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The reorganization procedure in U.S. Bankruptcy Law: Chapter 11

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Debtor as Debtor-in-Possession.

Chapter 11 of the U.S. Bankruptcy Code is available to individuals or business entities to reorganize the finances of financially distressed individuals or businesses. One of the key features of Chapter 11 is that current ownership and management continues in place as the debtor-in-possession during the reorganization process, unless the court for cause appoints a trustee. Some level of mismanagement is present in many cases. But simple mismanagement prior to the filing is not enough to warrant the appointment of a trustee. Appointment of a trustee is the rare case and requires an affirmative showing of ongoing fraud, dishonesty, incompetence, or gross mismanagement. Chapter 11 can also be used to achieve a sale of the business, typically as a going concern.

The debtor-in-possession has all of the rights and shall perform all of the functions and duties (except certain investigatory duties) of a trustee. So wherever the word trustee appears in the U.S. Bankruptcy Code, in a Chapter 11 where no trustee has been appointed, substitute ñdebtor-in-possession.ò

The debtor-in-possession exercising many of the functions of a trustee has a fiduciary obligation to the unsecured creditors in the case. Note that with solvent corporations, the fiduciary obligations imposed on the board of directors and senior management runs in favor of the company shareholders. But that changes when the debtor becomes insolvent. This is because the typical Chapter 11 debtor is insolvent. When a company is insolvent, managementôs obligation flows to creditors, not the shareholders.

Operational Issues.

The debtor-in-possession may use, sell, or lease property of the estate in the ordinary course of business without any court authorization. So business in the ordinary course continues as usual. However, this precludes payment of prepetition claims without court authority.

Also, while sales in the ordinary course of business are permitted, the sale of substantially all of the debtorôs assets or of a major operating division would not be considered in the ordinary course of business, and court authority would need to be obtained.

While the business is being operated in the chapter 11, the debtor-in-possession must file periodic reports as required by the office of the United States Trustee. These reflect cash receipts and disbursements and other financial transactions that occur after the filing of the bankruptcy case. These are available to any interested party and are a useful source of information for creditors and the U.S. trustee as they continue to monitor the case.

Employment of Professionals.

Only professionals that have been employed by the debtor-in-possession with court approval can represent a debtor-in-possession and be compensated. The Bankruptcy Codes requires that in order for professionals to be retained, the professional must not hold or represent an interest adverse to the estate and must be a disinterested person.

A professional will get a sizable retainer prior to undertaking representation of a Chapter 11 debtor. The professional can apply the retainer to fees as they are incurred. Further payments from the debtor-in-possession cannot be made absent application and court approval.

First-Day Motions.

A Chapter 11 case is commenced by the filing of a petition with the bankruptcy court. Upon filing, the automatic stay goes into effect, the debtor becomes a debtor-in-possession, and all of the debtorôs property becomes property of the bankruptcy estate to be administered subject to the restrictions on using, selling, and leasing property outside the ordinary course of business.

A notice of the filing of the Chapter 11 case is immediately sent to all creditors. The notice of the filing schedules a meeting of creditors between 20 and 40 days after the filing. At the meeting of creditors, the debtor will be present and represented by counsel. Those attending may question the debtor about any matter that may affect the administration of the case.

There are a number of motions that are considered to be of an emergency nature that will be heard by the court during the first days of the bankruptcy case. These are generally referred to as ñfirst-day motions.ò They will be promptly scheduled by the court for hearing immediately following the filing. Notice of these first-day hearings is typically required to be given to any secured creditor whose collateral interests might be affected by the relief granted, the 20 largest unsecured creditors, and the Office of the U.S. Trustee.

The most common of these first-day motions is a motion to use cash collateral. This is required by the fact that in most cases there is a bank with a lien on all of the debtorôs current assets: cash, accounts receivable, and inventory. The proceeds from this type of collateral is called ñcash collateral.ò The debtor in a Chapter 11 is specifically prohibited from using cash collateral unless the lender consents or the court after notice and hearing authorizes the use.

This protects the lender from a debtor continuing to burn up the lenderôs collateral as this sort of collateral dissipates quite rapidly if it is used to fund losses. Just as importantly, the lenderôs lien, which floats over the ever-changing current assets (accounts receivable, inventory, and cash) under its after-acquired clause, is cut off as to the collateral acquired by the debtor after commencement of the case.

So one of the first motions filed in a case is a motion to use cash collateral. The court will then typically authorize the debtor-in-possession to use the lenderôs cash collateral provided that it is proven by the debtor-in-possession that the lenderôs secured position is adequately protected and will not diminish during the course of the case.

