The Fundamentals of Business Bankruptcy
(Reorganization and Liquidation)

I. INTRODUCTION

Contracts govern countless commercial transactions entered each day by businesses throughout the United States. In connection with the need to promote and regulate commerce, Congress has exercised its power to establish uniform laws on the subject of bankruptcies by enacting the Bankruptcy Code (the “Code”). The Code embodies the power to alter contractual rights and is an implicit part of every contract.

In general, once a bankruptcy case has been commenced by a party to a contract, state law (and/or applicable non-bankruptcy federal law) continues to define a party’s rights under the contract and federal bankruptcy law determines how those rights are enforced in a bankruptcy case. For example, damages may be calculated under state law, but they are paid out according to bankruptcy priorities and principles. Additionally, the Code contains provisions designed to promote the equal treatment of creditors with claims of the same priority.

The Code has provisions providing for reorganization and liquidation of eligible entities and is divided into different Chapters. Cases are commenced under the Code by filing a bankruptcy petition with the bankruptcy court under one of five operative Chapters: 11 (reorganization); 7 (liquidation); 11 (reorganization); 12 (adjustment of debts of individuals with regular income); or 13 (adjustment of debts of individuals with regular income). As far as business entities are concerned, the operative Chapters discussed in this article are Chapters 11 and 7. Chapter 11 of the Code governs reorganization cases (although Chapter 11 can be used for liquidation). Chapter 7 solely applies to liquidation cases.

The provisions in Chapters 1, 3 and 5 of the Code apply to both Chapter 11 (reorganization) and Chapter 7 (liquidation) cases. In some instances, it is feasible for entities to reorganize (e.g., through an out-of-court debt restructuring or workout) or liquidate (e.g., through an assignment for the benefit of creditors) without resorting to the jurisdiction of the bankruptcy court.

II. REORGANIZATION VERSUS LIQUIDATION

A. Chapter 11

Chapter 11 of the Code provides a framework for business reorganization (Chapter 11 may also be used for liquidation). In contrast, Chapter 7 solely involves liquidation. Upon the filing of a voluntary Chapter 11 petition, a reorganization case is commenced. Contemporaneously with the commencement of the case, the debtor (the entity filing the voluntary petition) becomes a debtor-in-possession. The filing of a bankruptcy petition creates a bankruptcy estate which includes all legal and equitable interests of the debtor in property as of the commencement of the case. The debtor-in-possession continues to control and possess property of the estate and is authorized to manage and operate its business unless and until otherwise ordered by the Bankruptcy Court. The primary goals of Chapter 11 are rehabilitation of the debtor, equality of treatment of creditors holding claims of the same priority, and maximization of the value of the bankruptcy estate.

B. Chapter 7

Chapter 7 provides a formal, judicial procedure for the orderly liquidation of the assets of the debtor and the ultimate payment of creditors in the order of priority set forth in the Code. Under Chapter 7, an independent bankruptcy trustee is appointed to conduct the liquidation and is charged with the responsibility of marshalling the debtor’s assets, liquidating them, and ultimately distributing the net proceeds to creditors. The trustee is armed with powers that include the ability to avoid and recover preferential and fraudulent transfers made by the debtor and the trustee may assert claims and initiate actions on behalf of the bankruptcy estate.

C. Out-of-Court Alternatives

1. In General

In some situations, an out-of-court debt restructuring or workout involving secured and/or unsecured creditors may be a viable option for a distressed enterprise. Moreover, in certain instances, where the goal is to transfer the assets of the troubled business to an acquiring entity free of the unsecured debt incurred by the transferor and wind down the company in a manner designed to minimize negative publicity and potential liability for directors and management, the most advantageous and graceful exit strategy can be an assignment for the benefit of creditors.

2. Assignments For The Benefit of Creditors.

An alternative to a formal bankruptcy proceeding is a business liquidation device known as an assignment for the benefit of creditors. See Credit Managers Ass’n v. Nat’l Indep. Business Alliance, 162 CA3d 1166, 1169 (1984). The assignment is a contract under which the assignor transfers all of its right, title, interest in, and custody and control of its property to a third-party assignee in trust. The assignee liquidates the property and distributes the proceeds to the assignor’s creditors. Like a bankruptcy trustee, an assignee may recover preferential transfers. The statutory scheme under California law for recovery of avoidable preferences by an assignee for the benefit of creditors is almost
identical to the analogous provision in the Bankruptcy Code. Compare CCP § 1800 with 11 USC § 547. The common law assignment by simple transfer in trust may, in some cases, be more advantageous than use of the more cumbersome statutory procedures governing a formal Chapter 7 bankruptcy liquidation case and allows for a quicker and more flexible liquidation process.

