BASIC BANKRUPTCY
FROM F TO C (FILING TO CONFIRMATION)

A PRACTICAL CHAPTER 11 OVERVIEW FOR THE NON-BANKRUPTCY PRACTITIONER

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INTRODUCTION

This outline is intended to provide a basic overview of the Chapter 11 process, from cradle to grave, or, in bankruptcy terms, from F to C (filing to confirmation). We hope it provides a basic overview which you will find valuable.

I. RECEIPT OF THE NOTICE OF COMMENCEMENT

The debtor, upon filing a bankruptcy petition, is required to file a list of creditors and equity security holders, complete with names and addresses. This is known as the Matrix. Based upon the Matrix, the Court will send a notice to all creditors and equity security holders noted on the Matrix, advising them of the filing of the Chapter 11 case and of the imposition of the automatic stay.

- *Upon receipt of the notice (if not advised sooner), your client and any collection counsel and agencies acting for your client are required to immediately cease all efforts to collect the debt.* This is based on Section 362 of the Bankruptcy Code, which imposes an automatic stay against actions to collect a debt, upon the filing of a bankruptcy petition.

- *Review the notice to determine if the client contact information is correct (name and address).* If the client contact information is not accurate, you should file a Notice of Appearance in the bankruptcy case, advising that your client wishes to receive notices at a different or corrected address. *In addition to correcting any client address, it is recommended that the attorney who will be monitoring the Chapter 11 case file its own Notice of Appearance, specifying the attorney's name, address and the creditor represented.* This will result in the attorney's contact information being added to the Matrix and will allow the attorney to receive notices without having to rely on the client to forward pleadings, as received, or a daily monitoring of the docket on line. The timelines in bankruptcy court are much shorter than in state court and therefore, timely receipt of pleadings is critical in the bankruptcy realm.

II. THE FIRST MEETING OF CREDITORS

The notice sent to creditors based on the Matrix, in addition to advising of the filing and the imposition of the automatic stay, will state a date that has been set for the "first meeting of creditors" which is a mandatory meeting the debtor must attend, as mandated under Section 341 of the Bankruptcy Code. This is also known as the "Section 341 Meeting."

At the Section 341 Meeting, the debtor appears, not before the judge assigned to the debtor's case, but rather before a representative of the Office of the United States Trustee (the "OUST"). The OUST is a federal agency, charged with overseeing the bankruptcy process. Apart from conducting the Section 341 Meeting, the OUST oversees pleadings filed in the bankruptcy case, reviews professional engagement pleadings and fee applications, has the power to be heard in any aspect of the bankruptcy case and is there to be sure the creditor interests are being adequately represented.

The debtor is represented by bankruptcy counsel at the Section 341 Meeting. The debtor is under oath and the proceeding is recorded. A transcript may be ordered and used in the bankruptcy case, as would a deposition in any court proceeding. No judge presides over the Section 341 Meeting.

At the Section 341 Meeting, the debtor is asked by his counsel if the Schedules and Statement of Financial Affairs (discussed below) are true and accurate. After that, counsel usually asks very little more. Then, a representative of the OUST has the right to question the debtor on anything related to the bankruptcy case. Usually the OUST representative will ask any questions it might have regarding ambiguities in, or information missing from, the Schedules and Statement of Financial Affairs, will ask for the reasons the bankruptcy was filed, will inquire as to the status of taxes and tax returns and will otherwise try to familiarize himself with the overall status and complexity of the Chapter 11 case.

After the representative of the OUST completes his questioning, any creditor has the right to ask questions of the debtor. This is free discovery. There is no limit to the type, amount or scope of questions that may be asked. There is no ability for debtor's counsel to instruct the debtor not to answer a question, unless it impinges on the attorney client privilege. There is no one to rule on an objection. So the Section 341 Meeting is a great opportunity to develop some key facts in support of your client's case or position, very early on. Some representatives of the OUST set aside a whole morning or afternoon for the Section 341 Meeting if they believe creditor interest will be heavy. Other offices of the OUST will limit questioning to 30 minutes or less and advise that any additional questioning should be taken pursuant to a Rule 2004 exam (discussed below). *Don't be shy. If you need questions answered, ask them. There are no rules, other than the rules of ethics, to which we all are bound.*

Generally, the Section 341 Meeting concludes at the end of the session. The OUST has the right to leave the meeting open and will do so, if material information is missing or if the debtor representative takes the 5th or otherwise refuses without justification to answer material questions, etc.

III. SCHEDULES AND STATEMENT OF FINANCIAL AFFAIRS

Bankruptcy Rule 1007 requires that the debtor file what are called the Schedules and the Statement of Financial Affairs. The Schedules are a comprehensive listing of all assets and liabilities of the debtor, including each creditor name and address, setting forth the dollar amount owed to each creditor and contain a designation whether the debt to a given creditor is contingent, unliquidated and/or disputed. The Schedules segregate the information into various categories, such as real

property, personal property, property claimed as exempt, creditors holding secured claims, creditors holding unsecured priority claims, creditors holding unsecured non-priority claims, executory contracts and leases, co-debtors, and if an individual Chapter 11 debtor, current income and current expenditures. There is (or should be, if completed accurately) a treasure trove of information in the Schedules.

