Published on *The National Law Review* https://natlawreview.com

The Nuts and Bolts of a Chapter 11 Plan

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Editors' Note: Most business people, finance professionals, and even attorneys have no more than a passing familiarity with bankruptcy. If your company is (or you, personally are) having financial difficulties, then bankruptcy may be an option (although there are other options). A business and its owner/senior executives often have two types of bankruptcy available to them: Chapter 7 and Chapter 11. Chapter 13 is also available to individuals but there are limits that apply that commonly make the option unavailable to business owners.

The word 'Chapter' refers to how the US Bankruptcy Code is organized: Chapter 7 is titled "Liquidation" and Chapter 11 is titled "Reorganization." The title of Chapter 11 is, however, misleading because one (a company or a person) who files Chapter 11 can use it to reorganize or liquidate. In either case, a 'successful' Chapter 11 usually — but not always — involves the confirmation of a Chapter 11 plan.

Chapter 11 bankruptcy serves as a vital mechanism for businesses aiming to restructure their debts and continue operations. This article delves into the intricacies of Chapter 11 plans, highlighting the process, key participants, and essential elements for successful reorganization.

What Is a Chapter 11 Plan?

A Chapter 11 plan is essentially a contract — a legally binding document that dictates how a company will distribute its assets and/or equity in itself to satisfy its financial obligations. Once approved by a bankruptcy court, the plan dictates how creditors are repaid and how the company will proceed financially.

Evan Hill, a partner at Skadden, Arps, Slate, Meagher & Flom, describes it as a roadmap that lays out how creditors will be treated and how the company will be structured post-bankruptcy. Once confirmed by the court, the plan becomes binding on all parties involved.

Initially, the debtor (the business filing for bankruptcy) has the exclusive right to propose a plan for the first 120 days after filing. This exclusivity period can be extended or challenged by creditors if they believe the debtor isn't making sufficient progress.

Key Players in a Chapter 11 Case

There can be many parties involved in a Chapter 11 plan, often with different or competing motivations:

- **The Debtor:** The company (or individual) filing for bankruptcy, aiming to restructure debt and continue operations or to sell its assets for the highest price possible to repay creditors as much as possible.
- **Secured Creditors:** Lenders with collateral, such as banks holding a mortgage.
- **Unsecured Creditors:** Suppliers, vendors, or litigation claimants without collateral. Their interests vary widely depending on their relationship with the debtor.
- **Equity Holders:** Shareholders who are at the bottom of the distribution hierarchy.
- **The US Trustee:** A branch of the US Department of Justice ensuring the process is fair and compliant.
- **The Bankruptcy Judge:** The final authority who confirms or denies the Chapter 11 plan.

David Wood, a partner at Marshack Hays Wood, notes that secured creditors usually just want to get paid, while unsecured creditors may have business interests beyond just repayment.

Creating a Chapter 11 Plan

Some companies enter bankruptcy with a pre-negotiated plan in place, which can expedite the process. Others develop their plans during the bankruptcy case through negotiations with creditors.

Matt Christensen, a partner at Johnson May, explains that the more a debtor can pre-negotiate with major creditors, the smoother the process tends to be. Otherwise, the debtor may face competing plans from creditors who have their own ideas about how the company should be restructured. In smaller cases, debtors often draft a plan after filing, once they have a clearer picture of their financials and creditor positions.

Key Requirements for Plan Confirmation

To be confirmed by the court, a Chapter 11 plan must meet several legal requirements under Section 1129 of the Bankruptcy Code:

1. **Feasibility:** The plan must be realistic and demonstrate that the reorganized company can survive.
2. **Good Faith:** The plan must be proposed in a fair and honest manner.
3. **Best Interests Test:** Creditors must receive at least as much as they would if the company were liquidated under Chapter 7.
4. **Impaired Class Acceptance:** At least one class of impaired creditors must vote in favor of the plan.
5. **Cramdown Provisions:** If not all creditors agree, the plan can still be confirmed if it meets certain fairness criteria.

Christensen notes that Subchapter V of Chapter 11, which smaller businesses can opt into, have fewer hurdles and allow for debtor-friendly provisions like the elimination of the absolute priority rule.

The Role of the Disclosure Statement

In traditional Chapter 11 cases (but not in Subchapter V cases), the court must approve a disclosure statement before a plan can move to a vote. In some cases, debtors seek conditional approval to streamline the process. A disclosure statement, which accompanies the Chapter 11 plan, provides detailed information for creditors. Creditors and other interested parties need to understand what they're voting on. A disclosure statement lays out the financial situation, how debts will be treated, and why the plan is viable.

Voting and Confirmation Process

Once the disclosure statement is approved, creditors vote on the plan.

- **Acceptance:** A class of creditors approves if two-thirds in amount and more than half in number vote in favor.
- **Cramdown:** If certain classes object, the court can confirm the plan anyway, provided it is fair and equitable.

Wood emphasizes that this is where negotiation skills come into play. The process of building consensus can go more smoothly with more buy-in upfront.

Reorganization vs. Liquidation Plans

Not all Chapter 11 cases aim to keep a company operating. Sometimes, a debtor files a liquidation plan, which outlines how assets will be sold to maximize creditor recovery. Hill points out that liquidation plans don't typically grant the debtor a discharge from debts, making them different from reorganization plans.

Understanding Key Legal and Financial Considerations in Chapter 11

1. Debtor-in-Possession (DIP)

In Chapter 11 cases, the debtor often continues to operate the business as a 'debtor-in-possession' (DIP). This means that the debtor retains control of assets and business operations during the bankruptcy process, without the appointment of a trustee. The DIP has fiduciary duties to creditors and must operate within the confines of the Bankruptcy Code.

2. Automatic Stay

Upon filing for Chapter 11, an automatic stay is enacted, which halts all collection activities, foreclosures, and lawsuits against the debtor. This provision provides the debtor with temporary relief from creditors, allowing time to propose a reorganization plan.

3. Priority Claims

Certain creditors have priority claims under the Bankruptcy Code, meaning they are entitled to be paid before general unsecured creditors. Priority claims include certain tax obligations, employee wages, and administrative expenses incurred during the bankruptcy process.

4. DIP Financing

Businesses in Chapter 11 may require financing to continue operations during the bankruptcy process. DIP financing allows debtors to secure new loans, often with court approval, giving these lenders priority repayment status.

Final Thoughts

Although the confirmation process commonly takes place long after the filing of the Chapter 11 case, it is typically critical to consider the strategy for confirmation before filing the case.

To learn more about this topic view The Nuts & Bolts of Chapter 11 (Series I) / The Nuts & Bolts of a Chapter 11 Plan. The quoted remarks referenced in this article were made either during this webinar or shortly thereafter during post-webinar interviews with the panelists. Readers may also be interested to read other articles about Chapter 11.

This article was originally published on here.

National Law Review, Volume XV, Number 51