UNDERSTANDING BANKRUPTCY – A BASIC INTRODUCTION

Two companies holding cable franchise agreements with several Oregon municipalities, Broadstripe and Charter Communications, already have filed or announced plans to file for bankruptcy. It is sadly all too possible that other companies and individuals will not be far behind as we struggle through these turbulent economic times. As a result, one question that that cities likely will need to address is how they will deal with contractors, franchisees, or utility customers who file for bankruptcy protection.

Unfortunately, there is not a simple, one-size-fits-all answer for how to deal with every company or individual that files for bankruptcy protection. Rather, cities are going to need to work with legal counsel to address the best methods to protect their interests as a creditor. What follows is a basic introduction to bankruptcy law to help get that conversation started.

The Goal of Bankruptcy Law

To begin a conversation about bankruptcy law, it is important to understand the basic goal of the law, which is to provide debtors who can no longer pay their debts a financial fresh start. To achieve this goal, the bankruptcy law discharges a filer's debts and prohibits creditors from taking any action against the filer to collect those debts. The law does not discharge certain debts for public policy reasons, including, in most circumstances, debts to government entities for fines and penalties and certain types of tax claims.

Types of Bankruptcy Filings

The federal bankruptcy law is codified in Title 11 of the United States Code. Title 11 is divided into several Chapters. Bankruptcy cases are traditionally given the names of the Chapter in Title 11 under which they are filed. For example, an individual who files for Chapter 7 bankruptcy protection has filed under Chapter 7 of Title 11 of the United States Code. There are six basic types of bankruptcy filings possible under Title 11. This article will briefly explain three of the most common of those filings, chapters 7, 11 and 13.

- <u>Chapter 7</u>

A Chapter 7 bankruptcy filing is known as a liquidation filing. Under a Chapter 7 filing, a trustee takes over the assets of the filer, turns them into cash, and makes payments to creditors. Certain personal property, such as clothes and household furnishings, are exempt from liquidation to assist the filer in achieving a fresh start. If a debtor's income is in excess of specified thresholds, the debtor is not eligible to file under Chapter 7.

Money raised in a Chapter 7 liquidation is paid to creditors in the order set forth by the bankruptcy law. Secured creditors – creditors holding claims to debts for which collateral has been pledged – receive payment first. Then, if there is money left, unsecured creditors receive payment based on priority levels. For example, money owed for child support must be paid in full before credit card debt is paid. Money is distributed to creditors within the same priority level on a pro rata basis if there are not enough funds available to pay all of the debts at that priority level. Typically because of exemptions and payments to secured creditors there are no payments to unsecured creditors in a Chapter 7 filing. In addition, a creditor holding an unsecured claim will receive a payment only if the creditor files a proof of claim with the bankruptcy court.

- <u>Chapter 13</u>

Chapter 13 is used by consumer debtors who do not qualify to file under Chapter 7 because of their income level. Under Chapter 13, the debtor proposes a plan to repay creditors over a period of time, usually three to five years. The bankruptcy court must approve a filer's plan at a hearing before it takes effect. Under Chapter 13, a filer usually remains in possession of the property of the estate and makes payments to creditors, through a trustee, based on the filer's anticipated income over the life of the plan. Unlike a Chapter 7 filing, the debtor does not receive an immediate discharge of debts. Rather, the debtor must complete the payments required by the approved plan before a discharge is received. The debtor is protected from lawsuits and other creditor actions while the plan is in effect.

- <u>Chapter 11</u>

A Chapter 11 filing is known as a reorganization filing and is generally used by business entities. Under a Chapter 11 filing, a business continues to operate while it reorganizes itself and repays creditors through a court approved plan. A Chapter 11 filing is most often done voluntarily by a debtor, but it may be done involuntary by creditors that meet certain requirements.

A Chapter 11 case begins with the filing of a petition with the bankruptcy court. Generally, the filer must also provide a written disclosure statement and a plan of reorganization. The disclosure statement must contain information concerning the assets, liabilities, and business affairs of the filer sufficient to enable a creditor to make an informed judgment about the debtor's plan of reorganization. The contents of the plan must include a classification of claims against the filer and must specify how each class of claims will be treated. Creditors whose contractual rights are to be modified or who will be paid less than the full value of their claims under the plan, vote on the plan by ballot. After the disclosure statement is approved by the court and the ballots are counted, the court conducts a hearing to determine whether to approve the plan.

Once a plan is approved by the court, the filer can reduce its debts by repaying a portion of its obligations and discharging others. The filer can also reorganize by terminating contracts and leases, recovering assets, and revising its operations. Under Chapter 11, the filer normally goes through a period of consolidation and emerges with a reduced debt and a reorganized business with a chance to return to profitability. On occasion, however, a Chapter 11 filer will sell all of its assets and liquidate the business.

Automatic Stay

Once a debtor files for bankruptcy protection, an automatic stay is put in place. The automatic stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the bankruptcy filing. The automatic stay enables a reorganization of the debtor's finances and/or the liquidation of assets in a reasonable manner. It also prevents some creditors from gaining an unfair advantage over other creditors simply because they are the first to try to collect a debt or enforce a judgment.

There are some exceptions to an automatic stay. For example, under specific circumstances, a secured creditor can foreclose on secured property. In addition, a government entity is not subject to the stay if it is seeking to enforce its police and regulatory powers. Thus, under this narrow exception, a city was able to continue a condemnation and demolition action even though a bankruptcy filer attempted to avoid the demolition by invoking an automatic stay. Javens v. City of Hazel Park, 107 F.3d 359, 365 (6th Cir. 1997).

Conclusion

Because of the complexities of the bankruptcy law, this article is necessarily general and is not intended to provide legal advice. This article should not serve as a substitute for competent legal counsel. Please consult with your legal counsel to ensure that your city's interests as a creditor are properly protected.

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On the Web - the full text of the publication can be found at: http://www.uscourts.gov/bankruptcycourts/bankbasics0908.pdf.