

CHAPTER 11 REORGANIZATION - IN DETAIL

Background

Frequently referred to as a “reorganization” bankruptcy, Chapter 11 is the ticket for debtors who need the protection of the automatic stay while they seek to free up cash from servicing old debt so that they can continue the current operations.

As with all chapters, there are stipulations to being eligible to file a Chapter 11. The filing of a Chapter 11 bankruptcy will be denied if a prior bankruptcy, occurring within the preceding 180 days, was dismissed due to the debtor’s willful failure to appear before the court or comply with orders of the court, or was voluntarily dismissed after creditors sought relief from the bankruptcy court to recover mortgaged property.

Individual Chapter 11 debtors must complete a credit counseling course under the direction of an approved credit counseling agency within 180 days of their filing and the certificate of completion must be filed along with the petition.

Who Can File a Chapter 11

Individuals and married couples

Individuals and married couples are eligible to file a Chapter 11 but it is most often used to reorganize a business, which may be a corporation, LLC, or partnership. Individual debtors who file for Chapter 11 relief typically have heavy debt loads, high income and significant assets. A person who wishes to reorganize in a bankruptcy must file a Chapter 11 if their non-contingent liquidated secured debts exceed \$1,081,400 or their non-contingent liquidated unsecured debts exceed \$360,475.00. Individuals who have debt levels smaller than those amounts will usually file a Chapter 13 because it is a much simpler and less costly alternative. An individual with high debt levels may not be eligible to file for Chapter 7 relief because their means tests show that they are able to make payments to their unsecured creditors.

High income debtors who file under Chapter 11 in order to reorganize their debts and business affairs should be aware that post-petition income earned by individual debtors during the pendency of their Chapter 11 case will be considered property of the estate.

Corporation

The personal assets of the stockholders, except the value of their investment in the company's stock, are not put at risk when a Chapter 11 is filed with the corporation as the debtor.

Sole Proprietorship

A sole proprietorship (owner as debtor) does not have an identity separate and distinct from its owner(s). Accordingly, a bankruptcy case involving a sole proprietorship includes both the business and personal assets of the owners-debtors.

Partnership

Although a partnership is like a corporation in that the partnership exists separate and apart from its partners, the partners' (partnership as debtor) personal assets may, in some cases, be used to pay creditors in the bankruptcy case or the partners, themselves, may be forced to file for bankruptcy protection.

The Small Business Debtor

A *small business case* in a Chapter 11 is determined by a two-part test and once identified, is treated somewhat differently than a regular bankruptcy case. To determine if the case is a small business case and is to be defined as a case with a "small business debtor": (1) the debtor must be engaged in commercial or business activities (other than primarily owning or operating real property) with a total non-contingent liquidated secured and unsecured debts of \$2,190,000 or less; and (2) the debtor's

case must be one in which a creditors' committee has not been appointed or in which the appointed creditors' committee is insufficiently active and representative to provide oversight to and of the debtor.

The small business case debtor in possession must, among other things, attach the following to the petition:

1. The most recent balance sheet;
2. Statement of operations;
3. Cash-flow statement;
4. Most recently filed tax return;
5. Or provide a statement under oath explaining the absence of such documents.

Furthermore, the small business debtor must:

1. Attend an "initial interview" with the U. S. Trustee which will include:
 - a. Evaluation for debtor's viability;
 - b. Review of debtor's business plan;
 - c. Explanation about debtor's obligations and responsibilities.
2. Make ongoing filings, including monthly reports, with the court concerning its profitability and projected cash receipts and disbursements; report whether it is in compliance with the code and procedures; and whether it has paid its taxes and filed its tax returns; and
3. Must attend court and the U. S. Trustee meeting through senior management personnel and counsel.

Because certain filing deadlines are different and extensions are more difficult to obtain, a *small business case* normally proceeds more quickly than other Chapter 11 cases.

The Single Asset Real Estate Debtor

Single asset real estate is defined as a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor with the following stipulations:

1. The debtor is not a family farmer, and
2. No substantial business is being conducted by the debtor other than the business of operating the real property and activities incidental to the single asset real estate.

Creditors of a single asset real estate debtor may obtain relief from the automatic stay, after notice and a hearing, if:

1. The claim is secured by the single asset real estate, and
2. The debtor failed to file a feasibility plan of reorganization or failed to begin making interest payments to the creditor within 90 days from the date of filing the case or within 30 days of the court's designation that the case was a single asset real estate case.

