

**DUTIES AND OBLIGATIONS OF SMALL
BUSINESS REORGANIZING UNDER
CHAPTER 11 OF THE BANKRUPTCY CODE**

In a Chapter 11 case, the party filing the case is referred to as a "debtor." Upon filing, the debtor automatically becomes a "debtor in possession" unless the Court orders otherwise. A debtor in possession in a Chapter 11 case is legally charged with the rights, duties and powers of a trustee holding the debtor's property for the benefit of its creditors and shareholders. A debtor in possession must abide by the rules and standards of Chapter 11 and by the orders of the United States Bankruptcy Court ("Court"). A failure to abide by these rules, standards and orders may result in the appointment of a trustee to manage the debtor's business and property, a Court order terminating the debtor's business, or the conversion of the case to a Chapter 7 liquidation case. It is important, therefore, that a debtor perform its duties and obligations as a debtor in possession in an appropriate manner.

We have prepared the following set of questions and answers about Chapter 11. They should answer many of the questions that may arise in small business Chapter 11 cases.

1. What type of immediate relief may a debtor obtain by filing under Chapter 11?

The filing of a chapter 11 case automatically stays all foreclosures, collection actions, civil litigation and creditor action of any kind. The only significant proceedings not stayed by the filing of a Chapter 11 case are criminal proceedings against the debtor and proceedings by governmental agencies to enforce their police or regulatory powers. All other proceedings and acts against the debtor or the debtor's property, whether in or out of court, are stayed. Even telephone calls or the sending of letters or bills to the debtor, if for the purpose of collecting a debt, are precluded by the automatic stay. An act or proceeding that is stayed is held in abeyance, and no further action may be taken in the matter without the approval of the Bankruptcy Court ("Court").

2. What type of long-term relief may a debtor obtain under Chapter 11?

Long term relief in the form of either a reorganization of the debtor's business or an orderly, debtor-controlled liquidation of the debtor's assets may be obtained under Chapter 11. If the debtor's business is reorganized, it may continue to function either in its present form or in a revised form, and its present creditors will be permitted to satisfy their claims only as provided in the debtor's plan of reorganization ("Plan"). A reorganization may consist of anything from an extension of time for the repayment of debts to a total restructuring of the business.

3. How long does a Chapter 11 case last?

A Chapter 11 case may be broken down into two phases: prior to "confirmation" of a "plan of reorganization" and after. The first phase normally lasts from six to twelve months, although the time may vary depending on the condition of the debtor, the type of plan proposed by the debtor and the reaction of creditors to the plan. The second phase lasts normally from three to five years, although it, too, may vary in duration.

4. When does the debtor receive a discharge in a Chapter 11 case?

In a Chapter 11 case, the debtor receives a discharge when a Plan is confirmed by the Court. The order of the Court that confirms the Plan also contains the debtor's discharge.

5. What debts are discharged by a Chapter 11 discharge?

The extent of a Chapter 11 discharge depends on whether or not the debtor is an individual debtor. A Chapter 11 case discharges an individual debtor from the same debts as would be discharged in a Chapter 7 (liquidation) case. The discharge received by a non-individual debtor in a Chapter 11 case discharges the debtor from all debts listed in the debtor's schedules without exception, except that if the Plan confirmed is a "Plan of Liquidation" and the debtor does not engage in business after consummation of the Plan, the debtor is not discharged from any debts. A debt that is discharged is a debt for which the debtor is no longer liable, except as provided in the Plan.

6. Is the public informed of the filing of a Chapter 11 case?

When a Chapter 11 case is filed, all of the debtor's creditors, shareholders, partners and other persons directly involved with the debtor are notified. Notice of a Chapter 11 case is not normally published in newspapers or trade journals unless the filing of the case is considered newsworthy by the newspaper or journal. Generally, only the creditors, owners and employees of a small business debtor are aware that the debtor has filed a Chapter 11 case.

7. Does a person or business filing under Chapter 11 have to continue to pay its bills and debts after the case is filed?

Most Chapter 11 debtors receive a moratorium on the payment of their bills and debts for the period between the filing of the case and the confirmation of a Plan. This period usually lasts for nine to twelve months. During this period, it is necessary for the debtor to pay creditors whose property, goods or services are needed to continue the business operation and whose debts are incurred after the filing of the Chapter 11 case.

