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Debtor's and creditor's stronghold: Bankruptcy chapter 7, 11 & 13

Faith Cajudo Orillaza, External Contributor
faith.orillaza@westcliff.edu

ABSTRACT

Bankruptcy law is created to protect debtors from the hands of creditors. This law ensures creditors repay loans by engaging in a particular process. The United States Congress has enacted a decree governing bankruptcy in the form of the Bankruptcy Code. The different types of bankruptcy will be referred to in this article by their chapters: Chapter 7, 11 and 13 (Justia, 2019). This article will identify the differences between these three chapters, their objectives, as well as the advantages and repercussions of each. Further, the non-dischargeable debts, recommendable actions for the filers, numbers of petitioners who have undergone bankruptcy cases, the financial ratio of the petitioners, the common denominator on the filers, and the methodology performed by the chief executive officer (CEO) of the four companies, Coldwater Creek, Kmart, SEARS and Toys "R" Us, will be analyzed. Additionally, the design and methodology for reviving each company that were implemented and applied by each CEO will be examined, and the reasons they were proven ineffective will be offered. By investing more, borrowing can become essential and, liabilities can grow beyond what could be repaid. This results in the filing of bankruptcy for protection from creditors.

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Introduction

Bankruptcy is a state that refers to the lack of funds to repay an outstanding debt. When filing for bankruptcy, two major factors are taken into consideration: control and time. At a certain point, debts can compound until the repayment of that debt is beyond control. According to Mikhed (2013), 60% of bankruptcy reports are due to the overuse of credit; however, they have also been attributed to incorrect projections or overcalculations of lifetime earnings (Overton, 2008). Other causes for bankruptcy include extreme borrowing, mishandling of finances and catastrophes in life (Konish, 2019). It has been reported that two-thirds of individuals who filed for bankruptcy in the United States had medical issues (Konish, 2019). These are only some of the ways in which bankruptcy can occur without notice, necessitating a bankruptcy code. Other ways include unemployment, credit card debt (Byrne, 2012), poor investments and economic downfall (Jefferson, 2009).

It is important to realize that bankruptcy may not be the end for a debtor but a beginning to revive an organization; post-bankruptcy, individuals or organizations should reach out to their local court and become familiar with the three major US Bankruptcy Codes. Survival of debtors' liabilities can come through an understanding of the provisions of each code and realizing that there is hope for those who filed for bankruptcy protection. If a debtor is aware of his rights, a court can arbitrate and defend the debtor from creditors.

Discussion

Bankruptcy is a legal process handled by a court to mediate between a debtor who is unable to repay debts to creditors. In the United States, the congress has legislated laws governing bankruptcy in the form of the Bankruptcy Code. There are different types of bankruptcy filings available under the Bankruptcy Code. This information is published under Title 11 of the United States Code and is represented by chapters (Justia, 2019). This section will define three Bankruptcy Chapters: Chapter 7, Chapter 11, and Chapter 13.

Three Major Types of Bankruptcy

Chapter 7. Chapter 7 bankruptcy refers to liquidation. Liquidation is the process where a debtor's assets are converted into cash and the money is used to pay the creditors and shareholders (Dulin, 2018). This type of bankruptcy is common and ideal for debtors who need a fresh start since all debts except for the non-dischargeable debts can be wiped out. After filing, the debtor would be free from any obligation to further repay debt. Individuals and business owners avail this protection to pursue orderly resolution. Chapter 7 bankruptcy was created to help low-income debtors to release general unsecured debts such as that accumulated through credit cards, medical bills, personal and payday loans (Irby, 2019). However, once a Chapter 7 is filed, the debtor's nonexempt assets will be gathered by a trustee who will liquidate these assets sell any property and convert that amount into cash to repay the creditors (Bankruptcy Directory, 2017). Liquidation takes three to five months before a creditor is to be discharged from repayment obligations. Moreover, with Chapter 7, the debtor is unable to recover properties after foreclosure. On the other hand, for those who do not have non-exempt assets, creditors cannot claim any debtor's property as payment for debts (O'Neill, 2017).

