

## **THE CHAPTER 11 REORGANIZATION PROCESS**

The primary objective of the filer of a Chapter 11 case (called "debtor" or "debtor-in-possession" herein) is to continue to operate its business. The basic rule is that the debtor may continue to operate its business and manage its property, but as a new entity known as the "debtor in possession." In the ordinary course of events, the debtor retains management control and has certain additional powers not previously available to it, such as the right to reject contracts or leases or move to set aside certain prepetition transactions.

The debtor in the post-petition phase of a Chapter 11 case is authorized to use, sell or lease property of its "estate" in the ordinary course of business without Bankruptcy Court ("Court") approval. Court approval is, however, needed if the proposed use, lease or sale is not in the ordinary course of the debtor's business. In addition, the debtor may not use "cash collateral" (which consists mainly of cash equivalents such as accounts receivable) without Court approval. Further, the debtor may not pay any pre-petition claims because such payments or transfers can be recovered as violating the fundamental principal applicable in all bankruptcy cases that there should be an equality of distribution to all creditors.

Immediately after the filing of a Chapter 11 case, the debtor has to commence operation of its business as a debtor in possession. It must first complete the task of filing all schedules, lists, statements of affairs and other documentation

required under the Bankruptcy Code and the Bankruptcy Rules. This procedure also includes attending to the various immediate financial problems of the business, including all efforts to stabilize the operations. New bank accounts must be opened in the name of the debtor in possession so as to ensure that all pre-petition obligations are frozen and that only post-petition expenses are paid from the "D.I.P." accounts. Creditors dealing with a post-petition debtor in possession know that their post-petition claims will be favored on a higher level than pre-petition claims because the latter will qualify for an "administrative expense" priority. Secondly, the debtor in possession must proceed to meet with its creditors and interested parties at a meeting of creditors, where the debtor will explain why it filed its Chapter 11 case and review its financial condition; it will also explain how it expects to proceed in the direction of promulgating an acceptable plan of reorganization that can be confirmed by the Court. During this process, the United States Trustee, acting in the capacity of an administrative officer in bankruptcy cases, usually appoints representative committees of creditors, and sometimes shareholders or other classes of interested parties, which committees may then select their own professional representatives to assist the committees in negotiations with the debtor in possession for the purpose of formulating a "plan of reorganization."

To counter efforts by creditors and others to proceed with claims against the debtor for the payment of pre-petition and post-petition debts, when a Chapter 11 case is filed an "automatic stay" is immediately imposed as a matter of law. The automatic stay gives the debtor a temporary "breathing spell" in order to stabilize its operations. It also affords the opportunity for the debtor to commence negotiations with creditors and others which might lead to the formulation of a "plan of reorganization." The automatic stay enjoins: the commencement or continuation of all suits and the enforcement of all pre-petition claims and judgments against the debtor, as well as all acts to obtain property from the estate, the creation, perfection or enforcement of liens against the estate or property of the estate, and all acts to recover prepetition claims against the debtor. Generally, however, the automatic stay does not restrain actions against third-party non-debtors, such as guarantors, officers, non-debtor parties and affiliated corporations.

Relief from the automatic stay is available by application to the Court. Generally, relief is available on two grounds: first, when cause has been established, including proof that the moving party lacks "adequate protection" such as a decrease in value of collateral security as a result of a debtor in possession's use of the property; second, when the debtor does not have equity in the property in question and the property is not necessary to an "effective reorganization." As a practical

matter, most debtors argue that all the property is necessary to an effective reorganization. Therefore, the test is whether or not a reorganization is realistically feasible.

The key words for the purpose of maintaining the automatic stay are "adequate protection." Creditors may seek adequate protection in exchange for modifying the automatic stay, or as consideration for allowing a debtor to sell, lease or use property in which a creditor has an interest. Similarly, if the existing lien claimants are given adequate protection the debtor may be allowed to obtain additional secured credit during a Chapter 11 case, or additional secured credit senior to, or equal to, existing lien claims. Additionally, a third party holding property in which the debtor has an interest may be ordered to turn the property over to the debtor subject to being awarded adequate protection. The Bankruptcy Code does not define precisely what adequate protection may be in any given situation. However, the general rule is that creditors holding secured claims may not be deprived of their property rights within the context of the Fifth Amendment of the U.S. Constitution without being protected for the value of the collateral. Adequate protection is not defined in the Code, although three potential methods are set forth: periodic payments, replacement liens and such other relief as would give the secured claim holder the "indubitable equivalent" of its interest in the property. Adequate protection is intended to protect a creditor against a decrease in the value of the creditor's secured collateral from a

modification of the automatic stay, or the debtor in possession's use, or lease of the property, or the grant of a lien against the property in favor of a third party.

While delay may be a debtor's immediate objective, its long range goal should be to negotiate a plan of reorganization which will be accepted by the requisite two-thirds in amount of claims, and more than one-half in the number of claims, held by voting creditors. Equity security holders are deemed to have accepted a plan of reorganization if at least two-thirds in amount of the outstanding securities which have actually voted have accepted the plan. Furthermore, a class that is not "impaired" under a plan is deemed to have accepted the plan, so that solicitation of acceptances of a non-impaired class is not required. On the other hand, a class of claims or interests which are not entitled to receive or retain any property under the plan are deemed not to have accepted the plan.

If a plan of reorganization is ultimately proposed by a debtor, a hearing is then held for the purpose of obtaining Court approval of a "disclosure statement" that the debtor in possession must submit, containing sufficient detailed financial and related information and history about the debtor and its operations so as to enable a hypothetical, reasonable investor typical of those involved in the case to make an informed judgment about the plan.

