



# First Considerations for the Financially Distressed Business

## **A Collaborative Effort**

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Minnesota  
Department of  
Employment and  
Economic Development

Lathrop GPM

***First Considerations for the  
Financially Distressed Business 2021***

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# **First Considerations for the Financially Distressed Business**

**2021**

**A Collaborative Effort** \_\_\_\_\_

**Minnesota Department of Employment and Economic Development  
Lathrop GPM**

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## **DISCLAIMER**

This publication is intended to alert the reader to legal issues related to restructuring of financially distressed businesses. It is intended as a guide and not as a definitive source to answer your legal and business questions. It should not be relied upon for specific legal advice. Legal and other professional counsel should be consulted. Lathrop GPM LLP and the Minnesota Department of Employment and Economic Development, Small Business Assistance Office cannot and do not assume responsibility for decisions made based upon the information contained herein.

## **INTRODUCTION**

At one time or another many businesses experience a level of financial distress that threatens the continued viability of the business and its related outcomes of wealth creation for its owners, continued employment for its workers, production of goods and services for its customers, and economic growth for the nation. As this publication appears in January 2021 there has been an order of magnitude increase in distressed businesses bought on the COVID-19 pandemic as businesses face an unprecedented level of market failures, customer loss, and complete disruption of supply and distribution chains.

This publication is intended to be a brief introduction to two means of remediating business financial distress and avoiding liquidation of the business: out-of-court remediation through negotiated workout with creditors, and in-court restructuring under Chapter 11 of the Bankruptcy Code.

Although in-court restructuring takes place through actual court supervised legal process, and out-of-court restructuring involves the resolution of many legal issues, the decision to attempt restructuring is in the end a business management decision that will affect the business and its operations, its customers and suppliers, its managers and

employees. Neither means is a magic wand to remedy business management deficiencies or inattention, and both will involve substantial expense of money, time, and effort to remediate problems and rehabilitate the business.

Hopefully, this publication will serve to guide conversations with lawyers, accountants, and other professional advisors; to inform and facilitate the restructuring decision; and to enable business owners and managers to manage expectations.



## **Alternative to Bankruptcy - Out-of-Court Workout**

When a business is facing financial difficulties, it must decide whether or not it should engage in discussions with its creditors to try to work out a consensual repayment plan or if it would be better to seek the protection of the bankruptcy court. As with any decision, both alternatives present various advantages and disadvantages.

If a company is facing insolvency, it may be able to quickly reorganize its debt through an out-of-court workout or restructuring. A “workout” or “out-of-court” restructuring is a process in which a financially troubled company and its creditors reach an agreement to adjust the amount and/or the timing of payment of the company’s financial obligations. An out-of-court workout is almost always more cost-efficient than a formal, court-supervised bankruptcy proceeding for both the debtor and creditors. This is because it has the potential to achieve higher returns at a lower cost for all stakeholders. Within this context, debtors and creditors are generally free to modify their debt terms by agreement.

## **1. Signs that Company Needs Restructuring**

Nearly every business, from inception to growth, will experience financial challenges throughout its development. These challenges are oftentimes unexpected – especially in today’s climate with the COVID-19 pandemic affecting every facet of our lives – and sometimes require financial restructuring from seasoned professionals. Although acknowledging financial difficulties is often difficult for businesses, identifying the signs early may help to provide the longevity a business needs to remain successful. While this list is not exhaustive, here are several signs a business may need restructuring:

### **A. Runaway Expenses**

One major concern a business may have is increasing runaway costs. If a business is spending more than it’s bringing in, the business may need restructuring of its financial obligations. Restructuring can help identify those unnecessary expenses, expenses which may be deferred, and provide a healthy pathway to profitable cash-flow. In addition, reducing costs may open better credit opportunities and provide a business with consistent supply chains.

### **B. Lack of Efficiency**

A business with poor efficiency may call for financial restructuring. A business that lacks efficiency is typically disorganized, poorly designed, and lacking smooth operations. Inefficiency can be procedural (business operations) or in human resources, or both. However, a restructuring professional can identify these operational defects and minimize their financial impact.

### **C. Overextended Debt**

A business with poor efficiency may call for financial restructuring. A business that lacks efficiency is typically disorganized, poorly designed, and lacking smooth operations. Inefficiency can be procedural (business operations) or in human resources, or both. However, a restructuring professional can identify these operational defects and minimize their financial impact.

