



When and How to File for Bankruptcy

A Brief Legal Guide for California Small Business Owners

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What Information is Contained in this Guide?

This guide provides a basic understanding of the types of bankruptcy most commonly filed by small business owners, as well as related resources for further information and attorney referrals.

***Disclaimer:** This guide is only intended to give you general information about bankruptcy for small businesses in California. It is not intended to provide you with legal advice. For legal advice about your specific situation, you should talk to an attorney. Please see <https://www.calbar.ca.gov/Public/Need-Legal-Help/Lawyer-Referral-Service> to find a lawyer referral service near you.*

What is Bankruptcy?

Sometimes, businesses rack up so much debt to creditors that they can't pay it back when it's due. Bankruptcy is a legal proceeding that enables individual business owners to resolve creditors' demands without losing essential personal property like a portion of the equity in their house or car (*up to an exempt amount*), while also treating creditors fairly. The proceeding begins when the debtor files paperwork (a *petition*) in a federal bankruptcy court.

Bankruptcy may also allow a business or its owner to:

- *Discharge* some of the debt owed, meaning the business or owner doesn't have to pay it back anymore after the debt is discharged in bankruptcy.
- Propose a plan to reorganize the business and modify its debts, and eventually pay back the debts (or a portion of the debts) at a later point.

Who Should File for Bankruptcy?

If you are a small business owner struggling with debts, filing for bankruptcy could help you discharge or reorganize your debt.

Whether bankruptcy is a good idea depends on a variety of factors, such as:

- How much property you own that is *non-exempt* under bankruptcy laws, meaning it can be sold during bankruptcy proceedings to repay your debts.
- The amount of debt you owe.
- Whether those debts are dischargeable under bankruptcy laws.

- Whether the debts are owed by the business owner individually, or through a formal business entity, like a corporation or limited liability company.

The answers to these questions can change depending on the type of bankruptcy you choose to file. The different types are each briefly covered in this guide.

Bankruptcy may be a good option for you if one or more of the following are true:

- Your business has a lot of *unsecured debt* that you can't pay back.
 - *Unsecured debt* is debt where you haven't promised a lien to the lender on property (*collateral*) that the lender can take and sell if you can't pay. Examples of unsecured debt may include credit card debt; unpaid bills to suppliers, vendors, utility companies (although sometimes such creditors may take liens and be secured creditors).
 - *Secured debt* is debt where you agree that the lender can take possession of specific property in case you can't repay it, such as a home mortgage or a car loan.
- Your business owes a lot of taxes to local or state governments, or to the federal government, and you can't pay them. However, taxes may be entitled to special treatment in bankruptcy, which sometimes mean that they cannot be discharged or that they receive priority treatment. Special attention should be paid to tax claims.
- Someone filed a lawsuit against you, or your home mortgage lender is foreclosing on your home, and you need a way to stop the lawsuit or foreclosure process temporarily while you work out a solution to your debt issues and keep the business operating.
 - Filing for bankruptcy puts an *automatic stay* in place, which can temporarily stop some lawsuits or foreclosure proceedings filed by creditors.

Alternatives to Bankruptcy

Alternatives to bankruptcy include the following:

- Assignment for the benefit of creditors (ABC):
 - A proceeding based on state law that allows the person who owes money to transfer their assets to a liquidator ("assignee"), who gives notice to creditors and sells the assets to pay back the creditors.
 - Some people prefer this option because they don't want to be associated with a business that went into bankruptcy.
 - It's important to note that there is no automatic stay or other court protections in an ABC.
- Winding up and dissolving your corporation or LLC by filing the required paperwork with the Secretary of State, without filing for bankruptcy.
- The "hunker down approach," i.e., trying to avoid creditors and gain time to make the business profitable again or ensure that the business is ready to file for bankruptcy.
- Liquidation or reorganization outside of bankruptcy.
 - For example: If you show your creditors how you will re-organize your business to eventually pay back the debts in the future, they might agree to hold off filing lawsuits because they know they will get paid more this way.

Note: Before filing for bankruptcy or choosing one of the alternatives listed below, you should carefully consider each option with an attorney. None of the below options will stop lawsuits against you (“automatic stay”) or discharge your debt by court order.

Roles in the Bankruptcy Process:

Debtor: a person or business who owes a debt to another entity. Debtors may file bankruptcy if they have trouble paying their debts, or may choose one of the above alternatives to bankruptcy.

Creditor: A person or a company to whom money is owed. Creditors have claims against the debtor.

Bankruptcy court: A debtor’s bankruptcy proceedings begin when the debtor files a document called a *bankruptcy petition* with a bankruptcy court. Bankruptcy courts are part of the US Federal Court System and are overseen by bankruptcy judges.

