The Life and Times of a Commercial Chapter 11 Debtor

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Aggressive creditor pressing foreclosure? Contentious litigation draining financial resources? Simply suffering from a crippling liquidity crisis? Your business client may need to consider bankruptcy. Chapter 11 proceedings can overwhelm lawyers who don't regularly practice in the area. What should you know?

There are three stages in every Chapter 11 debtor's life: the pre-petition period; the post-petition period, after filing the case but before a plan is confirmed; and the post-confirmation period. The pre-petition stage comes, of course, before the post-petition stage, but the progress of a Chapter 11 case is not necessarily linear. Events within each stage may occur at different times and in a different order depending on the type of business, the issues facing the particular business, and the conduct of other parties in the case.

Before Filing

Before filing, the debtor company should identify key parties. Some are important pre-petition; others come into existence only later. Key parties for a hypothetical retail debtor would include secured creditors, critical trade vendors, the U.S. Trustee, the official committee of unsecured creditors, and others like landlords, contract parties, and aggressive creditors.

Secured creditors hold liens against the debtor's assets. In a retail case, that might be a bank that provided secured financing or a line of credit used by the company to fund operations. Debtor's counsel should meet with secured creditors before filing the bankruptcy. Doing so enables the debtor to, among other things, receive the creditor's consent for continued use of revenues on which a secured creditor has a lien. To the extent the company needs additional financing from those lenders after filing, the process will be much smoother if things are arranged pre-bankruptcy.

Critical trade vendors are those from which the company needs continued receipt of goods or services to continue operating. When in Chapter 11, a company cannot pay any pre-bankruptcy claim without court authority, so it's important to identify which of a company's vendors are critical before filing. That will facilitate an uninterrupted payment process that incentivizes vendors to continue working with the debtor while it is in bankruptcy.

The United States Trustee is an arm of the Department of Justice charged with oversight of the bankruptcy system. It is, in essence, the watchdog in the case. The U.S. Trustee is generally active at the start of a case but may later take a less active role, especially when a case has active creditor participation.

The committee of unsecured creditors becomes relevant only post-petition. Appointed by the Trustee, the committee generally consists of 3 to 7 of the largest general unsecured creditors in the case, and up to 11 in the biggest cases. The committee represents the interests of all general unsecured creditors and has standing


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to participate and be heard in all aspects of the case. The committee may retain its own counsel and other professionals, all paid by the bankruptcy estate, and is an important player in the case.

Depending on the type of case, other key parties may include landlords, counterparties to significant contracts, or aggressive creditors. It is important to identify these key parties as early as possible to ascertain the need to discuss or negotiate matters pre-filing or to figure out the best way to deal with them post-filing.

The Three Types of Cases

Before filing, the company and counsel should consider how they want to present the Chapter 11 case and to what extent creditors can participate in planning. Generally speaking, there are three approaches: a free-fall case, a prearranged case, and a prepackaged case.

A free-fall bankruptcy is a surprise filing. It involves no coordination of the timing of the case with the company's lenders or key parties, even if they were aware of the anticipated filing. A prearranged bankruptcy entails consensus among the lenders and other key parties that the case should be filed and when, but no agreement on the terms and conditions of the filing, on a Chapter 11 plan, or on the treatment of creditors. That approach typically contemplates negotiations and agreement on a Chapter 11 plan shortly after filing. A prepackaged bankruptcy entails the consensus of a prearranged bankruptcy plus agreement before filing on the terms and conditions of filing, on a plan, and on the treatment of creditors. Any company hoping to be in and out of bankruptcy quickly should consider filing a prepackaged case.

Bankruptcy counsel should closely consider due diligence about the debtor in the pre-filing phase. Counsel should understand whom at the debtor company they may contact to prepare for the filing, obtain information for creditors that will require immediate notice of the filing, and conduct lien and litigation searches. Counsel should determine who should serve as points of contact at the debtor, along with which creditors may be contacted. Strategic decision-making on the front end mitigates the risk of leaks that could cause vendors, for example, to cease shipping, competitors to lure customers away, and employee morale and retention to plummet.

During this pre-petition period, counsel also should ensure that the debtor has fully considered other, non-bankruptcy options—out-of-court restructuring, which requires creditor agreement and confidence in the company; settlements with key parties or creditors pushing the company toward bankruptcy; forbearance agreements or other extensions of foreclosure proceedings pending settlement discussions; or state-sanctioned alternatives such as California's out-of-court assignment for the benefit of creditors. Pursuing alternatives to Chapter 11 could save the company substantially in fees, costs, reputation, and stress.