### **D. Market Share Erosion**

An obvious sign that a company is in need of restructuring is the loss of market share. Losing industry market share is the result of being uncompetitive. If a company is being outperformed on price, service, or product quality, a restructuring professional may provide the necessary opportunity to restore a company's competitive edge. Here, a restructuring process can provide a company with new organizational structure and enhance productivity. Additionally, restructuring can help a company find alternative revenue streams and reduce costs.

### **E. Rapid Business Expansion (Burn Rate)**

Finally, a business may need restructuring despite experiencing high-growth. In certain industries, a business can expand so quickly, the rate of growth creates disorganization and decentralization at all levels, including financial. A business experiencing accelerating growth may also burn through funds at unsustainable levels, making restructuring services doubly important. Restructuring those high-growth expenses can provide better sustainability and financial health.

## **2. Creditors who should be restructured**

Similar to debtors, not all creditors are built the same. As businesses consider filing for bankruptcy or otherwise restructuring their debt, creditors should be uniquely advised on their approach to a restructuring depending on the type of relationship they have with their debtor. A successful solution for one type of creditor might be deeply consequential for another. For example, those creditors with a contractual relationship with a debtor (e.g., landlord/tenant) may need to think strategically before looking to either bankruptcy or restructuring. Under the Bankruptcy Code, remedies that are available under a contract are sometimes impaired when a debtor files bankruptcy. In a landlord-lease situation, a distressed debtor filing for bankruptcy may prohibit the landlord from terminating the lease on account of a pre-bankruptcy default, a remedy available to the landlord prior to the filing of bankruptcy. Overall, creditors should consider the composition of their relationships and how the contractual landscape can be affected once bankruptcy is initiated. A restructuring professional can help identify those specific relationships and find safeguarded solutions.

## **3. Advantages of Out-of-Court Restructuring**

### **A. Far Less Expensive**

Although out-of-court restructuring often involves an attorney, the cost of that attorney will be significantly less than if formal bankruptcy proceedings are initiated. This is because there are fewer steps for an attorney to take when negotiating directly with creditors. In a court proceeding, where courts often serve an intermediary function, attorney

time is spent on drafting motions, researching, factual investigations, and appearing before the court. These costs are in addition to the negotiating work the attorney would normally be doing, work that is very similar to an out-of-court restructuring.

Additionally, the court related fees and costs are removed from the equation as well. For example, the filing fee for a chapter 11 bankruptcy alone is \$1,716, with a few hundred to a few thousand dollars paid to the chapter 11 trustee every quarter as the bankruptcy progresses, depending on the amount of the debtor's quarterly disbursements. None of these costs are present when a debtor chooses to restructure outside of a bankruptcy.

## **B. Avoid Messy Investigations/Litigation**

Out-of-court restructuring serves to stymie the flow of litigation based on the unpaid debt by offering the creditors an opportunity to agree to a mutually beneficial outcome. This discourages debtors from needlessly litigating issues, because the outcome is only binding if all parties agree to it.<sup>1</sup> It also discourages tactics that serve to delay or expend resources, encouraging efficiency among the creditors and discouraging exhaustive investigation.

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<sup>1</sup> This is true as a general matter, but is dependent on the actual agreements between a debtor and their creditors. In certain cases, an out-of-court restructuring plan may allow for a majority, or a super-majority, of creditors to agree in order for the result to be bind. All of this is part of the negotiation with multiple creditors.

Because of the formal, public nature of bankruptcy proceedings, filing can have the unintended consequence of putting the intimate financials and affairs of a company on display. In contrast, an out-of-court restructuring can remain private among the restructuring company and its creditors. While different businesses would be affected by this in different ways, it generally is a net benefit to keep business affairs private. This is especially true of a business that is already on the verge of insolvency, where prospective creditors may grow wary of doing future business.

### **C. No “Clawbacks” of Money – Preferential Transfers**

A preferential transfer occurs in bankruptcy when a debtor makes a payment to a creditor, for a prior debt, within the ninety (90) days before the bankruptcy filing is made, while the debtor was insolvent, and the payment allows the creditor to receive more than it would have had the payment not been made and results in the creditor receiving more than it would have in a hypothetical chapter 7 bankruptcy liquidation. By default, these transfers are avoidable, meaning the trustee can, subject to various creditor defenses, require creditors to pay the money they received for their debt *back to the estate*.

