Bankruptcy and Non-Bankruptcy Alternatives for Individuals Engaged in Business

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Introduction

Self-employed individuals present special problems in bankruptcy and business restructuring. For the purpose of this presentation, we will consider self-employed persons to include sole proprietorships, partnerships, and small or solely owned corporations and LLCs. Each business form presents its own set of challenges and solutions. The following materials are strategies I have employed to assist self-employed individuals restructure their businesses using bankruptcy and otherwise.

Sole Proprietors

Sole proprietors who provide personal services are not significantly different from wage earners. A typical restructuring strategy for a self-employed individual who provides personal services, is simply to file a bankruptcy case, discharge his or her debts, and continue with the business of providing services. Issues are presented if that person's business incurs trust fund taxes (sales tax for lawn care or landscaping businesses for example or payroll taxes for employees) involve inventory sales, or if the individual leases equipment or has financed equipment.

For sole proprietors whose business incurs trust fund taxes, the business must be shifted into a corporation or limited liability company before a bankruptcy filing. The reason for that is because a chapter 7 trustee will not permit a debtor to operate and incur trust fund taxes. A debtor who is providing personal services—with no sales taxes associated with them—like accountants, attorneys, or painters for example, can continue to operate through a chapter 7 filing. If such debtors have payroll and incur payroll taxes, the employment cannot continue post-petition. Employees can be retained as 1099 contractors (if allowable by the IRS) or temporary employees or "leased" either through a temporary agency or through another company formed by the debtor.

Sole proprietors who carry inventory for sale and valuable equipment create 2 problems for bankruptcy filings: (i) the inventory and equipment would be property of the estate for a trustee to sell; and (ii) inventory sales will generate sales taxes which a trustee cannot permit. Additionally, the debtor's lender most likely has a security interest in the inventory and equipment, or equipment may be subject to a lease. That debtor cannot simply form a limited liability company and shift the inventory and equipment into that company to continue operating the business. The debtor's trustee could claim the transfer to the company is a fraudulent transfer (if it is unencumbered) or the lender/lessor may be unhappy that its collateral is now in the name of a non-debtor thereby risking its security interest. In that instance, the debtor must transition the business property into the new company in a way that avoids creating assets of a bankruptcy estate, constitutes a fraudulent transfer, or violates a lender's or lessor's loan or lease agreements.

Equipment or inventory may be conveyed into the new company but fair value must be paid (typically agreed upon with the lender that may or may not be the full amount owed). If an agreement can be reached with a lender to sell the debtor's assets to a newly formed company for fair value, the new business must pay the debtor the purchase price. That purchase price may be paid over time, but, when a bankruptcy is filed for the former sole proprietor, the trustee will begin receiving the purchase price. Leases may be assumed/reaffirmed to continue using property that is necessary to the business operations—caveat, most leases are finance leases that can be handled similar to a secured loan.

Finally, care must be used to not comingle assets of the proprietorship with the assets of the new company. The reason for this is to avoid claims of successor liability against the new company. For example, sales of inventory under the proprietorship done in the ordinary course, and cash generated thereby, must be kept in the proprietorship and used for proprietorship debts. Purchases made by the new company cannot be made with proprietorship cash. Obviously, capitalizing the new company may be problematic but certainly will be less problematic than comingling proprietorship assets with the new company's assets and exposing the new company to successor liability claims.

Done right, the business survives outside of the bankruptcy case with a corporate structure and a clean balance sheet and the debtor receives a discharge of all the debts incurred during the proprietorship operations. The foregoing strategies will enable the proprietor to continue in business with the firewall of a chapter 7 discharge between him or herself and the new company and the old business debts, and with little risk of successor liability claims against the new company.

Closely Held Companies

Restructuring small and closely held companies may be summarized as the sole proprietorship strategy in reverse. The operations and assets of the company are transferred to the owner personally. The corporate form is abandoned and ultimately the corporation may be dissolved. The owner can file a bankruptcy case to discharge the debt of the company that he or she has guaranteed. That strategy may seem contradictory to the proprietorship strategy but in reality, with the goal being to set up a firewall between the debt and the continuing business, they are complementary strategies. The trick is keeping the business active through a bankruptcy.

