

REICH, REICH & REICH, P.C.

**OVERVIEW OF CHAPTER 11
OF THE BANKRUPTCY CODE**

BACKGROUND

The provisions of Chapter 11 of the Bankruptcy Code allow a "debtor" (as a Chapter 11 filer is called) to continue its business operations and to restructure its finances so that it may continue to operate. When a business develops financial difficulties, such as not being able to pay its creditors due to cash flow problems, it may consider filing a Chapter 11 case. If the business can extend or reduce its debts, or lower its operating costs, it may be able to be returned to a viable condition.

HOW CHAPTER 11 WORKS

Upon the filing of a Chapter 11 case, a debtor assumes the status of "debtor in possession" (i.e., a debtor which keeps possession and control of its assets while undergoing reorganization under Chapter 11).

A debtor's proposed "plan of reorganization" (further discussed below and sometimes referred to as "plan") and a "disclosure statement" (further discussed below) must be filed with the Bankruptcy Court (sometimes referred to as "Court"). The contents of a plan of reorganization must include a classification of claims and must specify how each class of claims will be treated under a plan. A plan must be voted upon by those creditors whose claims are "impaired" (i.e., those whose contractual rights are to be modified or who will be paid less than the full value of their claims under a plan). After a disclosure statement is approved and the ballots are tallied, there is a "confirmation hearing" (further discussed below) at which the Court determines whether to confirm a plan.

THE AUTOMATIC STAY

The "automatic stay" (a stay of creditor actions against a debtor which goes into effect when a Chapter 11 case is filed) provides for a period of time in which all judgements, collection activities, foreclosures and repossessions of property are suspended and may not be pursued on any debt or claim which arose before the filing of a Chapter 11 case. The automatic stay provides a "breathing spell" for a debtor during which appropriate steps may be taken to attempt to resolve its financial difficulties.

Under certain circumstances, such as when a debtor has no equity in a particular piece of real or personal property, and that property is not necessary for an effective reorganization, a secured creditor (i.e., a creditor which has a lien against property of a debtor) may obtain an order from the Bankruptcy Court granting relief from the automatic stay to allow it foreclose on the property, sell it and apply the proceeds to the debt.

ADMINISTRATION EXPENSES

Although the fees of a debtor's attorneys, accountants or other professional advisors may be paid pursuant to authorization of the Bankruptcy Court, a debtor cannot make payments to creditors on pre-petition obligations (i.e., obligations which arose before the filing of a Chapter 11 case). However, the ordinary expenses of the ongoing business must continue to be paid; these are called "administration expenses."

CREDITORS' COMMITTEE

A "creditors' committee" may play a major role in a Chapter 11 case. The "U.S. Trustee" (discussed below) attempts to appoint a creditors' committee, which ordinarily consists of the persons or firms willing to serve on the committee which hold the seven largest "unsecured claims" against a debtor. Unsecured claims are most often those for which an extension of credit was based upon an evaluation by a creditor of a debtor's ability to pay, as opposed to retaining a lien against a debtor's property. A creditors' committee (assuming one is able to be appointed by the U.S. Trustee) may consult with a debtor as to the administration of the Chapter 11 case, investigate the conduct of a debtor and the operation of its business and participate in the formulation of a plan of reorganization.

APPOINTMENT OR ELECTION OF AN OPERATING TRUSTEE

Although the appointment of an "operating trustee" is a rarity in a Chapter 11 case, a creditor, a creditors' committee or the U.S. Trustee may request such appointment. The Bankruptcy Court may order such appointment for fraud, dishonesty, incompetence or gross mismanagement of a debtor. If an operating trustee, is appointed he or she becomes responsible for management of a debtor's property, operation of its business and, if appropriate, the filing of plan of reorganization.

THE UNITED STATES TRUSTEE

The U.S. Trustee (a federal employee, as distinguished from an operating trustee) plays a significant role in monitoring the progress of a Chapter 11 case and supervising its administration. The U.S. Trustee is responsible for monitoring a debtor's

operation of its business, the submission of operating reports, applications of professionals for compensation, plans of reorganization and disclosure statements and creditors' committees. The U.S. Trustee conducts a meeting of the creditors at which an attorney from the U.S. Trustee's Office and creditors may question a debtor under oath concerning a debtor's acts, conduct and property and the administration of its Chapter 11 case. The U.S. Trustee has standing to appear and be heard on any issue in a Chapter 11 case but may not file a plan of reorganization.

The U.S. Trustee also imposes certain requirements upon a debtor concerning matters such as reporting its monthly income and operating expenses, the establishment of new bank accounts and the payment of current employee withholding and other taxes. A debtor must pay a quarterly fee to the U.S. Trustee (computed on a sliding scale depending upon the amount of a debtor's disbursements during the quarter).

APPLICATIONS TO THE BANKRUPTCY COURT

Although the preparation, confirmation and implementation of a plan of reorganization is at the heart of a Chapter 11 case, other issues may arise which must be addressed by a debtor. A debtor may use, sell or lease property in the ordinary course of its business without prior Bankruptcy Court approval unless the Court orders otherwise. If the sale or use is outside the ordinary course of business, permission from the Court is required.

The continued operation of a debtor's business may also lead to the filing of a number of other applications to the Court. The most common are those seeking relief from the automatic stay or to obtain credit. There may also be Court proceedings over executory (i.e., unfulfilled) contracts and unexpired leases and the assumption or rejection of those contracts and leases by a debtor.