The Three Post-Petition Phases

The next major stage is post-petition, after the case has been filed but before confirmation of a Chapter 11 plan. That is the longest stage of a Chapter 11 debtor's life. It consists of three phases.

The early phase begins with the debtor filing the bankruptcy petition and paying the filing fee, which starts the bankruptcy case. A company may have more than one option of where to file. Venue could be where the company is incorporated, where it has maintained its principal place of business or principal assets for at least the last 180 days, or where the bankruptcy case of an affiliate is already pending. Although bankruptcy is a federal, not state-specific, system, case law from the various districts nationwide interprets Bankruptcy Code sections differently, adopts and applies different standards and tests on various issues, and tends to rule more or less favorably for debtors on certain matters. If the three noted venue tests would allow the company to file in more than one district, bankruptcy counsel should determine which would be in the company's best interests.

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Once a Chapter 11 bankruptcy case has been filed, the company becomes what's known as a debtor-in-possession (DIP). The company is a debtor that remains in possession and control of its operations and assets and that manages its bankruptcy case. The debtor remains a DIP unless and until a plan is confirmed, a trustee is appointed, or the case is converted to Chapter 7 or dismissed.

The first few days of the case are extremely busy. Representatives of the company must be present at first-day hearings; handle inquiries from customers, suppliers, creditors, investors, employees, and sometimes the media; meet early in the case with the Trustee;

Illustration by Tim Bower

gather extensive information for the debtor's bankruptcy schedules and statement of financial affairs, unless prepared ahead of time; and comply with various Trustee requirements.

One immediate benefit is the automatic stay under Bankruptcy Code section 362(a). That extremely important protection arises upon filing of the petition. It is an injunction that prohibits a broad range of actions against the debtor, the debtor's property, and any property of the bankruptcy estate. For example, pending litigation is automatically stayed until the court grants relief from the stay.

The automatic stay is designed to protect both the debtor and creditors. It gives the debtor a breathing spell from collection and litigation, and it facilitates an orderly proceeding. For creditors, it eliminates the race to seize assets. It does not, however, protect parties not in bankruptcy, such as guarantors or co-obligors, or co-defendant officers of the company.

The filing of the debtor's bankruptcy case, while providing the debtor with certain statutory protections such as the automatic stay, also subjects the debtor to certain restrictions. Those restrictions limit a debtor's discretion and require court approval for certain actions. In light of the restrictions, on or about the first day of a case, the company usually files several motions and appears at initial hearings on those motions. Those motions are generally operations-related motions and procedural or administrative motions.

The first group of motions is designed to minimize any disruptions to the company's operations and to ensure the smooth transition from non-debtor to debtor. Examples are a motion seeking permission to pay pre-petition employee wages, a motion seeking permission to pay pre-petition claims of critical vendors, and a motion for authority to use cash collateral. The second group of motions addresses procedural or administrative matters, including a motion seeking to limit notice of certain hearings to a smaller group of parties or a motion for an extension of time to file the mandatory bankruptcy schedules.

First-day hearings are usually set within the first few days after a case is filed. In addition to providing essential relief, those hearings are counsel's first chance to introduce the case to the bankruptcy court and establish, gain, or lose credibility with the court.

Within 14 days after the case is filed, the company must file its bankruptcy schedules and statement of financial affairs. The schedules are a comprehensive list of all of the company's assets and liabilities, including asset values and claim amounts, with each claim identified as secured, priority unsecured, or general unsecured. The statement provides more detail about the company's financial condition and pre-petition transactions. Depending on the size and complexity of the debtor's case, preparation of the schedules and the statement may be a large project that requires a significant amount of management's time, so it helps to start gathering that information and preparing those documents early, even before the case is filed.

During the early phase of the case, the debtor will have to address insider compensation. Insiders are, among others, controlling shareholders, officers, and directors. Insiders may not be paid any compensation without first serving a notice of insider compensation, subject to objection and a hearing. As a practical matter, if an insider wants to get paid, that notice should be submitted with the filing or right after filing.

Another task that should be addressed promptly is employment of professionals. A Chapter 11 debtor must obtain court approval to retain any professional. That applies to the company's retention of bankruptcy counsel, accountants, real estate brokers, and others who will render services post-bankruptcy. With only certain exceptions, those professionals are not allowed to hold pre-petition claims against the company.

During this stage of the case, a debtor will need to comply with various Trustee requirements. Within seven days after the case's inception, the company must submit to the Trustee a "7-day package" that includes copies of real estate leases, tax returns, bank account information, a summary of the case and timetable of important events, evidence of current insurance, and other operations-related materials. In addition, the Trustee will schedule an early initial debtor interview. That interview includes a meeting between the Trustee and the debtor's representatives—its principal, controller, or financial advisor, and its counsel—to discuss the company's background, restructuring goals, and Trustee compliance requirements. The interview is informational in nature and not under oath.

