What is Chapter 11, Anyway?

What are the consequences of a Chapter 11 filing? What does it mean to be a "debtor in possession"? If all of the assets are covered by liens, how does the Chapter 11 debtor get the cash to keep operating? How can the Chapter 11 debtor deal with contracts-favorable and unfavorable? How can secured debt be restructured under a Chapter 11 plan? How about unsecured claims? What's a pre-packaged or pre-negotiated Chapter 11?

Chapter 11 allows a company to remain in business while it addresses its financial problems. Chapter 11 is based upon the economic premise that a business, even though not currently able to meet its obligations, can often be restructured so that creditors and stockholders would receive more from future profits (or a sale of the restructured company) than from a forced liquidations of assets by a bankruptcy trustee under Chapter 7 of the Bankruptcy Code. Chapter 11 can also maintain employment and other economic benefits for the community where the debtor company operates. An ailing company will typically consider Chapter 11 of its business, or some portion of it, is likely to be worth substantially more as a going concern than on the auction block. Chapter 11 can also be used as an orderly way to liquidate a company's assets and wind up its affairs.

Commencement of Chapter 11 Reorganization

A Chapter 11 reorganization begins when a company files a petition and various related documents with the United States Bankruptcy Court. The immediate result of the Chapter 11 petition is to impose the "automatic stay." The automatic stay is the equivalent of a court order freezing all debts of the company and preventing creditors from demanding payment, bringing lawsuits, seizing assets or engaging in any other kind of collection activity. The purpose of the automatic stay is to preserve the status quo while the company and its creditors negotiate the terms upon which pre-Chapter 11 debts will be settled. The proposed terms of settlement will be set forth in a document known as the "plan of reorganization," or, more simply, the "plan." A successful Chapter 11 reorganization culminates in the "confirmation" (i.e., approval) of the plan by the bankruptcy court.

Parties that play a significant role in a Chapter 11 case include the debtor, secured creditors, the creditors' committee appointed to represent the interests of general unsecured creditors, the United States Trustee (who appoints the creditors' committee and monitors the reorganization process for compliance with the administrative requirements of the Bankruptcy Code) and the bankruptcy judge, who by determining legal issues, establishing procedures, and signaling to the debtor and other parties the court's view of whether proposed courses of action are desirable or disfavored – can greatly influence the tenor and outcome of a Chapter 11 case.

Creditors' Committee

Soon after the filing of the Chapter 11 petition, a creditors' committee is formed if there is sufficient interest among unsecured creditors in having one. The committee ordinarily consists of representatives of seven largest unsecured creditors who are willing to serve. The committee is charged with representing the interests of all unsecured creditors. The committee almost always engages counsel and will often hire an accountant and/or financial advisor as well. These professional persons are paid from assets of the Chapter 11 company. The committee's most important function is to negotiate, on behalf of all unsecured creditors, the treatment of their claims under the plan. To this end, the committee will often monitor quite closely the business operations of the Chapter 11 company, and is entitled to be heard on all matters that come before the bankruptcy court.

Operation of the Business

During Chapter 11, the company's existing management continues to operate the company as a "debtor-in-possession." However, the company must obtain court approval for any transaction out of the ordinary course of its business (such as sale of a major asset), after notice to the creditors' committee and other interested parties. This process shields managers and directors from liability for decisions that are "pre-cleared" by the bankruptcy court after full disclosure.

Creditors may ask the court to oust the company's management if there has been fraud, dishonesty, incompetence or gross mismanagement or if it would be in the best interest of creditors, for example, where the owners are deadlocked or have a conflict of interest with the company. If such a request were granted by the bankruptcy court, a trustee would take over operation of the business. Appointment of a Chapter 11 trustee is fairly unusual.

If creditors lose confidence in the company's ability to reorganize successfully, they may move to have the Chapter 11 case converted to a liquidation under Chapter 7 of the Bankruptcy Code. The bankruptcy court seldom grants this type of motion unless the company is continuing to incur substantial operating losses and is not making progress toward confirmation of a reorganization plan.

Funding Operations During Chapter 11

A company that has filed a Chapter 11 petition will often face an immediate cash crunch. Suppliers are typically reluctant to ship on credit, even though the bankruptcy law provides for payment of obligations incurred by a debtor-in-possession ahead of pre-bankruptcy unsecured claims. Where will the money come from to pay C.O.D.? Accounts receivable and inventory have typically been assigned to a bank creditor as collateral, with proceeds to be used to repay loans upon default.

The bankruptcy law allows the Chapter 11 company to obtain emergency relief from the court. The bankruptcy court may permit the company to use proceeds from cash sales or collection of accounts receivable for continuation of the business if the company can provide "adequate protection" to the secured creditor against any deterioration in its economic position. Typically, "adequate protection" can be provided by putting up substitute collateral, such as new accounts receivable or newly purchased inventory. Knowing this, secured lenders will often agree, in advance, to finance the Chapter 11 company on at least a provisional basis.