This adequate protection would typically provide for the continuation of the lenderôs lien on its collateral such as accounts receivable, inventory, and their proceeds arising from post-filing collections to the same extent, validity, and priority that the lenderôs lien had prior to the filing of the bankruptcy. In addition, to the extent that the value of the lenderôs collateral is diminishing during the case, the court may require that the debtor make periodic payments to compensate for this diminution in collateral value.

Typically the court will only grant partial relief at the first hearing on the motion to use cash collateralð giving the debtor permission to pay expenses essential to the short-term continued operation of the debtorôs business such as current wages, utilities, and to make COD payments to suppliers who are no longer providing credit to the debtor because of past-due arrearages.

The court may also have to consider on an emergency basis approval of financing for the debtor-in-possession to meet its short-term financial obligations. While this sort of debtor-in-possession (ñDIPò) lending is rare in smaller cases and in single-asset real estate cases, it is common in cases involving large operating companies such as manufacturers or retailers.

An industry has developed that provides DIP financing in the larger cases that are filed. In addition, often the source of DIP financing is the existing lender that is already in the case because of a prepetition lending relationship. The existing lender has the incentive to be the DIP lender because that lender does not want to share its collateral with a new DIP lender. It also gives the lender a level of control over the case and the ability to demand concessions as a condition of their extending postpetition financing.

Critical Vendors.

As mentioned, there is a general prohibition on paying prepetition unsecured creditors during the time that the Chapter 11 is pending prior to confirmation of a plan of reorganization. However, some of these creditors may be critical to the continued operations of the debtor. While there is no applicable provision in the Bankruptcy Code authorizing the debtor before a plan of reorganization is approved to pay any prepetition unsecured claims while others remain unpaid, debtors do it on occasion, with court authority, at the beginning of Chapter 11 cases.

The most common example is the stub period of employee salaries owing for the one to two-week period prior to filing. While these wage claims will be given priority under any confirmed plan, experience has taught us that telling employees that in lieu of their weekly paycheck they are going to get a priority claim is not a viable alternative. They will quit and the business will cease operations. So routinely debtors-in-possession request and receive orders authorizing the payment of these pre-petition wage claims to the regular employees.

The other common situation in which certain creditors are preferred through immediate payment after the bankruptcy is filed is in the case of so-called critical vendors. The theory behind the need to pay these suppliers is that they are unwilling to do business with a customer that is behind in payments and, if the debtor cannot obtain the merchandise, the debtor will be unable to carry on its business to the detriment all of its creditors.

A typical showing that the debtor must make in order to obtain a court order authorizing the payment of pre-petition debt of critical vendors is that the services or goods they provide are essential to the debtorӧs business operations and they have refused to do business with the debtor absent payment; and the disfavored creditors will be at least as well off as a result of the courtӧs granting critical vendor status to the select vendors.

Executory Contracts.

While the Chapter 11 process allows a debtor to reorganize its finances through a restructuring of its terms of repayment and amounts owed of secured and unsecured debts, there is another type of economic relationship that a debtor may have that needs to be dealt with as part of the reorganization process. These relationships are the prepetition contracts to which the debtor and others are parties and under which both parties have continuing obligations to perform. In the Bankruptcy Code they are defined and treated as ñexecutory contracts.ò

These are to be distinguished from contracts under which the only remaining obligation is the payment of money that the debtor has borrowed. A contract by the debtor to repay money simply gives rise to secured or unsecured claims. On the other hand, in contrast, a simple example of an executory contract would be the debtorӧs lease of office space. The debtor has a continuing obligation to pay rent, and the landlord has the obligation to maintain and allow the debtor to occupy the premises.

Another example is a contract by the debtor to manufacture a product for a customer. The debtor has the obligation to manufacture the product by a certain date and deliver it to the customer. The customer has the obligation to pay for the goods when they are delivered. Because these contracts are still in process at the time of the bankruptcy filing, they are defined and treated as executory contracts.

These contracts are an integral part of the business operations of a debtor. However, not all of these contracts are profitable. For example, the debtor may be paying too much rent under a multi-year lease for premises that are now available at a much lower rental rate. Or the debtor might have undertaken an unprofitable manufacturing contract that is consuming financial resources and causing the debtor financial problems.

To address this situation, Bankruptcy Code allows a debtor-in-possession to either assume or reject its executory contracts with third parties. Where the debtor-in-possession assumes an executory contract, it will be contractually obligated to fully honor the contract to include curing any arrearages. The debtor must also demonstrate that it can perform under the assumed contract.