About a month or so into the case, the debtor will need to attend an initial meeting of creditors. That is an examination, conducted by the Trustee, in which the debtor testifies under oath. The examination relates to the debtor's assets, liabilities, schedules, reorganization progress, status of operations, and more. The committee and individual creditors may appear and ask questions.

Other Trustee requirements that span the entire post-petition period include the filing of monthly operating reports (MORs) and the payment of quarterly Trustee fees. The MORs identify post-petition cash receipts and disbursements on a monthly basis. The amount of the quarterly fees is based on total disbursements over a particular quarter.

Another important event in the early stages of the post-petition period is the Trustee's formation of the committee. That starts with the Trustee soliciting creditors, usually from those among the top 20 largest unsecured creditors, to join the committee. If there is interest, a committee is formed. The committee represents the interests of the entire unsecured creditor body, consults with the debtor on the administration of the case, investigates the debtor's conduct and business operations, and negotiates with the debtor about the plan's treatment of general unsecured creditors. The committee can be a significant ally, so transparency and regular contact are important.

Funding Operations During the Case

The company must address early on how it will fund operations while the case progresses. The debtor will need cash to function. It has cash collateral and new debtor-in-possession financing as its primary sources of funding. Cash collateral is cash that is subject to a lender's security interest. To use cash collateral post-bankruptcy, a debtor must obtain the consent of the secured party or court authorization. If the secured creditor does not consent, the debtor must provide the creditor with adequate protection designed to protect the lender's interest in its collateral, such as periodic payments to the lender or replacement liens on new collateral acquired during the case.

Sometimes a debtor's revenues are insufficient to maintain operations. The debtor may need to borrow money to fund the shortfall. The Bankruptcy Code permits a debtor to obtain such financing, which comes with various protections as incentives to lenders to make the loans. Those protections generally consist of a steadily increasing series of liens and priorities to make sure the loan is repaid ahead of other preexisting creditors. Over the course of a debtor's case, the debtor may need to obtain court approval of several debtor-in-possession financing arrangements to address liquidity needs.

The Middle Stage of the Case

About two months after filing, the case moves to its middle stage. The level of activity subsides slightly. Business operations tend to normalize. The debtor conducts business as usual, except with a little less confidentiality and a little more public scrutiny. This is when the debtor should evaluate its business plan and future financial outlook; methods to shrink operations or cut expenses; options for exiting the case successfully; potential litigation; and other legal and business strategies such as reducing its space needs and workforce, rejecting burdensome contracts, or selling assets.

The court will set a deadline for creditors to file proofs of claim. Because the debtor will need to know the full universe of claims asserted against it to address them in its Chapter 11 plan, it is a good idea to gather that information well before filing a plan.

The debtor may determine that disposing of certain contracts or leases, or a sale of assets or its entire operations, is necessary to exit the case successfully. The Bankruptcy Code provides the debtor with the power to take such actions. The code allows a debtor to ask the court for permission to sell certain assets, unprofitable stores or divisions, or even all of its assets, so long as the debtor is able to articulate a valid business justification for doing so.

The code also allows a debtor to reject any executory contract (where performance is due on both sides) or unexpired lease. Rejecting a contract or lease means that the contracting parties are relieved of any further obligations to perform their contractual duties. While that is a great way to relieve the company of future, burdensome obligations under the contract or lease, the other party still retains a claim against the estate.

Chapter 11 is complex, but when used properly it is extremely beneficial to a business facing difficult times.

The company also has the option to assume, or assume and assign (that is, sell), executory contracts and unexpired leases by binding itself to perform the pre-bankruptcy contract in accordance with its original terms. To assume a contract or lease, the debtor must cure both pre-petition and post-petition defaults and provide adequate assurance it could perform under the contract or lease going forward. There may be an objection to the debtor's proposed cure amount, asserting for example additional defaults or amounts due. The decision to assume, assume and assign, or reject a lease or contract requires court approval, although the court typically defers to a debtor's business judgment.

The Chapter 11 Plan and Confirmation

No later than the middle phase of the case, the debtor should formulate and negotiate its Chapter 11 plan. Broadly speaking, a plan provides for comprehensive changes in the financial and business structure of the debtor; may include a sale of assets, the cancellation or refinancing of debt, or changes in interest rates; and generally dictates how all legitimate claims against the company will be treated. A plan can provide that a creditor's claim will be paid back over a longer period or at a different interest rate than otherwise required under the pre-petition agreement, and can provide for the conversion of debt to equity. During the first 120 days of the case—the exclusivity period—the debtor is the only party that is allowed to file a Chapter 11 plan. The debtor should take advantage of that time to negotiate with creditors and other parties in interest about its desired plan.