Additionally, with Chapter 7 bankruptcy, creditors are classified into two categories: secured creditors and unsecured creditors (Irby, 2019). Repayment for secured creditors are prioritized and paid through the debtor's collateral, provided that the claim is lower than the value of the collateral. The secured creditor has the option of receiving either the collateral or the claim. Conversely, the unsecured creditor can be protected through the trustee whose role is to sell a secured creditor's collateral in the case that the value of the debtor's properties and possessions are higher than the collateral interest (Salxman & Hibschweiler, 2012). Furthermore, court rulings dictate the order of payment; hence, debts for domestic support, obligations, administrative costs, salaries and benefit plan contributions of employees are

given priority. After the aforementioned, the unsecured creditor will then be paid (Salzman & Hibschweiler, 2012). It is to the disadvantage of unsecured creditors when a debtor files for Chapter 7 Bankruptcy as the unsecured creditors cannot expect repayment from the debtors, unless they hire a debt collector or file for a lawsuit (Irby, 2019). This is why lienholder, or a secured creditor, is in a better position when compared to an unsecured creditor.

Chapter 11. Chapter 11 bankruptcy refers to reorganization. This type of bankruptcy is designed for corporations or commercial organizations which intend to operate their business throughout the process of bankruptcy (Battersby, 2005). With this filing, the debtor would create a reorganization plan for how to repay debts, and the debtor's assets will be evaluated by the creditor. After the order of relief, within a period of 120 days, a reconstruction repayment plan is finalized by the debtor (Bankruptcy Directory, 2017). Chapter 11 Bankruptcy is not limited to business debtors but also accommodates individual debtors who earn a fixed income as repayment is not through liquidation of assets but through the deduction of salary or revenue of the organization. Proof of continuous income is required to enable a lighter payment scheme. The amount deemed affordable to be repaid for a specified period is agreed upon by the creditor and generally falls between three to five years. This time frame could be adjusted dependent upon the state. The debtors who fail to meet the requirements of Chapter 7 or Chapter 13 bankruptcy laws are required to file for Chapter 11 (DeSellier & Tomlinson, 2016).

Chapter 13. With Chapter 13 bankruptcy, the debtor has to repay debt on an installment basis. In contrast with Chapter 7 and 11, Chapter 13 bankruptcy allows for the integration of an adjustment plan to repay an individual's debts. This chapter is designed for an individual with regular earnings who has the intention to repay debts within three to five years. The advantage of Chapter 13 is that it allows a debtor to keep his valuable assets. This characteristic is what differentiates it from Chapter 7. In Chapter 7, the properties are liquidated for non-exempt assets. Once the court approves the application plan submitted by the debtor for this particular type of bankruptcy protection, the individual would provide payment to the creditor through a trustee. The trustee would then manage the bankruptcy estate and arrange for the monthly payments.

Chapter 13 is ideal to assist debtors from balance payments of mortgages and to protect debtors' properties from foreclosure. In Chapter 13, since the debt is not entirely annihilated, the assets could be retained if the debtor is able to repay all the debts at an agreed upon time (3-5 years). Exemption amounts are dependent upon each state. Exemption items can include pensions and 401 (k) plans (Holmes, 2005). This is a provision of the federal law which protects retirement accounts from creditors and bankruptcy trustees. Chapter 13 is a type of bankruptcy which can be filed on the condition that the debtor owes under $419,275 of unsecured debt or below $1,257,850 of secured debt. For unsecured debts, the interest is waived, and the court offers a discount on the principal amount (O'Neill, 2017). Furthermore, the Chapter 13 code discharges tax penalties and debts related to non-dischargeable tax payments (Weil, 2010). Nevertheless, it is up to the court to approve the all aforementioned bankruptcy chapters.