3. Out-of-Court Workouts
Bankruptcy reorganization and out-of-court workouts are fundamentally different processes. The Bankruptcy Code provides for the comprehensive restructuring of all obligations of the debtor. In a bankruptcy reorganization, all of the constituencies of the debtor are brought before the bankruptcy court. Workouts, on the other hand, are often more narrowly focused. Frequently only a company’s lenders and other major creditors participate.

Because the United States Constitution prohibits states from passing any law that impairs the obligation of contracts, only federal bankruptcy law can provide for the involuntary restructuring and discharge of obligations. Outside bankruptcy court, a debtor lacks the authority to resolve disputes unilaterally or to impose a restructuring on dissenters or to block creditors seeking to exercise their remedies. Thus, a workout is essentially a privately negotiated transaction. The debtor can rely only on its powers of persuasion. If a dispute cannot be resolved consensually, the matter must be left unresolved. If a troubled company’s financial condition or the terms of the restructuring will not permit this, the workout will fail.

The debtor may attempt to accomplish and implement the workouts directly or through the auspices of an intermediary. The use of a third party intermediary can lend credibility and structure to the company’s informal (i.e., out-of-court) restructuring efforts.

Out-of-court workouts may include composition, extension or standstill agreements or exchange offers. In a composition agreement, creditors agree to release a portion of their claims against the debtor in exchange for payment of less than what is owed. Under an extension agreement, payment terms are revised, but the obligation to pay remains. Standstill or moratorium agreements allow the debtor to delay repayment for a specified period without continuing accrual of interest or penalties. In an exchange offer, the issuer of public debt securities offers its existing security holders some combination of new debt securities, equity securities or cash in exchange for their existing debt securities, permitting each existing security holder to make an independent determination concerning the merits of the restructuring. The economic leverage of these offers is reduced by the level of acceptance by the existing security holders, often as high as 90 or 95 percent. In many cases, the need for such a high rate of acceptance makes an exchange offer impractical.

III. PROPERTY OF THE ESTATE
All of the debtor’s interests in property are included in the bankruptcy estate. Various provisions of the Code allow property that the debtor did not have a possessory interest in at the time of the commencement of the bankruptcy estate to be brought into the estate and/or allow the estate’s representative to nullify and/or recovery pre-bankruptcy transfers of property made by the debtor.

IV. DEBTOR-IN-POSSESSION/TRUSTEE
Upon the filing of a Chapter 7 bankruptcy petition, a bankruptcy trustee is appointed and acts as the estate’s representative. The Chapter 7 trustee is responsible for administering the estate and holds the rights of the debtor as supplemented by the additional rights and powers provided under the Code. A trustee is not automatically appointed upon the commencement of a Chapter 11 case.
Under Chapter 11, management of the debtor (the debtor becomes a debtor-in-possession once the Chapter 11 petition is filed) generally continues in place and is not automatically ousted. Although the presumption is that a debtor-in-possession will continue to control and possess its assets and manage and operate its business, a creditor or other party in interest can request that the bankruptcy court appoint a trustee for "cause" or if it is in the best interest of creditors for an independent fiduciary to take over control and management of the debtor's affairs. Examples of "cause" for the appointment of a trustee include, fraud, dishonesty, incompetence or gross mismanagement (just ordinary mismanagement of a trustee include, fraud, dishonesty, incompetence or gross mismanagement is not sufficient) of the affairs of the debtor by current management.

V. AUTOMATIC STAY

A. In General
Upon the commencement of a bankruptcy case, an automatic stay goes into effect. It is self-executing and no court order is required. The effect of the automatic stay is to prohibit and invalidate certain post-bankruptcy actions taken against the debtor, property of the debtor or property of the bankruptcy estate. The purpose of the stay is to give the debtor a breathing spell from creditor action; to achieve an equality of distribution of property of the estate among claimants; and to promote an orderly administration of the bankruptcy case.

