The US chapter 11 process

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The US chapter 11 process

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Why chapter 11?

Chapter 11 provides a debtor with an opportunity to reorganise a business or capital structure while continuing normal business operations under the control of the debtor's management and board of directors.

Although the debtor continues to run the business operations (ie the debtor remains in possession), the United States Trustee monitors the bankruptcy case and typically appoints an official committee of unsecured creditors to represent the interests of unsecured creditors.

Types of chapter 11

A pre-packaged bankruptcy occurs when the debtor negotiates a plan of reorganisation with its creditors and other stakeholders and solicits votes on the plan before filing for bankruptcy.

A pre-negotiated or pre-arranged bankruptcy occurs where a reorganisation deal is struck before filing for bankruptcy, but votes on a plan are not solicited prior to filing for chapter 11.

A conventional or traditional chapter 11 is where a debtor files for chapter 11 protection without any prior agreement for a plan of reorganisation.

Choosing the venue for a chapter 11 filing

A chapter 11 case may be commenced in the district:

- in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or
- in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership

References: 28 U.S.C. § 1408

Choosing the appropriate venue is important for a variety of reasons ranging from convenience for the debtor and the stakeholders to variations in binding precedent on certain legal issues in different jurisdictions.

The filing of the case

A chapter 11 case is commenced by the filing of a petition which can be either a:

- voluntarily petition or
- involuntary petition filed by at least three creditors

References: 11 U.S.C.§§ 301, 303

On filing the petition, the bankruptcy estate is created, which includes all property (wherever located) of the debtor at the time of the bankruptcy filing.

Who may be a chapter 11 debtor

References: 11 U.S.C.§ 109

US Bankruptcy Code, s 109(d) states that railroads as well as individuals, partnerships, and corporations that are eligible to file for chapter 7 (except a stockbroker and a commodity broker), and certain State banks may be debtors under chapter 11.

US Bankruptcy Code, s 109(b)(2)-(3) states that insurance companies and banks, among others, may not be debtors under chapter 7, and are not therefore eligible to be chapter 11 debtors.

Protection of automatic stay

One of the fundamental protections of bankruptcy is the automatic stay, which comes into effect upon the bankruptcy filing and:

- provides the debtor with a 'breathing spell' and thereby allows the debtor to focus its resources on reorganising
- stays all pending litigation and prevents new pre-petition suits from being filed against the debtor, prevents a pre-filing judgment from being enforced against the debtor, and prevents the creation, enforcement or perfection of a lien against the bankruptcy estate

References: 11 U.S.C. § 362

The automatic stay can be lifted for, among other reasons, cause, including the lack of adequate protection of secured creditors or the debtors' lack of equity interest in the property.

DIP Financing

Debtors operating in chapter 11 typically require financing (also known as debtor-in-possession financing or DIP financing) to help fund the chapter 11 process.

The DIP financing can come in various forms:

- unsecured credit
- if a debtor is unable to obtain unsecured financing, a court can authorise a debtor to obtain credit by providing a priority over all other administrative and priority claims, secured by a lien on unencumbered assets, or secured by a junior lien on encumbered assets
- finally, a debtor can obtain credit by providing a senior lien on property that is already subject to a lien only if (a) no alternative financing is available and (b) adequate protection of the existing liens is provided to the current lien holders. Adequate protection may be demonstrated by the existence of a sufficient 'equity cushion' in the lien holders' collateral, periodic payments to the existing lien holders, and/or 'replacement' liens in other unsecured assets to protect against any diminution in the collateral's value during the case

References: 11 U.S.C. § 364

Assumption and rejection of executory contracts and unexpired leases

Executory contracts refer to those contracts where the debtor and the counterparty have remaining obligations to perform under the contract. If the debtor wants to continue the contract or lease with the counterparty they can, on notice and a hearing and with certain exceptions, assume or assume and assign the unexpired executory contract or lease if the they cure outstanding defaults and provide adequate assurance of future performance.

A debtor can reject an executory contract or unexpired lease upon notice and a hearing. Rejection constitutes a breach of the contract and the counterparty would be entitled to an unsecured claim for damages.

References: 11 U.S.C. § 365

References: 11 U.S.C. § 1113

Generally a debtor has until confirmation of a plan of reorganisation to assume or reject executory contracts and unexpired leases. The exception is with respect to unexpired leases on non-residential real property, which must be assumed or rejected within 120 days of the bankruptcy filing (unless further extended for cause and with certain limitations). If the debtor fails to assume or reject unexpired leases within the time limit, the unexpired lease will be deemed rejected.

There are certain types of contracts that may not be assumed or assigned including contracts involving financial accommodations, personal service contracts, and other limited types of contracts.

The Bankruptcy Code also has special provisions for assuming and rejecting collective bargaining agreements as set forth in US Bankruptcy Code, s 1113.

Use and sale of property

Because a chapter 11 debtor continues to operate its business, a debtor can use or sell property in the ordinary course of business without first seeking approval of the bankruptcy court.