The bankruptcy law makes available an extraordinary level of protection to postpetition lenders. A lien on all assets can be provided at the stroke of the bankruptcy judge's pen, without the need to file at the registry of deeds, the Secretary of State, the Patent and Trademark Office, or anywhere else. A lender can be provided with priority over pre-bankruptcy claims (including, in some instances, secured claims) and also the right to be repaid in full immediately on the effective date of any Chapter 11 plan or at any prior date. The lender can even be granted "super-priority," which means priority over even post petition claims. Because of these protections, a worried lender will sometimes require the company to file a Chapter 11 petition as a condition to further extension of credit.

Secured Creditors

A secured creditor may seek relief from the automatic stay. The two principal grounds on which such relief is granted are: (1) if the creditor's collateral is declining in value, and the company is not able to provide "adequate protection" in the form of cash, a replacement lien or the like, or (2) if the company has no equity in the collateral, and either has no reasonable prospect of obtaining confirmation of a plan within a reasonable time or has no genuine need for the collateral in the reorganization effort.

Contracts and Other Assets

Firms having contracts with a Chapter 11 debtor often wish to cancel them because of concern that the debtor might shut down. This, of course, could become a self-fulfilling fear. Therefore, the bankruptcy law generally forbids cancellation by the non-debtor party just because of the Chapter 11 petition or because of payment defaults occurring before the petition. However, the Chapter 11 company is generally required to pay rent and meet other kinds of contractual obligations relating to the post-petition period.

If the terms of a particular contract (especially a real estate lease) are advantageous, the Chapter 11 company will often have the right, despite anything to the contrary contained in the agreement, to assign the contract to a third party in exchange for a cash payment. In the converse situation, where the company wants to cancel a disadvantageous contract or lease, it may do so with court approval. The non-debtor party can claim damages for breach of contract, but usually this will be just one more unsecured claim to be paid at a discount under the Chapter 11 plan. The ability to reject unfavorable contracts and leases, and to perform or assign favorable ones despite contractual provisions to the contrary, can be one of the most important benefits of Chapter 11.

Another important benefit of Chapter 11 is the ability to sell assets, with the bankruptcy court's permission, free and clear of creditors' liens. Outside bankruptcy, in order to sell an asset that is subject to a lien, a company will usually need either to obtain the lienholder's approval or to pay off the lien in full. In bankruptcy, however, the court may permit the company to sell the asset free of the lien, with the lien to attach to the proceeds instead. This procedure allows the Chapter 11 company and other parties, without jeopardizing an advantageous sale, to challenge the amount claimed by the lienholder or to argue that the lien holder has enough other collateral so that the company should be permitted to use the sale proceeds.

Plan of Reorganization

Once the process of stabilizing the company's operations and disposing of surplus assets is under way, attention turns to negotiation of the Chapter 11 plan. Unless otherwise ordered by the bankruptcy court (which would be highly unusual), the Chapter 11 company has the exclusive right to propose a plan during the first 120 days of the reorganization. The purpose of this provision is to allow the company's management a fair chance to propose a settlement with creditors. The "exclusive period" for proposing a plan can be extended by the bankruptcy court at the company's request. If the exclusive period expires, then any creditor, committee or other interested party may propose a plan.

The company will usually negotiate the terms of the plan with the creditors' committee, representatives of the principal bank lenders and lessors, and anyone else who will be particularly important to the success of the reorganization (for example, union officials). Two factors will generally determine the terms of the settlement with creditors. One is the ability of the company to generate cash over and above its operating expenses. The other factor is the set of minimum standards for the treatment of each type of claim contained in the bankruptcy law. These standards, essentially a "bill of rights" for creditors, can be summarized as follows:

1. Secured creditors are entitled to receive the full value of their collateral. If a secured creditor's claim is greater than the value of the collateral, the unsecured balance is usually treated as a general unsecured claim (discussed below). The secured portion of the claim need not be paid at once. However, if it is paid over a period of time, the secured creditor has a right to receive interest at a fair market rate and to keep its lien on the collateral or to receive equivalent assurance of payment.

2. Unsecured claims are divided into two categories: "priority claims" and "genera unsecured claims." The principal types of priority claims are obligations incurred since the filing of the Chapter 11 petition, pre-bankruptcy wages and employee benefits, and taxes. In general, priority claims must be paid in full when the plan takes effect. The most important exception is pre-bankruptcy taxes, which can be extended for as long as six years if interest is paid.