B. Scope of Automatic Stay
The automatic stay is a basic protection afforded to debtors under the Code, and its scope is intended to be broad. The automatic stay prohibits: (1) the commencement or continuation of any judicial, administrative or other proceeding against the debtor based on a pre-bankruptcy ("pre-petition") claim; (2) the enforcement of a pre-petition judgment against the debtor or property of the estate; (3) any act to obtain possession of or from property of the estate or to exercise control over property of the estate; (4) any act to create, perfect or enforce any lien against property of the estate; (5) any act to create, perfect or enforce any lien against property of the debtor, to the extent it secures a pre-petition claim; (6) any act to collect, assess or recover a pre-petition claim against the debtor; (7) setoff of a pre-petition debt owing to the debtor; and (8) commencement or continuation of a tax court proceeding concerning the debtor.

C. Exceptions to the Automatic Stay
There are certain statutory exceptions to the automatic stay. Among other things, the following actions are not automatically stayed: criminal proceedings against the debtor; commencement or continuation of a proceeding by a governmental unit to enforce its police or regulatory powers; enforcement of a judgment obtained in a proceeding by a governmental unit to enforce its police or regulatory powers, other than a money judgment; and actions by a lessor to obtain possession of non-residential real property leased to the debtor under a terminated lease.

The automatic stay does not apply to actions against non-debtor third parties such as co-obligors, guarantors, co-defendants, partners, sureties, affiliates or officers of the debtor. When uncertain as to whether a proposed action is subject to the automatic stay, a party should seek an order of the bankruptcy court for clarification. Violators of the automatic stay may be responsible for damages.

D. Relief from Stay
The prohibitions of the automatic stay are not necessarily permanent. Relief from the automatic stay may be sought by filing a motion with the bankruptcy court. In many instances, the bankruptcy court has broad discretion regarding whether to grant relief from the automatic stay since it may do so for "cause" and that term is not defined in the Code.

VI. PROOF OF CLAIMS

A. Filing Claims
In every business bankruptcy case where funds are available for distribution to creditors, there is a deadline (bar date) for filing claims. In a Chapter 7 liquidation case where there are sufficient assets to pay a dividend to creditors, with certain exceptions, a proof of claim is timely filed if it is filed with the Bankruptcy Court not later than 90 days after the first date set for the meeting of creditors called under Section 341(a) of the Code. In a Chapter 11 case, all creditors with claims not scheduled by the debtor-in-possession or scheduled as disputed, contingent, or unliquidated must file proof of claims if they desire to preserve their right to obtain any recovery from the estate. In Chapter 11 cases, a bar date is set for the filing of claims and creditors are provided with notice of the deadline. Failure to timely file a proof of claim can result in disallowance of the claim (even if it is otherwise meritorious).

The debtor and other parties in interest have the right to object to claims and the Bankruptcy Court may determine and allow or disallow claims, including contingent and unliquidated claims. If objected to, the Court will determine the amount of the claim as of the date of the filing of the petition. It should be kept in mind that, in most Chapter 11 cases, general unsecured creditors will receive pro rata payments in an amount that is substantially less than 100 percent of their allowed claims. Although a filed claim is deemed allowed unless it is objected to by a party in interest, before an unsecured creditor files a proof of claim, it should carefully consider negative ramifications of such a filing. The filing of a proof of claim will constitute submission to jurisdiction of the Bankruptcy Court for determination of that claim and any related counterclaims and may constitute the waiver of any right to a jury trial otherwise possessed by the claimant. Accordingly, before filing a proof of claim, the creditor should balance losing its right to participate in any distribution from the bankruptcy estate against submitting to the jurisdiction of the Bankruptcy Court.

B. Limitations on Allowance of Claims
The Code contains a general limitation on the allowance of claims (claims that are unenforceable against the debtor under any agreement or applicable law for a reason other than because the claim is contingent or unmatured) as well as specific limitations on allowance. Interest that has not matured as of the time of the filing of the bankruptcy petition is generally not allowed with regard to unsecured claims (the exception is when there is
100 percent distribution to unsecured creditors. Claims of landlords for damages resulting from the termination of a real estate lease are capped. Similarly, claims of an employee of the debtor for damages resulting from the termination of an employment contract are also capped. Further, any contingent claim for reimbursement or contribution of an entity that is liable with the debtor on or has secured the claim of a creditor of the debtor is to be disallowed.