The Statement of Financial Affairs contains a series of written questions, similar to what would be asked at a creditor's exam, regarding the historic operations of the debtor. They address such topics as past income, suits pending, professionals previously engaged, payments to insiders (owners, directors and relatives), gifts, the location of records and bank accounts, pension accounts, former owners, etc.

- *If your client's claim is listed as disputed, contingent or unliquidated, you should prepare and file a proof of claim, setting forth the exact amount of your client's debt and the documentation in support of it.* The Notice of the Section 341 Meeting will advise creditors of the deadline by which a proof of claim must be filed. In some instances it will state that no date has yet been set. This is common in consumer bankruptcy cases but not in Chapter 11 cases. *Make sure you take note of the claims bar date and docket the same.* Under the Bankruptcy Code, a proof of claim is deemed conclusive of the amount of a creditor's claim. If no proof of claim is filed, the debtor's representation of the claim amount in the Schedules is controlling. *Your client will only receive a payment if its claim is allowed, meaning that it has been finally determined. If listed by the debtor as disputed, unliquidated or contingent, it is not an allowed claim and no distribution will be made related to it. The claims process is therefore critical to the preservation of your client's rights in the bankruptcy case.*

- There is a standard proof of claim form (Form 410) that is accessible from all bankruptcy court websites. This form was revised as of December 1, 2015, so be sure you are using the correct form. *The form may be filed in any bankruptcy case, using the electronic filing system in place in all bankruptcy courts across the country. You do not need local counsel or be locally admitted to file a proof of claim. Most other actions taken in a foreign jurisdiction to where you are licensed to practice law will require you to be admitted to the local practice and usually have an affiliation with local co-counsel.*

IV. COMMITTEE SOLICITATION

The Bankruptcy Code provides for the appointment of a committee of unsecured creditors in each Chapter 11 case (the "Committee"). When a debtor files its Chapter 11 petition, it is required to submit a list of unsecured creditors holding the 20 largest unsecured claims (the "Top 20 List"). From this Top 20 List, the OUST sends a letter to each of the Top 20, inviting them to serve on the Committee. From the responses received, the OUST is generally to appoint the seven largest unsecured creditors willing to serve.

The seven member rule is not written in stone.

- The OUST is permitted to form Committees smaller than seven members, usually if there is not sufficient interest to form a Committee of seven.

- Further, the OUST seeks diversity on the Committee and therefore will attempt to appoint unsecured creditors with differing interests, such as landlords, unions, trade creditors, utilities, etc.

- So it is not always the case that the seven largest in dollar amount are appointed to the Committee.

The duty of the Committee is to act as a fiduciary to the unsecured creditors generally, and not to advance the agenda of an individual Committee member.

- This duty generally centers around maximizing the return to the unsecured creditors.

- All things being equal, the Committee will also seek to maximize value if, at the same time, it can result in a continued source of supply to the debtor, rather than a straight out liquidation, where no further profit opportunity is available to the supplier base.

The Committee has the right to engage counsel and other professionals (financial advisers, investment bankers, appraisers) to assist them in carrying out their fiduciary duties.

- The fees of the Committee professionals are not paid by the individual Committee members, but instead by the debtor.

Because of this statutory grant, the Committee becomes a key player in the bankruptcy process. Further, as a new “client” previously unrelated to the bankruptcy case, solicitation of business by professions (attorneys, financial advisors, liquidators and investment bankers) to represent the Committee becomes a highly competitive venture for the professionals and subjects the Committee members to an overwhelming barrage of lobbying and posturing by the professions seeking their engagement.

If your client is appointed to the Committee, the Committee will undertake to interview the professionals it seeks to retain.

- The Committee members will be buried in brag materials from the various professionals and a series of “beauty contests” or interviews will be held to determine the professionals to be retained.

- Much politicking and arm-twisting occurs as the professionals jockey for position.

- Generally professionals, other than attorneys (such as consultants, appraisers, accountants and investment bankers), are not bound in any way to their methods of solicitation (letters, phone calls, dinners, etc.).

- Under the rules of ethics and applicable US Supreme Court authority (which arose out of "ambulance chasing"), attorneys are only permitted to send a letter to a group of similarly situated clients, after which they cannot follow up unless contacted. The only exception is attorney to attorney contact to a given committee member's attorney. Sadly, this ethical restraint is rarely respected.

If your client is on the Top 20 List, your role is as follows:

- *Determine if the amount listed as being owed to your client is accurate.* As the Committee is formed from the top seven in dollar amount, if your client wishes to up its chances of service, it should make sure its listed amount is not understated. When the OUST sends a letter to your client soliciting their participation on the Committee, your client will be asked to list the amount of the debt owed. This is not presumptive unless a proof of claim is also filed. Therefore, this may be the time to file a proof of claim and submit a copy of the same to the OUST at the time the solicitation form is returned.