If the business owner takes the assets of the small company free and clear of liens, then files a bankruptcy case, the trustee will claim the assets as assets of the estate. However, because the owner must pay fair value for the assets of the company, and either the company's lender will claim a security interest in the assets or there will be unsecured creditors of the company, there are multiple ways of protecting the assets from a bankruptcy trustee. First, the owner can buy unencumbered assets from the company via a seller financed sale, with the company taking a note for the purchase price and security interest back in the assets. The amounts paid to the company would be sufficient to pay the amount demanded by the lender—typically based upon an appraised value. For example, I restructured a cement contractor's business by closing the corporation and offering the lender $15,000 for all the company's assets (the appraised value). The lender agreed and the remaining bank debt guaranteed by the owner (about $75,000) was discharged in his bankruptcy. The assets remained subject to the lender's lien until the agreed amount was paid thereby protected from the chapter 7 trustee. The same is true even if the assets are not encumbered by a lender's lien. The company can sell the assets to the debtor and take a note and security interest in the assets. The lien protects the assets from the debtor's chapter 7 trustee and the purchase price paid for the assets must be used by the company to pay corporate debts—typically nondischargeable taxes like wage withholding or sales tax for which the debtor will have personal liability.

If the new proprietorship needs employees, then that must be addressed before the bankruptcy is filed. As before, a proprietor will not be allowed to operate in chapter 7 with employees due to the employment tax issues. One strategy to solve that problem is for all the employees to sign up at a temporary service agency and the proprietor contracts with the temporary service agency for their employment. Alternatively, the new proprietor could leave the employees with the old company. The old company would "lease" the employees to the proprietor on a contract basis thereby acting as a captive temporary service company. When the bankruptcy is concluded, the new proprietor can then hire the employees and end the temporary service arrangement.

Ultimately, the debtor can form a new limited liability company or corporation at some point in the future after the bankruptcy has closed. The business then can continue without the debt load of the old corporation with the exception of secured debts (including the debtor's purchase price for the corporation's assets) or leases that may have to be assumed.

Chapter 13 Alternatives

Chapter 13 can also be used to restructure either a sole proprietor or a closely held company. Assuming the debtor is under the chapter 13 debt limits ($1,184,200 secured and $394,725 unsecured, each noncontingent, disputed debt), then chapter 13 can be a powerful tool to employ to restructure the debtor's finances.

First, as with the chapter 7 strategy for the owner of a closely held company, the corporation must cease to operate the business and the individual must begin to operate the business as a proprietor. That way, the bankruptcy will insulate the business and the individual from their debts. The old corporate form will be dissolved in order for the individual to begin operating the business as a sole proprietor before the bankruptcy filing.

Once that is accomplished, the chapter 13 filing will allow the debtor to continue operating the business (the debtor will qualify so long as he or she has "regular income") even if the debtor has assets, inventory, or are incurring trust fund taxes. The unsecured debts will be paid a dividend through the plan, and secured debts—other than claims secured solely by the debtor's residence—may be reduced to the value of the collateral. This is an especially attractive option for the business owners who have guaranteed business lines of credit secured by business assets and their homes. Because that creditor has collateral in addition to the residence, the mortgage may be reduced thereby enhancing the benefit of the restructuring.

Additionally, a chapter 13 plan may be confirmed in a very short period of time with considerably less expense than in a chapter 11 case. Depending on the financing structure of the business and other factors, the majority of the first day motions required in a chapter 11 case may be eliminated such as use of cash collateral, wage & tax motions, utilities motions, and the like. Motions to set bar dates for filing claims are not necessary and even when compared to the abbreviated confirmation process available to a small business chapter 11, the chapter 13 confirmation process is much more efficient.

Conclusions.

The foregoing is a sampling of strategies I have used to assist business owners restructure their businesses. Each employs some form of bankruptcy to create a firewall between the debts of the old business and the operations of the new business. For a business person who can be restructured through a workout, chapter 7, or chapter 13, the transactional costs certainly will be less than chapter 11. Regardless of the form of restructuring, there are means available to counsel to assist business owners restructure their finances.