Should a debtor fail to take the appropriate steps to bring its Chapter 11 case to an expeditions conclusion, the U.S. Trustee, creditors or a creditors' committee may apply to the Court to have a debtor's Chapter 11 case converted to a case under Chapter 7 of the Code (under which the business would be closed and its assets liquidated) or to have the case dismissed (in which event there would be no more protection from creditor action).

ADVERSARY PROCEEDINGS

A debtor may institute a Court action (known as an "adversary proceeding") to recover money or property. Adversary proceedings may take the form of lien avoidance actions, actions to avoid preferences, actions to avoid fraudulent transfers or actions to avoid post-petition transfers.

AVOIDABLE TRANSFERS

Under the Bankruptcy Code, a debtor has what are called "avoiding" powers. Such powers may be used to undo a "preferential" transfer of money or property made during a certain period of time prior to the filing of a Chapter 11 case. By avoiding a particular transfer of money or property, a debtor can cancel the transaction and force the return or disgorgement of the payments or property, which then are available to pay all creditors, rather than only one.

CLAIMS

In some instances, a creditor must file a "proof of claim" form along with documentation evidencing the validity and amount of its claim. When proofs of claims are required to be filed, they must be filed with the Clerk of the Bankruptcy Court. Creditors whose claims are not listed on bankruptcy schedules as disputed, contingent or unliquidated need not file claims because the schedule of liabilities is deemed to constitute evidence of the validity and amount of those claims. Any creditor whose claim is not scheduled, or is scheduled as disputed, contingent or unliquidated, must file a proof of claim in order to be treated as a creditor for purposes of voting on a plan of reorganization and distribution under it. If a scheduled creditor chooses to file a claim, a properly filed proof of claim supersedes any scheduling of that claim. It is the responsibility of a creditor to determine whether its claim is accurately listed in a debtor's schedules. A debtor must provide notification to those creditors whose names are added after a Chapter 11 case is filed.

CONVERSION OR DISMISSAL

A debtor in a Chapter 11 case has a one-time absolute right to convert to a liquidation case under Chapter 7; it does not, however, have an absolute right to have its Chapter 11 case dismissed.

As stated above, when there are continuing losses, an inability to effectuate a plan of reorganization, unreasonable delay that is prejudicial to creditors or inability to confirm a plan of reorganization, upon the request of a creditor, a creditors' committee or the U.S. Trustee, the Bankruptcy Court may convert a Chapter 11 case to a case under Chapter 7, or dismiss the case.

THE PLAN OF REORGANIZATION

The Bankruptcy Code lists mandatory provisions for a plan of reorganization, as well as discretionary provisions; it also provides that a plan shall designate classes of claims and equity interests and the treatment that such classes will receive. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors and equity security holders.

THE DISCLOSURE STATEMENT

The filing of a disclosure statement is preliminary to the voting on a plan of reorganization. A disclosure statement must provide "adequate information" concerning the affairs of a debtor so as to enable a creditor to make an "informed judgement" about the plan. After the disclosure statement is filed, the Bankruptcy Court holds a hearing to determine whether it should be approved. Acceptance or rejection of a plan cannot be solicited without prior Court approval of the disclosure statement; after it has been approved, a debtor may begin to solicit acceptances of a plan.

THE CONFIRMATION PROCESS

During the first 120-days after the filing of the Chapter 11 petition, only a debtor may file a plan of reorganization. A debtor has 180 days after the filing of the Chapter 11 case to obtain acceptances of the plan. The Bankruptcy Court may extend this exclusive period.

If the exclusive period expires before a debtor has filed and obtained acceptance of a plan, a creditors' committee or a creditor (but not, as mentioned above, the U.S. Trustee) may file a plan.

It should be noted that a "plan of liquidation" is permissible in a Chapter 11 case. Such a plan may allow a debtor to liquidate its business under more economically advantageous circumstances than under a Chapter 7 liquidation. It also permits creditors to take a more active role in fashioning the liquidation of the assets and the distribution of the proceeds than in a Chapter 7 case.

The Bankruptcy Code provides that an entire class of claims has accepted a plan of reorganization if it has been accepted by creditors holding at least two-thirds in amount and more than one-half in number of the allowed claims of the class held by creditors who have voted on the plan. If there are impaired classes of claims, the Court cannot confirm a plan unless it has been accepted by at least one class of non-insiders holding impaired claims (i.e., claims that are not going to be paid

completely or in which some legal, equitable or contractual right is altered). Moreover, holders of unimpaired claims are deemed to have accepted a plan.

Creditors and a creditors' committee (but not the U.S. Trustee) may file an objection to confirmation of a plan of reorganization. If no objection to confirmation has been filed, the Code allows the Court to determine that the plan has been proposed in good faith and according to law. Before confirmation can be granted, the Court must be satisfied that there has been compliance with all the other requirements of confirmation set forth in the Bankruptcy Code. In order to confirm a plan, the Court must find that: (1) a plan is feasible, (2) is proposed in good faith and (3) is in compliance with the Bankruptcy Code. In addition, the Court must find that confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization.

**PLEASE NOTE THAT THIS OVERVIEW OF CHAPTER 11 OF THE
BANKRUPTCY CODE IS NOT INTENDED AS A SUBSTITUTE FOR SPECIFIC
ADVICE APPLICABLE TO YOUR PARTICULAR CIRCUMSTANCES.**

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