- *If your client wants to serve, return the form within the timeframe given.*

- *Once the Committee is formed, either seek to represent the Committee (if you have the expertise), invite an experienced colleague to pitch the Committee or just sit back and attend the beauty contests. It is a great learning experience*. First, you will see how the marketing process works. But more importantly, the attorneys who are interviewed will set forth their proposed strategies for the Committee to maximize creditor value. This "free advice" is invaluable in assisting the Committee in determining its ultimate case approach.

V. THE RULE 2004 EXAM

Bankruptcy Rule 2004 allows any party in interest to seek documents and depose any other party or non-party having knowledge of the debtor's financial affairs. No litigation is required to be pending before a Rule 2004 exam may be taken. Therefore, this is a very powerful tool and is used routinely by creditors and Creditors' Committees to dig up dirt on the debtor which may be used as leverage later in the case. Examples include inquiries into breaches of fiduciary duty, fraud before or after the bankruptcy case was filed, historic operating reports and tax returns, asset investigations, review of appraisals and other historic valuations, bank statements, loan documents and other key contracts.

VI. CASH COLLATERAL

Section 363 of the Bankruptcy Code governs a debtor's ability to conduct its business post-filing. For ordinary course of business transactions (i.e. conducting its day to day affairs in providing goods or services) the debtor needs no permission. Actions taken outside of the ordinary course of business, such as selling substantially all of its assets, or using assets subject to a lender's lien, require court approval.

Section 363 prohibits a debtor from using "cash collateral" absent the consent of the secured lender or approval of the court. Cash collateral sounds mysterious, but it is not. It is cash, cash equivalents (certificates of deposit), receivables and inventory.

- The theory is that this bundle of cash collateral, on the filing date, has a given value. Because it is liquid, it could easily be consumed and if not replaced by new cash, inventory and receivables, the lender holding the lien on the cash collateral could be harmed by its usage. This is especially true if the debtor is operating at a loss during the Chapter 11. The losses have to be funded from some asset pool—usually a reduction in cash, inventory and receivables.

To use cash collateral, the debtor must show that the secured creditor will not be harmed by its usage. This is called "adequate protection." Adequate protection can be demonstrated in two ways.

- First, the debtor can show that during the period the debtor proposes to use the cash collateral (a 90 day period, for example) the amount of cash, inventory and receivables on day 90 will be no less than they were on day one.
    - This is demonstrated by a line item budget attached to the cash collateral motion, showing the beginning and ending cash, inventory and receivables, usually on a weekly basis.
    - It is common that the court, on an emergency basis, upon the filing, will permit the use of cash collateral, but only in the amount necessary to avoid immediate and irreparable harm to the debtor's business, pending a final hearing.
    - A final hearing will then be held, usually 15 days later, to assess whether continued cash collateral usage should be permitted.
    - In order to maintain the same level of cash collateral, a debtor must operate at break-even or better.
    - Some secured creditors will not oppose the use of cash collateral, even when they will not be adequately protected by the replacement cash, inventory and receivables, on the basis that the debtor needs time to accomplish a goal that is in the secured creditor's interest, such as a sale of the debtor's assets.
- A debtor can also adequately protect a secured lender's lien on cash collateral, even if the cash collateral is diminishing, if the debtor can show that the secured lender has an equity cushion in other collateral.
    - For example, if the secured lender's collateral pool includes not only cash collateral but also a mortgage on real estate and a lien on equipment, the value of those other assets may be such, when combined with the cash collateral, that even if the debtor

consumes a given portion of cash collateral, the secured lender would still realize a full recovery on its loan from equity in the other assets.

- When an equity cushion argument is made, the ox who is being gored shifts from the secured creditor to the unsecured creditors. It means the amount available to pay the unsecured creditors will diminish as the overall value of the debtor's asset pool diminishes. In this case, it is the Committee who must determine whether the diminution in assets is worth a loftier goal, such as a going concern sale of the assets of the debtor to a third party.

If you represent the secured lender or the Committee:

- *Pay careful attention to the cash collateral pleadings and the budget provided. Cash collateral fights move at a feverish pace, as the debtor needs to use cash from the first day it files.*

- *Be prepared to utilize an expert to contradict the debtor's projections. Many times they are far rosier than reality. Having access to historical operating statements will help test the validity of the budget and projections presented.*

- *Be creative in what you ask for in exchange for providing consent to the use of cash collateral. Trading items include:*

    - *Modifications to the budget.*

    - *An agreement that the stay will lift if the budget is violated outside of a given range (5% is common).*

    - *A blessing of the validity and perfection of the secured creditor's lien and debt.*

    - *An agreement to abide by a given timeline for the sale of the debtor's assets or some other restructuring objective (a plan filing deadline) (commonly called "milestones").*

    - *A right to enhanced reporting, a physical inventory, an appraisal or other non-economic safeguards.*

    - *Credit enhancement from a debtor or non-debtor affiliate, such as a guaranty or pledge of additional or new collateral.*

VII. POST-PETITION FINANCING

In addition to seeking to use cash collateral, a debtor may find a need to borrow additional funds to meet certain restructuring goals. It could be dollars to complete work in process that without completion, would have little or no value, money needed to cover losses until a sale of assets can be consummated or funding of a parts bank in a manufacturing setting.