If the disclosure statement is approved by the Court, a copy of the disclosure statement and a summary or copy of the

plan of reorganization is then submitted to all the creditors and necessary parties for their vote of acceptance or rejection.

If, after a specified time, the debtor obtains the requisite majority of consents from those classes of creditors and entities whose votes are required to accept the plan, the Court will then enter an order that the plan of reorganization is accepted and set the matter down for a hearing on the issue of "confirmation."

In voting on a plan of reorganization, interested creditors and parties do so as classes. The required majority will bind the minority interests in each class. Minority claims, however, are not disregarded entirely. In order to satisfy all of the conditions for confirmation delineated in the Bankruptcy Code, a debtor must establish at the confirmation hearing that each creditor or interest in a specific class, including minority interests, will receive under the plan property of a value, as of the effective date of the plan, that is not less than the claimant would have received in a straight bankruptcy liquidation under Chapter 7 of the Bankruptcy Code. This is known as the "best interest test" which, together with the "feasibility" test, are two of the major hurdles any plan of reorganization must clear to achieve confirmation of the plan.

One of the major principles applicable to all Chapter 11 cases is the concept that, notwithstanding specific requirements under the Bankruptcy Code, the parties may agree to different treatment as a result of negotiations. Thus, each class of

claims or interests which is impaired by the plan must accept the plan. However, if as a result of negotiations, the financial impairment of a specific class is cured, or the default is reversed, the class is no longer regarded as impaired, with the result that such class need not be solicited for voting purposes. Similarly, there is a rule incorporated in the confirmation section of the Bankruptcy Code which provides that not only must the plan not discriminate unfairly, but it must be "fair and equitable." The words "fair and equitable" generally mean that no junior class will receive anything under the plan until all senior classes who have not consented to the plan are paid in full. Thus, if through negotiations a senior impaired class consents to a plan which provides a distribution to junior classes, the "absolute priority" test does not come into play because of the negotiated consent, with the result that the consenting senior classes could receive less than full payment. Fair and equitable also means that in the absence of consent by impaired senior classes, dissenting secured classes must retain their liens securing their claims and receive deferred cash payments for the allowed amount of their claims of a value at the effective date of the plan at least equal to the present market value of the claimholders' interest in the collateral. Thus, the value of the collateral is "crammed down" to a stream of payments equaling the remaining useful life of the collateral, discounted to its present value. Because of the fact that dissenting classes are accorded the current discounted value of their

property, rather than the outstanding unpaid principal amount, the process under which this result is obtained is generally referred to as a "cram down" against dissenting secured classes. Unsecured claimholders simply receive the balance of funds available after the payment of secured claims and are not crammed down because no valuation process is needed.

Upon confirmation, a debtor in possession is revested with all of the property of the estate, and the property dealt with by the plan is free and clear of all claims and interests of creditors, shareholders and general partners. An order of confirmation discharges a corporate debtor from any debt that arose before the date of confirmation (as distinguished from the date of the petition). Thereafter, a confirmed plan of reorganization may only be revoked on motion by an interested party made no later than 180 days after the entry of the order of confirmation. The only ground for such revocation is that the confirmation was procured by fraud.

The rights of creditors in the Chapter 11 process are protected in various ways depending upon the particular issue which confronts them. As previously stated, one of the fundamental rights available to secured claimholders is the motion for relief from the automatic stay. Even if not granted, the claimholder must be provided with adequate protection. Another right available to a secured claimholder is the opportunity to object to the debtor's attempted use of cash collateral from the proceeds of the secured property.

Additionally, parties to executory contracts and unexpired lease with a debtor may bring on motions to compel the debtor to make a prompt decision either to assume or reject the contract or lease. If the debtor desires to assume the contract or lease, it must promptly cure all outstanding defaults, compensate the creditor for any losses resulting from the default and provide adequate assurance of future performance under the contract or lease.

Another weapon available to creditors, usually employed by unsecured claimholders who do not have a right to seek adequate protection and relief from the automatic stay because they hold no interest in property subject to the automatic stay, is the motion to convert the Chapter 11 case for straight liquidation under Chapter 7 or to dismiss the case entirely. There are ten statutory grounds for this relief. However, the first four grounds are the most generally cited reasons. The first is the continuing loss to or diminution of the estate and absence of reasonable likelihood of rehabilitation. The second is an inability to effectuate a plan. The third ground is unreasonable delay by the debtor that is prejudicial to creditors. The fourth is failure to propose a plan within any time fixed by the Court. Additionally, a fifth ground which is not listed in the Code section dealing with this subject, is also entertained by the Courts. This ground raises the issue that the Chapter 11 case was filed in bad faith and solely for the purpose of delay, with no expectation that any plan could be accepted and confirmed.

In the end, either a plan of reorganization is accepted and confirmed, or the Chapter 11 case is converted to Chapter 7 liquidation case or, if there are no realizable unsecured assets, the case is dismissed.

A dismissal of a Chapter 11 case reinstates any transfers "avoided" during the life of the case and any liens avoided because there was no collateral value for them to attach during the case. The dismissal also vacates any order, judgment or transfer ordered through the use of the bankruptcy avoidance powers available to a trustee or a debtor in possession. As a result of the dismissal, the property of the estate is the entity in which the property was vested immediately before the commencement of the Chapter 11 case. Therefore, the creditors, and the debtor are free to pursue whatever remedies are available under state or federal non-bankruptcy law.

October, 2008