C. Secured Claims
The Code divides an undersecured creditor’s total claim into a secured claim to the extent of the collateral’s value and into an unsecured claim to the extent of the deficiency. In situations involving only one secured creditor and one debtor, the value of the undersecured creditor’s secured claim is simply the value of the underlying collateral. The difference between the collateral’s value and the amount of debt become an unsecured claim that is added to the existing pool of unsecured claims. The value determination of the creditor’s collateral is to be made in light of the purpose of the valuation and the proposed disposition or use of such property. Generally, a claim in a Chapter 11 case secured by a lien on property of the estate is to be allowed against the debtor as if the claimant had recourse against the debtor, whether or not by a contract or under applicable law, the creditor had such recourse. However, an undersecured non-recourse creditor may elect to forego its right to have its claim treated as a recourse claim in return for treatment as a secured claim to the extent that the claim is allowed.

The most common exception to the general rule prohibiting the accrual of post-petition interest on creditors’ claims is a provision allowing the accrual of post-petition interest on over secured claims. The holders of oversecured claims have an unqualified right to the accrual of post-petition interest on their claims that exists whether or not there is an agreement giving rise to a claim for interest. However, oversecured creditors with consensual liens are not always granted their contractual rate of interest. Under a plan of reorganization or pursuant to a sale outside of a plan, the debtor may “cure” and nullify all consequences of the default, including a high post-default interest rate. While the recovery of post-petition interest by oversecured creditors is unqualified, the recovery of fees, costs and charges provided for in the agreement is only allowed to the extent such claims are reasonable.

The general rule is the property acquired by the debtor post-bankruptcy is not subject to a lien created by a pre-bankruptcy security agreement. The exception is that post-petition proceeds, product, offspring, profits or rents (including the fees, charges, accounts or other payments for the use of occupancy of rooms and other public facilities and hotels, motels or other lodging properties) are covered by the pre-petition lien if the security agreement expressly provides for an interest in such property, and the interest has been perfected under applicable non-bankruptcy law.

D. Unsecured Priority Claims
The Code sets forth a priority scheme that ranks unsecured claims in the order of priority established by Congress. Administrative expenses are granted first priority. Under limited circumstances, the court may allow the payment of administrative expenses from the proceeds of the collateral of a secured creditor of the debtor. Second priority involves “gap” claims incurred in connection with involuntary bankruptcy cases. Wage claims to the extent of $4,650 earned within 90 days of the commencement of the bankruptcy case hold the third priority position. Additional claims granted priority include, among others, tax claims.

E. Payment of Pre-Petition Unsecured Obligations
Without special court authorization, the estate’s representative is prohibited from paying or otherwise honoring any pre-petition unsecured obligations. Generally, these claims can only be satisfied through a plan of reorganization (in Chapter 11 cases) or the ultimate...
distribution to creditors (in Chapter 7 cases) unless the court issues an order directing earlier payment. It is relatively routine in Chapter 11 cases for the court to authorize special payment of certain pre-petition unsecured obligations such as unpaid employee wages for the period immediately prior to a Chapter 11 filing to the extent of the priority limitation on such claims ($4,650). Further, upon motion of the debtor, the court might approve early payment of critical pre-petition obligations to certain critical vendors and service providers.

VII. EXECUTORY CONTRACTS

A. In General

As indicated above, a primary goal of Chapter 11 is rehabilitation of the debtor. Thus, a longstanding principle of bankruptcy law is that a debtor should not be compelled to perform under a pre-bankruptcy contract that is burdensome to the estate. In the context of a bankruptcy case, the issue of whether a contract is “executory” is a question of federal bankruptcy law. The Code, however, does not define the term “executory contract”. In enacting the Code, Congress recognized that there is no precise definition of what contracts are executory, but said that the definition generally includes contracts on which performance remains due to some extent on both sides. The United States Supreme Court has followed this definition. Agreements which constitute outright conveyances of property rights (as opposed to agreements requiring an ongoing relationship involving mutual obligations between the parties) are not executory contracts.