Implications

Chapter 7 bankruptcy provides a lighter load for the debtor who wishes to wipe its liabilities by a discontinuation on repayment of debts. In contrast, Chapter 11 and 13 allow a debtor to rearrange finances and work to repay the debts within a specified period of time provided by the court. This leaves an overall impression that the debtor is not running from commitments. A debtor can apply for a loan immediately after the debt is discharged or after a specified number of years post the last filing of bankruptcy. Loan application is dependent upon the debtor's needs since the filing of bankruptcy results in unfavorable circumstances. As per Chapter 7 and Chapter 11, the credit record will reflect bankruptcy for up to ten years, while for Chapter

13, the time allotted is seven years. Thus, the bankruptcy record will manifest on a debtor's credit report in that duration of time (Marquit, 2019). In addition, the debtor regains trust of their creditors who know that these individuals will not be able to submit another bankruptcy application for the coming years (Weber, 2014). In Chapter 7, only after eight years can refiling be done, while in Chapter 13, a period of two years is required. For Chapter 11, there is no specified time frame to wait to refile after a previous filing (Bulkat, 2019).

On the other hand, the aforementioned could be grounds for refusal when applying for future loans. Bankruptcy has the potential to leave an impression that a debtor is unreliable and lacks credibility. Therefore, filing for bankruptcy must be the final resort after every other attempt (Berdsman, 1992). In other words, if an individual chooses the path of bankruptcy, the debtor must reintroduce themselves as a changed person, as a responsible borrower to creditors. Since the debtor has to rebuild a better image, there is a higher need to handle finances wisely the second time around. Filing for bankruptcy has a number of limitations apart from the aforementioned. Not all debts can be discharged. According to the Bankruptcy Directory (2017), the non-dischargeable debts in Chapter 7, 11 and 13 are as follows:

1) Debts which are not included in the filing of a bankruptcy
2) Debts on alimony and child support
3) Debts which occurred due to the effect of drug influence or driving while intoxicated
4) Debts acquired from student loans
5) Debts due to law violations, including the payments of fines and penalties like traffic tickets and criminal charges
6) Debts on federal and state tax payments charged through credit cards
7) Any non-dischargeable debts of the previous filed bankruptcy cases that were terminated due to fraud

Non-dischargeable debts are considered exempt from repayment termination. If all debts could be discharged, a debtor would be more prone to deliberately acquire debt without intention to repay.

Bankruptcy Company Petitioners

In this section, the methodologies and design applied by the chief executive officer (CEO) from several companies who filed for bankruptcy are presented and analyzed. The examples given and discussed in this article come from the petitioners, Coldwater Creek, Kmart, SEARS, Ultimate Electronics and Toys "R" Us. They all applied for Chapter 11 Bankruptcy, the chapter which is commonly applied for by large organizations since it will help these companies to position themselves, if they decide to sell their business or assets as part of repayment (Armstrong, 2019). Also, it is advantageous to apply for the reorganization payment of debts knowing that the value of the long-term revenue will be higher compared to the liquidation value of the assets. The aforementioned companies did not qualify for Chapter 7 nor Chapter 13. The latter may only be filed by individuals, not by business partnerships or corporations. The former is ideally filed by a sole proprietor to liquidate the assets without intention to continue operating a business. Unlike the subject petitioners, the companies used within this article decided to remain in business while the reorganization of debt payment was ongoing. Another common denominator which could be noticed from all their cases is that they invested more by borrowing more while their income and assets hardly improved.

Coldwater Creek, a woman's clothing retailer and women's catalogs producer, was unstable since 2007. In order to survive in the fashion industry, the president and CEO, Jill Dean, put his concentration on developing an ad merchandising strategy, which was not appealing to the market or to their existing clients. Though they already cost-cut expenses by closing more than 50 stores, which saved the company $10M in expenses, the company could not meet the target revenue to repay its debts (Popovec, 2014). Coldwater Creek considered the possibility of merging their businesses with other firms by borrowing or trading its business

to a private equity (Glazer, 2014). However, they ended up filing for Chapter 11 bankruptcy protection and closing its 372 stores and liquidating its assets and inventories.