In an out-of-court restructuring case, these preferential transfer avoidance actions rarely occur. This has both positive and negative aspects. It benefits the debtor because it allows payments to be made to creditors and encourages creditors to openly deal with the debtor. It also prevents further litigation over preferences, one of the most common in-bankruptcy litigations. However, it is not without drawbacks, since preferential transfers serve

to prevent creditor behavior that may deplete the estate and further harm the debtor’s chances of actual financial recovery. As a result, although situational, debtors may want to consider whether preferential transfer avoidance actions would be necessary in their particular cases, and thus more helpful than harmful.

#### **D. Faster Process**

While some aspects of bankruptcy are relatively quick compared to other legal disputes, it still takes significant time to proceed through and complete the bankruptcy process. In some instances, the debtor may require court approval prior to a sale of some its assets. This would require a motion from the debtor justifying the sale, an opportunity for creditors to review and object to the motion, a possible hearing on the motion, and then an order from the court. These steps could take weeks to fully complete, which may interfere with the asset sale in the first place! Out-of-court restructuring is not burdened by the need to give all parties notice, opportunities to be heard, and a hearing. Instead, the debtor can act quickly and flexibly in ways that interest it, without having to wait to do so.

### **4. Disadvantages of Out-of-Court Restructuring**

#### **A. Lacks Sense of Finality**

An out-of-court restructuring agreement between a debtor and creditor – whether forgiving, reducing, or allowing for repayment in installments – is only as strong as the document itself and relies heavily on the debtor’s ability to enforce such an agreement. In contrast, a court ordered discharge

(like those usually granted in a bankruptcy proceeding) has the full authority of the federal court system and, therefore, an increased sense of finality.

While this problem can be resolved by careful drafting of the agreement and meticulous efforts by the parties involved, it is still a contract, which is a document that is almost always subject to ambiguity, disagreement, and, ultimately, litigation. Therefore, debtors with a less-clear path to solvency may want to consider the assuredness that comes with a bankruptcy filing rather than an out-of-court restructuring.

### **B. No Automatic Stay**

While this problem can be resolved by careful drafting of the agreement and meticulous efforts by the parties involved, it is still a contract, which is a document that is almost always subject to ambiguity, disagreement, and, ultimately, litigation. Therefore, debtors with a less-clear path to solvency may want to consider the assuredness that comes with a bankruptcy filing rather than an out-of-court restructuring.

Without a bankruptcy filing, a debtor relying on out-of-court restructuring may not have this powerful benefit. Instead, the debtor must find a way to convince their creditors to stay their collection efforts on their own accord, avoid filing lawsuits, and listen to the alternative options for payment the debtor presents. This may be a dubious effort, especially if relations with creditors have turned sour, as they often do when payments aren't being made.



### **C. Sales Will Not be Free and Clear of Liens**

The Bankruptcy Code provides that the debtor (or trustee) may sell property “free and clear of any interest in such property of an entity other than the estate.” The goal of this is to allow debtors to freely dispose of assets to create liquidity, which itself is better suited to reorganization.

An out-of-court restructuring does not have the benefit of this provision. As a result, a debtor with assets that are tied up in multiple liens would have more difficulty in disposing of assets and restructuring quickly, having to convince lienholders to agree to certain actions. While this is by no means impossible—in fact it is a process that such lienholders would already be a part of generally in an out-of-court restructuring—it takes time and may require concessions to be made.

### **D. Inefficient With Too Many Creditors**

Although the need for consensus, or near-consensus, among the creditors is advantageous against needlessly litigious actions by creditors, it can put the debtor at a disadvantage if there are simply too many creditors. Because of the costs that are associated with creating an adequate plan that will convince creditors that an out-of-court agreement is in their best interests, if there are too many creditors with too different of interests, it can become difficult to manage. Businesses with several dozen to hundreds of creditors of varying types may be better off using bankruptcy, which would uniformly treat all creditors, rather than an out-of-court agreement, which may require custom tailoring to each kind of creditor.

## **In-Court Restructuring**

Although an out-of-court restructuring is preferable to filing for bankruptcy in most circumstances, exceptions can arise leading a debtor to determine that an out-of-court restructuring is not the best option. Instead, the debtor may need a more formal process with specific rules and procedures that must be followed. This brings us to a discussion of the bankruptcy process.