Things to Know and Documents to Have

The petition can either be a voluntary petition filed by the debtor or an involuntary petition filed by creditors. In addition to the voluntary petition, the debtor must also file the following documents with the court:

1. Schedule of assets and liabilities;
2. A schedule of current income and expenditures;
3. A schedule of executory contracts and unexpired leases; and
4. A statement of financial affairs.

If the debtor is an individual or a husband and wife, filing either individually or jointly, additional documentation must be filed:

1. Certificate of credit counseling and copy of any debt repayment plan developed through credit counseling;
2. Evidence of payment from employers, if any, received 60 days before filing;

3. A statement of monthly net income and any anticipated increase in income or expenses after filing; and
4. A record of any interest the debtor has in federal or state qualified education or tuition accounts.

The Filing and Administrative Fee

There is a \$1000 filing fee and a \$39 miscellaneous administrative fee that must be paid to the clerk of the court when petition is filed, unless, the court has given permission for the fees to be paid in four installments with the last installment being paid no later than 120 days after filing the petition.

Debtor in Possession

In a Chapter 11, the debtor is also known as the “debtor in possession” or “DIP”. This term refers to a debtor that keeps possession or control of its assets while undergoing reorganization. The debtor in possession operates the business. A Chapter 11 trustee may be appointed in unusual circumstances and occurs in only a small number of cases.

The debtor in possession can, with the court’s approval, employ attorneys, accountants, appraisers, auctioneers, or other professional persons to assist the debtor during its bankruptcy case.

Other responsibilities of the debtor in possession include filing monthly financial reports, tax returns and other reports which are either necessary or ordered by the court after confirmation, such as the final accounting report. The U. S. trustee monitors the debtor in possession for compliance with reporting requirements.

Stock and commodity brokers are prohibited from filing under a Chapter 11 and are restricted to a Chapter 7.

The United States Trustee

The U. S. Trustee monitors the progress of the case and supervises its administration which includes the debtor in possession's operation of the business and the submission of operating reports and fees. Additionally, the U. S. Trustee monitors applications for compensation and reimbursement by professionals, plans and disclosure statements filed with the court.

The U. S. Trustee also conducts the Section 341 hearing also called the meeting of the creditors. At this hearing, the U. S. Trustee and any other party in interest can question the debtor under oath concerning the debtor's acts, conduct, property, and the administration of the case. All these inquiries should be limited to questions relating to the debtor's financial condition.

Other requirements monitored by the U. S. Trustee include reporting monthly income and operating expenses, establishing new bank accounts, and paying current employee withholding and other taxes.

If the debtor in possession fails to comply with the reporting requirements monitored by the U. S. Trustee or orders of the Bankruptcy Court, or fail to take the appropriate steps to bring the case to confirmation, the U. S. Trustee may file a motion with the court to have the debtor's Chapter 11 case either converted to another bankruptcy chapter or dismissed.

U. S. Trustee Fees

The U. S. Trustee is paid a fee each quarter by the debtor in possession until the case is discharged or dismissed. The amount of the fee is determined by the amount of the debtor's disbursements or income each quarter and may range from \$250 to \$10,000.

The Case Trustee

Although rare, a party in interest or the U. S. Trustee, through a motion filed with the court, can request the appointment of a case trustee or examiner at any time prior to confirmation. The most common reason for requesting a case trustee is for “cause” which can include suspicion or evidence of fraud, dishonesty, incompetence, or gross mismanagement. An appointment can also be made if it appears an appointment will be in the interest of the creditors, equity security holders, or other interests in the estate. Although the court orders the appointment of a case trustee, the U. S. Trustee actually makes the appointment after consultation with parties in interest. The appointment is subject to the court’s approval.

The case trustee assumes the responsibility of managing the property of the estate, operating the debtor’s business, and, if appropriate, filing of a plan of reorganization.

Upon the request of a party in interest or the U. S. Trustee, the trustee’s appointment can be terminated and management responsibility returned to the debtor in possession. This can occur anytime before confirmation.

The Examiner

The appointment of an examiner is rare, is more limited than a trustee, and normally performs the investigatory functions of the trustee and files necessary reports. In some cases, additional duties may be required of the examiner.

Creditor’s Committees

Creditors’ committees can play a major role in Chapter 11 cases and can be an important safeguard to the proper management of the business by the debtor in possession. The unsecured creditors committee is appointed by the U. S. Trustee and

ordinarily consists of unsecured creditors who hold the seven largest unsecured claims against the debtor.