8. How does a Chapter 11 case proceed after it has been filed?

In connection with the commencement of a Chapter 11 case, the debtor must file documents with the Court listing the names and addresses of all of its creditors and equity interest holders, describing all of its property and other assets, and disclosing other financial information about the debtor. The debtor (as a "debtor in possession") is usually permitted to continue to operate its business during the course of the case, but must comply with the requirements of Chapter 11 and the Court in so doing. A creditor whose security is threatened may apply to the court for relief from the automatic stay or for "adequate protection" of its security interest. The debtor must prepare a Plan and file it with the Court. The debtor must also prepare, file, and obtain Court approval of, a disclosure statement that adequately informs its creditors and equity interest holders of its financial condition and of its future plans. After the disclosure statement has been approved by the Court, copies of the statement and the Plan are distributed to creditors and equity interest holders, who may then vote on whether to accept or reject the Plan. If the Plan is accepted by at least one class of creditors whose claims are "impaired" under the Plan, the Plan may be confirmed by the Court. Impaired claims are described in the answer to question 31 below. After the completion of voting, a confirmation hearing is held at which the Court must decide whether to confirm the Plan. If the Plan is confirmed by the Court, it becomes effective and must be carried out and consummated by the debtor. When the Plan is confirmed by the Court, the debtor receives a Chapter 11 discharge. After the Plan has been consummated, a final report is filed and the case is closed.

9. What is an interest holder and what is its role in a Chapter 11 case?

An interest holder is the holder of an equity interest in the debtor. In Chapter 11 cases interest holders are often referred to as "equity security holders." For example, a shareholder is an interest holder of a corporation and a limited partner is an interest holder of a limited partnership. Individual and general partnership debtors do not have interest holders. If the rights of interest holders are dealt with in a Plan, interest holders are treated like creditors and are permitted to file proofs of their interests, vote on the acceptance or rejection of a Plan, and participate in distribution under the Plan. However, most Plans in small business Chapter 11 cases deal only with creditors and do not deal with, or affect, the rights of interest holders.

10. What is a creditors' committee?

It is a committee appointed by the United States Trustee that represents the interests of creditors in the case. In most small business Chapter 11 cases, the only committee appointed is the unsecured creditors' committee, which represents the interests of non-priority unsecured creditors in the case. The unsecured creditors'

committee is usually composed of the seven largest unsecured creditors willing to serve on the committee.

11. What is a "debtor in possession" and what is required of it in a Chapter 11 case?

A "debtor in possession" is the debtor in a Chapter 11 case in which an trustee has not been appointed. As to the latter, see the answers to questions 14 and 15 below. As a debtor in possession, the debtor is legally charged with the rights, duties, and obligations of a trustee holding the debtor's property and operating the debtor's business for the benefit of its creditors and interest holders. As a debtor in possession, the debtor must abide by the rules and standards of Chapter 11 and the orders of the Court. The failure of a debtor in possession to perform its obligations and duties may result in the appointment of a trustee, a Court order terminating the debtor's business, the conversion of the case to a Chapter 7 liquidation case or the dismissal of the case.

12. What is the United States Trustee and what does it do in a Chapter 11 case?

The United States Trustee ("U.S. Trustee") is an officer of the United States Department of Justice and serves independently of the Bankruptcy Court. The function of the U.S. Trustee in a Chapter 11 case is to monitor the case, appoint one or more creditors' committees, call and preside at meetings of creditors, and appoint a trustee to operate the business if ordered to do so by the Court. Generally, the U.S. Trustee takes appropriate action to insure that all reports and documents are filed, that all fees are paid and that there is no undue delay in the case. Most Chapter 11 debtors are required to make periodic financial and operating reports to the U.S. Trustee during the course of the case, at least until a plan is confirmed. The U.S. Trustee should not be confused with a trustee appointed in a Chapter 11 case to operate the debtor's business and take possession of the debtor's property. The appointment of the latter type of Trustee is, however, unusual.

13. What are the grounds for the appointment of a trustee in a Chapter 11 case?

There are two grounds for the appointment of a trustee in a Chapter 11 case: a trustee may be appointed for cause, or if the appointment would be in the best interests of creditors. Cause for the appointment of a trustee includes, but is not limited to, fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or during the case. A trustee is not appointed in most Chapter 11 cases.