Like cash collateral, to borrow funds, a debtor must obtain court approval. Consent of the secured creditor providing the funding is implicit, as the lender will have negotiated the lending package with the debtor before it is brought to the court. No lender can be forced to lend.

- *If you represent a secured creditor whose lien will be "primed" by the financing, you have the right to object and seek adequate protection of your collateral position in the debtor's assets.*

- *Adequate protection could be in the form of credit enhancement from a third party, payment of monthly payments to cover the loss in collateral value or some sharing with the senior secured lender in proceeds resulting from a sale.*

- *Secured creditors who provide post-petition financing or junior secured creditors whose liens are impacted by a priming lien routinely ask for the same types of milestones and protections set forth above related to the use of cash collateral.*

- *Be prepared to use a valuation expert if you are representing any secured creditor in a post-petition financing transaction or fight.*

VIII. ASSET SALES

Many Chapter 11 cases are filed with the specific intent of selling the debtor's assets in a bulk transaction. This occurs when the debtor's business model is sound, but the assets are over-leveraged.

Section 363 of the Bankruptcy Code allows a debtor to sell its assets before a plan is confirmed, outside of the ordinary course of business. The sale process is usually structured as follows:

- A motion is filed seeking to sell the assets described.

- Preferably, the debtor has already identified an initial bidder, who is referred to as the "Stalking Horse." A Stalking Horse is not required, however.

- A form of asset purchase agreement and any material contracts related to it (consulting and non-compete, employment and transition agreements) are attached to the motion.

- A set of bidding procedures are included with the motion. These set forth the timetable for the sale, the dates competing bids are due, deposits required, due diligence timetables, bidding increments and requirements of bidders to be "qualified bidders" (such as proof of financing or ability to close, permitting and licensing in hand).

- Many times the Stalking Horse will request a "Break-Up Fee." A Break-Up Fee is a sum of money paid to the Stalking Horse, in the event the Stalking Horse is outbid. It is designed to reimburse the Stalking Horse for development of the sale documentation and for providing the guaranteed opening bid for the assets.

- Publication and/or investment bankers are used to attract competitive bidders.

- Once other bids are in hand, an auction is held (usually at the offices of debtor's counsel) and then the results of the auction are confirmed by the court at a hearing, usually immediately thereafter.

What to look for in a sale process, regardless of the hat you are wearing:

- *Sales structured to chill bidding.* Unreasonably short due diligence periods, unnecessarily large initial incremental overbids, onerous bidder qualification requirements and/or lack of cooperation of key members of management to negotiate non-compete or consulting agreements are the usual tools.

- *Insiders who are seeking to purchase their own assets.* Insiders are not permitted to purchase their own assets. 18 USC 154, part of the bankruptcy crimes statute, prohibits one who is a trustee from purchasing assets over which the trustee has oversight. In a Chapter 11 case, trustees usually are not appointed. Instead, the debtor is deemed to assume the fiduciary duties of the trustee and therefore, cannot be the one to control both the sale and purchase of the same asset pool.

- *Administrative or secondary insolvency.* Many sales are structured in a way that coincidentally provide just enough consideration to pay the secured creditors in full, but leave nothing else.

    - Once a closing occurs and the merry-go-round stops there are usually two to three months of payables, generated during the Chapter 11 that must be paid. Creditors who were kind enough to extend credit to the debtor during the Chapter 11 case now find themselves going unpaid not only for the pre-bankruptcy debt, but also for the post-petition debt.

    - *There is no direct provision of the Bankruptcy Code that prohibits an administrative or secondary insolvency. However, case law has recognized that any sale must be in the best interest of the estate and its creditors and has used that standard to require that the interests of all creditors be considered.* Courts argue that if the sale is only benefitting the secured creditor, then the secured creditor should simply foreclosure and take back its assets. It should not have the benefit of the post-petition assets generated (cash, inventory and receivables) which were the inputs converted to the assets being purchased (cash, inventory and receivables).

IX. EXECUTORY CONTRACTS AND LEASES

Every lease and executory contract to which a debtor is a party must be dealt with in a Chapter 11 case. Section 365 of the Bankruptcy Code governs leases and executory contracts.

- "Lease" is a commonly understood term.

- An "executory contract" is a contract where the performance by both parties has not been completed. Examples are supply agreements, service contracts, non-compete agreements, etc.

Generally, a debtor may defer making any decision on whether to assume or reject a lease or executory contract until it confirms its plan. However, certain congressional lobbies have been successful in carving out exceptions for their benefit:

- If it is a lease of non-residential real property under which the debtor is the lessee (your standard industrial or retail lease) the debtor is obligated to either assume or reject the lease within 120 days of filing of the bankruptcy petition. The debtor is allowed one 90 day extension, but no other.