Additionally, Kmart Corporation, filed Chapter 11 bankruptcy protection as well. In 1893, its founder, Sebastian Kresge, sold his business assets for five or ten cents, after which, he managed to multiply his income and built numerous additional stores. In 1912, he received a yearly revenue of more than $10 million from his 85 stores (Lehavy & Udpa, 2011). He continued expanding his businesses for a number of decades, and the first Kmart discount department was launched in 1962 (Lehavy & Udpa, 2011). For another decade, the company changed its name to Kmart Corporation. This happened the same year Wal-Mart opened its first discount store. However, within the 30-year time-lapse, Wal-Mart had topped the retail business in the United States. Subsequently, Wal-Mart continued managing around 2,700 stores while Kmart had around 2,000 stores. The former was receiving a net income of almost $7 billion while the latter experienced a net loss of $1.3 billion.

To overcome this failure, Kmart applied well thought out strategic plans initiated and implemented by the new chairman and CEO, Charles Conway. In 2000, two years before the company filed for Chapter 11 bankruptcy protection, Conway invested more on the supply chain. Consequently, Kmart released $1.4 billion in investments allocated for technological items, gave priority to customer concern, enhanced marketing strategies with a lower budget for advertising, developed a food division, limited selling, reduced general and administrative costs, and worked on the 250 stores to maximize profits (Lehavy & Udpa, 2011). Even though Kmart adopted several strategies to improve their sales, fighting with more attractive competitors led to Kmart's downfall. Kmart shut down 72 of its stores situated in inactive locations as it attempted to lease out other locations (Scherer & Paulson, 2002).

In January of 2002, Kmart was unable to pay their weekly obligations of around $78 million to one of the major distributors of food and grocery's supplies. Thus, the distributor cancelled the delivery of goods. In the same month, Kmart Corporation filed for Chapter 11 bankruptcy (Lehavy & Udpa, 2011). The corporation was purchased by SEARS in 2004, The company's CEO, Edward Lampert, filed for bankruptcy in 2018 (Wahba, 2018). Lampert had focused on e-commerce and upon targeting the improvement of cash flow. He attempted to sell valuable assets and high-quality brands focused upon the sales of appliances and tools as opposed to clothing and downsized the amount of property while focusing on the online business component (Sullivan, 2018). Despite the strategic changes, SEARS was unable to overcome its debt and filed for Chapter 11 bankruptcy.

Ultimate Electronics, one of the giant electronics retailers in Colorado, filed for Chapter 11 bankruptcy protection in January 2005. Four years prior to filing, the company invested in the expansion of its stores, going from 31 to 65 locations throughout 14 states. However, due to the infrastructure, the economic downturn and tight competition with competitors, the company was unable to repay debts (Wolf, 2004). Furthermore, in the fiscal fourth quarter of 2003, the company hired a specialized consultant, Peter Hanelt, to maximize the company's profit. Unfortunately, the company was already in the middle of battling with many issues like losing many items due to poor inventory, low product demands, ineffective promotion campaigns, competitor's advancements, manpower issues, the needs for installation of new software which made them released $23.5 million for the management information system (Bernarz, 2004). The company incorrectly projected the profitability of establishing additional stores for product distribution. Even, with the contribution of a specialist, the company still suffered from insolvency. For the fiscal year of 2000, sales were $385 M while in the fiscal year of 2004, the sales went up to $712.9 million. The net income of the company, in 2001, was at $14.6M, $12M in 2002, and in 2003 it decreased by almost half, resulting in the loss of$16 million (Paone, 2005). The losses stemmed from an increase in sales that

was proportional to the increase of opening up new stores, which augmented the release of income together with the issues mentioned above.

Lastly, on September 18th, 2017, Toys “R” Us, a toy company founded by Charles Lazarus in 1948 filed for Chapter 11 bankruptcy in Virginia. The company owed its debtors nearly $7 billion (Tan, 2017). Dave Brandon, chairman and CEO of Toys “R” Us, tried to revive the company from its swelling debt by enhancing sales during the holiday season. He strategically increased inventory and sold items which gained additional profit with a lower cost of production (Bomey, 2018). However, he failed to fight with titans like Amazon, Walmart and Target which offered the same products for lower prices (Bhattarai, 2017). Despite the effort to improve the product structure, there were no viable solution allowed for mitigating the increasing volume of electronic gadgets replacing the need or desire for toys. The company even hired a financial consultant to fix the capital arrangement (DiNapoli & Rucinski, 2017). Yet, creditors became unwilling to provide more funds to finance the business.