14. What happens if a trustee is appointed in a Chapter 11 case?

If appointed, a trustee assumes most of the management functions of the debtor's business and takes control of the debtor's property.

In effect, the trustee will replace the debtor's current management in the operation of the debtor's business during the course of the Chapter 11 case. The trustee may also assume control over many aspects of the debtor's Chapter 11 case. When a trustee is appointed in a Chapter 11 case, the debtor ceases to be a debtor in possession.

15. What is cash collateral?

"Cash collateral" is cash or property easily converted to cash. Property such as bank accounts, checks, securities, and other cash equivalents constitutes cash collateral. Because it is easily disposed of, the use or sale of cash collateral is subject to strict rules in Chapter 11 cases.

16. What limitations are placed on a debtor's right to use, sell, or lease its property during a Chapter 11 case?

For purposes of use, sale, or lease during a Chapter 11 case, a debtor's property is divided into two categories: cash collateral, and all other property. During the case, the debtor, as a debtor in possession, may not use, sell, or lease cash collateral unless each creditor secured by the cash collateral consents to the proposed use, sale, or lease, or unless the Court approves the proposed use, sale, or lease. Unless the Court orders otherwise, the debtor may use, sell, or lease any of its property except cash collateral in the ordinary course of business during the case without prior notice to creditors or Court approval. The debtor may use, sell, or lease property other than cash collateral outside the ordinary course of business during the case only after notice to any affected creditors and a Court hearing.

17. May the debtor incur new debts and obtain new credit during a Chapter 11 case?

Yes. Unless the Court orders otherwise, the debtor, as a debtor in possession, may obtain unsecured credit and incur unsecured debt in the ordinary course of business during a Chapter 11 case without Court approval. Further, the unsecured credit or debt so obtained or incurred is payable as an administrative expense in the case, which means that those creditors get paid ahead of all other unsecured creditors. Court approval is required prior to obtaining or incurring any other type of credit or debt during the case. Thus, secured credit or unsecured credit not in the ordinary course of business may be obtained during the case only with the prior approval of the Court.

18. May the debtor break its contracts or leases in a Chapter 11 case?

Yes. Generally, under Chapter 11, the debtor, as a debtor in possession, may, at its option and without the consent of the other party, reject, assume, or assign most contracts or leases under which the debtor is obligated. This may be done either by motion during the Chapter 11 case or as part of a Chapter 11 plan. It should be noted

that, in the event of rejection, the other party to the contract or lease would then have a claim for the damages it sustains as a result of the rejection.

19. What is a Chapter 11 plan?

It is a document that shows how the debtor will deal with its creditors and interest holders. The Plan may be very simple or very complex, but it must comply with the legal requirements of Chapter 11. Most Plans are plans of reorganization, but a Plan may also be a Plan of Liquidation.

20. What is a disclosure statement?

It is a document prepared by the proponent of a Plan that discloses to creditors and interest holders financial and other information about the debtor and the proposed Plan sufficient to enable them to make an informed decision on whether to accept or reject the proposed Plan. A disclosure statement must be approved by the Court before it is distributed to creditors and interest holders.

21. How may secured creditors be dealt with in a Chapter 11 plan?

The claim of a fully secured creditor must be paid in full in cash, and if deferred cash payments are made on the claim, interest must be paid to the creditor. A partially-secured creditor may elect to have its claim treated as being fully secured, and if such an election is made, the claim must be paid in full in cash, but if deferred cash payments are made, interest does not usually have to be paid on the claim. If a partially-secured creditor does not elect to have its claim treated as being fully secured, the secured portion of its claim must be paid in the same manner as a fully secured claim, while the unsecured portion may be paid as an unsecured claim.

22. How may unsecured creditors be dealt with in a Chapter 11 plan?

The answer depends on whether a creditor has a priority or a non-priority claim. Priority claims must be paid in full in cash under a Plan, unless a creditor agrees otherwise. Further, all priority claims except tax claims must be paid when the Plan is confirmed or shortly thereafter, unless the creditors agree otherwise. Tax claims may be paid in deferred cash payments with interest over a period not exceeding five years from the filing of the Chapter 11 case. A creditor with a non-priority claim must be paid at least as much as the creditor would have received had the debtor filed a Chapter 7 liquidation case, and payment need not be in cash. Non-priority claims may be paid in cash, property, or securities of the debtor or of the successor to the debtor under the Plan.

