Business Viewpoint: Sam G. Bratton II on bankruptcy

By SAM G. BRATTON II Business Viewpoint | Posted: Thursday, October 10, 2013 12:00 am

You hear it all the time. "I loaned Jones some money and I lost it all because he filed bankruptcy." Or, variation on the theme, "I sold a truckload of widgets to Jones Co. on credit and never got paid because they went into bankruptcy."

Yes, you lost your money. Yes, they went into bankruptcy. But no, you did not lose your money because of the bankruptcy. You lost your money because you extended credit to someone who could not, or would not, repay and who had insufficient assets to cover his debts. By the time your debtor landed in bankruptcy, your money was already gone. Yet, all is not lost.

Bankruptcy comes with many built-in protections for creditors. The debtor in any chapter of bankruptcy is required to file detailed schedules of all assets and debts and make comprehensive disclosures regarding financial condition and history.

In a Chapter 7 liquidation case, a trustee, whose job it is to preserve and recover assets for the creditors, is appointed. In a Chapter 11 reorganization case, the debtor cannot obtain confirmation of a reorganization plan unless the plan provides at least as much money for the unsecured creditors as they would receive in a liquidation.

In a reorganization case, a committee composed of unsecured creditors holding the larger claims can be appointed. The committee's mission in life is to maximize the return for unsecured creditors. Committees often use their leverage to gain a recovery for the unsecured creditors where none existed before. A trustee may be appointed in a Chapter 11 case, and the court may appoint an examiner to investigate and report on any aspect of the business or financial affairs of the debtor.

Creditors can effectively participate in a reorganization case, and to a lesser extent in a liquidation case, and may resist any action in the case which might reduce their recovery.

Secured creditors (those creditors holding a lien or mortgage against property of the debtor to secure the debt) have a formidable arsenal of rights in a bankruptcy case to protect their claim and their rights in the collateral securing it.

For the unsecured creditor, there are fewer weapons, and recovery may be a lost cause. Often the money was spent before bankruptcy, there are no assets left, no assets to recover, no business to reorganize. If there is a business with assets, the bank, owed an enormous sum, holds all of the assets as collateral, which means the bank gets it all, despite the best efforts and best intentions of the trustee or the debtor. Remember those formidable secured creditor rights?

What does this all mean to the unsecured creditor? It means that the crucial factor in determining whether or not you get paid is the initial credit decision. When you lend money or extend credit to someone, you are placing yourself at risk to the extent of the credit. You probably need and want to accept this risk for business or personal reasons.

Most business operates largely on credit, and individuals have numerous business, personal and family reasons to loan money. However, to the extent circumstances permit, a lender can lessen the exposure to a bankruptcy and enhance the prospects of repayment with prudent lending practices in the first place.

Do your homework on the credit worthiness of the borrower. Get a credit report. Get current financial statements. Get collateral for the debt. Obtain personal guarantees. Lower the credit limit. Shorten the repayment term. Only loan money to solid Fortune magazine companies like American Airlines or Commercial Financial Services. Oops. Never mind. Bad examples.

But you get the picture. Extending credit, and the occasional but inevitable bad debt expense, are parts of business and life. Bankruptcy law is written with good intentions to maximize the return to unsecured creditors, but bankruptcy costs can be high, delays are inevitable, and sometimes it just isn't there. But generally not because of the bankruptcy.

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