In a Chapter 11 case, an unexpired lease or executory contract may be treated under four options: (1) it may be rejected, (2) it may be assumed and retained, (3) it may be assumed and assigned, or (4) it may “ride through” the bankruptcy process. In Chapter 7, the fourth option (ride through) is not available.

B. Performance or Breach of Pre-Bankruptcy Contracts

The Code provides that, subject to court approval, the estate’s representative may assume or reject any executory contract or unexpired lease of the debtor. This power was designed to allow a debtor-in-possession/trustee to elect to discontinue performance under a burdensome contract, while permitting the debtor to force the other party to the contract to continue performance under a contract valuable to the bankruptcy estate. When a debtor is in default under an executory contract, the estate’s representative may nonetheless assume the contract if it cures (or provides adequate assurance that it will promptly cure) such default, compensates (or provides adequate assurance of prompt compensation) for any pecuniary loss of the other party resulting from such default, and provides adequate assurance of future performance under the contract. Assumption of the contract may become more complicated when non-monetary defaults are involved. If the debtor-in-possession/trustee has reasonably exercised its business judgment in determining whether to reject or assume an executory contract, the decision will generally be approved by the court. If the contract is assumed, the estate’s representative is then obligated to comply with all of its terms (unless the other party to the contract agrees otherwise).

Rejection of an executory contract that was not previously assumed constitutes a breach of the contract relating back to the date immediately preceding the filing of the debtor’s bankruptcy petition. A claim resulting from rejection of an executory contract thus becomes a pre-petition unsecured claim, which must be presented through the normal claims administration process. In contrast, if an executory contract is breached after it is assumed, the resulting claim is an administrative expense of the bankruptcy estate. When a debtor rejects the contract, most courts hold that the other party to the contract is limited to asserting a claim for damages resulting from the breach and generally cannot compel further performance of the debtor.

The non-debtor party to an executory contract can bring a motion requesting that the court set a deadline for the debtor to assume or reject the contract. Depending on the circumstances, including the prejudice to the non-debtor party and the status of the bankruptcy case, the court may or may not grant the motion and, if granted, may set a relatively short deadline or may provide the debtor with a loose rein. In any event, the estate’s representative is supposed to perform its post-bankruptcy obligations under the contract on a timely basis. Failure to do so may result in the assertion of administrative priority claims by the non-debtor party.

C. Assignment

In general, once an executory contract can be assumed, it can be assigned, subject to providing adequate assurance of future performance by the assignee. However, courts and Congress have struggled to interpret section 365(c) of the Code which may preclude assumption and/or assignment of executory contracts that are nonassignable under otherwise applicable non-bankruptcy law. While courts have ruled inconsistently in this area, this prohibition should be found to apply with certainty in very limited circumstances where assignment is absolutely prohibited as a matter of otherwise applicable non-bankruptcy law regardless of what the contract says about assignment and who the assignee may be. In most circumstances, assuming the requirements for assumption are met and adequate assurance of future performance by the assignee is provided, assignment is permitted in bankruptcy even though it would be barred under the contract and/or by otherwise applicable non-bankruptcy law.

D. Anti-Forfeiture Provisions of the Code

The Code explicitly invalidates provisions of private agreements that deprive the debtor of the use and benefit of property as a result of the debtor’s financial condition, the commencement of a bankruptcy case, or the appointment of or taking possession by a bankruptcy trustee or a custodian before the commencement of a bankruptcy case. Thus, under the Code, ipso facto clauses are generally unenforceable forfeiture provisions.

The Code eliminates restrictions that prevent transfer of the debtor’s property to the bankruptcy estate. Although eliminating barriers to the transfer of property to the estate, this only preserves a debtor’s property rights; it does not increase them. Accordingly, restrictions
imposed pre-bankruptcy pursuant to contracts and/or applicable non-bankruptcy law on what later becomes property of the estate are enforceable, unless they violate one of the anti-forfeiture provisions of the Code.