- If it is a lease of non-residential real property, the debtor must pay currently under that lease during the course of the bankruptcy case.

- If it is a lease of personal property, the debtor must commence making payments on the 61st day after the bankruptcy filing date.

A debtor has the right to seek to reject, at any time, any lease or executory contract it wishes to exit. The standard is business judgment and it is rare that any court does not permit the rejection of an executory contract or lease.

A debtor at any time can seek to assume a lease or executory contract. In order to assume a lease or executory contract, the debtor must bring the lease or executory contract current, as to both monetary and non-monetary obligations thereunder. These are known and the "Cure Obligations."

Once a lease or executory contract is assumed (meaning the Cure Obligations have been paid and/or met) the debtor can seek to assign the lease or executory contract to a third party. This is common in sale transactions, where critical leases or executory contracts are desired or required by the purchaser to be assigned to it.

- In order to assign an executory contract, the assignee must provide "adequate assurance" of its ability to service the lease or executory contract, once assigned. Generally, this means the assignee must demonstrate that its financial condition is at least equal to, if not better than was the debtor's financial condition at the time it entered into the lease or executory contract.

If you are representing a party to a lease or an executory contract that a debtor is seeking to assume and assign to a third party, it is critical that you pay attention to the sale pleadings.

- *The sale pleadings and/or bidding procedures will state a deadline by which the debtor is to set forth its determination of the amount of the Cure Obligations.*

- *The other party to the lease or executory contract is given a very short period of time to object to the proposed Cure Obligations.* In some instances it is as short as three days and may be over a weekend.

- *The sale pleadings and/or bidding procedures routinely state that unless an objection to the Cure Obligations is filed, the debtor's number will be binding on the non-debtor party.*

- *The debtor's proposed Cure Obligations are notoriously smaller than what is routinely owed.* Usually the debtor's record keeping is behind or the debtor seeks to settle long standing disputes between the debtor and the non-debtor party related to the lease or executory contract by asserting its position only.

- *Therefore, you must be certain that you are (a) routinely receiving all pleadings filed in the case; and (b) reading carefully each of those pleadings.*

Once a lease or executory contract is assumed, the debtor is relieved of all obligations thereunder. Guarantors are not released.

Once a lease is rejected, the rejection is deemed to date back to the date of filing of the bankruptcy case. Rejection is essentially a breach and the non-debtor party is entitled to file a proof of claim in an amount equal to the damages that would have arisen had the lease or executory contract been breached and terminated on the bankruptcy filing date. *The time period for filing a rejection damage claim is usually within 30 days of the date the executory contract or lease is rejected. Therefore, pay careful attention to this deadline.*

Generally, there is no stated cap on the amount of the rejection damage claim that may be filed.

- The exception is the rejection of a non-residential real property lease. In that instance the damages are limited to the lesser of one year of rent due under the lease or 15% of the aggregate rent due under the lease for its remaining term.

X. AVOIDANCE ACTIONS AND PREFERENCES

Bankruptcy Code Sections 546-548 govern what are called the Chapter 5 causes of action.

- Section 546 provides the debtor with the powers of a trustee and permits the debtor to use state law remedies (usually fraudulent conveyance statutes) to bring assets back into the estate.
- Section 547 provides the debtor with special powers to bring back into the estate monies paid to creditors within 90 days of the filing date, or with respect to insiders, within one year of the filing date.

    - These transfers are known as "Preferences."

    - The concept of a Preference is that it is presumed that within the 90 day period leading up to a bankruptcy filing, a debtor is aware of the imminence of a

bankruptcy filing and therefore, human nature is to send money to friends or those who may be critical to the bankruptcy reorganization.

- The Preference laws seeks to bring all of these preferred payments back into the same pot, so that all unsecured creditors are able to share in them, on a pro-rata basis.
- The elements of a Preference are: (a) the transfer of property of the debtor; (b) to or for the benefit of creditor; (c) for or on account of an antecedent (past due debt); made while the debtor was insolvent; and (e) which enabled the creditor to receive more than it would have in a Chapter 7 liquidation.
- The debtor has the burden of providing each of the elements of a preference.
- Even if the debtor is able to prove the elements of a preference, there are certain defenses available to a creditor. Generally they are based on whether even though a transfer was made to the creditor, the debtor's estate was not diminished, based on consideration given by the creditor which flowed back to the debtor.
- Examples of defenses are transfers made on a COD basis, transfers made in the ordinary course of business and according to ordinary business terms (meaning the debtor did not speed up payment to prefer the creditor over another) or if "new value" in the form of new goods or services were provided by the creditor after the debtor made the payment.

- Section 548 provides the debtor with the right to bring fraudulent conveyance claims specifically contained in Section 548 (versus those under state law). These include transfers for less than reasonably equivalent value or transfers made with the intent to hinder, delay or defraud creditors.

Generally, these Chapter 5 causes of action are not brought by the debtor until after confirmation, as the debtor seeks to preserve its supply base during the reorganization. That need may lessen as the case matures.

