Debtor was insolvent, or became insolvent as a result of the transfer, and did not receive "reasonably equivalent value" in exchange
 - ▶ Avoidance of statutory liens – 11 U.S.C § 545
 - ▶ Avoiding Preferences – 11 U.S.C. § 547(b) –
 - ▶ 90-day look-back period for non-insiders for any payment on an antecedent debt that paid a creditor more than they would have been entitled in a chapter 7 liquidation so long as the debtor was insolvent (the Code presumes insolvency)
 - ▶ 1-year lookback period for insiders of the debtor
 - ▶ Defenses: 11 U.S.C. § 547(c)
 - ▶ Liability of Transferee – 11 U.S.C. § 550 – Transferee must either return the property transferred or the value of the property transferred

My client is shutting down a small business, so which bankruptcy is best?

- ALL depends on the debtor and their unique situation
 - Have them contact a reputable bankruptcy attorney as soon as possible!
- Chapter 7 is best for a client with little assets or income (or those willing to liquidate or surrender assets)
- Chapter 13 is best for a client with income and assets that they would like to keep (but within the debt limits)
- Chapter 11 is best for a client that operates a small business and would like to keep that business open

Thank you for having us!



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