### **1. General Overview**

Filing bankruptcy is a much more structured process than an out-of-court restructuring. It is highly supervised by a federal bankruptcy court and has specific rules and procedures that must be followed. Because of this, a formal bankruptcy proceeding can be expensive and time-consuming. Additionally, a bankruptcy filing is not confidential. The public will have knowledge that the company or individual is going through bankruptcy; a fact that customers, suppliers, and employees may not view favorably.

However, there are also benefits to filing for bankruptcy – one of which is the introduction of the automatic stay. As discussed above, the automatic stay under 11 U.S.C. § 362 of the Bankruptcy Code stops secured lenders from foreclosing and suspends all interest and principal payments on pre-bankruptcy debt until a reorganization or liquidating plan is confirmed. This protection is unique to bankruptcy and not available in out-of-court restructurings. It is meant to provide those filing for bankruptcy with “breathing room”; allowing debtors time to develop a plan of action.

Federal district courts hold original and exclusive jurisdiction over bankruptcy cases. 28 U.S.C. § 1334(a). However, it is the normal practice of district courts to automatically refer all bankruptcy cases to bankruptcy courts. Filing for bankruptcy is a complicated process and one that normally requires the assistance of an attorney. In order to commence a bankruptcy case, the debtor's attorney must file certain documents with the correct bankruptcy court. Upon filing these documents, the automatic stay immediately goes into effect.

### **A. Eligibility Generally**

In the context of bankruptcy, a debtor is the individual or entity who files for bankruptcy relief. *See* 11 U.S.C. § 301. There are many different types of bankruptcies under which a debtor can file for protection. These include: chapter 7 (liquidation); chapter 9 (municipality); chapter 11 (reorganization); chapter 12 (farming reorganization); or chapter 13 (debt repayment). Each of these (with the exception of chapter 9) are discussed in more detail below.

Generally, anyone can file for bankruptcy. The only constraint is that a person must "reside or have a domicile, a place of business, or a property in the United States." 11 U.S.C. § 109(a). A "person" is defined in the Bankruptcy Code as an individual, partnership, or corporation; or in limited defined circumstances, a governmental unit. *See* 11 U.S.C. § 101(41).

However, not everyone may qualify for a particular kind of bankruptcy. Additionally, if you have previously filed for bankruptcy, your options may be further limited. One important consideration is that an individual may not be a debtor unless and until that individual has received credit counseling by and approved agency within 180 days of the bankruptcy filing. *See* 11 U.S.C. § 109(h)(1).

## **2. Types of Bankruptcy Cases**

As previously stated, this publication focuses on the needs of a business who wishes to restructure their debts and continue operating. Therefore, the main focus will be on chapter 11 bankruptcies.

However, there are various types of bankruptcies available to potential debtors. A brief overview of each type is discussed below.

### **A. Chapter 7: Liquidation**

A chapter 7 case is commonly referred to as a straight liquidation case and is the most common type of bankruptcy case filed. This is mainly due to its wide availability—it is available to individuals, partnerships, limited liability companies or corporations. Once a chapter 7 bankruptcy case is filed, the debtor’s business operations generally cease and everything owed by that person or entity as of the date of the bankruptcy filing becomes part of the “bankruptcy estate.” The trustee is then tasked with collecting and liquidating any non- exempt assets and distributing the proceeds to the creditors in accordance with the bankruptcy priority scheme.

### **B. Chapter 11: Large Reorganization**

A case filed under chapter 11 of the Bankruptcy Code is commonly known as a “reorganization” case. While available to individuals (and, sometimes the only reorganization option for individuals whose debt exceeds the maximum debt limits for chapter 13), it is most often used by incorporated businesses to reorganize their business or financial affairs. Upon the filing of a chapter 11 case, the debtor becomes

the “debtor in possession.” As a general rule, the debtor in possession continues to operate its business subject to the protection and control of the bankruptcy case. The debtor in possession may attempt to develop a plan of reorganization under which it promises to pay a portion of its debts out of future profits. Alternatively, the debtor in possession may sell its business as a going concern and pay its creditors from the sale proceeds under a plan of liquidation.

### **C. Chapter 12: Family Farmers Reorganization**

Chapter 12 bankruptcy is a relatively new addition to the Bankruptcy Code. It is designed to be used by “family farmers” or “family fisherman” with “regular annual income.” This chapter is mainly available to an individual, an individual and spouse, a corporation or a partnership; however, the debtor’s aggregate debt cannot exceed \$10,000,000.00. It allows a financially distressed family farmer and fisherman to form and carry out a plan to repay all or part of their debts.