- *As discussed below, it is essential that you first determine if the debtor has sought to preserve causes of action against your client in the Disclosure Statement; if not, you may have a grounds for dismissal of the underlying suit before addressing the merits of the suit.*
- *There are a multitude of defenses to fraudulent conveyance and preference claims; if your client is sued or receives a demand for repayment, your client should seek expert advice in how to defend against such claims*

XI. DISCLOSURE STATEMENT AND PLAN

Every debtor is under an obligation to file a plan of either reorganization or liquidation (depending on what the debtor has accomplished or seeks to accomplish in the Chapter 11 case) (the "Plan").

1. Time for filing the Plan.

Under Section 1121 of the Bankruptcy Code, the debtor is given an initial exclusive period of time after the filing date, within which to file its Plan (120 days) and obtain confirmation of its Plan (180 days). The 120 day period, upon approval of the court, may be extended, but not longer than 18 months and the 180 day period may be extended not longer than 20 months. This is known as the "Exclusivity Period." Once the Exclusivity Period expires, any other party in interest (a creditor or equity holder) is permitted to file a Plan. Therefore, it is possible that more than one Plan may be put forth, in which case, creditors will be asked to vote on each of them.

- *If you are in a hotly contested bankruptcy case, make note of the time periods for the filing of the Plan. If the debtor misses the deadline, you can gain significant leverage by proposing your own Plan. Likewise, be wary of a debtor's request to extend the Exclusivity Period. Unless good reason exists for the extension, the court should not just hand it out.*

2. Contents of the Plan.

Section 1123 of the Bankruptcy Code sets forth what must be contained in a Plan. The Plan is an outline of how creditors are to be paid.

First, the types of creditors are segregated into separate classes and then the treatment of the creditors in those classes is addressed in the Plan. The following are the general classes most frequently noted in a Plan:

- Administrative claims
- Secured claims (each secured creditor must be placed in a separate class)
- Priority claims (employee wages and taxes)
- General unsecured claims (those with no priority under the Bankruptcy Code and are not otherwise secured)
- Interests (meaning the treatment of the shareholders' or member's interests held as of the bankruptcy filing date)

Administrative claims are debts incurred by the debtor after the bankruptcy is filed. Generally, those claims are paid in the ordinary course during the bankruptcy case and the Plan will provide for their payment after confirmation in the ordinary course, according to their usual payment terms. *There are a special category of administrative claims, created under Section 503(b)(9) of the Bankruptcy Code, which elevate an unsecured claim to an administrative claim for goods received by the debtor within 20 days of the filing date. If you represent a creditor who has provided goods*

(not services) within the 20 days, then you will need to take special action to have that 503(b)(9) claim allowed.

Secured claims are those of creditors who have a perfected lien on an asset of the debtor. First, the Plan or the court (if the amount is contested) must determine the amount of the secured claim. It is the lesser of the bona fide debt amount and the value of the collateral securing the debt. The present value of that amount must be paid under the Plan. Therefore, the debtor can either surrender the collateral to the lender, or agree to repay the secured claim at a market rate of interest, over a period of time that is realistic, in light of the useful age of the collateral and the terms of the Plan. Usually any payment term over 5 years is out of the ordinary, although balloon payments are permissible.

Priority claims are unsecured claims which the Bankruptcy Code elevates to a higher status, under Section 507. These include such things as wages earned within 180 days of the filing date (subject to a cap), contributions due to employee benefit plans and taxes owing to governmental agencies incurred within a certain period of time prior to the bankruptcy filing. These priority claims, in some instances, have no specified repayment period, while others, such as taxes, must be repaid within 6 years from the date of assessment.

General unsecured claims are all other claims that are not secured or given a priority. Generally, unsecured creditors must be paid as much as they would receive on liquidation. So if a debtor liquidated and it could only pay a 10% distribution to its unsecured creditors, 10% is all the unsecured creditors are required to be paid, either in a lump sum or over time under a Plan. A debtor can seek to stretch out the payment to unsecured creditors over a period of years. Generally a debtor will be seeking recovery of money from various parties as part of its Plan, so having a longer timeframe for payment of unsecured creditor claims is commonplace.

Interests are the equity (stock, LLC interests) held by the shareholders or members of the debtor. The rule is that interest holders are not entitled to retain their interests unless the unsecured creditors agree that they can, or the unsecured creditors are paid in full. Since neither of these two thresholds are usually met in a bankruptcy case, the Bankruptcy Courts were left with the odd situation that that debtors were proposing plans, where there was no surviving equity interests. To plug the hole, the US Supreme Court decided that current equity could retain its equity, or new equity could be issued, so long as the equity was auctioned off to the highest bidder. This results in a Plan that provides for an infusion of cash by an existing or new set of equity holders, in exchange for the equity. The bidding keys off of the restructured balance sheet caused by the Plan—what is someone willing to pay to be an owner of the reorganized debtor with a different balance sheet than that which existed when it filed.

