

# CALIFORNIA LAWYER

## Resolving Business Financial Crises

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Businesses in financial crisis are often in a state of chaos. Moving from emergency to emergency, the people running the business frequently fail to focus on long-term needs and alternatives. Management, feeling under siege, often makes strategic errors, offers excessive concessions, and pursues short-term solutions. Counsel for entities in such distress should be aware that there are alternative frameworks for resolving financial crises. Understanding these different frameworks can help counsel meet the specific needs of a particular client.

### Chapter 11 Reorganization

Chapter 11 of the Bankruptcy Code provides an outline for formal, court-supervised business reorganization. Upon filing a voluntary Chapter 11 petition, a reorganization case is commenced and the debtor (the entity filing the petition) becomes a debtor in possession. 11 USC §§301 and 1101(1). The filing of the petition creates a bankruptcy estate that includes all legal and equitable interests of the debtor in property as of the commencement of the case. 11 USC §541(a). The debtor in possession continues to control and possess the property of the estate and is authorized to manage and operate its business in the ordinary course until otherwise ordered by the court. 11 USC §§1107,1108, and 1104(a).

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 estate. See *NLRB v. Bildisco & Bildisco* (1984) 4665 US 513,527; *Union Bank v. Wolas* (1991) 501 US 151,161; *In re Bonner Mall Partnership* (9th Cir. 1993) 2 F3d. 899,915. Some important bankruptcy concepts that attempt to further one or more of these goals include:

- **The automatic stay.** Upon the filing of a bankruptcy petition, an automatic stay that is self-executing goes into effect. 11 USC §362. The stay prohibits the commencement or continuation of any judicial, administrative, or other action or proceeding against the debtor that was or could have been commenced before the filing of the bankruptcy case unless the bankruptcy court authorizes the action by modifying or terminating the stay. 11 USC §362(a)(1). Relief from the stay may be sought by filing a motion with the bankruptcy court. See 11 USC §362(d); Fed. R. Bankr. P9014 and 4001. The stay is designed to give the debtor a breathing spell from creditor action, preserve property for use in the reorganization, and prevent dismemberment of the estate. *Hillis Motors, Inc. v. Hawaii Auto Dealers' Ass'n.* (1993) 997 F.2d. 581,585-86. The scope of this protection afforded debtors is intended to be broad. *Midlantic Nat's Bank v. N.J. Dept. of Env'tl. Protection* (1986) 474 US 494,504.
- **Estate property.** To facilitate the rehabilitation of the debtor's business, the debtor's interest in all property is included in the reorganization estate. *United States v. Whiting Pools, Inc.* (1983) 462 US 198, 203-4; 11 USC §541(a). Various provisions of the Bankruptcy Code allow property that the debtor did not have a possessory interest in at

the time of the commencement of the bankruptcy case to be brought into the estate. See, e.g., 11 USC §§542 (turnover of property of the estate), 543 (turnover of property held by a custodian), 547 (avoidance of preferential transfers), and 548 (avoidance of fraudulent transfers).

The debtors is generally permitted to operate its business without court involvement (11 USC §§1107 and 1108) but must obtain court approval for any use, sale, or lease of estate property outside the ordinary course of the debtor's business (11 USC §363©(1)). Property of the estate may be sold free and clear of liens if requirements specified in the Bankruptcy code are satisfied. 11 USC §363(f).

- **Control and management.** The presumption is that the debtor in possession will continue to possess and control its assets and to manage and operate its business. However, a creditor or other party in interest can ask the bankruptcy court to 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. 11 USC §1104(a). Examples of cause include fraud, dishonesty, incompetence, or gross mismanagement on the part of current management. 11 USC §1104(a)(1).
- **Executory contracts.** The Bankruptcy Code is designed to allow a debtor in possession or trustee to reject burdensome obligations while retaining those that have value to the estate. A debtor in possession or trustee may assume or reject any executory contract or unexpired lease of the debtor. 11 USC §365(a). Most courts have held that an executory contract contains "obligations of both parties that are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other." *In re Qintex Entertainment, Inc.* (9th Cir. 1991) 950 F.2d. 1492,1495. When there has been a default in an executory contract, the debtor in possession or trustee may not assume the contract unless the default is cured (or assurance that it will be promptly cured is provided), compensation (or assurance of prompt compensation) is provided for any pecuniary loss of the other party resulting from the default, and future performance under the contract is assured. 11 USC §365(b)(1). The court will generally approve the decision of a debtor or trustee who has exercised reasonable business judgment in determining whether to assume or reject most executory contracts. *Bildisco & Bildisco*, 465 US at 523.
- **Claims priorities.** The bankruptcy process is designed to address and resolve all claims against the debtor. All creditors with claims not scheduled by the debtor or scheduled by the debtor as disputed, contingent, or unliquidated must file proofs of claim. 11 USC §§1111(a) and 501. 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. 11 USC §502. Unsecured claims are ranked in the order of priority established by Congress. See 11 USC §507.
- **Confirmation of the reorganization plan.** With a limited exception that applies only to certain small businesses, the debtor in possession has the exclusive right for 120 days to file a reorganization plan (11 USC §1121) and can also request that the court for "cause" extend the exclusivity period (11 USC §1121(d)). A disclosure statement containing enough information to allow creditors to evaluate the plan must be approved by the court before the plan is disseminated to creditors who vote on the plan. The disclosure