The accumulated debts, resulting in the resistance of the creditors to lend more, limited these companies in their ability to manage their working capital, impeding their ability to produce larger earnings. Higher debts repel investors from providing funds.

With the knowledge of the financial situations for these companies, an analysis will be offered regarding the two-year annual record of their progress. The information displayed in Table 1 will be used to identify if the companies reached the bankruptcy stage when the debtor is no longer capable of repaying debts on a given income; thus, a review of the financial status of each corporation will be used to determine if filing for bankruptcy could resolve the issue.

		Total Assets		Total Current Assets		Total Liabilities		Total Current Liabilities	
Company	USD	1 Yr Prior to Filing For Bankruptcy	2 Yrs Prior to Filing for Bankruptcy	1 Yr Prior to Filing For Bankruptcy	2 Yrs Prior to Filing for Bankruptcy	1 Yr Prior to Filing For Bankruptcy	2 Yrs Prior to Filing for Bankruptcy	1 Yr Prior to Filing For Bankruptcy	2 Yrs Prior to Filing for Bankruptcy
		Feb-13	Jan-12	Feb-13	Jan-12	Feb-13	Jan-12	Feb-13	Jan-12
Cold Water Creek Inc.	In Thousands	345,908	413,115	170,415	203,262	308,772	296,702	146,383	149,040
		Jan-01	Jan-00	Jan-01	Jan-00	Jan-01	Jan-00	Jan-01	Jan-00
Kmart Inc.	In Million	14,630	15,104	7,624	8,160	8,547	8,800	3,799	4,076
		Feb-18	Jan-17	Feb-18	Jan-17	Feb-18	Jan-17	Feb-18	Jan-17
Sears Inc.	In Million	7,262	9,362	3,812	4,996	10,985	13,186	4,915	4,681
		Jan-17	Jan-16	Jan-17	Jan-16	Jan-17	Jan-16	Jan-17	Jan-16
Toys "R" Us Inc.	In Million	6,908	6,910	3,389	3,288	8,068	8,064	2,738	2,798

		Total Stockholder Equity		Debt to Equity Ratio		Current Ratio	
Company	USD	1 Yr Prior to Filing For Bankruptcy	2 Yrs Prior to Filing for Bankruptcy	Total Liabilities/Shareholders Equity		Current Asset/Current Liability	
		Feb-13	Jan-12	Feb-13	Jan-12	Feb-13	Jan-12
Cold Water Creek Inc.	In Thousands	37,136	116,413	8.3	2.5	0.6	1.4
		Jan-01	Jan-00	Jan-01	Jan-00	Jan-01	Jan-00
Kmart Inc.	In Million	6,083	6,304	1.4	1.4	0.9	2.0
		Feb-18	Jan-17	Feb-18	Jan-17	Feb-18	Jan-17
Sears Inc.	In Million	3,723	3,824	3.0	3.4	0.3	0.4
		Jan-17	Jan-16	Jan-17	Jan-16	Jan-17	Jan-16
Toys "R" Us Inc.	In Million	1,292	1,265	6.2	6.4	0.4	1.2

Table 1. Company’s Assets/Liabilities.

Note. Total assets, total current assets, total liabilities, and total current liabilities were all taken from the financial records of Coldwater Creek (2012-2013), Kmart (2002), Sears Holding Corporation (2018) and Toys

In analyzing the figures presented in Table 1, debt to equity ratio and current ratio will be used. Debt to equity ratio is used to refer to a quantification of a company’s financial control

which can be obtained by dividing the total liabilities by the stockholder's equity. This ratio displays the amount of debt and equity availed by the firm to produce its assets. Current ratio is used to refer to a company's current assets over the current liability which is used to estimate the capability of the firm to repay current debts. The higher the ratio, the higher the chance the company will be able to repay the obligated amount to the creditors.