3. Disclosure Statement.

The Plan is required to be accompanied by a Disclosure statement. A Disclosure Statement is akin to a prospectus, if one was purchasing a stock. The Disclosure Statement is supposed to explain, in plain English, how the debtor proposes to repay creditors, based on the contents of the Plan.

A Disclosure Statement is subject to approval of the court. In large Chapter 11 cases, approval occurs earlier than the date the Court holds the hearing to "confirm" the debtor's Plan. In smaller Chapter 11 cases, approval of the Disclosure Statement can occur simultaneous with the hearing on confirmation of the Plan.

The standard to approve a Disclosure Statement is set forth under Section 1125 of the Bankruptcy Code. It mandates that the Disclosure statement contain "adequate information" which is defined to mean

> information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor and a hypothetical investor typical of the holders of claims or interest in the case, that would enable such hypothetical investor of the relevant class to make an informed judgment about the plan.

In deciding whether a Plan contains adequate information, the court is to consider "the complexity of the case, the benefit of additional information to creditors and other parties in interest and the cost of providing additional information."

A Disclosure statement, in addition to providing the breakdown of the types of creditors and interest holders and the proposed treatment of their claims, also contains a variety of information. This information includes:

> (1) the events which led to the filing of a bankruptcy petition; (2) a description of the available assets and their value; (3) the anticipated future of the company; (4) the source of information stated in the disclosure statement; (5) a disclaimer; (6) the present condition of the debtor while in Chapter 11; (7) the scheduled claims; (8) the estimated return to creditors under a Chapter 7 liquidation; (9) the accounting method utilized to produce financial information and the name of the accountants responsible for such information; (10) the future management of the debtor; (11) the Chapter 11 plan or a summary thereof; (12) the estimated administrative expenses, including attorneys' and accountants' fees; (13) the collectability of accounts receivable; (14) financial information, data, valuations or projections relevant to the creditors' decision to accept or reject the Chapter 11 plan; (15) information relevant to the risks posed to creditors under the plan; (16) the actual or projected realizable value from recovery of preferential or otherwise voidable transfers; (17) litigation likely to arise in a nonbankruptcy context; (18) tax attributes of the debtor; and (19) the relationship of the debtor with affiliates.

In re Metrocraft Pub. Services, Inc., 39 B.R. 567 (Bankr.N.D.Ga. 1984).

If you receive a Disclosure statement, you should do the following:

- *Determine whether your client's claim is properly described in the Disclosure Statement.* If not, you may object and request that it be properly noted.

- *There is a body of case law that requires that lawsuits that the debtor wishes to bring against third parties specifically name the proposed defendants in the Disclosure Statement. You should check this disclosure, first to determine whether your client is on the targeted list.* This could be related to a contract dispute, a proposed preference claim, a fraudulent conveyance claim a director and officer liability claim or some other type of action the debtor is contemplating against your client. *SOME COURTS HOLD THAT IF THE CLAIM IS NOT SPECIFICALLY IDENTIFIED, IT CANNOT LATER BE ASSERTED. THEREFORE, IF YOU ARE EVER DEFENDING SOMEONE SUED BY A DEBTOR, THE FIRST THING TO CHECK IS THE DISCLOSURE STATEMENT TO DETERMINE IF THE CLAIM WAS PROPERLY PRESERVED. IF NOT, YOU MAY BE ABLE TO DEFEAT THE CLAIM ON PROCEDURAL GROUNDS.*

- *The Disclosure Statement will contain a set of projections. These should be reviewed carefully, to assess the likelihood that the debtor will be able to operate as projected.* During the bankruptcy case, all debtors are required to file monthly statements of their operations (profit and loss and balance sheet). Therefore, there is a treasure trove of historic (impeachment) information in the court record that can be used to test the accuracy of the projections. For example, if the debtor's gross margin during the bankruptcy case has been 50% and the projections say it will be 80%, you will have an adequate basis to lodge an objection unless an adequate explanation for the change is provided.

- *Determine if the proposed treatment of your client's claim makes practical sense.* You have the right to seek to correct the treatment before the confirmation hearing. There is a body of case law that states that if a Disclosure Statement describes a Plan containing terms that are fatal to its approval, it would be a "fool's errand" for the court to take the time to approve the Disclosure Statement.

Once the Disclosure Statement is approved, the debtor is entitled to solicit votes for or against the Plan. This is done by sending to every creditor and interest holder the Plan, the Disclosure statement and a ballot. A creditor is only permitted to vote once, and only for the type of claims it holds.

4. Confirmation

Once the Disclosure Statement has been circulated and balloting has been completed, the court will hold a hearing on confirmation.

The Bankruptcy Code sets forth the requirements for Plan confirmation. Section 1123 of the Bankruptcy Code sets forth those items which must be included in the Plan. They include:

- A description of the classes of claims and interests

- A statement whether a class of claims or interests is impaired

- A description of the treatment to be given to each class of claims and interests
- A requirement that all creditors in a given class receive the same treatment
- Describe the means by which the Plan will be implemented (such as a sale of assets, equity infusion, merger, curing a default, etc.)