### **D. Chapter 13: Repayment Plan**

A case filed under chapter 13 of the Bankruptcy Code is generally known as a “wage-earner plan” case. This type of case is typically filed by consumer debtors with regular incomes; however, it is also available to small sole proprietorships. It is not available to companies. Under a chapter 13 case, the debtor develops a plan under which he or she pays a portion of his or her debts over three (3) to five (5) years. The statutory debt limits for a chapter 13 case are adjusted every three (3) years. Currently, chapter 13 cases may be filed only by individuals having total secured debts of less than \$1,257,850 and total unsecured debts of less than \$419,275.

### **3. Discussion of In-Court Restructuring (Chapter 11)**

Because this publication focuses on debtors who wish to continue to operate, the main focus of the discussion on bankruptcy will center on chapter 11 reorganizations.

#### **A. Debtor Eligibility – Chapter 11**

Legally, anyone except a governmental agency, an estate, a nonbusiness trust, a stockbroker, a commodity broker, an insurance company, a bank, or an SBA-licensed small business investment company may file under chapter 11. An individual may not file under chapter 11 if he or she has had another bankruptcy case dismissed upon certain grounds within the last 180 days.

It is important to note that, unlike certain other types of bankruptcies, there are no financial or insolvency requirements for filing a voluntary chapter 11 case other than the good faith requirement that the case be filed primarily for the purposes of reorganization. A voluntary chapter 11 debtor can be solvent or insolvent and have assets that exceed its liabilities by any amount (or vice versa). The only restriction is a practical one—chapter 11 restructurings can be extremely expensive, therefore a debtor must determine whether the cost of the case is justified by the intended benefit.

## **B. Bankruptcy Estate**

When a debtor files for bankruptcy, a bankruptcy “estate” is created. All of the debtor’s legal and equitable interests in property become property of its bankruptcy estate, including all tangible and intangible property. 11 U.S.C. § 541(a). This means that all of a business’s working capital becomes estate property as well as accounts receivables and inventory. Also part of the bankruptcy estate are all contract rights and causes of action. Estate property also includes “[p]roceeds, products, offspring, rents, or profits of or from property of the estate.” 11 U.S.C. § 541(a)(6).

## **C. Automatic Stay**

As previously discussed, one of the primary benefits of bankruptcy is the “automatic stay.” The automatic stay in bankruptcy goes into effect the moment a bankruptcy case is filed. The automatic stay broadly protects the debtor and the bankruptcy estate from creditor actions. Among other things, it prohibits a creditor from commencing or continuing any action or proceeding to collect a pre-bankruptcy debt or attempting to exercise control over property of the estate. This includes such actions as lawsuits, foreclosures, repossessions, bank levies, wage garnishments and other collection activities (subject to certain exceptions). The automatic stay is extremely effective in protecting a debtor as any action taken in violation of it is generally considered void, regardless of where the creditor action is taken or the creditor’s intent in taking the action.

## **D. Financing in Chapter 11**

Once a company or individual becomes a chapter 11 debtor, any financing arrangement that the debtor wishes to engage in must be approved by the Bankruptcy Court. This is true whether the financing is a continuation of an existing lending relationship or new financing.

### **a. Debtor-in-Possession (DIP) Financing**

Many companies who file for chapter 11 bankruptcy are facing a liquidity crisis – they simply do not have enough cash to continue operating. Because of this, one helpful aspect of chapter 11 for a debtor is the potential of obtaining debtor-in-possession (DIP) financing.

For distressed companies, traditional financing can be extremely difficult (if not impossible) to acquire on reasonable terms. Through a chapter 11 filing, a chapter 11 debtor can take advantage of DIP financing, however, which provides the necessary capital to finance a business's operations during the restructuring process. DIP lenders are incentivized through super-priority loans and claims (which are normally paid before any other claim in bankruptcy), attractive interest rates, and certain protections that minimize considered risks for the lender to provide financing to the chapter 11 debtor. The ability to obtain this emergency funding on an expedited basis is sometimes the driving force behind a company's decision to file for chapter 11 protection.