On the other hand, where contracts are unprofitable, the debtor-in-possession can reject the executory contract. The rejection is treated as a prepetition default. The party to the rejected contract would be entitled to file an unsecured claim in the case to be treated along with other unsecured creditors under the plan of reorganization.

The debtor-in-possession may also be party to contracts that the debtor is no longer able to perform but which may be valuable if assigned to a third party. For example, it is common when a retailer having multiple locations files for Chapter 11 to close unprofitable locations. But even though the locations were unprofitable to the retailer, the leases for the locations may be below market and valuable to another type of business. The Bankruptcy Code allows the debtor-in-possession to assume such leases and assign them to third parties provided that the third party can provide adequate assurances that it will be able to perform under the lease after the assignment. The debtor-in-possession benefits from the consideration paid by the party acquiring the debtorôs rights under the executory contract. The debtor-in-possession has the right to assume and assign an executory contract even if it has a provision that precludes assignment without consent of the counterparty to the contract.

Plan Formulation and Confirmation.

Of course, the overall objective of the chapter 11 case is to achieve a long-term solution to the debtorôs financial problems by restructuring its obligations with secured and unsecured creditors. This restructuring is accomplished through confirmation of a plan of reorganization filed by the debtor. The debtor has the exclusive right to propose such a plan during the first 120 days of the case, and if a plan is filed by the debtor during this period, the debtor has until 180 days after the filing date to obtain confirmation of that plan. If the debtor is unable to confirm a plan in the 180 days, absent an extension of the debtorôs exclusivity by the court, a creditor may file a plan.

The plan must comply with various statutory requirements. One of these is that the plan must designate classes of creditors with the exception of administrative claims and tax claims, which will be paid in full pursuant to other Code provisions. The Code requires that a creditorôs claim can be placed in a class with other claims only if the claims are substantially similar. So typically the unsecured creditors occupy a class because they do not have any collateral. They are just owed money, and their claims must receive the same treatment.

Typically a secured creditor occupies its own class because no two secured creditors are exactly the same. This is because the collateral given to different secured lenders typically differs either in type or priority of lien. For example, one secured creditor may have a security interest in equipment and another a mortgage on the debtorôs office building. Or even when two secured creditors are secured by the same property, one will generally have priority over the other such as the first and second mortgages on the debtorôs office building.

In some cases a secured creditorôs collateral is worth less than the amount of the debt. When that occurs, the creditor holding the secured claim will also hold an unsecured claim for the portion of the debt that exceeds the value of the collateral. As a result, the same creditor will hold a secured claim equal to the value of its collateral and an unsecured claim for its deficiency measured by the amount by which the debt exceeds the value of the collateral. The court is often called on to conduct evidentiary hearings to determine the value of a secured creditorôs claim. The portion of the secured creditorôs claim that is treated as unsecured will be included and receive the plan treatment provided for the class of unsecured creditors generally.

There is much flexibility in what terms may be included in a proposed plan of reorganization. For example, the plan may propose for the reorganization of the debtor as a going concern and continuation of operations under existing management and ownership. Frequently, however, as an alternative to reorganization under existing management and ownership, the plan will provide for a sale of the debtorôs assets under section 363 of the Bankruptcy Code. You may hear this referred to as a "363 sale.ò This has been increasingly common in the last 20 years.

There are many advantages to selling a business in a Chapter 11. One of these is that the assets can be sold free of any preexisting liens or claims of creditors, with the result that the buyer is guaranteed by court order that it will receive clean title to assets it is buying. Typically, any claims of creditors holding liens on the assets will attach to the proceeds and then be dealt with as ordered by the court. So the buyer knows that the buyer will be getting good title free of any potential creditor claims. There would be no such assurance in the sale of the assets of a financially troubled business outside of Chapter 11. And, importantly, the sale order is not subject to reversal on appeal so long as the purchaser acted in good faith.

In order to confirm a plan, the court must hold a hearing on 25-daysô notice to all creditorsð called a confirmation hearingð at which time the court will consider any objections to the plan and determine whether the plan meets the requirements of the Bankruptcy Code for confirmation. While there are numerous technical requirements, the key requirements include the following.

First, the debtor must receive the required vote of all creditor classes whose rights are being impaired under the plan. Impaired creditors are those whose rights are being altered by the plan. In determining whether a plan has been accepted by a particular class, it is a matter of counting the votes. If a creditor does not vote, it does not count for or against confirmation. Of those voting, creditors holding at least two-thirds in amount and more than one- half in number of the allowed claims must accept the plan.