Apart from the above stated mandatory provisions, a Plan may:

- Impair or leave unimpaired a class of claims or interests
- Provide for the assumption or rejection of leases and executory contracts
- Provide for the settlement or adjustment of a claim
- Provide for a sale of substantially all of the assets of the debtor
- Modify the rights of the holders of secured claims (other than a lien on a debtor's principal residence)

Under Section 1124 of the Bankruptcy Code, a claim is considered to be impaired unless it:

- Leaves unaltered the legal, equitable and contractual rights of the claim holder; or
- Cures any default, reinstates the maturity and compensates the holder for any damages incurred

Section 1129 of the Bankruptcy Code sets forth the standards for confirmation.

- The Plan must comply with the provisions of Chapter 11
- The Plan proponent must have complied with the provisions of Chapter 11
- The Plan has been proposed in good faith and not by any means prohibited by law
- Any payment proposed to be made under the Plan has been approved by or is subject to the approval of the court as being reasonable
- The debtor has disclosed the identity of all officers, directors and trustees who may act on behalf of the debtor post-confirmation and the appointment of those persons is in the best interest of the creditors
- Any insider who is to continue post-confirmation has been disclosed along with any compensation to be paid to that insider

- Any governmental agency that governs the rates of the debtor has approved any rates proposed to be imposed

- Confirmation of the Plan is not likely to be followed by a liquidation

- At least one class of impaired claims must vote to accept the Plan

In addition to the foregoing requirements, Section 1129 of the Bankruptcy Code imposes additional standards as it relates to how claims are to be treated and paid under the Plan:

- If a claim of a creditor is impaired (meaning payment is being modified from what the contract provided), the creditor must either agree to the treatment provided; otherwise the creditor must receive, as of the effective date of the Plan, as much as the creditor would receive if the debtor were liquidated

- If a creditor is secured, the creditor must receive an amount equal to the value of the collateral securing the claim (up to the amount of the claim) in cash, a return of the collateral or payments over time equal to the present value of the claim as of the effective date

- If a creditor is unsecured, and if the creditor has not accepted the Plan, the unsecured creditor must receive the full amount of its claim; otherwise those holding claims junior to theirs cannot receive any distribution (usually meaning the equity cannot retain its equity)

What this means to you, as counsel to a creditor:

- *Read the Plan and understand how it proposes to treat the creditor's claim that you represent*

- *Your client, if unsecured, must receive as much as it would receive in a liquidation, otherwise junior classes (equity) cannot retain their equity*

    - This creates a vacuum, where a debtor could have a Plan with no equity

    - As noted above, to resolve this, the US Supreme Court determined that a debtor can retain equity or acquire equity, so long as that equity is auctioned off, as part of the Plan process—meaning you are bidding on how much one would pay for a restructured balance sheet of the debtor

    - You have great leverage to object, as equity always is seeking to pay as little as possible to retain or acquire back its interest in the debtor

- *Your client, if secured, must be prepared to put forward a value of its collateral, as this sets the benchmark for what must be paid over time*

- To the extent the claim is not fully secured, the claim will be bifurcated by the court into a secured and unsecured claim, with the unsecured claim being the equivalent of a deficiency, had the secured creditor disposed of its collateral but not been fully paid

- Your client will then have to be prepared to debate the time period over which the secured portion of the claim is to be paid and the interest rate to be imposed

- As to interest rate, the courts look to the contract rate, but usually focus on a current market interest rate for similar loans, with an increase tacked on for the additional risk based on the fact that the debtor is not a "prime" borrower

- As to the term of the payback, the courts look to what is reasonable and feasible. If the underlying loan had a 30 year amortization and a five year balloon, the court would likely agree to a similar restructuring. If the debtor sought to pay it based on a 30 year amortization and a 20 year balloon, the court likely would not approve it, as the debtor would not be able to prove that it could make sustained payments over the 20 year period

- *Be prepared to challenge the feasibility of the plan*

  - Feasibility is the term given to determining if the Plan will or will not be likely followed by a liquidation

  - A debtor is required to put forward a set of projections in support of the Plan and the projected Plan payments

  - Be prepared to challenge those projections

  - Tools to use to mount the challenge include historic financials of the debtor before bankruptcy and the actual financials of the debtor while in Chapter 11, which may impeach the assumptions set forth in the projections (such as gross margin, COGS, expense line items, etc.)

  - Be prepared to use an accounting expert to challenge feasibility

- *Look for monies flowing to the insiders outside of the plan structure, such as under non-competes, consulting agreements and the like—argue that they are disguised payments on account of their equity interest, which are prohibited until unsecured creditors are paid in full or agree to lesser treatment*

CONCLUSION

If you are not a bankruptcy expert, don't go it alone when your client's rights are being adjusted in a bankruptcy case. The above was intended to provide a basic overview of Chapter 11. There are many other nuances, refinements, exceptions and strategies to be employed in any bankruptcy case, depending on the hat your client wears.