### **b. Cash Collateral**

When a debtor files bankruptcy, it immediately loses its right to use or spend any cash or cash equivalents in which a creditor claims an interest. Such cash and cash equivalents are called "cash collateral". In order to use its cash collateral in its ongoing business



operations in a chapter 11 or 13 case, the debtor must either obtain the consent of the creditors that hold interests in the cash collateral or obtain a bankruptcy court order authorizing its use of cash collateral. Typically, the debtor will do both; it will negotiate a cash collateral agreement with its secured creditor during the hours or days immediately before or after filing its bankruptcy case, and then request bankruptcy court approval of that agreement within the first few days after it filed bankruptcy.

If a bank or other secured creditor holds security interests in a business's inventory or accounts receivable, the payments received by the business from inventory sales or accounts receivable collection will constitute cash collateral. Therefore, it is critical that businesses operating on a going concern obtain the right to use their cash collateral so that the business can continue to operate and to pay any amounts that become due during the bankruptcy case.

### **E. Business Operations in Bankruptcy**

In chapter 11 cases, the debtor typically continues to operate its business during the bankruptcy case. The debtor may enter into transactions that are in the "ordinary course" of its business without the approval of the bankruptcy court. For example, a retail debtor may continue to purchase and sell inventory in the ordinary course of its business. A debtor may also incur unsecured debt, such as unsecured trade debt, in the ordinary course of business without bankruptcy court approval. However, transactions that are not in the ordinary course of a debtor's business, the incurrence of unsecured debt not in the ordinary course of business and the incurrence of secured debt not in the ordinary course of business all must be approved by the bankruptcy court. Any such transaction or debt that is not approved by the bankruptcy court may be set aside.

## **F. Executory Contracts and Unexpired Leases**

Filing a chapter 11 bankruptcy allows a company to reject certain contracts that require continuing payment or other performance obligations that may be negatively affecting operations. This ability can be extremely beneficial for a debtor as it is not uncommon for distressed companies to find themselves overwhelmed by obligations stemming from certain contracts, known in bankruptcy as “executory contracts.” While the Bankruptcy Code does not define the term “executory contract,” it is most commonly thought of as a contract under which all parties have continuing obligations and includes unexpired leases.

Executory contracts are treated differently in bankruptcy than other pre-bankruptcy obligations of a debtor. The debtor in a chapter 11 case has three options for dealing with executory contracts:

- Rejection of the executory contract;
- Assumption of the executory contract; or
- Assumption and assignment of the executory contract to a third party.

Each of these has different consequences to the debtor-creditor relationship and, for that reason, will be discussed separately.

### **a. Rejection**

The first option—and arguably the most important to a distressed company—is the ability of a chapter 11 debtor to reject an executory contract with the bankruptcy court’s approval. As a general rule, the bankruptcy court will approve rejection of an executory contract if the debtor can demonstrate that, in its business judgment, rejection will benefit the bankruptcy estate and the creditors. Often, this power allows a debtor to renegotiate contracts that are no longer

commercially reasonable. Because of this allowed treatment of executory contracts, a reorganization may be especially beneficial to a business that has financially burdensome long-term contracts and needs to be free from continued performance obligations that are no longer beneficial.

### **b. Assumption**

A debtor's second option is to assume an executory contract with the bankruptcy court's approval. The effect of assumption is to fully reinstate the executory contract and make it mutually enforceable as between the parties. This option allows a distressed business to maintain contracts they favor subject to the Bankruptcy Code's requirement that all outstanding defaults on said contract be cured.

### **c. Assumption and Assignment**

The final option available to the debtor is to assume an executory contract and assign it to a third party. In order to assign an executory contract, a debtor must first assume it by complying with certain requirements including curing any outstanding defaults. In addition, any assignee must provide "adequate assurance of future performance" whether or not the debtor has defaulted under the executory contract.

## **G. Treatment of Claims**

Filing for bankruptcy involves disclosing debt, or "creditor claims," on official bankruptcy paperwork. Generally, once a company or individual files for bankruptcy, it may not make any payments on claims that arose or existed prior to the date of filing. Instead, pre-petition creditors will have a claim against the bankruptcy estate. To be paid, each creditor is required to file a proof of claim with the

bankruptcy court indicating how much they are owed and the type of debt. There are three main categories of debts in a bankruptcy case: priority unsecured debt, secured debt, and general unsecured debt.