Bankruptcy judge: The official who oversees the bankruptcy court and makes decisions about the debtor’s bankruptcy proceeding. Depending on the complexity of the case and the chapter filed, the debtor may never see the judge, or may be required to attend court hearings in front of the bankruptcy judge. Attending court hearings in front of the judge is common for Chapter 11 and Chapter 13 bankruptcy, as explained below.

Bankruptcy trustee: An independent administrator who is appointed by the Office of the United States Trustee, which is part of the US Department of Justice. A bankruptcy trustee is assigned to oversee the debtor’s bankruptcy case and carry out orders of the bankruptcy court, such as selling certain assets of the debtor and using the proceeds to repay creditors. A trustee’s responsibilities vary depending on the chapter filed.

Assets: Property of the debtor. Assets are either *exempt* or *non-exempt*. *Exempt assets* are protected under bankruptcy laws and cannot be used by the bankruptcy trustee to repay debts. *Non-exempt assets* are unprotected and can be used to repay debts. Exemptions apply in the cases of individual debtors.

Limitations of Bankruptcy: Some Debts Will Not Be Discharged

Individual debtors are entitled to a discharge if they comply with the requirements of the chapter under which they file. Under US federal and state bankruptcy laws, some debts are not dischargeable in the bankruptcy. Non-dischargeable debts will remain after filing bankruptcy, and include the following:

- Any debts that the debtor failed to list on the bankruptcy petition filed with the court,
- Spousal or child support,
- Attorney’s fees in child custody and support cases,
- Certain taxes, fines, and penalties owed to the Federal Government,
- Court fines and penalties,
- Debts for personal injury caused by driving a vehicle while intoxicated.

The Most Common Types of Bankruptcy for Small Business Owners:

Bankruptcy in the United States is governed by federal law and needs to be petitioned for in federal court following the U.S. Bankruptcy Code (Title 11 of the United States Code). The different types of bankruptcy proceedings are divided into “chapters.” The types most useful for

small businesses are: Chapter 7, Chapter 11, and Chapter 13 bankruptcy (which only is available to individual debtors). Chapter 12 bankruptcy is also available for family farmers or fishermen, and is not covered in this guide. In addition, California has distinct rules about foreclosures on real estate, which *assets* are *exempt* (i.e., creditors can't touch it), and community property between spouses. California requires filers to follow the California Exemptions Code.

Below is a chart summarizing the most common types of bankruptcy for small business owners, with additional resources for each type.

	Chapter 7 Liquidation	Chapter 13 Reorganization	Chapter 11 Reorganization	Chapter 11 – Subchapter V
Summary	Dissolves the business and allows individual debtors to discharge qualified debts and keep only exempt property. All nonexempt assets may be sold by trustee. Debtor no longer controls business.	Reorganization bankruptcy for individual debtors who have a regular source of income that they can use to repay creditors over time – usually 5 years. Debtor stays in possession of business.	Reorganizes the debt of a business and revives the business by changing the terms of its debts.	Streamlined version of Chapter 11 for small businesses meeting a debt ceiling requirement.
Eligibility	Filer must: 1) Be an individual to receive a debt discharge. Business entities (like partnership, LLC or corporation) do not receive a discharge in Chapter 7. 2) Pass the Chapter 7 “means test,” if debts are primarily consumer debts and household income is above median. 3) Have not filed for Chapter 7 bankruptcy within the past 8 years.	Filer must: 1) Be an individual. 2) Have regular income. 3) Have unsecured debt of less than \$465,275 and secured debt of less than \$1,395,875 (current as of April 1, 2022). These numbers are adjusted periodically and should be reviewed ahead of filing a petition.	Almost anyone and any type of business entity can file Chapter 11. <i>You may be eligible for a more streamlined process – see column to the right.</i>	The business must have total debts less than \$2,725,625.
Pros	Wipes away dischargeable debts and allows filers to start fresh.	1) Filers can keep non-exempt property. 2) The repayment schedule is limited to 5 years. 3) May be able to reduce certain secured debt (e.g., loan payments for a car or business equipment) to the current value of the property,	1) No debt or income requirement. 2) The business can renegotiate the terms of its debts and come up with a plan to continue operating and pay back creditors.	1) Faster and less resource intensive than regular Chapter 11. 2) Does not require filing of a <i>disclosure statement</i> unless court-ordered. 3) Faster approval of the debtor’s payment plan. Creditors can object, but creditor vote not required for plan approval.