statement is frequently referred to as the equivalent of a prospectus in a stock offering. The plan must classify all creditors and security interest holders of the debtor by type of claim and interest. 11 USC §1123(a)(1). This classification is significant in that voting on the plan is calculated on a class-by-class basis. 11 USC §1126.

The plan must meet the best-interest-of-creditors test. This means that every creditor whose claim is impaired under the plan must receive or retain at least as much as the creditor would receive or retain in a Chapter 7 liquidation. 11 USC §1129(a)(7). The plan also must be found to be feasible. 11 USC §1129(a)(11). This requirement can be satisfied by showing that the debtor is more likely than not to be able to perform its obligations under the plan. See *In re Acequia, Inc.* (9th Cir. 1986) 787 F.2d. 1352,1364. A plan must be "fair and equitable" and must not discriminate against a creditor that does not vote for the plan. 11 USC §1129(b)(1). If the plan satisfies the requirements of Chapter 11 it may be "crammed down" over the objection of classes of creditors.

With limited exceptions, confirmation discharges the debtor from preconfirmation obligations, replacing them with obligations under the plan. 11 USC §1141(d). The plan is, in effect, a new court-sanctioned contract among the reorganized debtor, its creditors, and other parties to the plan.

### **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 and that all of the constituencies of the debtor are brought before the bankruptcy court. Workouts, on the other hand, are generally more narrowly focused, and 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, and 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 workout directly or through the auspices of an intermediary, such as the Credit Managers Association. 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 reduces the leverage of individual holders. However, the economics of the restructuring usually require that an exchange offer be conditioned on acceptance by a very high percentage of the existing 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.

## **Chapter 7 Liquidation**

Chapter 7 provides a 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 Bankruptcy Code. 11 USC §726. Upon the filing of a Chapter 7 petition, a trustee is appointed who is charged with marshaling all of the assets of the debtor, liquidating the assets, and distributing the proceeds of the liquidation to the debtor's creditors. 11 USC §§701 and 704. The trustee is armed with powers that include the ability to avoid and recover preferential and fraudulent transfers made by the debtor. In addition, the trustee may assert claims and initiate actions on behalf of the bankruptcy estate. 11 USC §§323,544,547, and 548.

### **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* (1984) 162 CA 3d 1166,1169. 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. Compared to Chapter 7 liquidation, assignments may involve less administrative expense, as well as a quicker and more flexible liquidation process.

### **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. 11 USC §303(a) and (b). The involuntary bankruptcy petition must be signed by three or more creditors (unless there are fewer than twelve 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 bona fide dispute and that amount, in aggregate, to at least \$10,000. 11 USC §303(b).

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. Fed. R. Bankr. P. 1011(b). If the petition is not timely controverted by the debtor, the court will enter an order for relief against the debtor. 11 USC §303(h). Otherwise, after trial, the court will enter an order for relief against the debtor if the debtor is not paying its debts as they become due (unless the debts are the subject of a bona fide dispute). 11 USC §303(h)(1). In the context of an out-of-court workout, there is always the risk that an involuntary bankruptcy petition may be filed against the debtor.

Ordinarily, after the filing of an involuntary bankruptcy petition and before 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. 11 USC §303(f). However, under certain circumstances the court, upon request of a party in interest, may order the immediate appointment of a trustee to take possession of the debtor's property and to operate any business of the debtor. 11 USC §303(g). In order to obtain the immediate appointment of a trustee, the petitioner must demonstrate to the court that a trustee is needed to preserve the property of or prevent loss to the bankruptcy estate. 11 USC §303(g).

To conclude, once a company's financial distress is recognized, counsel should consider all the alternatives. If rehabilitation is feasible, the next step is a careful analysis of the costs and benefits of pursuing reorganization inside compared to outside bankruptcy court. If rehabilitation is not feasible, neither an out-of-court workout nor reorganization under the Bankruptcy Code will make sense. At that point management should consider other options, including Chapter 7 liquidation or, possibly, an assignment for the benefit of creditors.