While dealing with plan-related matters, the debtor might commence litigation or address contested matters. Examples of common litigation are avoidance claims against preferential or fraudulent transfers, and claim objections. Oftentimes, such proceedings are addressed in the plan.

By far the most significant task is plan confirmation. Generally, plan confirmation proceedings follow a simple chronology—negotiate a plan with creditors, draft the plan and related disclosure statement, seek court approval of the disclosure statement, solicit and tally the votes for the plan, and ask the court to confirm plan.

The disclosure statement summarizes the plan and sets forth information about the assets, liabilities, and business affairs of the debtor sufficient to enable a creditor to make an informed judgment about the plan. The court must approve the disclosure statement before a debtor may send it and the plan to creditors for a vote. The plan could be a reorganization plan or liquidation plan. For many debtors, the goal is usually reorganization, with liquidation as a last resort.

The Bankruptcy Code dictates what must be, what may be, and what may not be in the plan. The plan puts each creditor in a class of similarly situated creditors and identifies how each class will be treated. The company has a lot of flexibility in determining the treatment of each of the various classes, which usually consist of secured creditors, general unsecured creditors, and equity interests. When the Bankruptcy Code dictates how certain creditors are treated under the plan, such as for administrative claims like fee claims of professionals employed during the case and priority tax claims, there is less flexibility.

After approval of the disclosure statement, the debtor solicits votes by mailing the disclosure statement and plan to all creditors and parties in interest. The package may include other solicitation materials, such as a letter of recommendation from the committee in favor of the plan. Voting is done on a class-by-class basis, and only creditors holding allowed (that is, undisputed) claims that are impaired (that is, their contractual rights will be modified under the plan) are allowed to vote. Claims that are not impaired are deemed to have accepted the plan without voting. For a class to be deemed to have accepted a plan, the plan must be accepted by a majority of the number of creditors in that class who vote and at least two-thirds in amount in that class not counting insider votes.

Broadly speaking, confirmation of a plan requires the court to make a number of specific findings. The most significant requirements for confirming a plan include a finding that the plan is in good faith, is feasible, and meets the best interests test or is accepted by every creditor. Good faith assesses whether the plan complies with all applicable law and has been proposed in good faith. Feasibility assesses whether the debtor will have enough money to make all payments required to be made on the plan's effective date and is reasonably expected to have enough money to make all future plan payments. The best interests test assesses whether creditors who rejected the plan are getting at least as much under the plan as they would receive if the debtor were liquidated under a Chapter 7 bankruptcy case. If all creditors vote to accept the plan, the last consideration is moot.

Another aspect of plan confirmation is the potential to cram down on creditors. While it would be preferable to have all parties and all classes accept the plan, the court may still confirm a plan over a class of claims that rejects it. Cramming the plan down on a class of creditors requires a showing that the plan's treatment of the objecting class does not discriminate unfairly and is fair and equitable.

After the court conducts the confirmation hearing and the plan is confirmed, the plan becomes law of the case. It is a substitute contract that governs the relationship between creditors and the debtor, and prior contracts or terms no longer apply. Once the reorganization plan is confirmed, the terms of the debtor's restructured arrangements control. As of the effective date of the plan, the debtor is generally free from the strictures of the Bankruptcy Code, just as it was before it filed bankruptcy.

Post-Confirmation

In the post-confirmation period, the debtor continues operations as usual, or as set forth in the plan; begins payments under the plan; and consummates transactions called for by the plan. The plan should identify a disbursing agent tasked with making the payments called for.

The debtor remains subject to the court's jurisdiction and supervision but to a lesser degree. Generally, the debtor must file quarterly post-confirmation reports on its progress in implementing the plan. And after the plan is substantially consummated, the debtor should file a motion for entry of a final decree and order closing the case.

Shortly after confirmation of the plan, the lawyers and other professionals engaged by the debtor during the case must file their fee applications to obtain final approval of all fees and costs incurred during the case. A professional's fees usually are allowed, although depending on how the case turned out, a court may reduce fees, deny the fee application, or even require disgorgement of fees previously paid on an interim basis.

Chapter 11 is complex. When used properly, though, it is extremely beneficial to a business facing difficult times. Engaging—or being—strategic, forward-thinking bankruptcy counsel early in the process is almost always necessary to make it worthwhile for a potential debtor. ■