As seen in Table 1, Cold Water Creek had a lower debt to equity ratio in 2012, but it increased by more than half after one year, from 2.5 to 8.3. The remaining companies saw similar decreases, as, Toys "R" Us went from 6.4 to 6.2, SEARS went from 3.4 down to 3.0. However, Kmart had a consistent debt to equity ratio of 1.4, which is an ideal figure since a good debt to equity ratio is between 1-1.5. With a high debt-to-equity ratio, a firm will have difficulty in producing finances to repay debts, since debt to equity ratio is equivalent to the amount of debt to finance the business over the shareholder equity. Wherein the shareholder equity is equivalent to the total assets minus the total liabilities. It is also identified as the net assets. Therefore, the higher the debt to equity ratio, the higher the debts in proportion to the net assets. Investors are not attracted when it is high, as the company is a risk due to higher debt. On the other hand, it is also not ideal to have a low debt to equity ratio since borrowing will gather more finances to support the business. An indication that a company's finances are not being managed properly is seen when the profit is high, leaving debt at a minimum level ("Debt to equity ratio," 2019). Thus, the implication from these figures suggest that Coldwater Creek and Toys "R" Us struggled in repaying debts especially when compared to SEARS and Kmart. Even though Kmart's debt-to-equity ratio was consistent, at 1.4 ratio, this does not automatically mean that Kmart would be entirely capable of repaying its debt. The relationship between current assets and current liabilities must be analyzed to determine the current ratio. A satisfactory number is a 2:1 ratio which means that the current asset is double of the amount of the current liability. As seen in Table 1, the companies' current ratios over the last two years before filing for bankruptcy are as follows: Coldwater Creek went from 1.4 to 0.6, Kmart went from 2 to 0.9, SEARS went from 0.4 to 0.3, and Toys "R" Us went from 1.2 to 0.4. Considering all the current ratios of these companies, all values decreased to less than one, which is a solid indication that these companies do not have the capability to repay their current debts within a year, thus, initiating the bankruptcy filings.

Despite the effort and various strategic initiatives applied by these companies, the income generated did not suffice in covering their excessive liabilities. The failure of handling finances properly was due to the failure to take action when the debt began to accumulate. Additionally, the implementation of the strategies was weak and required verification, which was lacking. When applying a new strategy, there is a demand for more expenses than their income could provide. At this point, each company should have doubled their efforts to produce more revenue. Some of the ways to do this are to concentrate on customer's demands, improve the transaction volume, expand the target market, raise or lower the price of goods, provide deals or promotions, and develop innovative marketing plans. Unless a positive result can be manifested within a short period, the business strategies being attempted are futile. However, the five companies aforementioned perpetually invested and built up their liabilities while their income and assets continued to decrease. At the point when the creditor is no longer lending money to finance the business, suppliers hold the supply of goods, the debt is higher than the operating costs, or the income is lower than the debts, the court's protection becomes essential for the survival of an individual's or an organization's financial standing. Each company filed the appropriate chapter for their situation and experienced a relief from financial burden.

Conclusion

Bankruptcy, while seen as a failure by some, can also be a path of restoration for others. Coldwater Creek, Kmart, Ultimate Electronics,

Sears Inc. and Toys "R" Us exhausted their finances and entered a space of inability to repay debts. Regrettably, the strategies applied to rejuvenate the businesses were ineffective. This led to the foreclosure of their businesses and the filing of bankruptcy in court, specifically Chapter 11 bankruptcy. After filing for Chapter 11, the companies aforementioned were able to continue operating their businesses while they paid off the debts. Due to the reorganization of debts, their secured debts were restructured, they were able to bargain with the creditors for lower payments of debts, and they received extensions for the duration of the settlement. Though the businesses remained intact through a reconstruction period, all the entities analyzed still chose to sell their companies post-bankruptcy. While filing for bankruptcy can be a tedious and painful process, it is one that is there to enact both justice and a safety net for all involved parties.

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