Understanding the Bankruptcy Process

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WHAT'S COVERED

In this lesson, you will learn about the basic features of the bankruptcy process in the United States. Specifically, this lesson will cover:

1. Features of Bankruptcy in the United States

Business entities, just like individuals that are undergoing financial distress, may be forced to consider bankruptcy. **Bankruptcy** is the legal status of a firm that is insolvent, meaning they cannot repay the debt they owe the creditors.

Jurisdiction over bankruptcy cases lies with the United States District Court. The attorney general of the United States appoints trustees for each of the 21 districts, who in turn manage their own panel of trustees to hear bankruptcy cases.

The bankruptcy code imposes an immediate stay once a bankruptcy petition is filed. This stay keeps creditors from starting collection actions, enforcing collection actions, or appealing actions or judgments against a debtor for a claim that arose during a prior filing. As soon as the position is filed, the debtor has all the protection provisions under the bankruptcy code.

There are different chapters of the bankruptcy code that address different petitions being filed.

- Chapter 7 bankruptcy is a filing for liquidation. This is the most common form when the trustee gathers all the assets and delivers all the proceeds to the creditors. Most Chapter 7 bankruptcy cases are considered "no asset" cases.
- Chapter 11 bankruptcy allows an organization to reorganize. Businesses frequently take advantage of this by developing a bankruptcy plan where they reorganize the debts, which then gets voted upon by the creditors. Chapter 11 bankruptcies can take years, depending on the complexity of the case.

TERM TO KNOW

Bankruptcy
The legal status of an insolvent person or organization; one who cannot repay the debts they owe to creditors.

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2. Financial Management Before and During

Bankruptcy

Financial management before and during bankruptcy is critical for companies to remedy financial distress and insolvency. During a Chapter 11 bankruptcy, the business develops a plan to reorganize and then this plan gets voted on for approval by all the creditors involved. The disadvantage here is that the company faces future higher capital costs. It can make it difficult, if not impossible, for an individual to borrow in the future because companies that are reorganized are not dissolved. They may face a higher value of cost of capital for future operations after they emerge from bankruptcy.

To avoid the negative impacts of bankruptcy, companies in financial distress have some alternatives. They can:

- Decrease the amount of financial leverage
- Dispose of investments that are not producing a profit
- Stagger or extend debt payments
- Lower earnings distributions like dividends
- Diversify operations
- Severely reduce costs where possible
- Moderate risky investments
- Improve efficiency

During bankruptcy, after a Chapter 11 agreement has been confirmed, its provisions are binding and it prescribes how the details in operations are to be handled. Sometimes the organization may be able to acquire financing terms if they give new lenders first priority on the earnings. If the company's debts are greater than the sum of its assets, the company owner, in all likelihood, will be left with nothing.

SUMMARY

In this lesson, you learned that bankruptcy arises for an organization when it is unable to pay its creditors. Some **features of bankruptcy in the United States** include chapters of the bankruptcy code. A company can file for protection under Chapter 11 of the bankruptcy code, which provides for a reorganization of debts and the restructuring that allows operations to continue. It may be forced to file Chapter 7, which leads to liquidation.

To **financially manage before or during bankruptcy**, a company may implement a number of tactics, including disposing of non-profitable investments or diversifying operations.

Best of luck in your learning!

TERMS TO KNOW

Bankruptcy

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