		not what the debtor initially paid for it.		
Cons	<p>1) Requires dissolution of the business claiming bankruptcy and sale of all assets.</p> <p>2) Individual debtors can only keep exempt property under this chapter.</p> <p>3) May affect the filer's credit.</p>	<p>1) Sole proprietor is required to organize both personal and business income to make future payments on debt.</p> <p>2) Priority debts (such as taxes or spousal support) must be paid in full.</p> <p>3) May affect the filer's credit.</p>	<p>1) Complex process requiring a <i>disclosure statement</i> (detailed document about the debtor and the proposed payment plan, expensive to prepare). Also requires that creditors vote to approve the proposed plan.</p> <p>2) Expensive filing fees.</p>	<p>1) Very fast-track: 90 days to file reorganization plan.</p> <p>2) More complex than Chapter 7.</p> <p>3) Expensive filing fees.</p> <p>4) Small businesses are subject to more oversight by the bankruptcy trustee.</p>
Possible to file without a lawyer?	<p>Possible: Upsolve has a detailed guide on filing Chapter 7 bankruptcy, filing fee may be waivable. See: https://upsolve.org/ca/#how-to-file-bankruptcy-in-california-for-free</p>	<p>Possible, but representation by an attorney is highly recommended to complete payment plans and forms.</p>	<p>Representation by an attorney is required for a business entity. Pro se representation for an individual is highly discouraged.</p>	<p>Representation by an attorney is required for a business entity. Pro se representation for an individual is highly discouraged.</p>
Related resources	<p>Upsolve: Free online screening tool to determine if debt can be discharged by filing Chapter 7: https://my.upsolve.org/screeener</p> <p>Guide to filing Chapter 7 Bankruptcy in California: https://upsolve.org/ca/</p> <p>Chapter 7 Means Test for California: https://upsolve.org/ca/#california-bankruptcy-means-test</p>	<p>Forms for Chapter 13 Bankruptcy: https://www.thebalance.com/filing-bankruptcy-without-a-lawyer-chapter-13-issues-3956219</p>	<p>Link to your local lawyer referral service: https://www.calbar.ca.gov/Public/Need-Legal-Help/Lawyer-Referral-Service</p> <p>Article on Chapter 11: https://www.nolo.com/legal-encyclopedia/chapter-11-bankruptcy-overview.html</p>	<p>Link to your local lawyer referral service: https://www.calbar.ca.gov/Public/Need-Legal-Help/Lawyer-Referral-Service</p> <p>Article on Chapter 11 for Small Businesses: https://www.jdsupra.com/legalnews/cares-act-increases-eligibility-26531/</p>

California Exemptions for Chapter 7 and Chapter 13 Property:

Rules about exemptions decide what property the debtor gets to keep, and what property is subject to use for repayment of creditors. In California, individual filers can choose between two different sets of exemptions under the California exemption code, typically referred to as *System 1* or *704* on the one hand, and *System 2* or *703* on the other. More information about the two sets of exemptions in California can be found at <https://www.nolo.com/legal-encyclopedia/california-bankruptcy-exemptions-property-assets.html>.

What Is the Small Business Reorganization Act?

In 2019, the Small Business Reorganization Act (SBRA) created a subchapter (Subchapter V) under Chapter 11 bankruptcy for small business debtors with outstanding debts below \$2,725,625. In 2020, the CARES Act raised this debt limitation to \$7.5 million for debtors filing Chapter 11 before March 2021. The higher limit was extended to March 27, 2022 and expired as of that date. As of April 5, 2022, the lower debt limit of \$2,725,625 applies. Subchapter V strikes a balance between Chapter 7 liquidation bankruptcy and Chapter 11 reorganization bankruptcy by allowing eligible filers to keep their business while lowering required filing expenses and streamlining parts of traditional Chapter 11 process.

Tips for Filing Chapter 7 and Chapter 13:

1. Watch the US Court System's bankruptcy basics videos: <https://tinyurl.com/y2kg3wv8>
2. Understand which chapter of bankruptcy to file and whether you need a lawyer. See chart above.
3. Complete Form 2010: Notice Required by 11 U.S.C. Sec 342(b) for Individuals Filing for Bankruptcy: https://www.uscourts.gov/sites/default/files/form_b2010.pdf
4. Complete Credit Counseling within 180 days with an approved credit counseling agency: <https://www.justice.gov/ust/list-credit-counseling-agencies-approved-pursuant-11-usc-111#CA>
5. Complete Forms
 - A. For Chapter 7: listed on Form 2000 - include lists, schedules, statements, fees: https://www.uscourts.gov/sites/default/files/b_2000_0.pdf
 - B. For Chapter 13: Complete Form B122C-2: <https://www.uscourts.gov/forms/means-test-forms/chapter-13-calculation-your-disposable-income>
6. Determine which Court to file proceedings and file tax returns. Use: <https://www.uscourts.gov/federal-court-finder/search>.
7. Compile and mail matrix of list of creditors.
8. Obtain Certification of the Financial Management Course.
9. Pay Filing Fee: Waiver form for Chapter 7 only - 103B link here https://www.uscourts.gov/sites/default/files/form_b103b.pdf.
10. ***Be careful to disclose all debts and all assets.*** Failure to properly follow the legally required procedures may lead to denial of debt discharge by a court altogether. False statements in bankruptcy filings are a federal crime.