23. How does a priority claim differ from a non-priority claim?

A priority claim is an unsecured claim that is given priority in payment under the Bankruptcy Code. Priority claims include the

following types of claims: the administrative expenses of the Chapter 11 case, wage claims due an employee of yours for work performed within 180 days prior to the filing of bankruptcy case of up to \$10,950 per employee (as of the date of the writing of this memorandum), wage benefit claims of employees up to certain limits, consumer deposit claims of up to \$2,425 each (as of the date of the writing of this memorandum), and unsecured tax claims. Administrative expenses include legal fees payable to the debtor's attorneys during the case and unsecured credit or debt incurred in the ordinary course of operating the debtor's business during the case. A non-priority claim is a general unsecured claim incurred by the debtor prior to the filing of the Chapter 11 case.

24. What must a creditor do to become entitled to payment in a Chapter 11 case?

For a creditor to be entitled to payment in a Chapter 11 case, the creditor's claim must be filed and must be allowed by the Court. If a creditor's claim is listed in the schedules filed by the debtor in the case, and is not listed as being disputed, contingent, or unliquidated, then the claim is deemed to be filed in the case. Otherwise, a creditor must file a document called a "proof of claim" in order for its claim to be recognized. Once a claim is filed, either by virtue of being included in the debtor's schedules or by the filing of a "proof of claim" the claim is automatically allowed by the Court unless an objection is filed to the allowance of the claim, in which case the Court must hold a hearing to determine whether to allow the claim. Thus, if a creditor's claim is correctly listed in the debtor's schedules and if no one files an objection to the claim, the claim is automatically allowed in the case even if the creditor does nothing.

25. When do creditors vote on whether to accept or reject a Chapter 11 plan?

Voting on a Plan begins after the Court approves the disclosure statement prepared by the party proposing the Plan. Each eligible creditor is mailed a ballot for voting on the Plan. The ballot is accompanied by a copy of the disclosure statement and a copy or summary of the proposed Plan. The Court sets a deadline for voting on the Plan, and a creditor's ballot must be filed with the Court prior to the voting deadline in order to be counted.

26. What creditors are eligible to vote on the acceptance or rejection of a Chapter 11 plan?

Creditors must qualify both individually and by class in order to be permitted to vote on the acceptance or rejection of a Plan. A creditor's individual claim must be allowed by the Court in order to be eligible to vote. The allowance requirements for claims for purposes of voting are the same as the allowance requirements for purposes of payment, and are described in the answer to questions 28 and 29 above. Except for certain priority claims, a Plan must put

each claim in a class. To be eligible to vote on the acceptance or rejection of a Plan, a class of claims must be impaired by the Plan and must receive something under the plan. For a class of claims to be impaired by a Plan, at least one claim in the class must be impaired under the Plan. Classes of unimpaired claims are presumed to have accepted the Plan and classes of claims receiving nothing under the Plan are presumed to have rejected the Plan. Creditors in these classes of claims do not vote on the acceptance or rejection of a Plan. Creditors with allowed claims in all other classes of impaired claims are eligible to vote on the acceptance or rejection of a Plan.

27. What is an impaired claim?

A claim is "impaired" by a Plan if the rights of the creditor to enforce its claim are diminished or materially changed by the Plan. A claim that is not paid in full under a Plan is an impaired claim. Even if a claim is paid in full under a Plan, the claim is considered to be impaired if the original maturity date or any other obligation contained in the agreement upon which the claim is based is not met by the Plan. Under Chapter 11, a debtor is permitted to cure a defaulted note, mortgage or other obligation so that the creditor's claim is no longer impaired. A defaulted obligation is cured, and not impaired, if the obligation is made current, the creditor is compensated for any expenses incurred by reason of the debtor's default and the rights of the creditor under the obligation are thereafter unaltered.

28. How is it determined whether a plan is accepted or rejected by creditors?

All voting on the acceptance or rejection of a Plan is by class. The creditors in each class of impaired claims vote on whether the Plan will be accepted by that class of claims. To be accepted by a class of claims, a Plan must be accepted by creditors holding at least two-thirds in amount and one-half in number of the claims in the class that actually vote on the acceptance or rejection of the Plan. At least one class of impaired claims must vote to accept a Plan before the Plan can be confirmed by the Court.