The estate’s representative may use, sell or lease property in accordance with the applicable requirements of the Code, regardless of any provision in the contract or applicable non-bankruptcy law conditioned on the insolvency or financial condition of the debtor, on the commencement of a bankruptcy case concerning the debtor, or on the appointment or the taking of possession by a bankruptcy trustee or a custodian, that results in a forfeiture, modification, or termination of the debtor’s interest in the property. With certain exceptions, an executory contract or unexpired lease of the debtor may not be terminated or modified at any time after the commencement of the debtor’s bankruptcy case as a result of a provision in the contract or lease that is conditioned on the insolvency or financial condition of the debtor, the commencement of the bankruptcy case, or the appointment or taking possession by a bankruptcy trustee or a pre-bankruptcy custodian. The exceptions to the general rule correspond to the provisions of the Code preventing a debtor in possession/trustee from assuming or assigning any executory contract or unexpired lease if: (1) the other party to the contract or lease does not consent and applicable non-bankruptcy law excuses that party from accepting or rendering performance to an entity other than the debtor; or (2) the contract is a contract to make a loan, or extend other debt or financial accommodations, to or for the benefit of the debtor, or to issue a security of the debtor.

VIII. AVOIDANCE POWERS

A. In General

The Code arms the representative of the bankruptcy estate (trustee or debtor-in-possession) with an arsenal of avoiding powers designed to promote the goal of equalizing distribution to creditors holding similarly situated claims. The power to avoid “preferential” transfers by the debtor to creditors made within a certain period of time (90 days for non-insiders) before the filing of the bankruptcy petition is designed to prevent debtors from favoring some creditors over others by making payments or other transfers to them shortly before the filing of bankruptcy. “Fraudulent transfers” made within one year prior to the commencement of the bankruptcy case with actual intent to hinder, delay or defraud creditors or constructively fraudulent transfers where the debtor receive less than reasonably equivalent value in exchange for the transfer of property made when the debtor was insolvent (or rendering the debtor insolvent or with unreasonably small capital) may be avoided. Further, the “strong arm clause” provides the bankruptcy estate representative with certain powers under state law with respect to the debtor’s property. The bankruptcy estate’s representative is armed with the rights and powers of a lien creditor and judgment creditor and is conferred with the status of a bona fide purchaser of the debtor’s real property. Further, the estate’s representative may avoid certain statutory liens.

B. Preferences

The Code empowers the bankruptcy estate’s representative to avoid and recover a transfer as a preference if five conditions are satisfied: (1) the transfer is made for the benefit of a creditor; (2) the transfer is for or on account of a debt owed before the debtor made the transfer (an antecedent debt); (3) the debtor was insolvent when the transfer was made; (4) the transfer was made during the 90 days immediately preceding the filing of the bankruptcy petition (or in the event of a transfer to an insider, within one year prior to the filing); and (5) the transfer enabled the creditor to receive more than the creditor would otherwise have received from the bankruptcy estate in liquidation under Chapter 7 of the Code. For a transfer to be voided as a preference, all of the requirements must be satisfied. Further, the estate’s representative has the burden of proving each of the elements of a preference.

In the event that a demand is made or a litigation for recovery of a preference is brought against an unsecured creditor, even if all of the elements of a preference are satisfied, the Code sets forth defenses that a creditor may assert, including the following: (1) a transfer is protected to the extent that the transfer was a contemporaneous exchange for new value (the contemporaneous exchange defense); (2) a transfer is insulated from preference

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attack if the underlying debt was incurred in the ordinary course of the creditor's business, the payments were made in the ordinary course of the creditor's business, and the payments were made according to ordinary business terms (the ordinary course defense); and (3) transfers to a creditor are excepted from preference attack to the extent that after the transfer the creditor gave new value to or for the benefit of the debtor (the new value defense).

IX. CREDITORS' COMMITTEES

In a Chapter 11 case, a committee of creditors is generally appointed ordinarily consisting of persons, willing to serve, that hold the seven largest unsecured claims against the debtor. In very large cases, multiple committees representing different kinds of claims may be appointed. The fundamental rule of the creditors’ committee is to investigate the facts of the case and to negotiate a plan of reorganization. This role will vary from case to case depending on the size and complexity of the case. Serving as a committee member gives a creditor greater opportunity to monitor and influence the direction of the case. However, in order to play a proper role in the case, members of the creditors’ committee must be prepared to devote some time, effort and thoughtfulness to the representation of the interests of the committee’s constituency.