All secured debt is composed of a debt that is owed and a lien (also called a secured interest) on a piece of the debtor's property. This simple definition allows for many different types of secured lenders within the context of a chapter 11 bankruptcy. Some examples include: an equipment lender, the holder of a tax lien, the holder of a car loan or real estate mortgage, and a bank with a blanket lien on all assets. Some of the secured lenders may be oversecured or fully secured, while others are likely undersecured. A debtor may have only minimal contacts with the secured lender or they may be parties to a long-standing business relationship. As demonstrated, there is simply no "typical" secured lender/debtor relationship.

Generally, a debtor is permitted to continue to use a secured lender's collateral during the course of a bankruptcy case. For example, if a debtor has a loan on certain equipment, they will be permitted to use the equipment even if the secured loan is in default. Under certain circumstances, however, the Bankruptcy Code permits a secured lender to be compensated for any loss of value caused by the continued use of their collateral. Additionally, a secured creditor may seek relief from the automatic stay to proceed against collateral that is in default. If approved by the bankruptcy court, this relief allows a secured creditor to recover the property, sell it, and apply any proceeds to the account balance.

A bankruptcy discharge (the court order that wipes out debt) does not eliminate a secured creditor's lien on a debtor's property; instead, it only eliminates a debtor's liability to any of the debts. Thus, a secured creditor may still foreclose or repossess the property, even after discharge, if the loan has not been paid. Therefore, any distressed business who files for bankruptcy wishing to keep property securing a loan, needs to continue making payments to the secured creditor until the debt is paid in full. In some circumstances, a bankruptcy court can remove a lien; however, this is not guaranteed.

In contrast, a creditor with an unsecured claim does not have a lien and is not secured by collateral. There are two types of unsecured claims in bankruptcy: priority unsecured claim and general unsecured claims. Priority unsecured claims consist of debts that are not dischargeable in bankruptcy. If money is available, these types of claims will be paid before general unsecured claims. Examples of priority unsecured claims include child support, certain tax obligations and debts for personal injury or death caused by drunk driving. A debtor will need to pay these debts if there is a balance even after the bankruptcy is completed.

General unsecured claims, on the other hand, are those claims that are dischargeable in bankruptcy and will receive the lowest priority of repayment by proceeds of the bankruptcy estate. Examples of general unsecured claims include credit card debt, personal loans, and medical debt. It is not uncommon for creditors holding general unsecured claims to receive pennies on the dollar toward what is owed regardless of the bankruptcy type. Additionally, a debtor does not need to pay the balance of these debts (with the exception of student loan debts) once the bankruptcy is completed.

### **a. Basics of Chapter 11 Plan**

The goal of chapter 11 bankruptcy is for a business to become profitable again, maximizing the return to the business's creditors and owners. Achievement of this ultimate goal requires proposal of a plan of reorganization. A plan of reorganization can be thought of as a financial plan that the debtor, creditors, and bankruptcy court agree will help the debtor regain profitability and continue operating for the foreseeable future. The mechanics of structuring a successful chapter 11 plan vary widely depending on the needs of the debtor; however, most provide for the downsizing of a debtor's operations. The hope is that this will reduce the debtor's expenses, increase efficiency, and increase profits by reducing overhead costs. A chapter 11 plan of reorganization sets forth how a debtor will repay its debt obligations going forward. A plan may include modifying interest, amending payment schedules, extending due dates, or other terms. A debtor can even use a plan of reorganization to eliminate debt entirely. Once all necessary creditors have approved a debtor's plan, the plan functions as a new contract between the debtor and its creditors. In certain contexts, however, a debtor may not view reorganizing favorably and may instead choose to file a "liquidating plan." A liquidating plan shuts down a debtor's business and provides for the orderly sale of its remaining property. While this outcome can also be accomplished through a chapter 7 business bankruptcy, a chapter 11 plan of liquidation may be viewed as more suitable for a debtor in certain circumstances.

## b. Requirements of Plan

The good news for a chapter 11 debtor is that a debtor and its creditors are basically free to agree to any plan that they believe meets their respective needs. However, if a creditor objects to the plan, the bankruptcy court is required to consider certain factors, including:

- **Feasibility:** The bankruptcy court must determine whether the plan proposed by the debtor is “feasible” or likely to succeed. Bankruptcy courts want to avoid confirming plans that are then quickly followed by liquidation or further reorganization.
- **Good Faith:** This requirement is strictly a judgment call made by the bankruptcy court. It has been construed to mean that the plan must be proposed with honesty by the debtor and with an intention of actual reorganization (or liquidation).
- **Best Interests of Creditors:** The “best interests” test requires that each creditor receive at least as much under the proposed plan as it would if the debtor’s case was converted to a chapter 7 case (i.e. the debtor’s property was sold and distributed to creditors). In other words, it establishes a minimum level of recovery for creditors.
- **Fair and Equitable:** Any proposed plan must also be “fair and equitable.” This requirement is a legal-based analysis that requires certain determinations to be made by the bankruptcy court.