29. What happens when a plan is confirmed by the court?

To become legally effective, a Plan must be confirmed by the Court. A plan is confirmed by the Bankruptcy Court when the Bankruptcy Judge signs an order approving the Plan and rules that the debtor and all creditors and interest holders are bound by the provisions of the Plan.

30. When and under what circumstances may a plan be confirmed by the Bankruptcy Court?

After creditors and interest holders have voted on whether to accept or reject a proposed Plan, the Court will hold a hearing for the purpose of determining whether to confirm the Plan. This hearing is called the "confirmation hearing." At the confirmation hearing,

the party proposing the Plan, which is usually the debtor, must present evidence showing that the Plan complies with the Chapter 11 confirmation requirements. A Plan may be confirmed by the Court either through the regular confirmation method or through a "cramdown." The regular method of confirmation is used when the Plan has been accepted by every class of creditors with impaired claims and interest holders. The cramdown method of confirmation is used when the Plan has been rejected by one or more classes of creditors with impaired claims or interest holders, but has been accepted by at least one class of creditors with impaired claims. A Plan that has not been accepted by at least one class of creditors with impaired claims cannot be confirmed by the court.

31. How does confirmation of a plan under a "cramdown" differ from the regular method of confirmation?

When every class of creditors with impaired claims and every class of interest holders has voted to accept a Plan and confirmation is sought under the regular confirmation method, there are 13 legal requirements that must be satisfied in order for the plan to be confirmed by the court. When confirmation of a Plan is sought under a cramdown, in addition to satisfying each of the 13 confirmation requirements (except the requirement that the Plan be accepted by every class of impaired claims and interests) it must be shown that the Plan does not discriminate unfairly against any class of claims or interests not accepting the Plan and that the Plan is fair and equitable with respect to each class of claims or interests that has not accepted the Plan. For a Plan to be deemed fair and equitable with respect to a non-accepting class of claims or interests, the Plan must meet certain legal requirements that are too complicated to be explained here. It is significantly more difficult to obtain confirmation under a cramdown than under regular confirmation method.

32. What happens if the Court does not confirm a Chapter 11 plan?

If the Court decides not to confirm a Plan, it will usually permit the party proposing the Plan to modify the Plan so that it may be confirmed. If a Chapter 11 Plan is modified, it is usually necessary to hold another confirmation hearing on the modified Plan. If the Court refuses to confirm any Plan, the Chapter 11 case must either be dismissed or converted to a Chapter 7 case.

33. What happens after a Chapter 11 plan has been confirmed by the Court?

After a Plan has been confirmed by the Court, the Plan must be implemented and carried out by the debtor. If the Plan calls for a debtor to be reorganized or for a new corporation to be formed, this function must be carried out. If the Plan calls for property to be transferred or for liens to be created or modified, this must also be done. And, of course, the claims of creditors must be paid in the manner specified in the Plan.

34. For how long a period may a Chapter 11 plan run?

There are no specific limits on the length on a Plan. A Plan must be long enough to convince the Court and creditors that the debtor is making a good faith effort to pay as much of its debt as is realistically possible. On the other hand, the Plan must not be so long that it does not appear feasible to the court. Most Plans of small business debtors run from three to five years in duration.

35. What happens if the debtor is unable to comply with or carry out the provisions of a plan after it has been confirmed by the Court?

If the debtor, or the successor to the debtor under the Plan, is unable to comply with the provisions of a confirmed Plan, the Plan may be amended so that it can be complied with, if sufficient grounds exist for such an amendment. Otherwise, the Chapter 11 case may be dismissed or converted to a liquidation case under Chapter 7. If the debtor, or the successor to the debtor under the Plan, fails to carry out its obligations under the Plan, creditors may sue, or foreclose on the property of, the debtor or its successor either in the Bankruptcy Court or in other courts.

36. What happens when all of the provisions and requirements of a Chapter 11 plan have carried out?

When all of the provisions and requirements of a Plan have been fulfilled or carried out, the Plan is said to have been consummated. When a Plan has been consummated, a final report and accounting must be filed, and the case will be closed by the Court.

OCTOBER 2008