Duties of the creditors' committees include: consult with the debtor in possession on administration of the case; investigate the debtor's conduct and operation of the business; and participate in formulating a plan.

A creditors' committee may also, with the court's approval, hire an attorney or other professionals to assist in the performance of the committee's duties.

The Automatic Stay

The automatic stay automatically goes into effect when the bankruptcy petition is filed and provides a period of time in which all lawsuits, collection activities, foreclosures, and repossessions of property are stopped. Creditors may not resume any of these activities without filing a motion seeking relief from the automatic stay. If the debtor objects to the motion, the matter will be heard by the Bankruptcy Court Judge who is assigned to the case. There are limitations on the automatic stay if a debtor has previously filed for bankruptcy relief.

Disclosure Statement

A detailed disclosure statement must be filed with the court. The information required on this disclosure is governed by judicial discretion and the circumstances of the case.

The disclosure statement must contain enough information concerning the assets, liabilities, and business affairs of the debtor to enable a creditor to make an informed judgment about the debtor's plan of reorganization.

Plan of Reorganization

The plan must classify claims and must specify how each class of claims will be treated under the plan. Except for a small business debtor, the debtor has a 120-day period during which it has an exclusive right to file a plan which can be extended or reduced by the court but can never be longer than 18 months.

After the exclusivity period has expired, a creditor or the case trustee can file a competing plan but the U. S. Trustee cannot file a plan.

When competing plans are presented that meet the requirements for confirmation, the preferences of the creditors and equity security holders will be considered by the court when determining which plan to confirm.

Confirmation of the Plan of Reorganization

Only 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 claim under the proposed plan can vote on the feasibility of the plan. A ballot vote is used and the ballots are collected and tallied by the court before the court conducts a confirmation hearing to determine whether the plan can be confirmed.

An impaired creditor must vote to participate in the confirmation process. A class of creditors has accepted the plan if at least two thirds (2/3) in amount (\$) and more than one half (1/2) in number of the voting creditors accept the plan.

Any party in interest can file an objection to the confirmation of a plan. The Court will hold a hearing on the confirmation of a plan. In order to confirm the plan, the court must find, among other things, that:

1. The plan is feasible;
2. It is proposed in good faith; and
3. The plan and the proponent of the plan are in compliance with the Bankruptcy Code.

The court must satisfy the feasibility requirement by determining that the plan is not likely to be followed by liquidation (unless the plan is a liquidating plan) or the need for further financial reorganization.

After the plan is confirmed, the debtor is required to make plan payments and is bound by the provisions of the plan of reorganization. The confirmed plan creates new contractual rights, replacing or superseding pre-bankruptcy contracts with creditors.

Liquidating Plan

A *liquidating plan* is permissible and such a plan often allows the debtor in possession to liquidate the business under more economically advantageous circumstances than a Chapter 7 liquidation. It also allows the creditors to have a more active role in the liquidation of the assets and the distribution of the proceeds than in a Chapter 7 case. This method usually results in a larger distribution to creditors than a Chapter 7 liquidation.

Conversion or Dismissal

The debtor in possession has a one time right to convert the case to a Chapter 7 unless:

1. The debtor is not a debtor in possession;
2. The case originally was commenced as an involuntary case under Chapter 11; or
3. The case was converted to a case under Chapter 11 other than at the debtor's request.

The debtor does not have an absolute right to have the case dismissed upon request.

Payment of Professionals

The Bankruptcy Court must approve hiring by debtor of all professionals in a case. Certain professionals, such as the debtor's attorney, accountant, or a trustee, can make application to the court at intervals of 120 days for interim compensation and reimbursement payments. The court can allow for more frequent applications in very large cases.

Cash Collateral and Adequate Protection

The debtor in possession can use, sell, or lease property of the estate in the ordinary course of its business without prior approval but the debtor must obtain permission from the court if the intended sale or use is outside the ordinary course of its business.

Cash collateral is defined as cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents, in which the estate and an entity other than the estate have an interest. A debtor can not use *cash collateral* without consent of the secured party unless authorized by the court. The debtor in possession must file a motion requesting an order from the court authorizing the use of cash collateral before it is spent. This is to ensure that the secured creditors are *adequately protected*.

Borrowing Money after a Case is Filed

The debtor, with the Court's permission, may be able to borrow money by giving the lender a "super priority" over other creditors or a lien on property of the estate.