In most cases where a plan is confirmed, it is because the debtor has worked very closely with its secured creditors (and/or unsecured creditors) to make a deal of some sort which is then incorporated in the terms of the plan. While it will look different for every debtor—as the deal must meet the specific needs of both the debtor and the

creditor—it may include: restructuring a loan, returning collateral to a secured creditor, deferring payment for a certain amount of time, modifying payment terms or selling collateral to a third party. Reaching a deal is not required, however, as the Bankruptcy Code does allow a debtor to move forward with confirmation of a plan if it has the support at least one class of creditors whose rights are modified under the plan regardless of whether a secured creditor may object.

### **c. Disclosure Statement**

In conjunction with filing a proposed plan, a chapter 11 debtor must also include a disclosure statement. This is an important document in a chapter 11 bankruptcy case as a disclosure statement is meant to disclose any and all important background information and each creditor's treatment under the plan. Given that it is often easier to digest than the proposed plan, creditors rely heavily on this document to make an informed decision about the feasibility of the proposed plan. The requirement to file both a disclosure statement and a plan can be costly to a debtor, however, as creditors may object to both documents, leading to increased litigation.



#### **4. Small Business Reorganization Act**

As is evident from previous sections, chapter 11 bankruptcy cases are often times complex, costly and onerous. Because of this, they rarely succeed in helping small businesses to survive. Fortunately, in August 2019, Congress passed the Small Business Reorganization Act of 2019 (SBRA), which became effective in February 2020. The purpose of the SBRA is to make chapter 11 reorganization faster and less expensive for small businesses. It can be thought of as a balance between chapter 7 and chapter 11 bankruptcies. To take advantage of the SBRA, a debtor must elect to proceed under Subchapter V of Chapter 11 of the Bankruptcy Code.

Unfortunately, eligibility for Subchapter V is restricted to a specific group of debtors. To be eligible, a debtor must be an individual or entity “engaged in commercial or business activities” that has 50% or more of its debts arising from those activities, and with total non-contingent, liquidated debts (both secured and unsecured) of no more than \$2,725,625.00. In response to the Coronavirus (COVID-19) pandemic, the debt limit for eligibility has been increased to \$7,500,000.00 for one year, ending March 27, 2021. This increase allows for large companies to take advantage of Subchapter V. Upon filing its bankruptcy petition, a Subchapter V debtor must also file a balance sheet, statement of operations, cash flow statements and federal tax returns.

Upon a debtor's election of Subchapter V of Chapter 11, the court will appoint a trustee. This trustee does not take possession of the debtor's assets and lacks the ability to sell those assets. Instead, the debtor retains control of its assets and operations with the Subchapter V trustee acting more like an advisor. The trustee's main responsibility is to help facilitate a consensual plan among the debtor and its creditors. The thought is that the involvement of a neutral third-party may increase the likelihood that the debtor and creditors reach reasonable and just resolutions.

In a Subchapter V case, the debtor is the only party permitted to file a plan. Such plan is required to be filed within ninety days of the petition date, creating a timeline that is much faster than a traditional chapter 11 case. The bankruptcy court will hold a status conference within sixty days from the filing of the bankruptcy. Following this status conference, the debtor must report in writing on the efforts made, and to be made, to file a consensual plan. No disclosure statement is required in Subchapter V, instead the plan simply must include a brief history of the debtor's business operations, a liquidation analysis, and projections regarding the proposed plan payments. Lastly, there is no need to obtain the acceptance of an impaired consenting class of creditors for the confirmation of a Subchapter V plan as there would be for other chapter 11 plans.

Similar to a chapter 13 case for individuals with regular monthly income, a Subchapter V debtor is afforded the ability to spread repayment of its debt over three to five years. *See* 11 U.S.C. § 1191. During this time, the debtor is required to allocate all projected disposable income to paying creditors. *Id.* Additionally, unlike in a traditional chapter 11 case, administrative expenses do not need to be paid at plan confirmation, but instead can be paid over the life of the plan.

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