X. CREDITOR REMEDIES

As discussed above, upon the commencement of a bankruptcy case, an automatic stay goes into effect. The stay prevents creditors from continuing to attempt to collect claims, pursue litigation, assert control over property of the estate or otherwise pursue any remedy against the debtor. A request for relief from the automatic stay must be presented to the bankruptcy court. If creditors believe that a bankruptcy case was filed in “bad faith” or otherwise should not continue, they may request that the court dismiss the case. Further, in a Chapter 11 case, if creditors believe that it is in their best interests they may request that the case be converted to a Chapter 7 liquidation case or that the court appoint a Chapter 11 trustee. In a Chapter 11 case, creditors may, alternatively, request that the court appoint an examiner who will serve in a more limited capacity (generally the examiner is charged with making an investigation and reporting to the court) than a Chapter 11 trustee.

The benefits of participating on a creditors’ committee include the ability to ascertain and understand the facts underlying the case, and monitor and influence the direction of the case and the potential for recovery by creditors. Further, the creditors’ committee has the ability to retain professionals to represent the committee at the expense of the bankruptcy estate and to recover reimbursement for expenses incurred by committee members.

A committee member owes a fiduciary duty to the class of creditors the committee represents. Accordingly, when acting in the capacity of a committee member, the member must put the interests of the class it represents above its individual interests, avoid self-dealing and act in good faith. In instances where the committee member has a conflict of interest with those of the class the committee represents, depending on the scope of the conflict, the committee member must either resign from the committee or not participate in committee decisions related to the conflict of interest.

XI. USE, SALE OR LEASE OF PROPERTY OF THE ESTATE

The estate's representative must obtain court approval for any use, sale or lease of property of the estate outside of the ordinary course of the debtor's business. The debtor-in-possession/trustee is permitted to operate the business in the ordinary course and to engage in such activities without court involvement to the extent that they are in the ordinary course of the debtor's business. An exception is that a bankruptcy estate's representative may not use “cash collateral” without the consent of the creditors with liens on the collateral or court authorization. Property of the estate may be sold free and clear of liens if requirements specified in the Code are satisfied (if applicable non-bankruptcy law permits a sale of such property free and clear of the interest: if the secured creditor consents; if such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on the property; if the interest is in bona fide dispute; or if such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest). The bankruptcy estate’s representative may obtain unsecured credit and incur unsecured debt in the ordinary course of business allowable as administrative expense. Further, outside the ordinary course of business, the court may authorize, subject to the statutory requirements, the obtaining of unsecured or secured credit and incurring of associated debt. The Code provides that a secured creditor is entitled to “adequate protection” of its interest in any property the bankruptcy estate's representative seeks to use, sell, lease, encumber, or otherwise continue to possess under the protection of the automatic stay.

XII. PLAN OF REORGANIZATION

A. In General

A plan of reorganization is generally the vehicle for achieving the goal of rehabilitation (or liquidation in a liquidating Chapter 11 case) of the debtor under Chapter 11 of the Code. Confirmation (approval) of a Chapter 11 plan binds the debtor, any entity acquiring property under the plan, creditors and equity security holders of the debtor. Subject to certain limited exceptions, confirmation discharges the debtor from pre-confirmation claims and such obligations are replaced by the obligations under the plan. The plan is, in effect, a new court-sanctioned contract between the reorganized debtor, its creditors and other parties to the plan.

B. Plan Process

1. Exclusivity

Following the filing of the debtor's Chapter 11 petition, unless the court orders otherwise, the debtor-in-possession has the exclusive right to file a plan of reorganization for 120 days. If the debtor-in-possession files a plan during this initial 120-day period, unless the court orders otherwise, no other party may file a plan for an additional 60 days during which the debtor may attempt to obtain approval of its plan. In the event that the debtor-in-possession is not prepared to file a plan during its initial exclusivity period, the debtor-in-possession can
request that the court, for “cause,” extend the exclusivity period. If a Chapter 11 trustee is appointed, exclusivity is terminated.

2. Disclosure Statement
Before a plan of reorganization can be disseminated to the debtor’s creditors for their consideration and vote, a disclosure statement must be approved by the court. A disclosure statement is required to contain adequate information to allow creditors to evaluate the plan and determine how they will vote on the plan. The disclosure statement is frequently referred to as the equivalent of a prospectus in a stock offering.