Motions

Contested motions are often filed prior to the confirmation of a plan. The most common motions relate to the automatic stay, the use of cash collateral, to obtain credit or creditors may file motions to convert the case to a Chapter 7 or to dismiss the case altogether.

Adversary Proceedings

The debtor in possession can file a lawsuit known as an adversary proceeding to recover money or property of the estate, to determine the validity or priority of a lien, Creditors can also initiate adversary proceedings against the debtor to revoke an order confirming a plan, determine the dischargeability of a debt, obtain an injunction, or subordinate the claim of another creditor.

Avoiding Preferential Payments

Avoiding powers allow the debtor to recover payments not made in the ordinary course of business from pre-petition payments to creditors by allowing the debtor in possession (or trustee) to recover the transfer of money or property made within 90 days before filing the petition. If the transfer was made to an “insider” (i.e., relatives, general partners, and directors or officers of the debtor), then certain transfers and payments within one year before filing can be *avoided*.

Property of the Estate

Includes all real and personal property, tangible and intangible property in which the debtor has a legal or equitable interest even if that asset is held by others. With the limited exception, property acquired after the petition generally is not property of the estate. Income earned by individual debtors during the pendency of their Chapter 11 case will be considered property of the estate.

Claims and Proofs of Claim

A *claim* is the right to payment or an equitable remedy for a failure of performance by the debtor if the breach gives rise to a right to payment. An *unsecured claim* is a claim by a creditor that has no collateral to secure its claim. A *secured claim*, on the other hand, is a claim by a creditor that has collateral of equal or greater value than the amount of the claim. *Priority claims* are unsecured claims that are entitled to priority and distribution over other unsecured claims. (i.e. administrative fees, salary or taxes, commission claims.)

A creditor must file a *Proof of Claim* if their claim is either not scheduled (listed on the debtor's schedules) or is scheduled as disputed, contingent, or unliquidated in order to be treated as a creditor for the purposes of voting on the plan and distribution under it. The proof of claim must be accompanied with evidence that documents the claim. There is a deadline in which to file a Proof of Claim.

It is the creditor's responsibility to determine if their claim is accurately listed on the debtor's schedules.

Equity Security Holders

An equity security holder is a holder of an equity security of the debtor and can vote on the plan of reorganization and can also file a proof of interest, rather than a proof of claim. An equity security is a share in a corporation, an interest of a limited partner in a limited partnership, or a right to purchase, sell, or subscribe to a share, security, or interest of a share in a corporation or an interest in a limited partnership.

Post Confirmation Modification of the Plan

The proponent of a plan may modify the plan at any time after confirmation and before "substantial consummation" of a plan if the modified plan meets certain Bankruptcy Code requirements. A modified post-confirmation plan becomes the plan if circumstances warrant such modification and the court, after notice and hearing, confirms the plan as modified.

Post Confirmation Administration

The court has the authority to issue any order necessary to administer the estate.

Revocation of the Confirmation Order

The confirmation of the plan can be undone or cancelled with a *Revocation of the Confirmation Order*. A request for revocation of confirmation must be made by a party in interest within 180 days of confirmation. The court, after notice and hearing, may revoke a confirmation order “if and only if” the confirmation order was procured by fraud.

The Discharge

As a general rule, an order confirming a plan operates as a discharge which discharges a debtor from any debt that arose before the date of confirmation. It does not, however, discharge an individual debtor from any debt made non-dischargeable by section 523 of the Bankruptcy Code including but not limited to:

1. Alimony and child support
2. Any debt incurred by the debtor in the course of a divorce or separation;
3. Certain taxes;
4. Debts for certain educational benefit overpayments or loans made or guaranteed by a governmental unit;
5. Debts for willful and malicious injury by the debtor to another entity or to the property of another entity;
6. Debts for death or personal injury caused by the debtor’s operation of a motor vehicle while intoxicated; and,
7. Debts for certain criminal restitution orders.

Moreover, except in limited circumstances, a discharge is not available to an individual debtor unless and until all payments have been made under the plan. Also, confirmation does not discharge the debtor if the plan is a liquidation plan, as opposed to one of reorganization, unless the debtor is an individual.

When the debtor is an individual, confirmation of a liquidation plan will result in a discharge after plan payments are made unless grounds would exist for denying the debtor a discharge if the case was proceeding under a Chapter 7 rather than a Chapter 11.

The Final Decree

After the estate has been “fully administered”, a final decree closing the case must be entered. Local bankruptcy court policies generally determine when this will be done.

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