3. There is almost limitless flexibility in dealing with general unsecured claims. The company may propose one or any combination of the following: immediate cash, a fixed payment schedule, a payment schedule tied to profits or cash flow, or the issuance of stock, warrants, bonds, notes or any other instrument. Creditors protect their interests primarily through the exercise of two rights.

First, almost any creditor has the right to object to confirmation of a plan that leaves the creditor worse off than if the company were liquidated under Chapter 7 of the Bankruptcy Code. Thus, whatever the company offers its creditors under the plan must have a present value at least equal to the liquidation value of the company's assets (usually, but not always, auction value), less the cost of liquidation and the amount owed to secured and priority creditors.

Second, before the plan can be confirmed by the bankruptcy court, creditors receive a "disclosure statement" prepared by the company and approved by the court, containing information concerning the company and the plan. Then the creditors may vote to accept or reject the plan. If a majority in number and two-thirds in amount of the general unsecured claims have voted in favor of the plan, it will be deemed to have been approved by that class of creditors and will be confirmed so long as all other statutory requirements are met. If not approved by the general unsecured class, the plan be confirmed only if the court finds the plan to be "fair and equitable." In general, this means that if the plan does not provide for creditors to be paid in full, then all junior interests (such as stock or subordinated debt) must be canceled. Some bankruptcy courts in limited circumstances recognize a "new value corollary" to this rule, and will permit the existing owners to continue to own the business (or, more accurately, to buy back ownership of the business) by making a new investment in the company under the plan, even though unsecured creditors will not be paid in full and have voted against the plan. Confirming a plan over the objection of a class of creditors is known as "cramdown."

The company's management usually has a prominent place at the negotiating table because management will often be the best (and will sometimes be the only) party in a position to deliver more to the creditors than they would receive in a liquidation of the company. Because the consequences of failure to agree are typically so unpleasant for both sides, the company its creditors can usually reach agreement on the terms of the Chapter 11 plan.

The Prepackaged Bankruptcy Case

The bankruptcy law permits a company to file its Chapter 11 petition after already having proposed a plan, distributed a disclosure statement and obtained the necessary votes of creditors. This is colloquially known as a "prepackaged" bankruptcy case. In this situation, all that remains to be done during the Chapter 11 case is to confirm the plan, which can be accomplished in as little as 30-45 days. This contrasts with the six months to two years that a Chapter 11 case would typically take.

A prepackaged Chapter 11 case has two great advantages for the troubled company. First, by going into Chapter 11 only after locking up the creditors' acceptance of the plan, company management minimizes the risk that it will lose control of the Chapter 11 case to a creditors' committee or potential acquirer. Second, the short duration of the Chapter 11 case tends to keep down its cost (primarily professional fees), although savings during the Chapter 11 case are partially offset by fees that are front-loaded to the pre-bankruptcy period.

While a prepackaged Chapter 11 can be advantageous, in many situations it is not feasible. Sometimes, a troubled company may require months or even years in Chapter 11, protected from collection activity of creditors, while the company resolves litigation, restructures operations and negotiates with key constituencies. Moreover, prepackaging only works if the company is able to stay out of bankruptcy until the prepackaged plan is negotiated, prepared, circulated for vote, and accepted. In addition, a prebankruptcy disclosure statement must comply with any applicable securities laws presenting risks, costs and a potential for delay that can be avoided by distributing the disclosure statement during the bankruptcy case. Finally, the bankruptcy court will not rubber stamp confirmation of a prepackaged plan. The disclosure statement, not having been approved by the court prior to distribution, will be subject to scrutiny as part of the confirmation process. Any perceived defect can serve as grounds to deny confirmation of a plan without ever reaching its merits. This would mean starting over with the disclosure and confirmation process.

Despite potential pitfalls, a prepackaged Chapter 11 can be the best approach in the right situation. Among the issues that must be weighted for each company contemplating a prepackaged plan are (i) what are the chances of success, and (ii) how serious are the consequences of not succeeding for example, if pressure from creditors requires filing a Chapter 11 petition before the votes are in, or if the first month of the Chapter 11 case turns out to have been wasted because the court denies confirmation of the prepackaged plan.

The Pre-Negotiated Bankruptcy Case

Even when a prepackaged Chapter 11 does not make sense, the duration and expense of the Chapter 11 case can sometimes be minimized through a “pre-negotiated” Chapter 11. In a pre-negotiated Chapter 11, the debtor reaches agreement with major creditors before filing for bankruptcy, but does not solicit the votes of creditors generally. The plan and disclosure statement are prepared prepetition and filed with the bankruptcy petition or shortly thereafter. In as little as 30-60 days, the disclosure statement might receive court approval, thus permitting the process of vote solicitation to begin, with plan confirmation obtained 30-45 days later,

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