With respect to the class that is made up of the unsecured creditors, the debtor will need to solicit their consent to the plan. Solicitation is not permitted unless the debtor first provides a disclosure statement to creditors that has been approved by the court as providing sufficient information for creditors to make an informed judgment about the plan.

On the other hand, the secured creditors do not vote as a single class. Rather they each occupy their own class. Accordingly, the consent of each secured creditor is required unless the debtor is able to obtain confirmation over the objection of the non-consenting secured creditor in a process that we call ñcramdown.ò

As discussed, a creditor holding a claim secured by collateral may also hold an unsecured claim for any deficiency in the value of the collateral to cover the amount of the debt. In such cases, such creditors will hold two claims each dealt with in separate classes. The creditorôs secured claim will be placed in a separate class. The creditorôs unsecured claim will be treated in the class of general unsecured creditors in an amount equal to its deficiency claim. Because the primary secured creditor in a case is typically the largest creditor in the case, the deficiency claim dealt with in the unsecured creditor class of such a creditor may be so large as to give the secured creditor the ability to block acceptance by the required two-thirds in amount for that class. This provides the secured creditor with leverage to use in negotiating the plan treatment of its claims.

In addition, the same creditor may attempt to block confirmation by refusing to accept the treatment proposed for its secured claim. In such cases, the debtor will still be able to confirm the plan if the proposed plan provisions satisfy the requirements for ñcramdownò of the treatment of the secured creditorôs claim over its objection. In a cramdown, the court can still confirm the plan over the secured creditorôs objection if the court finds that the treatment of the claim of the secured creditor is fair and equitable.

In order for the plan to satisfy the ñfair and equitableò standard to cramdown the terms of the plan over the objection of the secured creditor, the debtor must propose repayment terms under the plan that provide for payment in full to the extent of the value of the secured creditorôs collateral. Payment can be made over a reasonable time at a reasonable interest rate. For example, a common treatment of secured claims in my court would provide for payment of an amount equal to the value of the secured creditorôs collateral, payable monthly with interest based on a 20-year amortization, with a 5-year balloon payment.

Another important requirement for confirmation of the plan is that the plan must meet the ñbest interest of creditorsò test. Specifically, with respect to each impaired class of claims, either 100% of the creditors in such class must vote in favor of the plan, or the plan must provide that such creditors must receive as of the effective date of the plan an amount that is not less than the amount that would be received in a Chapter 7 liquidation.

Certain claims are provided priority status under the plan. For example, debts arising during the administration of the debtorôs business during a chapter 11 caseð referred to as administrative claimsð are given priority status. The professional fees approved by the court and owing to the professionals that provided services during the case are also treated as administrative claims and are given priority status. These claims must be paid in full in cash upon confirmation of the plan unless claimants have agreed to be paid over a period of time.

One of the most important requirements of confirmation of a plan is that the debtor-in-possession provide evidence that the plan is feasible and the reorganized debtor is not likely to require further financial reorganization. This will require the court to receive evidence in the form of financial projections demonstrating that the debtor will be able to generate sufficient earnings to fund the plan payments.

Matters are greatly simplified in terms of what needs to be proven at a confirmation hearing if the plan proposes to sell all of the debtorôs assets and operations to a third-party buyer. Typically in such cases the requirements for feasibility simply require that the court find that the buyer has the ability to close on the sale transaction based on the terms negotiated with the major secured creditors.

Postconfirmation Proceedings.

Confirmation of the debtorôs plan does not conclude the case. The debtor, however, is no longer a debtor-in-possession and is back in the real world of managing its own business without court restriction or supervision. Still there are a number of things that need to be done to conclude administration of the case.

One of these is the issuance of all notes and execution of all documents required to give effect to the provisions of the confirmed plan. Another is the review of all claims filed by creditors to ensure that the amounts claimed are owed. While this review process can commence prior to confirmation, it is often more economical to wait until after the debtor knows that its plan will be confirmed before it expends the time of its professionals and financial staff to review and object to claims.

In many cases, an asset of the bankruptcy estate is the right of the debtor-in-possession to pursue preferential payments and fraudulent transfers that might have occurred prior to the bankruptcy filing. Often the review and analysis of these potential recoveries is left until after confirmation. It is very common for a plan to provide that these claims be assigned to a trust established for the benefit of the unsecured creditors and that they be collected by counsel chosen by the creditors for that purpose.

Once the case has been fully administered, the court will issue a final decree closing the case.