After notice and a hearing, the debtor can use, sell, or lease property outside the ordinary course of business including the sale of substantially all of its assets.

A debtor can sell property free and clear of any interest in such property only if the following conditions are satisfied:

- applicable non-bankruptcy law permits sale of such property free and clear of such interest
- such entity consents
- 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 such property
- such interest is in bona fide dispute or
- such entity could be compelled, in a legal or equitable proceeding, to accept money satisfaction of such interest

References: 11 U.S.C §§ 363(b), (c), and (f)

Centralised location for resolving claims

Creditors generally must file proofs of claim to obtain a distribution of estate assets.

The time period by which proofs of claim must be filed is not set by statute. Rather, the bankruptcy court sets the date (known as a bar date) by which all claims must be filed. A failure to comply with the ordered time limit may result in extinguishment of the creditor's claim.

References: Federal Rules of Bankruptcy Procedure (Bankruptcy Rules), rules 3002 and 3007

Once claims are filed, the debtor has the ability to object to claims and the bankruptcy court has jurisdiction to adjudicate and liquidate most types of claims.

Plan of reorganisation

The purpose of reorganising under chapter 11 is to develop a plan of reorganisation so that the debtor can emerge from chapter 11 as a reorganised entity.

The debtor has the exclusive right to file a plan for the first 120 days after the bankruptcy case is filed and 60 days thereafter to solicit votes to accept the plan. The 120-day exclusive period can be increased or reduced by a showing of cause, but it may not be extended beyond a date that is 18 months after the filing of the petition.

US Bankruptcy Code, s 1123(a) lists various requirements that must be included in the plan.

US Bankruptcy Code, s 1129(a) lists 16 requirements that must be met for a chapter 11 plan to be confirmed. Some of the notable requirements include:

- the plan was proposed in good faith
- each impaired class of creditors either accepted the plan or will receive under the plan not less than such creditor would receive in a liquidation under chapter 7
- at least one impaired class voted to accept the plan
- confirmation of the plan is not likely to be followed by a liquidation or further reorganisation and
- each class of claims either accept the plan or is unimpaired

If all of the requirements under US Bankruptcy Code, s 1129(a) are satisfied except the requirement that each class of claims either accept the plan or is unimpaired, then US Bankruptcy Code, s 1129(b) allows the debtor to 'cramdown' on the non-accepting classes, which means the plan would be binding on the non-accepting classes of creditors. Cramdown is permitted if the plan does not discriminate unfairly and is fair and equitable.

References: 11 U.S.C. §§ 1121, 1123, 1129

References: 11 U.S.C. §§ 1123

References: 11 U.S.C. §§ 1129

References: 11 U.S.C. §§ 1129

Classification and voting

The US Bankruptcy Code provides that claims or interests may be placed in a class only if the claim or interest is substantially similar to the other claims in the class.

With respect to voting on a plan of reorganisation, a class of claims will vote to accept a plan if holders of at least two-thirds in amount and more than half in number vote to accept the plan.

To facilitate the voting on the plan, the debtor prepares a disclosure statement which provides adequate information so that holders of claims and interests can make an informed decision to accept the plan.

References: 11 U.S.C. §§ 1122, 1125, 1126

Discharge

Perhaps the most important benefit of chapter 11 reorganisation for a debtor that continues to operate its business following emergence is the discharge of debts, or a release of obligations arising before the confirmation of the plan.

US Bankruptcy Code, s 1141 provides that upon confirmation of a plan of reorganisation, the debtor is discharged 'from any debt that arose before the date of such confirmation...'

Because the discharge only applies to those creditors who receive notice of the plan, it is critical to provide the broadest notice possible to creditors.

References: 11 U.S.C. § 1141

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Chris Mallon leads Skadden's corporate restructuring practice in Europe. His restructuring and insolvency credentials span cross-border reorganisations involving a number of jurisdictions including England, the United States, Ireland, India, Russia, the Cayman Islands, Bermuda, Poland, Germany, Holland, Italy and Luxembourg. His clients have included Enron, Global Crossing, WorldCom, Loral, Telewest, Parmalat, Eurotunnel, Gate Gourmet, Carlyle and Calyon. Recent highlights include acting for Tele Columbus Group in restructuring its debt by means of a debt transfer and debt-for-equity swap implemented via several schemes of arrangement; Calyon in relation to ongoing negotiations with FGIC regarding settlement of transactions relating to the Rhineland Conduit; Carlyle in relation to Carlyle Capital Corporation Limited's restructuring and renegotiation of its credit lines; and Residential Capital LLC in connection with its financial restructuring. He advised British Vita in relation to the restructuring of complex debt facilities for its operating companies, as well as various clients regarding their distressed investments arising in relation to the U.S. Chapter 11 filing of Lehman Brothers. He also has been advising other lenders with structured investment vehicles on issues arising out of the recent credit crisis in the subprime and related structured investment markets.

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