Bankruptcy Basics

Chapter 11 of the Bankruptcy Code is federal statutory law. If a financially distressed company is seeking to continue to operate and emerge from bankruptcy as a new and improved company, while maintaining the option of selling off its assets in an orderly fashion, it would file Chapter 11. If it has no choice but to liquidate it may file Chapter 7, in which case a trustee is appointed to sell off the assets.

In addition to the company, which is known as the "debtor," the participants in a bankruptcy case include: (1) a United States Trustee, an individual who acts on behalf of the government and ensures that the case is administered by the books; (2) the owners of the company (i.e., the shareholders, partners, or other interest holders); (3) the management of the company, which, in smaller cases, often has significant ownership interests as well; (4) secured creditors (often lenders); (5) general unsecured creditors, which, in large cases, are frequently represented by a creditors' committee consisting of five or seven creditors; and (6) the bankruptcy judge.

Advantages of Chapter 11

The most immediate advantage of Chapter 11 is that the moment a company files a bankruptcy petition, creditors are prohibited from seeking to collect existing debts owed by the company, whether by trying to enforce a judgment, by calling on the phone to demand payment, or by other means. In this respect, the company is afforded some breathing room while in bankruptcy.

Moreover, while other parties are not allowed to terminate contracts and leases with the company on account of its bankruptcy filing, the company is able to reject burdensome contracts and leases, leaving the other parties to those contracts and leases to get in line with the general unsecured creditors in the case.

The company may also be able to undo transactions that occurred prior to the

bankruptcy filing, in the event, for instance, that it gave up something valuable and did not receive something of reasonably equivalent value in return. In addition, it may be able to recover payments made within the 90 days before the bankruptcy filing on the theory that the parties that received those payments were preferred over others.

The primary advantage of Chapter 11, however, is that it enables companies to reduce or eliminate their debts and restructure their balance sheets, often modifying their business plans in the process. This is accomplished through a plan of reorganization, which is basically a court-approved contract that outlines how a company will treat its creditors and emerge from bankruptcy. The Bankruptcy Code affords certain parties priority over others when it comes to distributions under a plan or otherwise. As a general matter, secured creditors are first in line. They are followed by creditors that have claims arising after the filing of the bankruptcy case. Then come creditors that have claims arising before the filing of the case but that are accorded special priority under the Bankruptcy Code. Wage and tax claims fall into this category. Next are creditors with general claims arising before the bankruptcy filing. The shareholders or other interest holders in the company are last in the pecking order. Thus, one will often encounter plans of reorganization that pay all parties in full, except for paying general unsecured creditors 20 cents on the dollar, for example, and paying shareholders nothing (although there are some circumstances under which shareholders or other interest holders may receive a distribution under a plan of reorganization, even if the creditors are not paid in full).

After a plan of reorganization is formulated, the company prepares a disclosure statement, which describes the company and the proposed plan in plain English. Once the disclosure statement is approved by the bankruptcy court, the company sends it, along with the proposed plan, to creditors and solicits their votes. If a certain number of creditors vote in favor of the plan, it may be approved by the bankruptcy court and enforceable against even those creditors that voted against the plan.

Small Business Cases

For many of us, Chapter 11 conjures up images of Enron, Delta, Adelphia, and other megacases. Most bankruptcy cases, however, do not make the front page of the New York Times business section, do not involve a whole battery of lawyers, financial advisors, and other professionals, and do not take eight years to complete.

Indeed, 70-80% of all Chapter 11 cases are small business cases, and the Bankruptcy Code recognizes as much by including special provisions for cases involving small business debtors. A small business debtor is defined by the Bankruptcy Code as a company with $2 million or less in debts, with certain exceptions. If a company qualifies as a small business debtor, it is entitled to skip a step in the plan of reorganization approval process. Generally, approval of the disclosure statement describing the proposed plan of reorganization takes at least 30 days from the date the disclosure statement is filed, and approval of the plan of reorganization itself takes at least an additional 30 days. The Bankruptcy Code allows small business debtors to receive preliminary or conditional approval of the disclosure statement, which can become final if no objections are raised. Small business debtors may also be able to combine the disclosure statement and plan of reorganization in a single document or otherwise streamline the process.

Moreover, a small business debtor generally has to file a plan within 300 days from the date it files for bankruptcy protection, and it has to confirm the plan within 45 days thereafter. For better or worse, these time limits move small business cases along.

Finally, a small business case may not require a committee representing unsecured creditors. The absence of a creditors' committee can further expedite the case.

The Fishbowl

For all of its advantages, Chapter 11 is hardly a walk in the park. A company has to operate in a fishbowl during Chapter 11. Any transactions outside of the ordinary course of business or payments of debts that were incurred before filing for bankruptcy protection, including those a company wants to pay, need to be approved by the bankruptcy court. The company will also have to file schedules of

assets and liabilities and statements of financial affairs, among other things, and have representatives attend meetings and show up in court. Accordingly, there may be compelling reasons not to file for bankruptcy protection but, instead, to use the threat of bankruptcy as a means to accomplish an out-of-court restructuring.