3. Important Plan Confirmation Requirements
(a) Classification
Under a plan of reorganization, all creditors and equity security interest holders of the debtor are put into classes of claims and interests. Each class can only contain similar claims or interests. The establishment of classes is significant in that voting on the plan is calculated on a class-by-class basis. Classification schemes designed to manipulate voting are frowned upon by the courts.

(b) Best Interest of Creditors Test
This requirement provides that every creditor whose claim is impaired under a Chapter 11 plan, must receive or retain under the plan at least as much as the creditor would receive or retain in a liquidation of the debtor under Chapter 7 of the Bankruptcy Code.

(c) Feasibility
In order to be confirmed, a Chapter 11 plan must be found to be feasible. The feasibility requirement can be satisfied if it is shown that the debtor is more likely than not to be able to perform its obligations under the plan. This does not mean that there is no risk associated with the plan, but rather that it is reasonable and appropriate to conclude that the reorganized debtor will, most likely, be able to perform the plan.

(d) Voting
A class of creditors or equity security holders is “impaired” under a Chapter 11 plan, if the rights of such creditors or equity security holders are altered. The members of classes of impaired creditors or equity holders are entitled to vote on a plan. A Chapter 11 plan that impairs one or more classes of creditors must include at least one class of impaired creditors that votes in favor of the plan. In order for a class of creditors to vote in favor of a plan, at least 50 percent of the members of the class actually voting on the plan must vote in favor of the plan and such members must hold at least two-thirds in amount of the claims of those members actually voting.

(e) Cramdown
The “cramdown” of a Chapter 11 plan simply means that the plan is confirmed by the court over the objection of a class or classes of creditors or equity security holders. A plan must be “fair and equitable” and must not unfairly discriminate against any class of creditors or equity security holders that does not vote in favor of the plan. With respect to a secured creditor class, the “fair and equitable” requirement generally, at a minimum, mandates that the creditor retain its lien and receive deferred cash payments that provide the secured creditor with the full present value of its allowed secured claim. With respect to a class of unsecured creditors, the “fair and equitable” requirement mandates that the equity holders of the debtor not receive or retain anything unless unsecured creditors receive full present value with respect to their claims. There is a “new value” exception to the absolute priority rule and, in addition, there are numerous other complexities relating to the issues of cramdown and plan confirmation. However, these matters are beyond the scope of the discussion in this article.

(f) Discharge
Confirmation of a Chapter 11 plan binds the debtor, and the entity acquiring property under the plan, creditors and equity security holders of the debtor. Subject, to certain limited exceptions, confirmation discharges the debtor from pre-confirmation obligations and such obligations are replaced by the obligations under the plan. The plan is, in effect, a new court sanctioned contract between the reorganized debtor, its creditors, and other parties to the plan.

XIII. INVOLUNTARY BANKRUPTCY
An involuntary bankruptcy case is commenced by the filing of an involuntary petition against the debtor under either Chapter 7 or 11 of the Bankruptcy Code. The involuntary bankruptcy petition must be signed by three or more creditors (unless there are less than 12 total creditors, in which case, the involuntary petition may be signed by one or more creditors) who hold unsecured claims against the debtor that are not contingent as to a liability or the subject of a bona fide dispute and which amount, in aggregate, to at least $11,625.

Upon the filing of an involuntary bankruptcy petition, a summons is issued, requiring the debtor to answer the petition within 20 days of service of the summons. If the petition is not timely controverted by the debtor, the court will enter an order for relief against the debtor. Otherwise, after trial, the court will enter an order for relief against the debtor if the debtor is generally not paying its debts as they become due (unless such debts are the subject of a bona fide dispute). In the context of an out-of-court workout, there is always risk that an involuntary bankruptcy petition may be filed against the debtor.

Ordinarily, following the filing of an involuntary bankruptcy petition and prior to the entry of an order for relief, the debtor may continue to operate and manage its business and may continue to use, acquire, or dispose of its property as if the involuntary bankruptcy petition had not been filed. However, under certain circumstances, the court, on request of a party in interest, may order the immediate appointment of a trustee to take possession of the property of the debtor and to operate any business of the debtor. In order to obtain the immediate appointment of a trustee, it is necessary to demonstrate to the court that the appointment of a trustee is required to preserve property of the bankruptcy estate or to prevent loss to the bankruptcy estate.

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